World economic prospects

Speech by the Governor[1]

After referring to the Bank of England's role in the arrangements that led to the release of the US hostages, the Governor comments on the world scene and the better response of the world economy to the second oil shock than the first. Looking ahead, he sees the possibility of some world economic recovery in late 1981, if there are no major new shocks. After noting that expectations are less buoyant than in earlier cycles, he identifies three possible constraints on growth: problems of energy, the financing of external deficits and the danger—'still very present'—of continuing inflation.

In the midst of general exchange rate instability, he welcomes '... the extent to which the exchange rate regime of the European Monetary System has provided relative stability for its members between themselves.... Let us hope that... conditions in the United Kingdom will become conducive to our own participation in the arrangements at the proper time'.

... By quoting Lewis Carroll, he [the Foreign Secretary] has contrived gently to put us bankers in our place by reminding us that we are in essence only either clerks or a particularly clumsy form of big game. I leave that unanswered, not least because at the same time he accorded us praise for the part we have been able to play in the recycling of oil surpluses, and also said some kind words about the Bank of England's role in the arrangements that led to the release of the US hostages. These I gratefully acknowledge—but add that the invitation to assist in the financial arrangements was an honour for the City of London as well as for the Bank. For the task ordained was not only that of acting as stakeholder for very large sums: it was also to be in a position to dispose of them rapidly—but without knowing precisely when—in a manner which did not disrupt markets. The facilities that the City of London was able to mobilise in this regard were second to none, as is amply demonstrated by the success of the financial operation. I am confident I speak for all of those involved—in the Bank and in the City at large—when I say that it was a privilege to have been able to play this part in the enterprise. We can all rejoice at its successful conclusion.

This annual occasion provides an opportunity to reflect briefly on the international economic scene against the backdrop of the world political scene sketched by the Foreign Secretary. How does the world economy look today? And what are the prospects for it looking better tomorrow?

I take my cue from the reference he made to the resilience and adaptability that the institutions of the West have demonstrated. We are in recession; but we should not forget that we have in some ways managed a better response to the second oil shock than to the first. Despite the relentless difficulty of bringing inflation down, the impetus to inflation from the 150% increase in crude oil prices has been well contained. It is also, I think, encouraging how, in many countries, both industry and labour have learnt from the experience of the last recession: stocks have been more tightly controlled, wage-earners have shown a degree of moderation which has enabled profitability to be considerably better maintained, and investment has not fallen away so sharply. The spectre of protectionism, while not wholly absent from the scene, has been kept in the sidelines.

As I make these sweeping generalisations about the world at large, some of you may be considering the extent to which they apply in your own countries. I am well aware that there is a wide variety of outcomes, and that the lessons of experience have been more quickly learnt in some countries than in others. But for that convenient aggregation—the world as a whole—it seems likely, in the absence of any major new shocks to the system, that the worst of the recession is behind us; and that at some point later this year the world economy will start to grow again.

Nevertheless, one must admit that, as the end of the world recession comes in sight, expectations about the upturn are less buoyant than in previous cycles. Few of us, I imagine, think that the world economy will surge ahead rapidly, for there remain major potential constraints on economic growth. There are three groups of problems with which countries are most concerned.

First, there is concern about energy. Clearly there are possible difficulties—dangers even—but encouraging signs too. It was once fashionable to say that savings from

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conservation were likely to be rather small; we can now, I think, take the opposite view, Energy use per unit of GNP in OECD countries has declined by over 10% since 1973, and there is scope for further major savings. As higher oil prices have bitten into budgets, users have reacted more strongly than some earlier calculations would have led us to suppose. Those reactions will surely cumulate now that the view that the price of oil is likely at least to be maintained in real terms is becoming more widely embedded in the consciousness of decision-makers.

The world, of course, remains vulnerable to interruptions of supply. But it is noteworthy that the loss of exports from Iraq and Iran has not so far led to shortages, or to major pressure on prices. No doubt the recession has curbed demand. Nonetheless, we should note with satisfaction the role of international co-operation through the International Energy Agency in maintaining orderly conditions in the markets, and pay tribute to the willingness of some OPEC members to make up part of the shortfall. Energy diplomacy, if I may so describe it, has proved its worth. We cannot, however, relax efforts to conserve energy and to develop alternative sources. We have to minimise the risk that pressures on OPEC supplies could trigger further massive jumps in the oil price, with consequences for all, including the United Kingdom, which would be baleful indeed.

