

World economic problems

Speech by the Governor⁽¹⁾

The Governor begins by contrasting the recent performance of the world economy with the first two post-war decades. But the remedy for present ills is not root and branch reform: 'in our efforts to restore balance and direction to our economies, we have . . . to start from where we are'.

Early post-war success rested on various factors, all now eroded. Energy is no longer cheap; the rise of labour costs became more rapid; and the fixed exchange rate system was abandoned. The Governor points to the need for new efforts in these fields:

- *Greater economy in the use of dearer energy.*
- *Striving to eradicate inflationary expectations—but not by accepting permanently lower growth. Success has gone to countries prepared to adapt in a flexible manner.*
- *Greater stability in exchange rates, for which the Governor detects a growing desire. Difficult though it may be to achieve a measure of international understanding and agreement, we need to direct our minds to the problem and search for solutions that may only be attainable over time.*

The Bretton Woods era

James Joyce, the Irish writer, began one of his novels with a phrase which, as I begin my remarks to you today, will serve my turn well for two purposes. The phrase is: 'Once upon a time and a very good time it was'.

Well, once upon a time, I attended more than one of these conferences, as I have not been able to in recent years, and I know what great honour you do me in inviting me to speak to this distinguished audience at the opening of the Conference. I am most sensible of the privilege, and I thank you.

In a wider context, too, as we survey the range of problems which form the subject matter of the Conference, I shall want for a moment to look back at the quarter of a century which followed the Second World War and which now sometimes evokes the feeling 'and a very good time it was'.

I recognise, of course, that, while history is written backwards, we have to live forwards; and it is with the future that you are concerned. But that future is, to varying extents, conditioned by the past. If we are to understand the challenges we face, it is, I suggest, helpful to look at where we have come from. I shall therefore begin by looking briefly at the first twenty-five post-war years, and try to analyse what was good and what went wrong—to show how it was that we came to the position in which we find ourselves. Then I want to examine a few broad questions which I have come to think of crucial importance, with a view to suggesting how we may hope to improve our present situation.

Inevitably I speak to you from the perspective of a Central Bank Governor in an industrial country. I shall leave you to judge the width or narrowness of that perspective. By reason of my responsibilities and professional deformation, I shall tend to emphasise the financial dimensions of the world economy. But I hope I shall not seem unaware of the political, industrial and social factors involved in economic progress, or economic decline.

To those who lived through them, the first two post-war decades did not appear a golden age. How could the reconstruction of the world's economy after six years of a destructive war be other than a period of problems and disappointments? But the last word will rest with the historian and the statistician, who can show that, in that period, the free world as a whole achieved an unprecedented combination of growth, relatively stable prices, high employment and expansion of trade.

From time to time individual countries ran into difficulties, often in the form of balance of payments crises. Prices did indeed rise. But in those days inflation of 5% per annum was reckoned a serious defeat, not an improbable success. Unemployment was low. Economic growth, for all the derided stop-go cycles in some countries, promised each year significant improvements in the standard of living. Expectations of a steady increase in economic wealth and welfare were firmly established, at least in the industrialised countries; and ambitious plans for spending that wealth became a major feature of political programmes. Furthermore the increased prosperity of the industrialised world, and the international trade that it engendered, was

(1) Delivered at the International Industrial Conference in San Francisco on 21 September 1981.

vital to the hopes and achievements of the underdeveloped world, whose performance, despite their difficulties, was also encouraging.

It is instructive to ask what were the foundations of this success. One might incline to attribute it to the post-war international settlement and to the policies pursued at that time. These, at the cost of great simplification, might be seen as falling under three heads—first, the framework of international monetary relations under the Bretton Woods system based on fixed but adjustable exchange rates; second, commercial arrangements under the General Agreement on Tariffs and Trade, designed to dismantle protectionism and encourage the freedom of international trade; and third, full or high employment policies and, to different degrees, an enlarged government role involving frequent interventions to affect the short-term path of the economy. These features were a conscious reaction to the experience of the 1930s—a period widely characterised by erratically floating exchange rates, by protectionism and by massive unemployment.

In pointing to the part which organisations and policies played in the successful economic performance of the 1950s and 1960s, it is right to reflect that that performance was also much assisted by more fundamental factors. In retrospect, I would select three as having been particularly relevant: the economic and financial dominance of the United States, which underpinned the Bretton Woods system; the prevailing general moderation in wage determination; and abundant and cheap energy.

