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Industrialized Countries: The Incipient Economic Recovery

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An Intelligence Assessment

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Industrialized Countries: The Incipient Economic Recovery [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] 25X1
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Industrialized Countries: The Incipient Economic Recovery

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Key Judgments

Information available as of 15 August 1983 was used in this report.

The industrialized countries are pulling out of the recession, but not uniformly and not at the rapid pace of earlier recoveries. Economic growth in the United States and Japan, for example, is expected to outpace growth in most of Western Europe. Real gross national product for the industrialized countries as a group will probably advance only 2 percent this year—less than half the rate during the 1976 recovery. Although we expect some acceleration next year, growth in most countries will remain relatively slow by historical standards. 25X1

No individual economic sector in the industrialized countries is likely to be particularly bright in 1983. Consumer spending will be held down by the depressed labor market, and investment for machinery and equipment will be slack because unused capacity and real interest rates are high. Although increased trade among the countries of the Organization for Economic Cooperation and Development (OECD) will help to improve economic activity in some countries, exports outside the region probably will slip in real terms. Both OPEC and the nonoil LDCs are struggling with financial constraints that are forcing them to reduce imports. 25X1

Government policies are not likely to provide much help for the weak economies. Although most OECD governments are relaxing monetary policies, most also are tightening their fiscal stance. Nominal interest rates have come down appreciably from the 1981 highs, and many monetary authorities are continuing to follow policies aimed at bringing interest rates down further. The major foreign governments, however, are loath to push interest rates down too far without comparable reductions in US rates out of concern about further weakening of their currencies. On the fiscal side, most governments are cutting spending programs and raising taxes in an effort to cope with outsized budget deficits. 25X1

Unemployment will continue to worsen in many industrialized countries this year. Economic growth will be too slow in most countries to create enough new jobs to offset increases in the labor force, although the United States and Japan may see some improvement in jobless rates. As a result, we expect overall unemployment in the Big Six industrialized countries to rise to 13 million persons—up an average 25 percent above the 1982 level.

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On the positive side, slow growth coupled with soft oil prices—we assume oil prices will average roughly $29 per barrel in 1983—should lead to lower inflation and improved current account positions for the majority of developed countries in 1983. Inflation for the OECD countries as a group should slow to perhaps only 5 to 6 percent, the smallest price rise since 1972. We expect the current account balance of the non-US OECD countries to turn positive this year—a $37 billion improvement over 1982. [redacted] 25X1

The recovery should pick up momentum in 1984, with the non-US OECD economies growing at about 3.1 percent. Most OECD governments probably will maintain their present policy stance of reducing budget deficits while moderately relaxing monetary policy. The resulting reduction in real interest rates should help stimulate consumer and business spending. Although the expansion should be strong enough to stop the rise in unemployment, it probably will not be vigorous enough to quicken inflation. The large number of jobless workers will help moderate wage demands, and record-high excess capacity should also ease cost increases for manufacturers. We expect the current account surplus of the non-US OECD to rise slightly to $15.8 billion in 1984 because of faster export growth. The comparatively strong US recovery is likely to absorb much of the higher output elsewhere in the OECD, thus keeping the balance-of-payments position of most OECD countries from weakening substantially. [redacted] 25X1

[redacted] 25X1 25X1 25X1 25X1

Some downside risk, however, also exists. Probably the biggest factor that could lead to slower OECD growth would be a sharper fall in LDC purchases from the developed countries than we have assumed. Continuing economic difficulties and the specter of additional debt rescheduling in such countries as Brazil and Mexico could lead LDCs to introduce new measures to reduce imports. Results from the LPIM indicate that each additional 1-percent drop in LDC imports would shave 0.1 percentage point from OECD economic growth. [redacted] 25X1

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A Dismal 1982

Real GNP growth in the non-US OECD [1] countries was disappointingly weak in 1982 for the second year in a row, rising just 0.7 percent compared with 0.8 percent in 1981. The recessionary effects of the 1979-80 oil price hikes continued to work through the OECD economies, and restrictive fiscal and monetary policies further dampened economic growth. Although interest rates in most countries declined somewhat from their 1981 peak, they remained high by historical standards.

Slack domestic demand in the OECD was reinforced by a shrinking demand for imports by the non-OECD countries. For the first time since World War II, the value of world trade contracted, falling an estimated 6 percent; in volume terms, trade was down 2 percent. Export earnings by the less developed countries were hurt by weak OECD import demand and falling commodity prices. Lower exports, coupled with increasing financial constraints, caused the LDCs to reduce their purchases from the OECD by almost 7 percent last year. In contrast, during the 1970s the LDC market was a major growth sector for OECD exporters. Despite last year's decline, LDCs still account for almost one-fourth of OECD exports, up from 18 percent in 1970.