A second area of concern to many countries relates to the financing of external deficits. The initial distribution among oil-consuming countries of the deficits corresponding to the new surpluses of the oil-producing countries has imposed less financial strain than that which followed the first oil shock. But this time round, the surplus is expected to be more persistent; and there are signs that the counterpart deficits may be shifting towards countries less well able to sustain them.

It is in the interests of all that the banks should continue to be able and willing to participate fully in the financing which will be needed, while countries grapple with the complex but necessary adjustments to more expensive energy, new technologies, and shifts in the balance of economic strength.

It is because we believe that international banking flows are so crucially important that the central bank Governors of the major industrialised countries stressed, in a communiqué we issued last April, both the importance of the maintenance of sound banking standards and that international banking development should be carefully monitored. This constructive piece of international financial diplomacy has, in some quarters, been quite erroneously interpreted as an attempt to hinder financial flows. Our objective was, on the contrary, to make those flows sustainable; wise supervision is essential for that purpose.

It has long been clear that recycling flows through private channels will need to be supplemented by increasing flows through international institutions. We should welcome both the increased lending which has already taken place and the fact that the IMF and the World Bank are positioning themselves for further increases.

I do not doubt that most deficits will continue to be financed in an orderly way. But there are risks, and they are not diminishing. We cannot stand indifferent to the problems facing the very poorest countries, whose needs are the particular focus of international aid. And in the years ahead, as in the past, other individual countries may face financing problems. But in most of these cases I think it probable that history will judge that it was adjustment that was insufficient, rather than that financing was inadequate.

The third factor widely perceived as making for slower growth in the period ahead is the danger, still very present, of continuing inflation. Virtually all countries have come to the view that it is inflation which—at the rates at which it is running in all but a few—is the most fundamental inhibitor of growth. It is this that underlies the generally cautious stance of fiscal and monetary policy. There has been a widespread recognition that policy must embody a clear counter-inflationary emphasis for the foreseeable future.

Then there are some countries where interest rates have recently been determined less by considerations of domestic monetary policy than by the need to strengthen the capital side of their balance of payments. For such countries the fluctuations that have taken place in US interest rates have added a new difficulty. Two things are to be hoped for here. First, that inflation in the United States will be brought further under control, permitting a reduction in the absolute level of interest rates. Second, that as US markets become accustomed to the new style of monetary management, swings in US interest rates will become less extreme.

Volatile interest rates have led to volatile exchange rate movements. More generally, the effective rates for the dollar, the yen and sterling have fluctuated considerably over the last couple of years; and most European exchange rates have moved a good deal against the dollar. What is striking, however, is the extent to which the exchange rate regime of the European Monetary System (EMS) has provided relative stability for its members between themselves. That it has done so—and in such disturbed conditions—is particularly noteworthy. The achievement is doubtless partly due to the recent pattern of current accounts among EMS participants; but the effect on exchange market expectations of the firmly announced policy of adhering to the EMS margins must surely have also been important. In the United Kingdom we have naturally followed such developments with keen interest. Let us hope that this greater stability, which we welcome, will find its reflection in the performance of the economies themselves, and that conditions in the United Kingdom will become conducive to our own participation in the arrangements at the proper time.

As I listened to the Foreign Secretary's speech, I was reminded once again how much of the job of Governor could be described as financial diplomacy, and the extent to which he finds much of his traditional diplomacy coloured by economic or financial considerations. Perhaps the most striking post-war development in the financial world has been the international expansion of commerce and finance without regard to national boundaries. At the same time, the rule which guided us central bankers for a significant part of the post-war period, as indeed earlier—the obligation to maintain stable exchange rates—has now gone. But we have learnt some lessons since the 1930s. We do not now see an international free-for-all. Protectionism has been kept at bay and capital movements are freer than ever before. Nations' economies continue to become increasingly interdependent, as do their political destinies. We regularly inform, consult, co-ordinate and negotiate right across the financial and economic board. Through those processes we reach towards a community of view, a compatibility of action, sometimes more and sometimes less successfully. Following as best we may the example set by the Foreign Secretary, we have to be indefatigable in our diplomacy.