The interconnectedness of the world economy

Among the features reviewed by the Governor[1] are:

- ***Exchange rate instability.** There are perhaps two reasons for concern about possible developments in the United States '... whether too much of the burden of combating inflation will not fall to... monetary policy...' and '... the risk that US interest rates... will continue to be volatile.' 'In the conduct of monetary policy it is... consistency, patience and common sense which count, rather than obsessive concern with short-term developments in the monetary aggregates. The steadiness of purpose of the US monetary authorities has earned the confidence of other countries, and none would wish the general anti-inflationary thrust... to be weakened. It would, however, be helpful to use whatever scope exists to moderate the impact overseas.'*

  In the foreign exchange markets '... the authorities' actions are an important element in the formation of market expectations; and it would be unwise to ignore this channel of influence.'

- ***Competition from the Far East.** Adjustments are needed both from the mature economies and from the more vigorous economies of the Far East. Japan, for instance, will either be forced to slow her export growth or to import more. 'Those sectors of the older industrial economies which no longer have a realistic chance of competing are faced with a loss of markets, which is painful.' The need then is to ensure a time-scale which reduces the inevitable dislocation.*

- ***The European dimension.** The Governor touches on the lack-lustre performance of European economies, reflecting rigidities which have become entrenched over years, and whose eradication will take time and continued effort.*

Tonight, I propose to consider some general implications of the interconnectedness of the world economy, which has of course been increasing steadily in recent decades. World trade, equivalent to about 10% of the combined GDP of the market economies in 1950, is now nearer to 20%. The international capital markets, virtually non-existent in their present form thirty years ago, are now a major force.

I have no need to remind you that the last two years have seen exceptionally sluggish growth in the major industrial economies—on average, hardly over 1% a year. Leaving aside Japan, where activity has been more buoyant, the prospect seems to be for somewhat faster growth, leaving it, nevertheless, a long way short of the rate to which we became used during the 1950s and 1960s. But it may be some time before we can again hope to accommodate that pace of expansion without re-stoking destructive inflationary pressures. Combating inflation is painfully slow going for us all. With Japan a notable exception, we are still faced with inflation rates appreciably higher than they were before the second oil shock, let alone before the commodity and oil price surge of the early 1970s. We can, therefore, scarcely afford to relax the anti-inflationary stance of policy.

We can, nevertheless, hope to see some acceleration in world trade in line with the pick-up in output. At the same time, there are likely to be large shifts in current balances of payments. Some of the shifts will be in correction of previous imbalances. Some, on the other hand, will represent emerging new imbalances which will in turn call forth a subsequent process of correction.

The OPEC surplus has been contracting sharply, with oil export volume falling unexpectedly fast, while their imports have been rising rapidly. The OPEC surplus in 1982 may be under half what it was in 1980. Against this, as a main counterpart, the overall current account of the major industrial countries should strengthen substantially.

There are also, however, likely to be large balance of payments swings between the major countries. The United States has been moving towards a deficit, despite weak domestic activity; while West Germany and Japan are shifting in the opposite direction. These shifts may go further than will prove to be tenable. If so, they are likely to provoke movements in exchange rates which will, in time, work to correct the imbalance—movements of exchange rates which must in that event be counted as beneficent.

Exchange rate instability and the influence of the United States

In recent years, however, far from all exchange rate movements have been of this sort. Between July 1980 and

(1) In a speech to the Overseas Bankers Club on 1 February.

August last year, the deutschemark fell by more than 30% against the dollar. In the first half of last year the yen fell by some 15% against the dollar. Since then, in each case, nearly a third of the depreciation has been reversed. In addition, very short-term fluctuations have increased, with movements between major currencies of up to 2% in a single day by no means infrequent.

When the world first moved over to floating exchange rates, firms engaged in international trade seemed to manage surprisingly well with the additional uncertainty. More recently, with the increased volatility of exchange markets, complaints from industry have multiplied. The present degree of volatility inevitably creates great difficulty for firms in planning their sales strategy in foreign markets and complicates investment decisions. It is not easy for firms to hedge against such uncertainty, particularly in the longer term; and even when they can, the expense can be high. Exchange rate volatility must therefore represent a barrier to international trade, with effects not altogether dissimilar to the protectionist barriers which we are accustomed to deplore.

