June 2008

Who’s to foot the bill?

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In 1999 oil cost 20 dollars a barrel and the euro area was spending 1% of its GDP on buying it. In 2007 the bill had gone up to 2.5% of GDP and a barrel cost 70 dollars. Today a barrel costs more than 130 dollars and, at that price, the bill will probably reach 4% of GDP. In other words almost all the growth of 2008 (1.7% for the euro area according to the latest OECD forecasts) will be spent on financing oil purchases and nothing will remain to increase household consumption and corporate investment.

On top of this first shock has come the rise in price of foodstuffs. This blow here is softer. First, because the price rise has been less pronounced. Real basic food prices are on average at the same level as ten years ago, much lower than during the 1980s. Second, because its impact is limited, at least in developed countries, where an increase of 50% in food prices only translates into a 1% cut in household incomes (the situation is quite different in developing countries where the same rise amounts for 10% of income). Finally, because the price rise redistributes income (from consumers to farmers) but not a national income loss. But this second shock compounds the first and has similar consequences: for the consumer, less purchasing power.

This ‘double whammy’ changes the terms of the economic discussion. Only yesterday globalisation essentially meant a wealth of low-price manufactures from emerging countries. It was disputed because of its impact on jobs and wages but no one seriously denied that, on the whole, it pushed up purchasing power. Several years ago a French economist by the name of Lionel Fontagné computed that imports from ‘offshore’ countries produced a benefit of the order of 1.5% of GDP for French consumers. The magnitude of the benefit has no doubt increased a little since then. But if it is supposed that the benefit today is 2%, this would still be less than the negative effect of the oil and commodity price rise.

This is a crude estimate. It disregards the fact that developed countries also benefit from the rise in price of their own exports to emerging countries. Neither does it take into account that massive Chinese savings are helping to keep interest rates low. But suffice it to say that competition for access to scarce resources is changing the politics of globalisation. Until now it was, at least for its champions, a positive-sum game. It is becoming, in part, a zero-sum game. This is likely, in its turn, to change the whole debate.

For now, however, governments have other worries and are everywhere seeking to ward off commodity price rises and find a response to public brickbats. Alas for them, the lesson of the 1970s is crystal clear – households must absorb the drop in purchasing power. At that time attempts were made, simultaneously and successively, to dive headlong into inflation, to escape by running up the public debt and by getting businesses to pay. All these responses were costly and ineffectual, and those countries which came off best from the oil shock were those which understood this the quickest.

It is even truer today. The European Central Bank has already flexed its muscles, implying that it will not hesitate if need be to put up interest rates in order to scotch an inflationist spiral. Countries are today a lot more heavily in debt than in the 1970s. As for the businesses, some are getting by thanks to the size of their margins but companies as a whole are not in a position to absorb a cost hike without cutting investment.

Of course this does not prevent governments from taking targeted measures to help poor households, nor from ensuring that the oil price rise is not used as an excuse for renting-seeking behaviour by refineries or distribution. But this means that, in the short term, there is no macroeconomic alternative to households' absorbing the extra cost of staples.

The true answer is different in nature. Throughout the last few years growth in the euro area has been made up of very weak progress in labour productivity, of about three-quarters of one percent per year, coupled with strong job creation. This way of growing – known as job-rich growth – relied on the assumption that consumers were benefiting from terms-of-trade gains, in other words that they were paying less for imported products. The rise in the price of commodities has – probably for a long time – put paid to that calculus.

Thus the way to boost purchasing power is to increase productivity gains. This implies a change in the growth model and policies which are designed to stimulate productivity, in particular through innovation and competition.