All three elements underwent changes in the late 1960s and early 1970s. US dominance had given place to a diffusion of economic power towards a reconstructed Europe and an emergent Japan. In many countries unit labour costs started to rise rapidly, leading to higher inflation and contributing to the destruction of the fixed exchange rate system. Then, having become unsustainably low, energy prices were raised massively and administered a *coup de grâce*.

The 1970s

The economic performance of the 1970s has been in depressing contrast with that of the earlier decades. By the second half of the 1970s the average annual growth of real GNP in the OECD economies as a whole was only around 2½%, half that registered in those earlier years. In many of our countries rapid inflation and high and rising unemployment now exist side by side—a combination of elements so apparently contradictory that the textbooks used not to acknowledge that they could co-exist. The payments disequilibrium between the oil exporting countries and the rest of the world and, equally important, between countries or groups of countries within the rest of the world, has been on a scale to tax not only the ability of different societies to adjust but also the stability and resilience of the international monetary and trading systems. This has brought in its train a disquieting increase in international indebtedness and has encouraged the forces of protectionism. Moreover, in the last eighteen months or so, a further source of instability has emerged in the form of

sharply fluctuating interest rates, especially for the dollar, and this in turn has brought with it by far the largest changes in exchange rates for major currencies since the breakdown of the December 1971 Smithsonian Agreement.

The general picture is thus widely seen as painted in brown or, in some cases, much darker shades. In face of this situation, some understandably hanker for a new economic order. But I doubt whether, either as a matter of what would be ideal or as a matter of practice, it is sensible to think in terms of root and branch reform. The reply of the drover asked the way to some distant town—'I wouldn't start from here'—is simply not available to us. In our efforts to restore balance and direction to our economies, we have no alternative but to start from where we are.

The present

I come then to consider three main elements of the present situation. These are energy, the problems of domestic adjustment, and exchange rates.

Energy

The continued momentum of economic expansion in the post-war period after the initial phase of reconstruction owed something to the remarkable developments in the world oil situation. In the 1960s, for example, as oil came on stream from reserves found in the Middle East after the Second World War, world oil production and consumption rose at annual compound rates of 7%–8%. The average price of crude oil during this period changed little in nominal terms and virtually halved in real terms. The consequence was not only a rapid rise in total energy consumption but a substantial rise in the share of oil in total energy.

This perspective is helpful in considering the dramatic events of 1973, when, following the interruption of supply and a quadrupling of the price, oil assumed a position on centre stage from which it has since shown no signs of withdrawing. The proximate factors, new relationships between oil states and the major oil companies and the Middle East War, no doubt provided the circumstances and occasion of the change. But at bottom the situation surely was that the pace of oil consumption—at a sharply declining real price—had become too fast to continue for long without threatening to outrun the available supplies.

We are paying dearly for the adjustments we have made and still have to make because of those years of unreality. The abrupt price increases in 1973 and 1979–80 have complicated two of the main problems with which our societies are struggling: inflation has been greatly exacerbated and the dimension of necessary structural change greatly extended.

The outlines of the present oil situation are well known. Our first task is to adapt as quickly as possible to dearer oil. On this count we should not be too self-critically despondent. Before 1973 we had a long period when the price signals misled us into types of investment and modes of behaviour which could not endure. The eight years since are a short

period by comparison; and adjustment to expensive oil is demonstrably taking place. True, some complacency may have developed over the period 1975–78 when the real price of oil began falling again. But in 1978 the real price was still four times that of 1970 and twice that of 1945, and it now seems generally recognised that much higher levels of oil prices are here to stay and that the consumer cannot be shielded from them. Total energy consumption per unit of GNP in the industrialised world has now declined by nearly 12% since 1973. Furthermore, there has been some shift away from oil towards other fuels, as well as an increase in oil production outside the OPEC countries. It is an important achievement that OECD countries are now a good deal less dependent on OPEC oil than they were before 1973.

But we still need, so far as lies within our power, to seek to minimise discontinuities in oil prices. The world is in poor shape to withstand a further oil shock. We remain highly vulnerable to shortfalls on the supply side which, even when they are quite small, can result in disproportionate price rises. It is important, therefore, that we continue to devote attention to those techniques of energy policy, such as use of oil inventories and emergency sharing schemes, which can help to moderate the effect of purely temporary shortages in oil supply.

