World economic stagnation and recovery

The ***Governor*** *gives a wider review of the international scene. Among the points he makes are:*[1]

- *The second oil shock forced on us restrictive measures to bring inflation under control. These played a part in bringing growth to a standstill—as did other factors which have been at work for a long time.*
- *We have now begun to enter a new phase. Good progress has been made in reducing inflation. The costs of counter-inflationary policies will not now be as great because continued progress will allow more scope for countering depressive influences.*
- *Few other single developments would be so helpful for world recovery as a further substantial fall in interest rates in the United States.*
- *In this country, bank lending provides an essential support to the economy, which monetary policy must seek to accommodate.*
- *Developing countries' debts were created in a less depressed world. A necessary process of adjustment is under way by the countries concerned—and by the banks who lent to them. It is important that we confront that problem with good sense on all sides.*
- *The volatility of exchange rates has been inimical to growth. The commitment of governments to strengthen the IMF in exchange rate surveillance needs to be made a reality.*
- *The international financial institutions' share in financing will need to increase, and they must have sufficiently large resources to meet that.*

There can I think be little dispute that it has been another difficult and disappointing year for the world economy—despite some hard-won and very welcome developments which are significant for the future. Stagnation recognising no frontiers has further extended its hold, and now apparently threatens even virile economies in the Far East, so far largely exempt from recession; and the recovery we would all like to see remains elusive. It is hardly surprising against this background that there have been sharpened political tensions, trade frictions and financial stresses.

In commenting on this situation I shall take a wide canvas—wide in time, because I am persuaded that many of the factors conspiring to bring growth to a virtual standstill have been at work in our economies for a long time—and wide in extent, because I have seen at first hand over this last turbulent decade the vastly increased economic and financial interdependence of the world economy.

It is well to remember that there were signs that inflation was accelerating even before the first oil shock. At the same time the Bretton Woods arrangements, which had played a key part in regulating international financial relations over the post-war years, had become unsustainable.

But looking back over the years one is bound to see as principal contributors to some of our worst problems the two explosions in oil prices, which, in the words of Helmut Schmidt, 'changed the scene like volcanic eruptions'. They forced major adjustments on countries throughout the world; decisively exacerbated inflation; and forced on us restrictive counter measures in our efforts to bring inflation back under control and to cope with the serious imbalances in international payments to which they gave rise.

The positive side of the picture

In this perspective, it was inevitable that the Western industrial world should embark on a process of disinflation. The measures taken have been rewarded with some signally positive results.

I cite, first, developments in the oil market—the easing in the price and the elimination of the OPEC surplus—owing something to recession but, encouragingly, perhaps more to greater efficiency in energy use. The importance of this adjustment, and the relief afforded, is best conveyed by the scale of disturbance previously caused.

(1) In a speech at the Lord Mayor's dinner to the bankers and merchants of the City of London on 21 October 1982.

I cite next—as the major accomplishment—progress on inflation itself. In industrial countries the rise in consumer prices has been reduced to half what it was two years ago. In the United States many hope to see the rate down to 5 per cent next year, and it is of course lower than that in Germany and Japan. In this country also we have made striking progress. We have, nevertheless, had a degree of help from external factors which could be temporary. The hard core—inflation of labour costs—remains too high and needs to be further reduced.

In the third place I must also point to helpful developments in the United States. What had been widely seen as a conflict between an expansionary fiscal policy and a determined counter-inflationary monetary policy has been eased by action to reduce the budget deficits over the next years. That, and the marked deceleration of the momentum in inflation, have allowed the Federal Reserve Board a greater flexibility in monetary policy without jeopardising continued progress towards price stability. The recent high level of interest rates in the United States imposed a large burden on many countries, developed and developing alike. It is highly welcome that they have dropped significantly. Without it, so large a fall in our own interest rates would hardly have been possible.

Beyond these major advances I like to think that I detect in this country at least the beginnings of a change in attitudes—a growing recognition among workers that wages, productivity and jobs are linked; among managers that competitiveness has to be won by efficiency; and among people at large that public expenditure has to be paid for and therefore must be kept under control.

Economic stagnation

But the dark side of the world picture is the long period of slow growth since the second oil shock. In the last year or so economic activity in industrial countries has failed to grow; and there could be forces inclining the world economy to continued stagnation. Many of the industrialised countries have recently seen exports falling away—in part reflecting weaker demand in OPEC and developing countries—which has contributed to the erosion of business confidence. And we cannot be confident that unemployment, already higher than at any time since the 1930s, will not grow further.

I need scarcely say that it is not we in the developed world alone who are affected. World recession on the present scale has fallen with especial force on the developing countries. The prices of commodities are now lower in real terms than at any time in the last thirty years. This may seem convenient for us in that we pay less for imported materials, and inflation is reduced. But for those who produce them it means lower incomes forcing them to cut imports.

Developing countries and international indebtedness

The position of different developing countries differs markedly. Most—and certainly the poorest—have little access to international capital markets. Their current balance of payments deficits have been limited by the availability of official finance; and they have had no option but to try to adjust to the worsening situation. For others the impact of falling commodity prices has been compounded by the burden of the external debt—most of it banking debt—they have incurred over the last decade. Heavy indebtedness is concentrated in a relatively small number of countries. Half, in fact, of non-OPEC developing countries' debt has been incurred by five countries. The rest is more widely spread.

