The Outlook for the World Economy [1]

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At the December 1981 conference of the American Economics Association, Edmund Phelps argued that 1981 had seen both "the demise of monetarism" and the deactivation of the Keynesian notion of fiscal stimulus. "Thus", he concluded, "theoretical macroeconomics is today in a state of crisis".[2] It is perhaps appropriate that the most severe recession since the Second World War should engender a crisis in economic theory's ability to analyse current economic patterns. Yet this has not helped in the understanding of those patterns, nor in developing effective government policies to counter the situation, nor in giving good guides to what prospects the capitalist economics now face.

The paper outlines the current state of the world economy, taking note of the present U.S. recovery and the level of international debts. A second section discusses several theories of economic slumps developed in recent years. A concluding section returns to the prospects for the world economy.

THE CURRENT STATE OF THE WORLD ECONOMY

The 1970s and 1980s have seen a marked deterioration in world economic performance from that enjoyed in the post war boom 1945-70. GDP growth, the inflation rate, and the unemployment rate for the major OECD countries developed (in summary) as follows:

- from annual averages of 4-5%, real GDP growth was minimal in 1974-75, recovered to about 3% p.a. in the late 1970s before slumping again in 1980-82.
- the late 1960s saw a rising trend, from a base of some 4% inflation per annum. This accelerated in 1973 and 1974 to 12%, before falling to 8% in the late 1970s. 1980 saw a further peak at 12% before a more sustained fall to an anticipated 6% in 1983.
- from typical post war levels of 3-4% unemployment, two upward movements have taken place: in 1975, which increased it to 5% where it remained until 1980, and 1980-83, which saw unemployment spiral to over 10%.

In general, the period has experienced higher inflation rates together with lower growth and higher unemployment levels. An indication of the depth of the malaise is reflected in recent statistics on the falling rates of profit in advanced capitalist countries, compiled by the OECD. (Table 1).

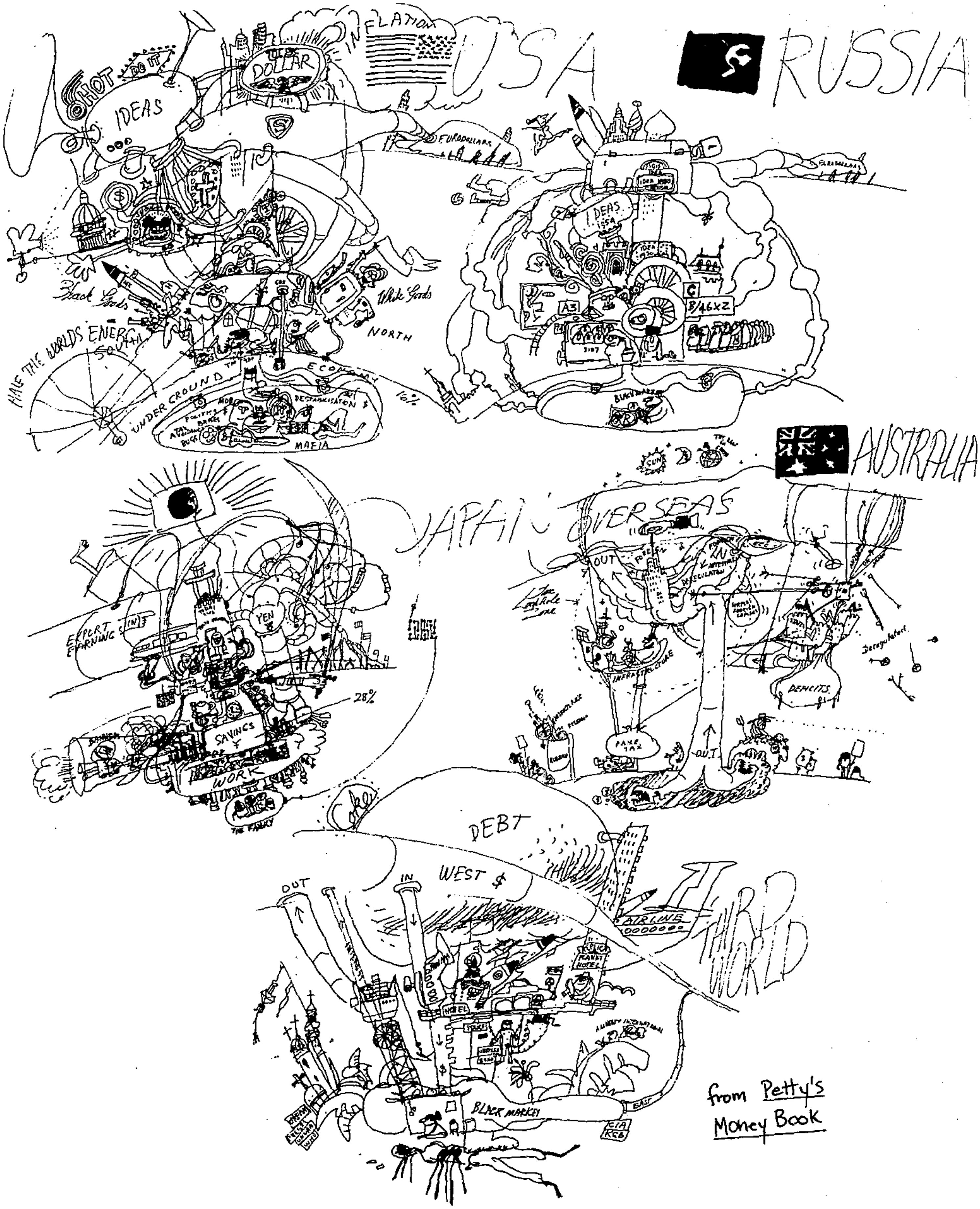
TABLE 1

Falling Rates of Profit, OECD 1965-82

Average rate of return on capital (%)