Apart from interruptions of supply, we also remain vulnerable to inadequate growth of supply, or to increases in demand, which could likewise put upward pressure on prices. The present oil market is soft, we must remind ourselves, largely because demand is slack. We must therefore not allow present conditions to induce relaxation in our efforts for greater economy and efficiency in the use of oil or to deter the search for new energy sources.

Domestic adjustment

I come now to my second topic: the problem of domestic adjustment in an inflationary environment. It is in many ways the most difficult of the three, because it is so closely concerned with behavioural attitudes.

Inflation was given two savage upward twists through two oil price shocks. But in most developed countries the upward trend in costs and prices had already begun to accelerate towards the end of the 1960s: the industrialised world had double-digit inflation before the first oil shock. No doubt there were many causes; different people emphasise different aspects. Some contend that monetary laxity—on an international scale—was crucial; others that this may have been conducive but hardly crucial, arguing that a pay explosion on the scale experienced in many western countries must surely have its source in altered attitudes and expectations of working people.

What is undeniable is that by the early 1970s productivity trends were less clearly sustained, fiscal expansion was progressively less reliable in eliminating unemployment, and unemployment less effective in reducing inflation—stagflation had arrived. One explanation of stagflation is that, although expectations of inflation were very slow to build up during the years of creeping inflation,

once price expectations had become sensitive, expansionary measures increasingly translated into rising prices rather than higher levels of activity.

That there was a change in attitudes seems certain, as also that it was associated with expectations that had become unrealistic. The sustained rise in the standard of living of earlier years led to expectations of continuing annual improvement. Attempts to secure such improvement when productivity growth had declined, together with the effects of stagflation on capacity utilisation, led to a severe and sustained squeeze on profits in many countries. The inevitable result has been to weaken present employment and investment, the safeguard of tomorrow's employment and growth.

This domestic process underwent a change of gear as a result of the major transfer of wealth from one set of countries to another resulting from OPEC's success in increasing oil prices. The effect of the oil shocks on many oil consuming countries was worsened by a fairly widespread resistance by work forces to cuts in real incomes. In many countries, too, policy in the immediate aftermath of the first round of oil price increases was directed more to sustaining demand than to containing inflationary forces. Wages were pushed up to offset the higher prices, which, in turn, generated further price rises. There is some comfort to be had that, following the second oil shock, inflation has been smaller and virtually all countries have given priority to reducing it.

This change in priorities has been given concrete expression most notably perhaps by increased emphasis on controlling the money supply. Monetary control has had some success in reducing inflation, but the process has been slow and difficult. The entrenchment of inflationary expectations has meant that monetary restraint has necessitated higher real interest rates and lower real output, rather than fulfilling the hopes held out by some of a quick and relatively painless readjustment in price inflation and nominal interest rates.

Unemployment has grown substantially, and now exceeds, in aggregate, the peak level reached in 1975–76. The prospect may be for only a gradual decline. Despite this, governments hesitate to reflate significantly. This does not imply any lack of concern about unemployment. It reflects rather the perception that to treat the present symptoms as though they belonged to a cyclical recession of the earlier era would produce only a short-lived boost to activity and a further resurgence of inflation. The strength and persistence of inflation has forced fiscal and monetary authorities to concentrate on medium-term objectives rather than on short-term demand management.

The interaction of differing rates of inflation with monetary policies of differing rigour has produced a wide dispersion in interest rates between different countries. This has stimulated capital flows across the exchanges and put divergent pressures on exchange rates. It is understandable in this recent phase that countries should give priority to domestic considerations. But, in the longer run, as I will argue later, mutual concern for the effects of policy on each

other will, I think, be desirable and could itself actually help the process of domestic adjustment.

I have mentioned differing explanations of inflation. What, I think, would be undisputed is that the eradication of inflationary expectations, once they have been built up, is very difficult. I do not conclude from this that we have to accept permanently lower growth.

There are, I believe, two hopeful lessons to be drawn from recent experience. First, all countries are much more concerned with inflation and have adapted policies accordingly. Anti-inflationary policies may work slowly, but they can be seen to work—the better where there is understanding of the methods as well as a measure of popular acceptance of the aims. To foster such understanding and acceptance is a prime challenge, not only to political leaders, but also to those of business and labour. In this they may draw conviction from the second lesson, to which I now come.