Half of the Big Six economies—West Germany, Canada, and Italy—contracted in 1982. In West Germany, a first-quarter spurt in export volume was short lived and could not counter yearlong declines in consumption and investment. The Canadian economy slumped by a record 4.8 percent, with nearly every major sector receding; only government consumption advanced. Italian exports and government consumption rose 3 percent and 1.5 percent, respectively, but declines in other sectors more than offset the gains.

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Japan, France, and the United Kingdom posted positive economic growth in 1982—Japan by 3 percent and France and the United Kingdom at about half that pace. Japanese GNP advanced on the strength of consumption and exports. French growth, running at a 2-percent annual rate in the first half, slowed at midyear because of an austerity package designed to control inflation and bolster the franc. The British economy, buoyed by investment, showed the first signs of recovery after a protracted recession that began in early 1980.

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Unemployment everywhere continued to climb throughout the year (see figure 1). For the OECD as a whole, the number of unemployed increased 20 percent in 1982 on top of the 15-percent jump in 1981. By the end of last year, an estimated 30 million people in the OECD countries were unable to find work, and the unemployment rate reached double-digit levels in four of the Big Seven countries. While Japan continued to hold its unemployment rate to about 2.5 percent, the 10-member European Community saw unemployment swell to 10.5 percent of the labor force by yearend; Ireland led the Community with an unemployment rate of almost 14 percent. Some other OECD countries were even worse off: Spanish unemployment topped 17 percent while Turkish unemployment reached an estimated 20 percent.

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On the brighter side, stagnant economic conditions had a salutary effect on inflation. Weak demand, as

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[1] The Organization for Economic Cooperation and Development (OECD) includes 24 countries: Austria, Belgium, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and West Germany in Western Europe; the United States and Canada in North America; and Japan, Australia, and New Zealand in the Pacific. The Big Seven countries, which are the seven largest economies in the OECD, are the United States, Japan, West Germany, France, the United Kingdom, Italy, and Canada; the Big Six consist of the Big Seven minus the United States.

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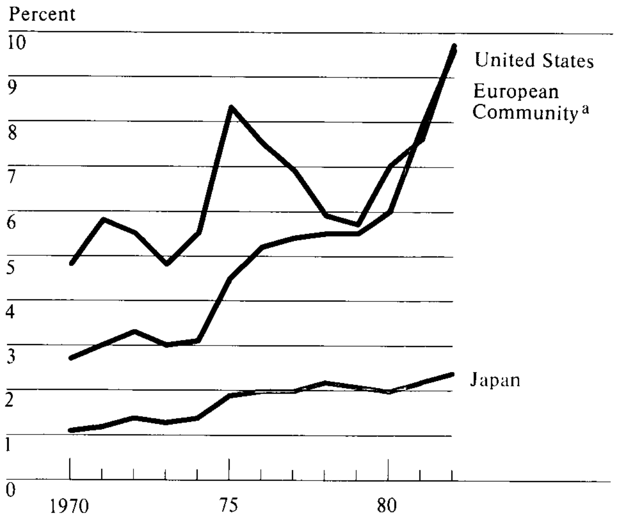
Figure 1
OECD: Unemployment Rates for Selected Countries



[a] Does not include Denmark, Ireland, and Greece.

[redacted]

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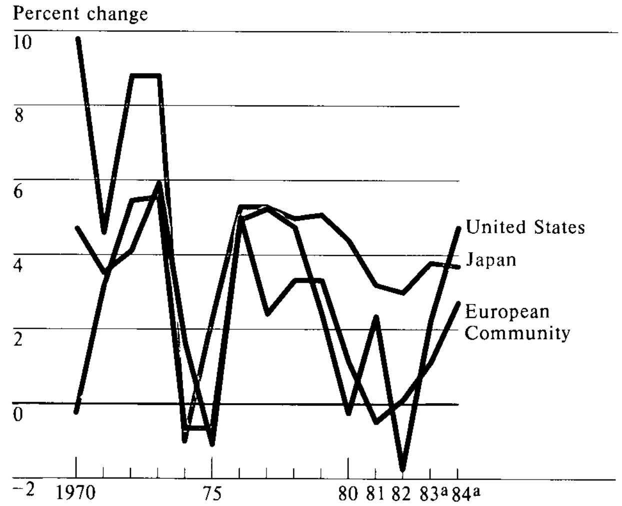
Figure 2
OECD: GNP Growth Rates for Selected Countries



[a] Projected.