Part of the present instability may perhaps be a natural feature of exchange markets. But markets work within a framework provided by monetary authorities; and much of the instability must be attributed to the interaction of the monetary policies pursued by different countries.

In this respect, it is natural that our eyes should turn first to the United States. For its influence is disproportionate even to its pre-eminence in terms of GNP. During the last two years or so, monetary policy in the United States, as was inevitable and proper, has been directed resolutely towards containing monetary growth within announced and non-accommodating targets as a basis for bringing down the rate of inflation; and interest rates in the United States have risen. Many other countries were at first reluctant to allow their own interest rates to follow US rates for fear of the impact on economic growth. But as their exchange rates weakened, governments increasingly felt constrained to match US rates, out of concern for the inflationary implications.

Looking to the future, and greatly simplifying a complex situation, there are perhaps two reasons which underlie the concern currently expressed about possible developments in the United States. The first is whether too much of the burden of combating inflation will not fall to be borne by monetary policy, and too little by fiscal policy. Here one has to look not only at the present, but at the future, when the US economy could be recovering, perhaps rather vigorously, from the present recession. It is such considerations which give rise to anxiety, both in other countries and in US financial markets, about the prospective size of the federal deficit, and cause fears that US interest rates will remain high. The second concern is the risk that US interest rates will not only remain high but will continue to be volatile. Such volatility has effects on domestic business analogous to those I have suggested unstable exchange rates cause for international business; and is of course itself an important factor in such exchange rate instability. In the conduct of monetary policy it is, I believe, consistency, patience and common sense which count, rather than obsessive concern with short-term developments in the monetary aggregates. The steadiness of purpose of the US monetary authorities has earned the confidence of other countries, and none would wish the general anti-inflationary thrust of US monetary policy to be weakened. It would, however, be helpful to use whatever scope exists to moderate the impact overseas.

Some, I know, take the view that the authorities' position in the markets, especially in the foreign exchange market, should be very much on the sidelines, on the argument that markets cannot be out-guessed or improved by official action. I believe this goes too far. Certainly the authorities cannot impose a view in the face of a strongly-held market judgment to the contrary. But the authorities' actions are an important element in the formation of market expectations; and it would be unwise to ignore this channel of influence.

I have tried to indicate the rationale for seeking greater stability of exchange rates. I recognise that, amongst a group of countries in differing circumstances with independent political institutions, the process cannot be carried beyond a certain point. Even so, in a world where the unavoidable risks are great, it is worth striving to minimise the uncertainties which we can influence.

I would like now to move to another great risk I see in our present situation—the pressure towards protectionism. We all know that protectionism is damaging, and that resort to it by one country is likely to produce a chain reaction. Yet in a world of continuing slow growth and high unemployment, the idea of trying to protect domestic markets from foreign intrusion may look dangerously seductive, especially where the process of adjustment in long-established industries is proving particularly painful.

Competition from the Far East will mean adjustments on both sides

The difficulty is sharpened for the mature economies by the need to adjust to the competition from the more vigorous and nimble economies of the Far East. Such adjustment must happen. We cannot ask these countries to discourage efficiency or sacrifice the momentum of their economies. But it is important to recognise that a response is needed on both sides if the world trading system is to accommodate the more vigorously growing economies and, further, that the adjustments required are of various sorts.

I should deceive no one if I did not mention Japan in this context; its export success over many years is little short of prodigious. It is possible both to feel, as I certainly do, that its efficiency, flexibility and competitive strength are an example to us, and yet also to have to admit that its very success poses a dilemma for the United States and Europe. We have an example of Japan's efficiency and drive in the way that its current account has strengthened so greatly since the second oil shock. In 1980, there was a deficit of around \$10 billion; last year there was a surplus of \$5 billion; and this year estimates of the surplus range upwards from \$12 billion.

Trends of this sort cannot, of course, continue indefinitely. It is inevitable that countervailing forces should be set up—bringing the situation in time back towards balance. The increasing surplus should ultimately bring a rise in the exchange rate of the yen; and this should in turn discourage exports and encourage imports—an example of the gradual working of what I earlier called a beneficent movement in exchange rates.