Comparison of the recent performance of industrialised countries shows that a greater degree of success, both in maintaining employment and in containing inflation, has gone to those prepared to adapt in a flexible manner. Where relative prices and the relative sizes of industries are allowed to change, employment and output are better sustained. A willingness to accept temporary setbacks in living standards enhances the prospects for sustained improvement in the longer term. Societies showing greater rigidity have experienced a more severe fall in company profitability, with inevitably damaging effects on industrial capacity and employment.

Exchange rates

I turn now to exchange rates. Domestic adjustment is vitally affected by external events. A country's exchange rate is the link between its domestic economy and the economies of other countries. The exchange rate is both a means by which external influences are transmitted to the domestic economy, and an instrument for adjustment within that domestic economy. Arguably, it was the inflexibility of the way we interpreted the Bretton Woods arrangements, when confronted with the acceleration and dispersion of world-wide inflation and the growth in the size and volatility of capital flows, that led to their breakdown. In the absence of any ready-made alternative, exchange rates floated.

The turbulent conditions of the following years, with structural maladjustments between major surplus and deficit countries and massive capital flows, have resulted in unsettling fluctuations in exchange rates. This cannot in itself be taken as a condemnation of floating rates, since the underlying economic turbulence would in any event have made a fixed rate system difficult, perhaps impossible, to work. What is, however, more worrying is suspicion that the adoption of floating rates may itself have led to a greater degree of volatility than justified by the underlying maladjustments. It may also be that in some cases governments, in embracing floating rates, entertained the

illusory hope that floating removed the external constraint on their policies.

For whatever reason, our experience of the floating rate regime has led to increasing dissatisfaction. Exchange rates have shown no signs of settling down into calmer patterns. Destabilising capital flows have continued apace. Such movements may have often been in response to clearly demonstrable differences in inflation rates or monetary policy, but by no means always. The highly volatile exchange rate movements we have experienced may themselves have initiated changes in economic trends, not all of which have been constructive.

We do not, of course, have a universal free floating system, but rather a spectrum of exchange rate practices. At one end are countries with genuinely free floating rates, at the other is a regional exchange rate bloc—the EMS, within which the fixed exchange rate relationships between the partners cover a major part of their trade. A number of smaller trading countries also have adopted the course of pegging their currencies to those of their major trading partner or group of partners. In between are countries which seek with varying degrees of priority to manage their exchange rates in accordance with their domestic policy aims. I detect a growing desire on the part of governments for greater exchange rate stability, shared, it seems to me, by many in the industrial and commercial community.

It is, however, easier to look for more stability of exchange rates than to say how it should be achieved. Some may argue that incompatibilities are bound to arise in trying to pursue the twin objectives of exchange rate stability and domestic monetary targets. Certainly I would accept that the two cannot be independent and must indeed start by being consistent. I would also accept that one of the channels by which monetary policy affects the real economy is by means of the exchange rate. But my experience suggests that for much of the time national authorities are able to use exchange rate and domestic monetary policies in a complementary rather than a competitive manner.

In seeking to combine an exchange rate policy with a monetary target, there is another question. Can intervention be effective in stemming basic market trends, given the size of the resources of the market against those available to the authorities? Market movements are in some sense a judgment on the authorities' policies, and this will tend to put the two sides in opposition. I would accept that there are severe limits to what a monetary authority can expect to achieve by exchange market intervention in a situation in which the exchange rate is believed to be materially out of line with the stance of domestic policy. This does not, however, imply that there can be no role for official intervention. Non-intervention, whether openly declared or simply empirically perceived, is itself a policy from which the market draws conclusions. Exchange market expectations on occasion clearly feed on themselves. At such times official intervention may be the only way of avoiding extreme and unnecessary instability.

I am not of course advocating that all countries should pursue overriding exchange rate policies. That way several

problems lie. A locking together of exchange rates could inject too great an element of rigidity; and would not of itself provide any assurance that inflation would be controlled. It is clearly of major importance that the United States, whose currency provides a high proportion of international reserves, should give high priority, as it is doing, to controlling inflation.