[redacted]

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well as lower wage increases, reduced upward pressure on prices, and slower monetary growth diminished inflation expectations. The overall OECD inflation rate slowed more than 2.5 percentage points from 1981, to an average 7.7 percent for the year. Among the Big Six, the British inflation rate improved the most, falling from just under 12 percent in 1981 to 8.5 percent in 1982. Still, inflation remained in double digits for France, Italy, and Canada, as well as for 12 of the 17 smaller OECD countries. [redacted]

Progress in lowering the OECD current account deficit came to a halt in 1982 after improving by nearly $40 billion in 1981 when imports of oil declined while exports, particularly to OPEC, continued to climb. The OECD current account deficit increased only $4.4 billion last year, to $33.4 billion. Of the Big Six, West Germany's current account showed the biggest swing, from a $7.6 billion deficit in 1981 to a $3.1 billion surplus in 1982. The depreciation of the West German mark, accompanied by stagnant import demand, led to most of the improvement. In France, on the other hand, the current account deficit almost doubled last year because the stimulative policies adopted after Mitterrand's election led to a rapid increase in imports. The current account positions of most other non-US OECD countries changed little, as declining oil imports offset falling exports to LDCs. [redacted] 25X1

[redacted] 25X1

Slow Recovery in 1983 [2]

The OECD economies are beginning to pick up steam, but in most countries growth will be comparatively weaker than in previous recoveries (see figure 2). For the non-US OECD countries, we expect real economic growth to average 1.6 percent, with the Big Six 25X1

[2] Our economic projections for 1983 and 1984 are primarily the judgments of CIA country analysts. As a starting point, each analyst was provided with a projection for the world price of oil and for the demand for imports by LDCs and Communist countries. The forecast for the US economy [redacted] was used. Individual projections were checked for consistency by using the CIA's Linked Policy Impact Model. [redacted] 25X1 25X1

expanding 1.9 percent and the smaller countries growing at 0.7 percent In the first year following the 1974/75 recession, the non-US OECD economies expanded by almost 5 percent

The OECD countries will not grow uniformly, however. While the United States and Japan are expected to post growth of 3 and almost 4 percent, respectively, most of the major West European countries are likely to advance by 1 percent or less; the French and Italian economies may show almost no growth at all. The West European countries are lagging in part because they suffer from more severe structural problems and because government spending cuts and tax increases imposed to reduce deficits are retarding growth.

The recession appears to have bottomed out in most major countries by the end of 1982 or the first quarter of 1983. Leading indicators have been rising in most countries for the past six months, and industrial production recently has begun to improve. Preliminary first-quarter results show GNP growth picking up in most of the Big Six countries. In France, however, the rate of economic growth continued to slow, and in Italy it was virtually flat. 25X1

The recent fall in interest rates, the decline in oil prices, the end of inventory rundown, and lower inflationary expectations are all factors that should promote the economic recovery. Indeed, economic sentiment, as measured by surveys of industrialists and consumers and by stock exchange prices, has been improving since the beginning of the year. No individual country or economic sector, however, will be sufficiently dynamic to lead the OECD economies out of recession. 25X1

Consumption. In most of the Big Six countries, consumer spending will remain weak through 1983 (see table 2). Although recent surveys by the EC Commission indicate that consumers have adopted a less pessimistic view of the economic and financial situation, the surveys also show that consumers remain unwilling to purchase big ticket items. We believe continued high unemployment and expected low wage gains will be the primary factors inhibiting a pickup in spending. 25X1

On a country-by-country basis, the role of consumption in the economic recovery will vary appreciably. Consumer spending in the United Kingdom and Japan will be relatively buoyant at 2.2 percent and 4.2 percent, respectively; London reduced personal income taxes this year, and consumers in both countries are reducing savings rates to maintain spending.

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Table 2
Big Six: Major Components of GNP

Percent change from previous year

	Japan		West Germany		France		United Kingdom		Italy		Canada	
	1982	1983	1982	1983	1982	1983	1982	1983	1982	1983	1982	1983
GNP	**3.0**	**3.8**	**−1.1**	**1.0**	**1.6**	**−0.1**	**1.4**	**2.3**	**−0.3**	**0.4**	**−4.8**	**1.4**
Private consumption	3.5	4.2	−2.2	0.3	3.3	0.2	1.0	2.2	−0.5	0.8	−2.5	0.5
Government consumption	2.0	−0.4	0.2	−0.4	2.2	2.0	1.9	1.3	1.5	1.5	2.1	1.8
Fixed investment	1.0	2.1	−6.2	2.8	0.5	−2.5	3.5	3.5	−4.0	−2.7	−12.1	−4.1
Additions to inventory	0.4	0.4	0.3	−0.4	1.4	0.5	1.1	0.7	NEGL	0.1	−2.9	0.7
Exports of goods and services	3.3	5.2	3.7	2.7	−3.7	1.5	0.7	2.8	3.0	2.5	−1.5	1.6
Imports of goods and services	3.1	−0.2	0.6	−0.6	4.8	−2.5	4.8	5.1	2.0	2.0	−10.4	1.5

