A review of the world economy

Speech by the Governor[1]

In discussing the world economy, the Governor makes the following points:

- *Countries have not only generally adjusted better to the second large rise in oil prices than to the first. Even more encouraging, they are saving in the use both of energy in general, and oil in particular.*
- *The banks and the international financial institutions both have key roles in the recycling process. It is important that official lending should continue to be accompanied by appropriate programmes for economic adjustment.*
- *European success in combating inflation depends heavily on corresponding success in the United States. High US interest rates, arising from a tight anti-inflationary policy, have created awkward policy dilemmas for some other European countries by putting pressure on their interest rates and exchange rates. In these circumstances, some resort by them to exchange market intervention is understandable.*
- *It is in our interest that the United States follow firm policies in both the monetary and fiscal fields, even if they are not those most immediately comfortable for us to live with.*

I come to you fresh—if that is the word—from the meetings of the IMF Interim Committee and the joint Fund/World Bank Development Committee in Libreville. These particular meetings were not expected to be ones at which major decisions would be taken; their purpose was rather to provide an opportunity to assess the state of the world economy and to consider the problems ahead.

It is scarcely two years since the world economy, still recovering from the effects of the first jump in oil prices, was subject to the renewed stress of a second. The response since that time shows welcome signs that lessons have been learnt from the previous experience. In general, wage costs have been better contained; the loss of output in the industrial countries seems likely to be smaller; and investment to have been better maintained.

Furthermore, evidence is beginning to accumulate of restructuring in industrial economies to adjust to the higher real price of energy. Energy use per unit of output has in fact declined substantially. For the OECD as a whole, it is estimated, I believe, that the decline over the seven years from 1973 to 1980 amounted to no less than 15%. Part of this decline is due to the effects of recession. But when that is allowed for, it is clear that an appreciable saving in energy use has been achieved. Equally important, there has been a switch within total energy consumption away from oil towards other fuels. Indeed, oil consumption in the industrial countries has now fallen back below the level in 1973, even though output is nearly 20% higher.

Notwithstanding these signs of progress, a number of features in the present situation give rise to continuing concern. In the industrial world, despite the success in many countries in containing the effects of the rise in oil prices, the average rate of inflation remains close to 10%, still disturbingly high. In the developing countries—and in a number of industrial countries—current account deficits remain very substantial and, partly because of the restrictive monetary policies which have been needed to curb inflation in the industrial world, they are likely to continue so for some time. These policies have involved a general upward shift in interest rates, thus compounding the difficulties of deficit countries in servicing the growing total of their borrowing.

The task of financing these deficits, especially given the likelihood of some move in the total non-OPEC deficit towards the developing countries, underlines the importance of maintaining sound standards in international bank lending. This is primarily for the banks themselves, but I do not apologise for reiterating my view that effective supervision of the international banking system, far from interfering with the smooth finance of payments deficits, is essential if the financing flows are to be sustained. The scale of the efforts of the international banking system in this respect scarcely needs emphasis from me.

Recognition, however, that there are limits to what the banking system can be asked to do in the recycling process, in respect both of those poorest countries which have no

(1) Delivered at the *Financial Times* lunch for representatives of the foreign banking community in London on 27 May 1981.

natural access to the international credit markets, and of those countries whose access is already approaching prudential thresholds, has concentrated attention on the larger role that might be played by the international financial institutions. Libreville provided an opportunity to take stock of how they are responding to the challenge.

The record is far from negligible. During the past year, the IMF has embarked on a policy of enlarged access to Fund resources. Through a combination of higher quotas, and access to a higher multiple of quotas, the amount the non-oil producing LDCs could borrow from the Fund has more than doubled. No doubt in part because these larger amounts are now available, the pace of Fund lending is increasing. Total Fund lending and new commitments nearly tripled in 1980. With the support of its membership, the Fund has, as you will be aware, taken special steps recently to continue to finance this enlarged scale of lending.

The World Bank, likewise, has taken steps to enable it to play a greater part in assisting countries to cope with persistent payments imbalances. In the middle of last year it introduced what is termed 'structural adjustment lending'—that is, essentially, programme lending aimed at adjustment without detriment to essential development plans. It has also been developing its co-financing operations in collaboration with other agencies, official and private.

Although these various sources of finance for developing countries are being promoted and enlarged, it was an important strand of the thinking at Libreville that such lending should continue to be accompanied by appropriate programmes for economic adjustment. This implies that the integrity of IMF conditionality should be maintained, and that World Bank lending should be attuned to the adjustment needs as well as the longer-term development needs of the borrowing countries.