	1965/69	1979/74	1975/79	1980/82
United Kingdom	23.4	17.4	16.8	11.6
Japan	36.5	32.7	20.2	20.4
Germany	19.3	16.9	14.5	12.1
France	16.9	18.8	13.2	n.a.
U.K.	10.8	8.6	6.5	4.5
Canada	14.5	14.0	12.5	12.0

Source: OECD Economic Outlook 33 (July 1983) p.57.



from Petty's Money Book

The OECD admits that there are data problems in assessing these figures, especially in estimating the size of the capital base, as there is currently a large wave of scrapping of industrial plant. However, the trends shown are very strong. Each of the major OECD countries has seen a marked decline in rates of profit in the last two decades, with average 1980/82 rates generally little more than half of the 1965/69 rates. The OECD comments "both cyclical and secular factors are currently influencing profits data". The cyclical factors are large in the present recession but there is also a longer-term secular decline in profitability "which is not well understood".

Many mainstream economists, such as those in the OECD, are recognising serious structural problems in the world economy. This is quite a change from the dominant attitude of the mid-1970s, which saw the problems as being essentially cyclical and/or due to policy mistakes. Thus, one of the more sophisticated mainstream analyses of the 1974 downswing, that of the McCracken Committee[3], saw the severe recession as a specific result of a coincidence of adverse factors:

- a series of 'shocks' in the early 1970s with the oil and commodity price booms of 1973;
- the breakdown in 1971 of the Bretton Woods fixed exchange rate system (by which all currencies were tied to the strongest currency, the $U.S.);
- policy errors by Western Governments, particularly very expansionary policies in 1971, in the lead up to an unsually high number of elections in OECD countries in 1972; and
- "changes in basic relationships endogeneous to the economic system" (including changing values and expectations).

It is worth noting that even in this analysis the price of oil was only one variable. That factor was widely seen as more important in the downturn of 1980/82, in conjunction with highly restrictive Government policies. In the December 1982 Economic Outlook the OECD interpreted this downturn (during which GDP grew only 2% in three years) as due to:

- the substantial oil price of 1979 and 1980;
- the restrictive macroeconomic policies of the main OECD Governments, especially the unusually high interest rates 1980-82;
- in 1982, the deterioration of international demand for OECD exports.

The report was especially critical of the second factor.

> "The degree of the present weakness in both OECD and non-OECD countries thus may indicate that the effect of generalised restrictive policies has been greater than governments intended. In particular, the international repercussions of the simultaneous pursuit by many countries of tight money policies may have been underestimated. Countries may individually have entertained an unduly optimistic view of the prospective world environment when formulating their own policies. Furthermore, the extent to which high interest rates would exacerbate the financial situation of important debtors, leading to systemic strains, became clear only fairly recently".[4]

Problems came from the restrictive policies on two fronts. A fallacy of composition existed for such policies. If one government imposes restrictive policies, it can hope to reduce domestic inflation by depressing domestic demand, and yet gain some economic growth from exports. However, if all major countries are depressing domestic demand at the same time, none will enjoy any growth from exports, and consequently all will experience more severe depression than expected. Moreover, in depressing major economies, and in pushing up interest rates, the policies made it doubly difficult for Third World Countries to handle their large debt problems. They had less prospect of exporting goods to the advanced capitalist countries, and more difficulty in funding international payments. In addition, the rising interest rates increased the payments due on existing debt. Higher oil prices further exacerbated the difficulties.

World financial markets have been haunted by the continued spectre of the international debt crisis. The Economist in early 1983 reckoned the chances of a major default during 1983 at about 50%. Most commentaries on the international debt crisis have stressed the role of oil prices. Oil-importing Third World countries, faced with major balance of payments problems when oil prices rose, borrowed heavily to cover their deficits. At the same time international banks were flush with funds, as they were recycling the petrodollars accumulated by the oil exporters. Opinions have differed on the extent of blame to be placed on countries following unsustainable policies, or on banks pursuing reckless lending. In any case, the stage was set for a massive expansion in debt.

The specific influence of the 1979 oil price shock certainly had a major impact. However, these events were imposed on a situation already experiencing secular decline. Third World debts had been accumulating at an increasing pace during the 1960s and 1970s. In constant 1978 prices the level of Third World annual borrowing rose from $US 23 billion in 1960 to $43 billion in 1970 and to $80 billion in 1978.[5] With the second oil price shock, coupled with international recession and high interest rates, the debt burden accelerated after 1980. At the beginning of 1983, the situation was as described in Table 2.