[redacted] 25X1

Canadian consumers are regaining confidence in the economy, in part because of the expected boost from the more buoyant US economy, since the United States purchases 70 percent of Canada's exports; improving real wages will spur consumption. In Italy, consumer spending is expected to grow almost 1 percent as moderate wage gains hold down real incomes. [redacted]

Consumers in France and West Germany, on the other hand, are expected to increase real spending only slightly, if at all. In France, higher taxes and utility rates—announced in March 1983 as part of the austerity program—will cut into household budgets, holding the increase in consumption to 0.2 percent. Utility and transportation rates were raised an average 8 percent, and oil import tax hikes offset the fall in oil prices to consumers. Paris boosted social security tax rates by 1 percentage point and increased taxes on alcohol and tobacco. The Mitterrand government also placed a 10-percent surtax on all people liable for at least 5,000 francs in income tax. [redacted]

In West Germany, the spring round of annual wage negotiations by the major unions yielded increases of less than 3 percent for most union members, and the federal government plans to hold public-sector wage increases to only 2 percent. We expect consumer prices in West Germany to rise almost 3 percent this year. In addition, consumers face a 1-percentage-point increase in the value-added tax on 1 July, a 5-percent surtax on taxable incomes above $20,000, and a 0.6-percentage-point increase (to 14.6 percent of taxable income) in employee contributions to the government-run unemployment fund. An expected reduction in the savings rate should cushion the decline in real disposable income. [redacted] 25X1

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Investment. The outlook for private investment in the OECD is also mixed. Among the Big Six, investment growth is expected to be positive only in Japan, West Germany, and the United Kingdom. Prospects are brighter in the United Kingdom because excess productive capacity began to shrink last year when the economy started to rebound. In West Germany lower mortgage rates and deregulation have stimulated private residential construction. Spending on plant and equipment, however, probably will remain weak, as most businessmen apparently are not yet convinced the recovery has started. Investment in Japan should grow by 2.1 percent, low by Japanese standards and an indication of cautious business attitudes. Businessmen are hoping, however, that buying by Japanese consumers will pick up this spring and summer, thereby lowering the amount of excess capacity that has dampened investment. [redacted] 25X1

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Canada, France, and Italy will show declines of 2 to 4 percent in investment, mainly because of excess capacity and sluggish domestic demand. To make up for several years of poor earnings performance, businessmen in Canada are likely to wait for profits to rise before making major investments in plant and equipment. The French Government is curbing consumer spending, which will depress investment in the short run. According to Italian surveys, businessmen there remain pessimistic, and industrial production has declined in recent months.

The level of real and nominal interest rates, as well as excess productive capacity, will be significant factors in determining investment growth. For the 14-month period ending April 1983, interest rates in West Germany and the United Kingdom dropped about 5 percentage points each, to 5 and 10 percent respectively, while interest rates in Japan have remained a low 7 percent. Still, long-term interest rates are running 3 to 4 percentage points higher than inflation in each of the Big Six countries. By contrast, at the end of the 1974/75 recession, real interest rates were negative in each of the Big Six; in the United Kingdom, interest rates were 14 percentage points below the inflation rate. Moreover, the high level of excess industrial capacity—about 24 percent in the European Community—will depress demand for new machinery and equipment.

Foreign Trade. Exports will not be a major positive force in the OECD recovery. Much of the export growth that does occur will be generated mainly by increased sales to other developed countries. One of the major impulses will come from the United States, where vigorous economic growth and a strong dollar will give foreign industrial economies an opportunity to expand sales.

Most export markets outside the OECD are likely to contract. OPEC countries probably will cut back on their purchases from the OECD in response to lower oil revenues. Moreover, the important nonoil LDC market is expected to shrink by 1 to 2 percent because of debt-financing problems and continued slack in commodity prices. In the Communist countries, gradually improving financial conditions should enable the OECD economies to boost exports to the region by 2 to 3 percent this year. The overall level will remain depressed, however, following the severe reductions of East European imports of the past few years.