Adjustment is not something simply for the poorer countries. Everywhere, energy has become expensive, economic growth is harder to win and expectations have to be lowered; adjustment to this new world is necessary for industrialised and developing countries alike. Since the economic policies pursued by industrialised countries were the subject of some critical comment at Libreville, it may be worthwhile to consider briefly the adjustment process as it affects them.

I have already mentioned signs of success in some of the longer-term, structural aspects of this process. The more immediate target has been reining back inflation: for without success here, structural adjustment itself is likely to be inhibited. I find it encouraging to see how widespread and how firm the commitment to reducing inflation has now become; there was general agreement on this at Libreville. There is not similar unanimity on how the objective is to be achieved; but in most countries, monetary policies have been called upon to play a major role in the anti-inflationary effort. This is first and foremost true of the United States.

It is not to be denied that some of the consequences of efforts to reduce inflation have been, and for a time will continue to be, uncomfortable. In the United Kingdom, for instance, we have every reason to be aware of the costs involved. The fact that output has fallen and unemployment has increased so sharply has in part to be seen as a cost of reducing inflation. Wage increases of some 20% on average last year were patently incompatible with the necessary adjustment to a lower level of inflation; this has magnified the impact of counter-inflationary policies on the real economy. Thankfully there are now signs of progress. The rate of increase in prices has fallen substantially, and settlements in the current wage round are running at no more than half last year's level. In recent years, costs in UK industry grew faster than in the generality of our competitors: and productivity grew barely at all. As a consequence, the international competitiveness of British industry suffered severely. But, since last autumn, earnings per head have probably been rising no faster than those abroad; and there are signs of an increase in productivity despite the severity of the recession. Obviously, these gains have to be consolidated and extended. Adjustment is not only difficult, but is likely to require perseverance over a relatively protracted period.

The position of the United Kingdom is not typical of the industrial countries. Although North Sea oil has not cushioned us from the price effects of the oil shock, our balance of payments has not been thrown into heavy deficit as have those of most of our industrial neighbours. In consequence, we have not been impelled as others have by the need to attract or maintain capital inflows. National efforts to contain monetary growth which have entailed higher interest rates, especially in the United States, have therefore not posed for us the problems which others have had—problems especially acute in those European economies which have already achieved a considerable measure of success in reducing or holding down their domestic inflation.

As the requirements of anti-inflationary policy and domestic monetary control in the United States have pushed interest rates to unusually high levels, the exchange rates for some European currencies have come under downward pressure, threatening to undo part at least of the success in containing domestic prices. There is a dilemma here. On the one hand, there can be little sustainable success for the industrial countries as a whole in bringing down inflation unless it rests on, or is at least accompanied by, corresponding success in the United States. On the other hand, the need for restrictive policies in the United States has meant that her European partners must either countenance a rise in their own interest rates, in some cases to levels which are very high in real terms and unwelcome from the point of view of domestic activity; or else run the risk of seeing their currencies depreciating, with the attendant likelihood of rekindling domestic inflation.

It has been argued that the general level of interest rates could be reduced without inflationary danger if the balance within the overall restrictive stance of policy were switched more towards a greater emphasis on fiscal restraint. This is certainly a point of view which has its attractions for bankers, central bankers in particular; and it is indeed one which underlies the recent Budget in the United Kingdom. Besides any question over the level of interest rates, a further concern has been the unusual volatility, again especially of US rates, which has been experienced over the past couple of years. This has focussed debate on the techniques of monetary control. Whatever the conclusion on this point, greater interest rate volatility has, in its turn, brought greater volatility in exchange rates. The resort to widespread market intervention has been understandable, not only in terms of the rules of the European Monetary System, but also because the volatility has apparently been more closely related to interest rate differentials than to underlying rates of inflation. Few would claim that intervention should be assigned a dominant role—but in a strong wind a hand on the tiller can be helpful.

These arguments are important. And the stakes involved on both sides are high. We must all seek to pursue the mix of policies which is most effective domestically and least damaging internationally. We must all, however, assign prime importance to bringing inflation, and inflationary expectations, under control. This means, I suggest, that it is in our interest that the United States follows firm policies in both the monetary and fiscal fields, even if they are not those most immediately comfortable for us to live with. A failure here, in the largest economy in the world, could put at risk gains laboriously made there and elsewhere.

The picture of the world I leave you with is one where internal adjustment issues of formidable complexity for many countries co-exist with equally formidable problems of external adjustment and financing—problems not simply between the oil-exporting and the oil-importing countries, but also, within the oil-importing countries, between the industrial world and developing countries. It is going to need all the understanding, mutual respect and wisdom available if we are to succeed in maintaining an orderly international environment. For bankers there is a practical observation. In a world subject to such stresses there are not only pitfalls for the unwary and incautious, but also opportunities for the skilful and energetic.