In this context I must say something about the recent tendency towards a multi-currency reserve system. There have been large shifts in world official reserves over the past two years. The dollar component has fallen from 83% of total foreign currency holdings to 73%, while holdings of deutschemarks, Swiss francs and Japanese yen combined have risen from 14% to 22%. Indeed, about four fifths of the increase in foreign currency reserves since 1978 has been in currencies other than the US dollar. These changes have not led to intolerable strains, although a plurality of reserve currencies is potentially destabilising. There needs to be responsibility on the part of reserve currency countries to preserve the value of their currencies and responsibility on the part of reserve holders to stabilise their holdings in spite of any temporary adverse pressures. Perhaps it might prove helpful to seek some form of agreed understandings regarding such matters; for the multi-currency reserve system is surely here to stay for some time, and it makes sense to minimise its destabilising potential.

I know that moving in the direction of giving greater priority to exchange rate stability, even in the modest ways I have indicated, would not be an easy task. Different countries have good grounds for attaching different weights to exchange rate considerations in the formulation of economic policies. In a time of high inflation, however, I doubt that many can for long remain indifferent to the consequences of rapid or persistent depreciation, any more than even the most inflation-resistant countries can for long ignore the loss of competitiveness arising from rapid appreciation.

I find myself therefore much in sympathy with remarks made by the President of the Bank for International Settlements at that Bank's last Annual General Meeting. 'If the domestic price of money,' he said, 'is not to be disregarded, why should its external price be? Or, to put it another way, what would happen if we were to disregard both over a prolonged period? We cannot safely adopt as a principle that exchange rates should be left to their own devices. The exchange rate is too important a macro-economic variable to be relegated to the position of a residual item, in the way that the money supply was in some countries until not so long ago.' A measure of international understanding and agreement in this area would surely help governments in the pursuit of what I am sure all of you here would agree to be one of their main tasks—that is, the provision of a framework of economic and social stability within which business enterprise can get on with the job of wealth creation.

Such understanding and agreement will not be easy to achieve, for it would involve some restriction, in the

interests of world order, of countries' flexibility to decide their policies on domestic grounds alone. This is always difficult and I do not suggest that quick progress is possible. But this is no reason against directing our minds to the problem, and searching for solutions that may only be attainable over time. Although we cannot go back to the par value system of Bretton Woods, we can perhaps distil from it the lesson of shared objectives within a co-operative framework. I am mindful of the central role which the International Monetary Fund can play in this.

Conclusion

Let me now summarise the themes I have been developing. The post-war decades were characterised by sustained economic growth, low unemployment, and a high degree of price and exchange rate stability. The threat of unemployment appeared greater than that of inflation. Of course there were problems, but the Bretton Woods institutions aimed to provide greater certainty and confidence and reduce risks, especially those caused by competitive currency depreciation and interference with trade. It is difficult, even at this distance, to assess how much of the success of that period can be attributed to well-directed and effective policies within a framework conducive to success; and how much to a peculiarly favourable combination of circumstances. Perhaps there was a greater element of the latter than those who grappled with the problems at the time would readily concede. However that may be, it is clear that the record of success in that period bred an excess of confidence which has been rudely shattered by the events of the 1970s. Most dangerously, perhaps, the illusion was generated that a rising standard of living was there for the taking.

We can hardly hope to recreate the conditions of the post-war years. But that does not mean that we have to continue to live with the extreme degree of uncertainty and lack of confidence which characterises the present. If we could restore greater stability to markets, this would ease the tasks of our fiscal and monetary authorities. Equally important, it would reduce the risks that industrial and commercial enterprises incur in undertaking investment and development. Nor does a return to more stable conditions, which might promote more hopeful attitudes and fundamentally better economic performance, require the assumption of any responsibilities by governments and central banks that are not already intrinsic to their basic duties.

My purpose has been to suggest that the way forward lies in seeking to restore balance in our domestic economies, and balance between our domestic aims and their external consequences in an economically interdependent world. I have made clear that this requires settled determination, adaptability, a willingness to focus on medium-term rather than short-term goals at home, and a consistency of objectives internationally. We must bend our efforts to success in these tasks, not only to avoid drifting into beggar-my-neighbour policies from which all will ultimately suffer, but also to demonstrate our faith that the world economy can regain the path of sustainable growth.