Correction of the trading position does not, of course, take place in isolation. As and when it occurs, Japan for her part will face the problems of domestic adjustments—problems in partially redirecting the energies of her dominant export industries and relying more on domestic utilisation of their productive potential. Major changes of this sort, which many observers in Japan recognise to be necessary, are difficult to bring about, as other countries needing to make parallel changes should fully acknowledge. Nonetheless the whole burden of adjustment need not fall on the side of exports. An alternative would be an increase in imports; the greater the increase in imports, the smaller the pressures which will be restricting the growth of Japanese exports. It would indeed be helpful if the great Japanese trading corporations saw it to be important in their own interests to turn their great skill and influence to securing a striking increase in their country's imports. Another route would be direct productive long-term investment abroad by Japanese firms. This process is, encouragingly, already under way.

But, even given a more balanced position for Japan's overseas trade, her trading partners will still be faced with having to make structural adjustments. Those sectors of the older industrial economies which no longer have a realistic chance of competing are faced with a loss of markets, which is painful. In such cases, the principle can only be not to avoid the adjustment, but to try to ensure a time-scale which reduces the inevitable dislocation.

The tasks for Europe

Because I have been talking about the policies and performance of countries outside Europe and the way they impinge on us, I should emphatically not want to be thought blind to the need for action on our part to improve the performance of our economies. Our performance, since the last oil shock, has been relatively lack-lustre. The blame can be laid at no door other than our own, and the solution can come only from our own efforts.

Of course, the individual economies in Europe are smaller than those of the powerful countries I have been discussing. The idea of the European Community indeed derived from a visionary awareness of the benefits of economic and political interdependence, in contrast to the beggar-my-neighbour policies of a fragmented Europe that had led to two world wars. I am profoundly convinced that that vision remains valid, even though the European institutions we have established implement it as yet only weakly. Disappointments there have certainly been, but there have been achievements also. The creation of a common market serving a population equivalent in size to that of the United States has led to a dramatic increase in intra-European trade which has also favoured economic growth. The exchange rate mechanism of the European Monetary System has provided its members among themselves with a significant measure of protection against the full force of exchange rate volatility. It has not, however, resulted in the convergence of economic performance that was hoped for, and indeed the continued dispersion of inflation rates among its member countries is one of the main obstacles to moving towards further development of the Community's financial institutions.

In seeking to identify the causes of the strength and persistence of the inflationary pressures that afflict many European countries, one is bound to put weight on the rigidities that have built themselves into our economic systems over a number of years. The mixture varies from one country to another, but the ingredients include the apparently inexorable rise of public expenditure, a relative slowness on the part of corporate management in adopting innovations neccesary to keep ahead in a changing world, labour immobility, inflexibility in wage-fixing mechanisms, not only where indexation of wages is firmly entrenched, and, in some countries, the size and power of bargaining units. Many of these rigidities are no doubt the consequence of European countries being among the first to reach industrial maturity. Some have arisen from the best of motives—namely, the wish to protect those least able to defend themselves in societies whose economic success in the first two post-war decades enabled them to take a generous view of the scale and coverage of what could be afforded.

Expectations created in ampler times can no longer be met and need to be greatly moderated, as is now happening. What surely we must acknowledge is that the problems we face in these mature societies and economies are not short-term in their nature. Just as their entrenchment has been the process of years, so now their amelioration and eradication will require continued effort. The time-scale for policy-makers has lengthened, and the long furrow is the prescription for success.

In conclusion, let me return closer to home. I have sought to emphasise the degree to which our economies and our prospects depend one on another, and how only by working together can we avoid the pitfalls ahead. These perceptions lie at the heart of the City of London's role as an international financial centre, in which I take particular pride. They can be applied not only to the broad field of international economic relations, but also to relations within the City between the institutions conducting business there on the one hand and the authorities on the other. The record of the City's development, historically and over a more recent time-scale, does not support for one moment charges we sometimes face of inflexibility or hostility to competition. The authorities' endeavours, so far as they lie within my responsibility, will be to continue to seek the appropriate balance between freedom and discipline, on which the City's success is founded, and to approach the adjustments which financial institutions face —as surely as other institutions—in a spirit of flexibility and through mutual consultation.

Mr President, I take the health and well-being of the Overseas Bankers Club as a particularly appropriate demonstration that the bankers of the City not only preach interdependence but practise it. We and your guests have especial reason to welcome this and to express our gratitude to you for it. . . .