Among the Big Six, Japan is likely to experience the best trade performance in 1983, with exports of goods and services expected to post 5-percent growth and imports to change little in real terms. The weak yen, coupled with rapid US economic growth, should guarantee a strong export sector, but trade restrictions—or threats—by Western Europe and North America will contain the potential export boom. The trade picture in the other major OECD countries is not as bright, but net foreign demand should improve in West Germany, France, and Canada. With the 25X1 pickup in economic growth elsewhere in the OECD, West Germany should be able to boost exports almost 3 percent while import growth should be held down by domestic tax increases. The austerity program adopted by Paris in March 1983 should cut after-tax income and thereby depress import demand. The continuing weakness of the franc should further hold back imports while helping to stimulate exports. 25X1 Canadian exports and imports, which fell in 1982, should both grow about 1.5 percent on the strength of the recovery at home and in the United States.

In the United Kingdom and Italy, on the other hand, trade performance should worsen somewhat. British exports should turn in a respectable performance, despite the falloff in oil export revenue, as other OECD countries pull out of the slump; the apparent British preference for foreign consumer goods, however, is expected to boost imports by almost 5 percent. 25X1 Italian competitiveness will suffer from continuing double-digit inflation. With the lira stabilized within the European Monetary System (EMS), Italian producers are losing sales to foreign goods at home and abroad. 25X1

Government Policies. The overall government policy mix this year is expected to have a positive, though slight, impact on economic growth. Although most governments are tightening fiscal policies, monetary policies generally are being relaxed. 25X1 25X1

Reducing budget deficits is a major policy goal for many OECD countries. Japan, France, the United Kingdom, Italy, Belgium, and the Netherlands all plan to keep government pay hikes at or below the expected inflation rate; West Germany, France, the United Kingdom, Belgium, Denmark, and the Netherlands are shaving social welfare programs. On the

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revenue side, almost every OECD country is raising income, value-added, excise, or social security tax rates; these hikes, however, are usually small because governments do not want to abort the recovery.

West European efforts to control budget deficits are likely to be undercut by mounting unemployment, which triggers automatic increases in government spending as well as revenue losses. In countries like Italy, Belgium, and Ireland, moreover, the additional debt incurred because of last year's outsized deficits will more than offset the budgetary impact of lower interest rates. While the Nakasone government in Japan is expected to continue most of the budget cuts proposed by former Prime Minister Suzuki, the Trudeau government in Canada is boosting spending to aid economic recovery.

Because of budgetary difficulties, we believe most OECD governments will rely on monetary policy to help pull their economies out of the slump. British Prime Minister Thatcher, French Finance Minister Delors, Bank of Japan Governor Maekawa, and Swiss National Bank President Leutwiler, among others, have stated publicly since the beginning of 1983 that present long-term real interest rates are hampering economic recovery. Moreover, lower interest rates would ease the budget crunch that many OECD governments face by lowering interest payments on the public debt.

Most of the major industrial countries are already relaxing monetary policies in an attempt to bring down interest rates and ease the road to recovery. West Germany and the United Kingdom have set targets of 7 to 9 percent for money supply growth—the same as last year—but lower inflation expected this year makes these targets relatively more expansionary. The Japanese want to lower interest rates by cutting the discount rate, which has remained at 5.5 percent since December 1981, without weakening the yen against the dollar; rumors of an impending cut have circulated for more than a year, however. Because the Canadian Government decided in 1982 to stabilize the Canadian dollar/US dollar exchange rate, US monetary policy ultimately determines the action of the Canadian monetary authorities.

The French and Italians, on the other hand, are pursuing more restrictive monetary policies. To lower inflation and strengthen the franc, the French Government has adopted a goal of 9-percent money supply growth for 1983, down from last year's range of 12.5 to 13.5 percent. The Bank of Italy has set limits on credit expansion and is directing more funds toward financing the public-sector deficit—which is expected to reach 16 percent of GNP this year—at the expense of private firms.

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Foreign governments are reluctant to push down interest rates too far without a comparable reduction in US rates. West European leaders fear that unilaterally lowering their rates would lead to further capital outflows and currency depreciation, which in turn would boost the cost of imports and rekindle inflation. During his July 1983 visit to Tokyo, West German Economics Minister Lambsdorff told a reporter for the *Nihon Keizai Shimbun* that high US interest rates are strengthening an already strong dollar, thus limiting the freedom of action of other countries. The Japanese, on the other hand, are concerned that lower interest rates would lead to capital outflows, a cheaper yen, and subsequently to an export boom. Bank of Japan Governor Maekawa told a bankers convention in April that faster export growth would exacerbate trade tensions with the United States, Canada, and the European Community.

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Implications of Slow Growth

Worsening Unemployment. Despite this year's improved economic outlook, new workers will enter the labor force faster than most OECD economies can create new jobs. Unemployment in the Big Six is expected to average 13 million in 1983—25 percent above the average 1982 level. The United Kingdom will continue to have the highest unemployment rate of the Big Six—probably averaging 13 percent for the year With the exception of Japan, the rest of the Big Six countries probably will see unemployment rates grow to about 10 percent in 1983 before leveling off next year. Unemployment in Japan should hover around 2.5 percent this year and next.