Five major debtors faced service payments in 1983 which totalled more than 100% of the value of their export earnings. Clearly, such debt burdens could not be easily financed, especially when many of the countries concerned were still running balance of trade deficits. The banks are also in trouble. Time estimated that "Altogether, the nine largest US banks have loaned out about

Table 2: Major debtor countries, 1983

Country	Total debt, end 1982 $US billion	Debt service payment, 1983 $US billion	Payment as % exports %
Brazil	87.0	30.8	117
Mexico	80.1	43.1	126
Argentina	43.0	18.4	153
South Korea	36.0	15.7	49
Venezuela	28.0	19.9	101
Israel	26.7	15.2	126
Poland	26.0	7.8	94
U.S.S.R.	23.0	12.2	25
Egypt	19.2	6.0	46
Yugoslavia	19.0	6.0	41

Source: Time 10/1/83

130% of their equity to Mexico, Brazil and Argentina".[6] If one of these major debtors had defaulted then (the Economist noted):

> "it would send a hurricane through Wall Street; it would cause the certain collapse of a number of American banks; it would set the price of gold flying; it would produce political chaos in the defaulting country; and, worst of all, through a crisis in confidence, it would put off hopes of a world economic recovery."[7]

The Brookings Institute has estimated that a one year moratorium by the three biggest debtors "would cause losses equal to one third of the capital of the nine largest US banks".[8] To avoid such prospects, the banks have had to reschedule their debts, in essence lending more funds to cover the payments on the previous debts.

The crisis first struck in August 1982 when Mexico revealed to its bankers that it was unable to meet its payments. After two weeks of feverish activity, a package was put together to present the facade that Mexico had not defaulted on its debt. More importantly, the US Federal Reserve Board was sufficiently scared by the crisis, and sufficiently aware of the role of the high interest rates engendered by its monetarist policies, to begin relaxing monetary controls.[9] Since August 1982 other Third World countries have "rescheduled" their debts. The rescheduling has become a co-ordinated operation between the banks, the banks' central bank, the Bank of International Settlements (BIS), and the International Monetary Fund (IMF). This process involves:

- the banks agreeing to turn over their short term 1-2 year debts into medium term 8-10 year debts, and often to provide extra medium term loans - albeit at higher interest rates;
- the IMF agreeing to provide medium term finance;
- the country's government introducing severely deflationary economic policies, with the aim of producing a balance of payments surplus, to eventually repay some of the debts.

The tortuous negotiations that occur in these packages can be illustrated by Brazil's case. Brazil reluctantly applied for $5 billion from the IMF in December 1982, and the government introduced severe deflationary measures and cuts in public spending. Even these measures, which produced strikes and street demonstrations in March 1983, were considered insufficient by the IMF and the banks. Payments of agreed new loans to Brazil, $4.5 billion each from the IMF and the commercial banks, were stopped in May. Consequently, Brazil was unable to make repayments on a $1.5 billion bridging loan from the BIS, missing $400 million payments in May and August. During subsequent negotiations, the Brazilian Government agreed to further cutbacks, for example limiting the country's indexation system, ensuring further cuts in living standards and employment. At the end of November, the IMF announced a compromise on the "performance criteria" and recommenced lending - with the first funds going to pay off the BIS loan. While Brazilians were experiencing these austerity measures, many were outraged by the announcement of major profits made by U.S. banks on their Latin American business. "In March 1983 Citibank announced record profits from Brazil - 35% up on the previous year - and while Brazil made up only 5% of Citibank's loans, it accounted for 20% of its profits".[10]

Yet the big American banks were facing problems at home. The initial loans to Latin America were often syndicated, with the large banks organising small regional banks into participating in the loans. With the onset of the debt problems, many of the smaller banks have been trying to reduce their loan exposure, and in consequence have not been willing to participate in the new loans. In Brazil's case, the larger banks have simply been unable to opt out, and have had to find the shortfall themselves - to the extent that Citibank's loans to Brazil in July 1983 equalled 83% of its capital, Chase Manhattan's reached 73% and Manufacturers Hanover's ran at 68% (very few of the smaller regional banks were over the 20% level).[11] The longer the problems continue, the deeper entangled the major US banks become.

A growing number of people are arguing for major changes to world financial arrangements to help resolve the debt crisis. However, at an UNCTAD meeting in June 1983, advanced capitalist countries rejected such suggestions. In July, the US and West Germany vetoed plans to let the IMF borrow on private markets, arguing that if Third World countries follow "prudent" policies they should be able to pay off their detbs as the recovery improves their export performance[12]

It will be argued below that major changes are necessary to resolve the debt problems. However, the Third World countries <u>will</u> get some small relief from the recovery at present under way in the West. The crucial questions are how long and how far this recovery will be felt. To help answer those questions, it is instructive to discuss some theories of economic slumps.

The initial reaction to the events of 1974-75 of most mainstream economists was to see the slump as the result of an unlucky coincidence of factors. Nine years later, many agree that something is seriously wrong with the world economy. Opinions vary widely however on what the 'something' is. Radical economists were more likely to see something fundamental amiss in the world economy in 1974-75. There was at least some ideological pinning to this, of a desire to see something fundamentally wrong with capitalism. Certainly left wing theorists have overworked the word "crisis" since. Some left economists, for example Ernest Mandel, have provided sophisticated analysis of the serious problems facing world capitalism.[13] But the left similarly lack general agreement on the nature of the problem.

Charles Kindleberger[14] has recently provided a succinct overview of the differing mainstream theories presented to explain the downturn. In doing this, he has also touched on many of the key ideas of radical economists as well Kindleberger outlines three major types of theory: 'real' theories of crisis, which he divides into business cycles theories and theories of what can be termed "structural arthritis"; and 'financial and monetary' theories of crisis. These will be considered in turn.