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Although unemployment rates are lower in many of the smaller OECD countries than in the Big Six, the number of jobless in the 17 smaller countries still should top 9 million this year—about 12 percent of the labor force. Extensive government employment programs in some of the Scandinavian countries, a high number of self-employed workers in Greece, and the expulsion of jobless foreign workers from Switzerland account for the lower rates in those countries. In both Turkey and Spain about 20 percent of the labor force will be jobless.

Slowing Inflation. We expect inflation rates to continue to decline through this year to an average 5.6 percent for the OECD countries, about one-half the 1981 rate For the Big Six as a group, inflation will stabilize at 6 percent, with rates of less than 5 percent for West Germany and Japan. Inflation in France and Italy should continue to be high, although improving. Paris's austerity package, coupled with continued jawboning and restraints on public-sector salaries, will help to contain inflation in

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France. Offsetting some of those benefits are the negative price effects of the fall in the franc's value, both against the dollar and against other currencies in the EMS. For other major OECD countries, improvements on the price front will stem mainly from weak consumer spending, moderating wage demands, soft commodity prices, and declining interest rates. 25X1

The smaller OECD countries also should experience a drop in inflation, from 10.8 percent in 1982 to 9.7 percent this year and 8.9 percent in 1984. Switzerland, Austria, and the Netherlands will be at the low end with inflation between 3 and 4 percent. Greece and Turkey will continue to improve but should still be coping with prices rising around 20 percent annually. Price increases should accelerate to more than 100 percent in Iceland. 25X1

An Improving Current Account. Continued weakness in overall demand in many OECD countries, coupled with lower oil prices, should help improve the current account position of the non-US OECD countries this year by some $37 billion; about two-thirds of the improvement will be due to lower oil prices. As a group they are expected to register a $14.9 billion surplus in 1983 For the Big Six, the balance is expected to be in surplus by $27 billion this year. 25X1 The Japanese and West German current account balances are expected to improve the most, reaching surpluses of $23.5 billion and $10.5 billion, respectively. Although French and Italian balances should improve, both still will be in deficit. The aggregate current account position of the smaller countries will show substantial improvement but still will register about a $12 billion deficit. 25X1 Only the Netherlands, Norway, and Switzerland will record significant surpluses. 25X1

Prospects Brighter for 1984

We expect OECD economic growth to pick up speed next year as the recovery takes hold. For the non-US OECD countries, GNP growth should average 2.6 percent in 1984, with the Big Six growing faster than the smaller OECD countries. Japan, Canada, and Australia are expected to post somewhat faster growth than most of the West European economies, in part because of the strength of the US recovery. 25X1

On the policy front, most OECD governments probably will maintain their present course. Measured relaxation in monetary policies should help bring down real interest rates, which in turn should stimulate business and consumer spending. Most OECD governments will continue their efforts to lower budget deficits gradually, and faster GNP growth should boost revenues.

Unemployment in the non-US OECD countries should level off at 9 percent of the labor force in 1984. Those economies with the closest ties to the United States—Japan, Canada, Australia, and New Zealand—may see some improvement in unemployment. The weak pace of economic recovery in Western Europe, however, will at best only stabilize unemployment in the region. High West European labor costs, both wage and nonwage, will continue to encourage businessmen to use more labor-saving equipment.

There is a good chance that in 1984 inflation will hover near the same rate as this year in the non-US OECD countries, despite faster economic growth. As the recovery continues, unused production capacity will be reemployed, and businesses may attempt to rebuild profit margins; these factors, however, should not increase inflation until late 1984 or early 1985. Moreover, we expect OECD growth will advance too slowly to place significant upward pressure on commodity prices and wages through 1984. Of the Big Six, only Italy is expected to confront double-digit inflation in 1984. At the other extreme, West German and Japanese inflation rates should remain at about 3 to 5 percent. Most of the smaller OECD countries will make progress in lowering inflation, but Greece, Iceland, Portugal, and Turkey are still expected to be coping with inflation of 20 percent or more.

The OECD current account balance, after showing improvement this year, probably will deteriorate again next year. Without a depreciation of the dollar, most of the worsening in the balance is likely to occur in the United States, where economic growth will exceed the average. The pickup in GNP growth in the United Kingdom and Canada probably will boost demand for imports, thereby pushing their current account balances slightly into deficit. Japan's enormous surplus should level off at about $24 billion as import demand revives, particularly for raw materials. On the more positive side, improved price competitiveness and less-than-average real GNP growth should enable West Germany to boost its current account surplus again in 1984, perhaps reaching $12.5 billion. The French current account deficit is expected to shrink $3 billion to $4.5 billion next year; the weakness of the franc should improve the price competitiveness of French goods and services at home and abroad, and this year's tax and utility rate hikes should dampen import demand. Faster GNP growth in the OECD should result in greater demand for Italian exports, leading to a modest improvement in the Italian current account deficit.