Business cycle theorists start from the well documented existence of swings in capitalist development. Three cycles have been extensively analysed and have, to a greater or lesser extent, been well theorised

- Kitchin or inventory cycles, which occur roughly every three years,
- Juglar or business cycles, occuring in 8-10 year intervals
- Kuznets or 20 year housing cycles.

"What's the world coming to?"

Many economists, view the downturn in 1974-75, and the poor subsequent economic performance, in terms of 50 year Kondratiev cycles - approximately 25 years of good economic performance being followed by 25 years muted growth. These long term cycles occur at the same time as the shorter cycles- thus in the upswing of a Kondratiev, the booms of the Juglar business cycles are strong, and the slumps weak, whilst in the Kondratiev downswing, the Juglar slumps become larger and deeper, while the intervening booms are weaker and short-lived. Subsequent discussion centres on these two "cycles" - the "Juglar" and the "Kondratiev".

The evidence for Kondratiev cycles is, at first, striking.[15] Downswings have been suggested for 1930-48, 1973-96, 1914-40, and now 1973 onwards, and the fifty year rule seems to be more or less followed. However, there are three major problems with theories presenting the Kondratiev as a fully self-generating cycle:

- the evidence and timing is neither as neat nor as coherent as these dates suggest. Van Juijn, in The Long Wave in Economic Life (ch. IX), which argues for long waves, notes that the various exponents of long waves have given often widely differing dates for swings in the waves;

- to be fully self-generating cycles, Kondratiev cycles have to include a wide variety of events as endogeneous, including two world wars. Both world wars could have been decided the other way - in particular, if Germany had won crushing victories in the first year or so. It is hard to conceive that such a difference would have not altered subsequent economic patterns;

- there is as yet no acceptable theory to explain Kondratiev cycles. Kondratiev himself suggested the importance of a 50 year life for fixed capital, such as business construction. There have been attempts such as that suggested by Joseph Schumpeter, to link them to bursts of invention and innovation, but these innovation theories have recently been severely criticised by orthodox economists.[16] On the left Mandel has been no more successful in relating Kondratiev cycles to Marxist economics.

Rather than viewing the Kondratiev as an all-encompassing cycle, it is more useful to view it as a long term wave that is influenced, in both timing and amplitude, by exogeneous factors. Thus, in the case of the First World War, the long term economic trends created imperialist rivalries and other tensions in the world system. However, the resolution of those conflicts was not totally determined - and the outcomes themselves affected the next stage of the economic patterns. Here Mandel's argument is of interest: while the upper turning point of the long wave is endogenously determined (ie there are forces within the economic structure itself that eventually cause downswing), the lower turning point is determined exogenously - there is no guarantee of recovery, as it depends on a variety of social, political and economic factors. Such a formulation however moves attention away from an repetitive cycle pattern to a specific examination of factors involved in each period, and closer to Kindleberger's second group of theories.

Kindleberger's second main group of theories can be termed those of 'structural arthritis.' They basically contend that the boom of the post-war years was based on certain economic and social institutions. As the boom continued however those institutions become less conducive to growth. An example here is Robert Reich's contention -

> "The central problem of America's economic future is that the nation is not moving quickly enough out of high-volume, standardised production. The extraordinary success of the half-century of the management era has left the United States a legacy of economic inflexibility. Thus America's institutional heritage now imperils its future.... The answer is that the transition requires a basic restructuring of business, labour and government. A reorganisation of this magnitude is bound to be resisted, because it threatens vested economic interests and challenges established values".[17]

This argument is similar to a more general theory which Kindleberger stresses. As a boom continues, various groups gain more power and form "distributional coalitions", which press their own interests - "tariffs on competitive imports, higher prices for a cartel, or wages for a labour union, legislation favouring an industry, and the like".[18] The more such coalitions develop, the more their conflict slows down decision-making, the development of new industries, and economic growth.

A similar argument has been developed by American radical economists Gordon, Weisskopf and Bowles.[19] These authors centre on the concept of the social structure of accumulation, by which they mean the social institutions which provide the framework for economic development. Taking detailed evidence of short period cycles in the United States, they argue that in the downswing of these cycles the critical question is what happens to real unit labour costs. In long term expansionary phases, real labour costs fall in short term downswings, restoring profitability. In "crises" however, (the authors refer to 1892-9, 1929-37, 1973 on) real unit labour costs do not fall in the downswing of the business cycle, meaning profitability is not restored and the next upswing is consequently muted.

Kindleberger's third major field is that of financial/monetary theories. The most important monetary theory of depressions was developed by Friedman and Schwartz in their Monetary History of the United States.[20] In this, the authors pointed out that the U.S. money supply contracted by more than 30 per cent after the Wall Street collapse of 1929. Some of this contraction induced lower prices, but the bulk devastated real economic performance in the States. Monetary theories of the 1970's and early 1980's are somewhat different from this, largely because of the existence of rapid inflation rather than severe deflation. However, it is argued that both patterns, albeit in different ways, restrict new business investment and hence slow the growth rate. Moreover, both the 1930's and the 1970's saw major international currency instability, further hitting the business environment.

The monetary instability of the 1970's stems to a large part from the breakdown of the Bretton Woods system. Under this system, agreed to in 1944, world currencies were to have fixed exchange rates, with the $US being used as the base currency. The system broke down in 1971, with the $US being devalued and the introduction of more readily moving exchange rates (so called "dirty floats", as there was still considerable Government control). This breakdown contributed to the major international inflation and considerable financial instability that were features of the early and mid 1970's.

In simple orthodox theory, freely floating exchange rates ensure quick responses to international economic developments. If one country runs a balance of trade deficit, its currency is devalued, which restores equilibrium. However, this simple theory ignores the role of large scale capital movements, which also enter into the balance of payments. Consider the 1983 situation of the United States and Japan. The U.S. had a massive balance of trade deficit, but also high interest rates which encouraged major inflows of capital. As the latter outweighed the former, the $US has climbed strongly. By contrast, Japan has a massive balance of trade surplus, to the extent that Western Europe and the U.S. imposed direct import controls on Japanese goods. However, the Japanese government maintained low interest rates, which contributed to a large capital outflow - pushing down the Yen. Such contrary patterns indicate some of the instability of world currencies. In understanding them, the role of interest rates and hence governments' monetary policies are crucial. To incorporate these requires a look at some factors behind Kindleberger's analysis.

A number of recent radical analyses of the situation of the 1970s have stressed the inter-relationship between 'structural arthritis' and monetary instability. Two recent analyses, those by Parboni and Aglietta, are noteworthy.[21] Briefly, it is argued that the key social structure of the post war boom was the central role of the United States in the international capitalist system. This was particularly symbolised by the use of the $US as the base currency in the Bretton Woods system. However, as the boom continued, strains both economic and political developed in the system. Economically, the US economy was not as dynamic as the Japanese and German economies (which may have been partly due to restrictions on US policies due to its reserve currency status).

Politically, the US as the key capitalist power became involved in various imperalist actions (especially in Vietnam) that imposed costs not experienced by Japan or Germany. The outcome of these strains was the collapse of Bretton Woods in 1971, with US attempts to resolve major balance of payments problems, and subsequent declines in the value of the $US.

The analysis of both Parboni and Aglietta is compelling - and is particularly of interest in their stress on international capitalist rivalries, in distinction to other left arguments (eg those centering on the Trilateral Commission or the Pacific Rim Strategy) which emphasise international capitalist co-ordination and/or conspiracy. However, the analysis runs into troubles in its direct association of the structural and the monetary problems. As Frieden has indicated in a review of Parboni's book, [22] if the declining value of the $US during 1971-79 was a crucial symptom of the structural problems of the US economy, how should we understand the strength of the $US since 1979? Frieden's suggestion is that, as well as stressing international capitalist rivalry, one also needs to take account of domestic rivalry between capitals within capitalist countries.

Rivalry between capitals in a recession is often associated with differing susceptibillty to, and roles in, the economic "cleansing"process that clears the way for renewed accumulation. Renewed accumulation requires a recovery in the rate of profit. This can occur in three critical ways:

- by reducing labour costs. The reserve army of unemployed labourers holds down wages (paradoxically, it also holds down consumption demand, delaying recovery);
- by devalorising existing capital. As a machine becomes less profitable, its value in production falls, relative to its initial (or even replacement) cost. With less efficient producers and machines forced out of production by the slump, the stronger firms can expand anew;
- by improving the efficiency of the system of production. This could involve technical items such as improving inventory control or reducing turnover time. It could also involve institutional changes at the macro level.

As the impact of any recession is uneven, hitting some branches of the economy much harder than others, so the extent of these cleansing operations is also uneven. This uneveness is accentuated by conflicts between contending interests over the changes, in particular:

- while most firms can agree that wages should be reduced, workers and unions will resist this,
- those firms with rapidly depreciating capital are likely to resist, possibly seeking government aid. This will be especially significant if the devalorising process is occurring particularly strongly in specific sectors of the economy;
- attempts to change institutions to improve the efficiency of production will encounter vested interests, be they of direct economic or more ideological form.

This recession has indeed seen marked conflicts between capital and labour, and between different sections of capital. One notable conflict has been between financial and industrial capital, manifest in Australia late in 1982 over attitudes to the exchange rate. Australia was then running a large balance of trade deficit, reflecting severe competition for local manufacturers, but high interest rates were encouraging sufficient capital inflow to give an overall balance of payments surplus. The Australian Industries Development Association' newsletter, representing local manufacturing, was demanding devaluation of the Australian dollar. By contrast the Syntec newsletter, more in tune to finance circles, was arguing for a revaluation.

The conflict between manufacturing and finance has also existed in the United States and in Britain, and does help explain the turn around in the value of the $US in 1979. In both countries monetarist policies, strongly supported by financial institutions, lifted interest rates, encouraged international inflows of capital, and pushed up the exchange rate. Consequently local manufacturers suffered increased international competition, and both countries ran large balance of trade deficits. The shakeout has considerably devalorised much industrial capital, with high levels of bankruptcies and scrapping. This experience is now reflected in manufacturers' attitudes to the present problems of US banks. Having suffered major losses themselves, the manufacturers can see no reason why the banks should not also suffer losses on their loans to Third World countries, and they specifically opposed any greater US contributions to the IMF.[23] The banks, who preached to manufacturers the virtues of the free market and monetarist policy for the last three years, are now demanding Government assistance. A sign of this battle was the narrow vote in the US House of Representatives on 4 August 1983 to approve a special $8.4 billion contribution to the IMF (which would indirectly assist the banks). The vote passed 217 to 211,[24] but embroiled the House and the Senate in further arguments when the Senate passed a somewhat different Bill in September. Agreement was finally reached late in November, with the Reagan administration agreeing to a large $16 billion expansion of new funds for housing and community development projects to win swinging Democrat votes,[25] and appease some manufacturing interests.