Appendix A

Sensitivity Factors Affecting the Forecast

Unexpected changes in the international economic environment would affect our forecasts for the OECD economies. We believe that the potential developments that could have the greatest impact are:

- Faster growth for the US economy than is now expected.
- A further decline in oil prices.
- An even sharper dropoff in imports by LDCs from the OECD.

The US Economy

Our projection of an upturn in the OECD this year and next hinges on the expected economic recovery in the United States because the US economy produces almost two-fifths of the OECD's output and absorbs 14 percent of exports by other OECD nations.

To quantify the influence of the United States on overall OECD economic performance, we used our Linked Policy Impact Model (LPIM) of the world economy. Our econometric model indicates that a 1-percentage-point increase in the US growth rate would raise overall OECD economic growth by 0.4 percentage point and non-US OECD growth by 0.1 percentage point (see table 6). Japan and Canada would experience the greatest gains—0.2 and 0.3 percentage point, respectively—primarily because larger shares of their exports go to the United States. A 1-percentage-point increase in US growth would also reduce unemployment in the non-US OECD countries by 100,000 people. Faster growth of US GNP, however, would speed up US import growth and result in a deterioration in the overall OECD current account balance—an $8 billion worsening in the US balance would more than offset the $4 billion improvement in the non-US current account. Reflecting their reliance on the US market, Japan and Canada, followed by West Germany, would post the largest gains in their current account balances.

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Oil Prices

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A further decline in oil prices would lead to more rapid economic growth—and lower inflation, unemployment, and current account deficits—than we now expect. Despite recent firming of crude oil prices around the OPEC benchmark of $29 per barrel, oil prices may come under new pressure in the months ahead. If oil prices fall, the impact on the industrial countries would depend on the depth and the speed of the price cuts, as well as on the policies chosen by OECD governments.

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To estimate the effects of lower oil prices, we ran several simulations with the LPIM. We simulated a decline in oil prices to $25 per barrel and compared those results with a baseline scenario in which oil prices stayed constant at the present level of $29 per barrel. The LPIM indicates that with the lower oil price:

- GNP growth would be about 0.4 percentage point higher for the OECD (see table 7).
- About 200,000 more people in OECD countries would find jobs, leading to a 0.1-percentage-point decline in the OECD unemployment rate.
- The average inflation rate for the OECD would fall by 0.8 percentage point.
- The OECD current account would improve by $13 billion because developed countries would pay less for oil imports and the falloff in exports to oil-producing countries would be offset, although after a lag, by more exports to oil-importing countries.

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Table 6
OECD: Impact of a 1-Percentage-Point Rise in US GNP Growth

Change from baseline projection

	GNP Growth *(percentage point)*	Inflation Rate *(percentage point)*	Unemployment Rate *(percentage point)*	Current Account *(billion US $)*
OECD	**0.4**	**0.2**	**−0.2**	**−4.7**
United States	1.0	0.5	−0.5	−8.4
Non-US OECD	**0.1**	**NEGL**	**NEGL**	**3.7**
Big Six	**0.1**	**NEGL**	**−0.1**	**2.6**
Japan	0.2	NEGL	−0.1	0.8
West Germany	0.1	NEGL	−0.1	0.5
France	NEGL	NEGL	NEGL	0.2
United Kingdom	0.1	NEGL	NEGL	0.2
Italy	0.1	NEGL	NEGL	0.2
Canada	0.3	NEGL	−0.2	0.7
Smaller countries	**0.1**	**NEGL**	**NEGL**	**1.1**

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Table 7
OECD: Impact of an Oil Price Decline to $25 Per Barrel

Change from baseline projection

	GNP Growth *(percentage point)*	Inflation Rate *(percentage point)*	Unemployment Rate *(percentage point)*	Current Account *(billion US $)*
OECD	**0.4**	**−0.8**	**−0.1**	**13.3**
United States	0.4	−0.9	−0.1	2.6
Non-US OECD	**0.4**	**−0.7**	**−0.1**	**10.7**
Big Six	**0.5**	**−0.7**	**−0.1**	**6.9**
Japan	0.7	−0.9	−0.1	5.4
West Germany	0.4	−0.9	−0.2	0.8
France	0.4	−0.5	−0.1	1.6
United Kingdom	0.2	−0.6	NEGL	−1.6
Italy	0.8	−0.8	−0.1	0.9
Canada	0.2	−0.3	−0.1	−0.2
Smaller countries	**0.2**	**−0.7**	**NEGL**	**3.8**

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Among the Big Six, Japan and Italy would benefit most from lower oil prices because they import almost all of their oil; GNP growth in both countries would increase substantially. West Germany and France also would reap an economic boost. Although the United Kingdom and Canada are net energy exporters, both would benefit from lower oil prices because nonenergy exports would expand as a result of greater economic growth among their trading partners, and inflation would slow.