In general, it is apparent that the world economy is experiencing a long term downswing, with the shorter business cycles having weaker booms and longer and deeper recessions. The character of long swings can not be seen as mechanistic and attention must be paid to the specific features of each longer period, both in the upswing and downswing. Moreover, while monetary instabilities do have effects of their own, in general they have reflected more basic economic movements, and also policy shifts associated with considerable political conflict. The "structural arthritic" approach appears superior, in which the institutional frameworks, both national and international, that fostered the post-war boom are now seen as less amenable to growth. Without major changes to those frameworks, it seems the overall prospects for the world economy are not bright.

PROSPECTS FOR THE WORLD ECONOMY

Recently, encouraging signs of recovery have appeared, especially in the United States and Japan (though Europe lags behind). The United States experienced real economic growth during 1983, at an annual rate of 2.6% in the first quarter, which soared to 9.7% in the second quarter and then slowed only slightly to 7.7% in the third quarter.[26] For the year, 5-6% growth was indicated, with an associated drop, albeit muted, in unemployment. Signs of recovery were observed in August 1982, when interest rates began to fall as the Federal Reserve loosened its restrictive monetary policy, and the stock market began to recover. In fact, much of the rise on Wall Street between August and the end of 1982 was simply due to interest rate movements. Only into 1983 could the market respond to some economic recovery. Consumer spending (automobiles and housing in particular) was very responsive to the fall in interest rates. The Government long term bond rate fell from 13.3% in early August to 10.5% by late April, with the commercial banks prime rate dropping faster, from 15% to 11.4% respectively (The Economist). By July 1983, US manufacturing industry was running at 75.8% of capacity, up from a low of 68.8% in November 1982.[27]

Most economic commentators, while welcoming these strong signs of growth, expressed concern about aspects of the recovery, concerns that remained to the end of the year:

- the recovery has been uneven, and as yet there has been little improvement in company investment;
- with a strengthening US economy, coupled with a high $US, imports are growing rapidly, putting pressure on many US manufacturing companies;
- interest rates are still historically high, and influenced to some extent by fears of Federal Government deficits, seem likely to remain high.

Central to most economic theories of the recovery phase of cycles, be they business cycles or Kondratiev cycles, is the behaviour of investment. The July 1983 OECD Economic Outlook discussed the recovery phase of the business cycle. It pointed out that private consumption and residential investment typically lead a recovery, encouraged by the fall in interest rates as credit demand slackens. This fall in interest rates is not sufficient to restart investment however, which typically lags in the recovery: "Spending on machinery and equipment typically rises once capacity utilization rises, inventory-to-sales ratios fall and expectations about the durability of the economic upturn became more confidently held".[28] While investment then does not lead the recovery, it is a vital component if the recovery is to continue. Yet, at present, the recovery of this vital component is by no means certain. From a study of the determinants of investment, the OECD argued, the central determinant of investment is changes in the level of aggregate demand, although such changes are mediated through both the level of stocks and the present degree of capacity utilisation. In addition there are secondary influences on the level of investment in the profit level, the level of interest rates and the state of business confidence. It is noteworthy that most current discussions of policies to encourage investment, both in Australia and internationally, concentrate on issues of profitability and interest rates, with aggregate demand often a poor also-ran.

In April, the Economist noted the signs of recovery in the United States, and argued the need was not so much to ensure a cyclical recovery, but to ensure a longer term recovery. Three related factors stood in the way of a long recovery:

> "Real interest rates are too high, particularly in the United States, choking any temptation for business to invest. One consequence is that the dollar is too strong, which turns Americans protectionists to keep out cheap imports. Third, bankers and businessmen are worried that over-borrowed countries like Brazil will not be able to service their debt if they are also finding it hard to earn enough foreign exchange from a protectionist world."[29]

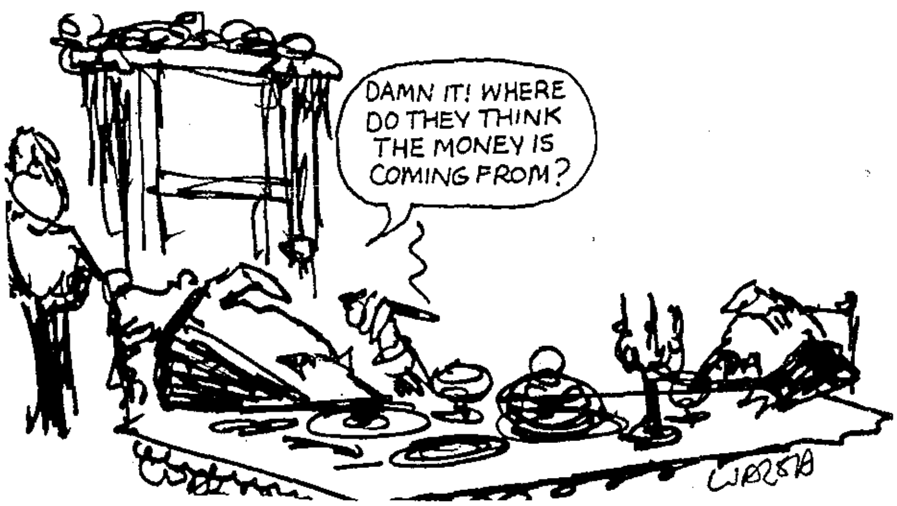
The key, in the Economist's view, was to bring down interest rates by ensuring that inflation is beaten. Indeed, inflation has fallen dramatically in many OECD countries in the past eighteen months. However, much of that was due to the recession depressing prices, and to the strength of particular currencies (inflation fell most in the US and UK, those with the strongest currencies). While inflation is low now, in the early stages of the recovery, there are good grounds for believing it will increase, especially in the US, as the business cycle recovery continues, due to demand inflation (as capacity is approached in some areas of the economy) and monetary inflation (due to both the present expansion of the money supply and to the size of the US Federal deficit). Given the importance laid on inflationary expectations in current conservative policy thinking, there would seem to be little scope under conservative governments for a dramatic loosing of economic policy to further encourage the recovery.

Despite such problems, conservative OECD governments have persisted in their beliefs that their policies are effective, and that no major changes need be made to present world economic arrangements. Both of these rest on a more fundamental belief in the bounty of the international free market which is not shared by many commentators, including (perhaps surprisingly) the normally staunchly pro-free market Economist. In recent months, the Economist has been arguing for significant changes - firstly, in terms of the international linking of economic policies. It was noted above that the restrictive monetarist policies of OECD governments 1979-82 encountered a fallacy of composition - each country ended up with a much worse economic deterioration than it intended, because all others were also deflating. A paradox of composition also exists for expansionary policies. As Mitterand's government in France discovered, if one country expands its economy, this quickly leads to an increased demand for imports, creating balance of payments problems and a need for tighter economic policies. However, if all major economies expand together, each is able to expand exports to the others at the same time as it is expanding imports, and consequently balance of payments difficulties should not emerge. This case for co-ordinated expansion has also been supported the OECD and Helmut Schmidt, the previous German Chancellor.[30] It has also been supported, not surprisingly, by Third World countries desperate to expand their exports to help pay international debts.

The second area of reform concerns Third World indebtedness. A major effect of a recession or depression is to devalorise existing capital, to write down values and hence help restore profitability. The present recession has done so to much industrial capital - it has yet to do so for finance capital. The complicating factor here is the way that the level of credit in the economy is related to the asset levels of the banks, through reserve requirements. If a bank has to write off large amounts of its assets (which would follow from default on an international loan) then it has to also reduce its lending. The problem now is two-fold, to get the banks to acknowledge that their loans to Third World countries are at hopelessly unrealistic levels, and need to be written down; and to establish a system whereby the loans can be gradually devalorised without creating a major contraction in credit.[31]

Both of these reforms requires a major expansion of international economic co-ordination. Both are strongly resisted by current right-wing OECD governments, and by the banks who are clearly reluctant to write down assets. Even if the reforms were to be instituted the world economy would still face problems, such as high interest rates, resurgent inflation and the difficulties associated with the social structure of accumulation. Without such reforms however, these problems will be significantly worsened - and the world recovery is likely to be much more short-lived, and much more susceptible to a major financial collapse.

While the economic recession has caused major suffering and social strains in all OECD countries, the divisions there do not appear to have the same potential for a major crisis as the Third World debt problems. By mid August 1983 in Brazil demands for a moratorium on international payments were coming from unions, the Opposition Party, businessmen, establishment economists and from within the Government's own party.[32] Two weeks later, on the eve of a meeting of the Organisation of American States which was to discuss the debt situation, Venezuela's Ambassador to the OAS, Victor Gimencz-Landinez, stated that "Latin America's foreign debts could not be paid under the present conditions."[33] Only days later, the present of Brazil's central bank, Carlos Langoni, resigned, claiming the IMF austerity conditions for Brazil could not be met and would be socially disastrous.[34]



With this background, it is not surprising that many financial observers feared a major debtors' revolt at the OAS meeting in Caracas, Venezuela, in September 1983. The World Bank publicly warned against any debt moratorium, arguing this would close all international sources of further credit. In the event, the meeting, attended by representatives from many US banks and the international finance organisations, did not produce a debtors' cartel. However, there was agreement by debtors to work more closely together in re-negotiating terms for debt rescheduling.[35]

Despite this and similar demands for reform by Third World countries at recent meetings of UNCTAD and the IMF, western governments have resisted any reforms, arguing that the economic recovery will take care of the debts by increasing developing countries' exports.[36] Estimates by US bank Morgan Guaranty indicate that improvement will be slow, even with major adjustments to the economies of the 21 major borrowers, coupled with a moderate and sustained OECD recovery. The total debt of these countries will still rise, from $501 billion in 1982 to $662 billion by 1986, which, as a percentage of exports, will fall from 172% to 127%. Other scenarios, with lower adjustments or poorer OECD growth, see even this limited improvement as doubtful.[37]

If the world economy manages to scrape through the present problems, the recovery now under way in advanced OECD countries should indeed provide some relief in 1984 and later years. However, it is a feature of long term downswings that business cycle booms are weaker and more short-lived, whilst slumps are longer and harsher. On the patterns of the traditional business cycle, a further slump can be expected around 1987. That date could be hastened by the weakness of the present recovery if investment does not pick up, and/or if deflationary economic policies are imposed on renewed inflationary pressures, perhaps some time in 1984.