These positive effects, however, would occur only to the extent that lower oil prices are passed through to consumers. In most OECD countries, the strength of the dollar has meant that oil prices in local currencies have not fallen as much as the dollar price. Moreover, some countries with sizable government budget deficits—France, Italy, and Belgium—have boosted tax rates on retail sales of gasoline and oil products to lower their budget and current account deficits and encourage further energy conservation; industrial consumers usually are exempt from the new taxes and pay less for energy, thereby helping them raise output and employment. Most other OECD governments are keeping their energy tax rates constant to avoid dampening the economic recovery. The Canadian Government, which had held the domestic oil price at 75 percent of the world level, decided to maintain the old prices, thus narrowing the gap between domestic and world prices.

The further oil prices fall below $25 per barrel, the more likely that OECD governments would increase taxes on oil. Most OECD governments want to reduce their budget deficits, and the greater the drop in oil prices, the easier it would be for them to raise revenues through new taxes on oil. Moreover, governments fear that significantly lower oil prices would erode the gains in energy conservation that have been made since 1973. Higher energy taxes on oil would, of course, dampen the stimulative impact of price cuts.

LDC Trade

If financial problems cause LDCs to reduce imports from the OECD by more than we expect, the economic recovery in the developed countries probably would be even more restrained than in our present forecast.

During the 1970s, LDCs became an increasingly important export market for OECD countries. Between 1970 and 1981, sales to LDCs jumped from $39 billion to $307 billion. At the same time, the share of OECD exports going to LDCs rose from 18 percent to nearly 25 percent. By 1981, sales to LDCs amounted to about 4 percent of OECD GNP—more than double the share in 1970. 25X1

In 1982, however, the worldwide recession, coupled 25X1
with the deteriorating international financial position of many LDCs, led to a 7-percent drop in the value of LDC purchases from developed countries. OECD sales to African OPEC members and Latin American countries slipped 28 percent and 19 percent, respectively, while exports to Mexico alone plunged 34 percent. 25X1

We used the LPIM to gauge the economic impact on the OECD of a further drop in LDC purchases. According to those simulations, each additional 1-percent drop in LDC imports from the OECD would pull down OECD GNP growth by almost 0.1 percent and add 100,000 more workers to the jobless roles (see table 8). 25X1

The Big Six countries would suffer more than the rest of the OECD because their exports to the LDCs account for 6 percent of GNP, compared with 5 percent for the smaller countries and 3 percent for the 25X1
United States. If the 1-percent cutback in the volume of total LDC imports is apportioned among only the 22 most financially troubled economies,[3] the overall impact on the OECD countries would be the same, but the United States would bear the lion's share of the burden. US exports to LDCs are concentrated in these countries while Big Six exports are spread more evenly among the LDCs. 25X1

[3] Argentina, Bolivia, Brazil, Chile, Costa Rica, the Dominican Republic, Jamaica, Mexico, Panama, and Peru in Latin America and the Caribbean; Bangladesh, India, Pakistan, the Philippines, and Thailand in Asia; and Ivory Coast, Kenya, Morocco, Sudan, 25X1
Uganda, Zaire, and Zambia in Africa. 25X1

Table 8
OECD: Impact of a 1-Percent Fall in Exports to LDCs

Change from baseline projection

	GNP Growth *(percentage point)*	Inflation Rate *(percentage point)*	Unemployment Rate *(percentage point)*	Current Account *(billion US $)*
OECD	**−0.1**	**NEGL**	**NEGL**	**−3.7**
United States	NEGL	NEGL	NEGL	−1.1
Non-US OECD	**−0.1**	**NEGL**	**NEGL**	**−2.6**
Big Six	**−0.1**	**NEGL**	**NEGL**	**−1.7**
Japan	−0.1	NEGL	NEGL	−0.5
West Germany	−0.1	NEGL	0.1	−0.4
France	−0.1	NEGL	NEGL	−0.3
United Kingdom	−0.1	NEGL	NEGL	−0.2
Italy	−0.1	NEGL	NEGL	−0.2
Canada	NEGL	NEGL	NEGL	−0.1
Smaller countries	**−0.1**	**NEGL**	**NEGL**	**−0.9**

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