Such a scenario is potentially disastrous for the indebted Third World countries. The recovery offers little hope beyond a very gradual scaling back of current debts, largely those incurred to pay previous loan commitments. If a further slump occurs about 1987, the Third World countries will be in little better position than they are at present, with the widespread knowledge that five years of social suffering have done nothing to improve that position. These economic strains will not by themselves create political turmoil. This was evident in both Brazil and Argentina during 1983. In both countries, military rule was being transferred to civilan administrations. Political parties were chary of mobilising political responses to the economic situation for fear of renewed military intervention. However, in the Phillipines the debt troubles accompanied major political conflicts over the murder of Aquino. Should similar coalescences of economic and political conflicts occur on a broader scale at the end of the decade, the international stability hard-preserved in 1983 will be even more shaky.

FOOTNOTES

1. I am grateful to Tony Nippard, Phil O'Hara and Stuart Rosewarne for their comments. This paper does not necessarily reflect the views of my employer, the Victorian Ministry of Employment and Training.

2. Edmund S. Phelps "Cracks on the Demand Side: A Year of Crisis in Theoretical Macroeconomics" American Economic Review, Vol. 72, No. 2 May 1982, p.378.

3. McCracken Committee Towards Full Employment and Price Stability (OECD, Paris, 1977). Of the author's discussion of this in "introduction" (to section on World economy). Thesis Eleven 4 (August 1982) pp 2-6.

4. OECD Economic Outlook 32 (December 1982) pp 9-10.
5. OECD Development Co-operation 1979 Review (Paris, 1979) p.74.

6. Time 10/1/1983 "The Debt-Bomb Threat" p.5 Cf also "International debt threat" Economist 30/7/1983.

7. Economist 11/12/1982

8. Cited by Anthony Sampson "Brazil Crisis Threatens World Economy" National Times July 22-28, 1983.

9. Lester Thurow "Is Paul Volcker a closet Keynesian?" AFR 10/6/1983.

10. Quote from Sampson, loc cit. Details on the critical months of the Brazilian crisis were given in the Economist (9/7/1983; 16/7/1983) and AFR (29/9/1983, 24/11/1983, 2/12/1983).

11. David B. Tinnin "The War Among Brazil's Bankers" Fortune 11/7/83.

12. "Selfish banks threaten recovery" AFR 25/7/83.

13. Ernest Mandel Late Capitalism (London, 1975) The Second Slump (London 1978) and other writings. Cf fn 30 for other radical analyses.

14. Charles P. Kindleberger "The World Economic Slowdown Since the 1970's" Institute for International Economic Studies Seminar Paper 229 (Stockholm, November 1982).

15. For comprehensive surveys of writings on Kondratiev cycles, see P. O'Hara "Theories of the long Kondratieff cycle: A Survey and Reconstruction" paper presented to the Twelth Conference of Economists, Hobart, August 1983 (and a similar paper to the Eighth Political Economy Conference, Canberra, September 1983), and J.J. van Duijn The Long Wave in Economic Life (London 1983).

16. cf Edwin Mansfield "Long Waves and Technological Innovation" and Nathan Rosenberg and Claudio R. Frischtak "Long Waves and Economic Growth: A Critical Appraisal" in American Economic Review Papers and Proceedings Vol. 73 No. 2 (May 1983) pp.141-5, 146-51 respectively.

17. Robert B. Reich The Next American Frontier (NY 1983). Quote from extract published in National Times 1/4/83

18. Kindleberger, loc cit, p.9.

19. David M. Gordon, Thomas E. Weisskopf and Samuel Bowles "Long Swings and the Non-reproductive Cycle" American Economic Review, Vol. 73 No. 2 (May 1983) pp. 152-7.

20. Milton Friedman and Anna Schwartz The Great Contraction 1929-33, reprint of chapter 7 of their Monetary History of the United States.

21. Ricardo Parboni The Dollar and its Rivals: Recession, Inflation and International Finance (London, 1981), Michel Aglietta "World Capitalism in the Eighties" New Left Review 136 (1982) pp. 5-41. A debate between Samir Amin, Giovanni Arrighi, Andre Gunder Frank, and Immanuel Wallerstein Dynamics of Global Crisis (London 1982) provides a succinct statement of these writers' arguments on the subject, while more truncated views from many writers are contained in a special section "Economic Crisis East and West" (ed T. Ward) Thesis Eleven 4 (1982) pp. 2-47.

22. Jeff Frieden "The Dollar and its Rivals" (review of Parboni op cit) New Left Review 135 (1982) pp. 91-96.

23. "Short of Cash" Time 8/8/83.

24. AFR 5/8/83

25. Age 30/11/83, 7/10/83, AFR 21/11/83

26. Figures as reported in Australian Financial Review 24/11/83

27. AFR 22/8/83

28. OECD Economic Outlook 33 (July 1983) p.9.

29. "The Recovery Game" Economist 23/4/83, Cf also "Boom or sputter?" Economist 16/7/83.

30. Helmut Schmidt "The World Economy at Stake" Economist 26/2/83

31. cf two special articles written for the Economist: Minos Zombanakis "The International Debt Threat - A Way to Avoid the Crash "Economist 30/4/83, and Lord Lever "A Concerted Way Out" Economist 9/7/83, both of which argue for co-ordinated action to gradually write down loans.

32. AFR 22/8/83

33. AFR 31/8/83

34. AFR 5/9/83

35 AFR 13/9/83

36. AFR 25/7/83

37. Figures cited by V Argy "Some Thoughts on the International Debt Crisis" Paper to Twelth Economists Conference (Hobart, August 1983).