These debts were created in a less depressed world; and were based on assumptions of growing export earnings which have not been met. For the countries concerned a necessary process of adjustment is under way.

Adjustment is also being made by the banks who lent to them as balance sheets have to be adapted to today's reality. In the environment in which the banks were operating, while balance sheet growth was readily achieved, assessment of risk had become altogether more difficult.

In retrospect it is hard to avoid the conclusion that, at times, lending was carried too far. Yet how many foresaw the recent level of interest rates, or the continuance of depressed world conditions in which the debt service would have to be found? But we are where we are; and it is important that we confront that position with good sense on all sides.

For the heavily indebted countries it is obvious that further bank finance will not be available on the scale it has been in the past. This will mean more adjustment, and in many cases restructuring of debt. While the rescheduling of debt is one of the problems facing international banking, it can equally on occasion be part of the solution. For it must be better to enable a debtor to repay his debts over a realistic timescale than to force him into default.

In their own collective interest the banks need to accept that it would be self-defeating to attempt quickly to reduce their exposure in respect of debtors whose creditworthiness has changed. It is in all parties' interest, also, for banks to continue to deal with individual borrowers on their merits, and not to treat all borrowers from one geographical area as identical in behaviour or prospects. Failure to act in these ways would not only further reduce world trade: it would also weaken the international banking system.

The domestic role of the banks

The role of the banks as international financial intermediaries parallels in importance their role in providing a channel of finance to domestic borrowers. In many countries recession has created equally serious difficulties for their customers at home.

In this country firms have done a great deal to better their position in the last two or three years. Vigorous exercises in shedding unnecessary costs and unprofitable activities have been carried through. Nevertheless the going remains rough.

A year of two back firms' immediate financial position was eased as they ran down stocks. This phase is now over, and firms this year have increased their bank borrowing considerably. The pace of bank lending complicates the task of the authorities in controlling monetary expansion. But it provides an essential support to the economy, which monetary policy must seek to accommodate. Nevertheless, from the point of view of both the banks themselves, and of their customers, the extension of credit is bound to raise increasing problems at a time when continued recession makes the test of future profitability difficult to apply.

Reasons for lack of growth

I turn back then to the wider question of the world economy. Economic growth has been very restrained for several years. It is worth asking why.

It is, I think, sometimes too readily assumed that the stalling of growth can be wholly related to the effects of the restraining stance of policies adopted to counter the inflationary impact of the oil shocks. Without question such policies have played their part. But other factors which have helped to bring growth to a standstill and cause the rise in unemployment on a worldwide scale are by no means recent in our economies.

Real corporate profits, which are needed to support investment, were being eaten away. Because real labour costs had risen too rapidly, much of the investment that has taken place was directed towards saving labour rather than towards increasing output. Higher taxation has hampered enterprise, and workers have sought wage increases to maintain the purchasing power of take-home pay.

I myself would give especial weight to a general factor—the increased uncertainties under which business has been operating in recent years. Uncertainty has been increased by inflation itself; by variable—often highly variable—interest and exchange rates; by protectionist measures; and by uncertain demand prospects.

The conclusions I draw are that, since there have been many factors holding back growth, action is needed on many fronts; and that renewed expansion can only be gradual. Companies must be optimistic enough about future trading conditions to warrant undertaking the commercial risks involved in planning for greater output, higher employment and ultimately greater investment. They need to be confident of reasonable profit; and confident therefore that the policies of unions and of governments will not produce explosions of wages, of prices or of taxes which would destroy the expectations on which their undertaking of risks is based.

We have, I suggest, begun to enter a new phase. The process of disinflation is powerfully at work. Good progress has been made in reducing inflation itself. Interest rates have come down. Though inflation is far from having been defeated, the costs of continuing with counter-inflationary policies will not now be as great as the costs of the first phase because continued progress will allow more scope for countering depressive influences.

Chairman Volcker's recent announcement is thus, I believe, significant. It represents a modification, not an abandonment, of previous policies. Though a long-standing advocate of monetary targets, he has stressed the need also for 'judgment, interpretation and flexibility'. As he has indicated, the behaviour of the monetary aggregates has therefore to be judged along with other factors—among them the course of business activity, the international scene and interest rates.

In this country, also, our response has been similar. Two years ago monetary growth overshot the target—even though other factors suggested that monetary policy was pressing tightly on the economy. The overshooting was in part because bank lending to industry was unexpectedly large, despite the onset of the recession. This year, too, bank lending is high, despite continued recession; and industry remains hard-pressed.

I have already welcomed the fall in interest rates this year in the United States. Real rates nevertheless remain high. A further substantial fall may not be easy. But if it were to occur, it would support activity in the United States itself and other industrial countries and assist the developing countries in their difficulties. Few other single developments would be so helpful for world recovery.

International co-operation

We cannot, of course, look to others to solve our economic problems. That responsibility rests in our own hands. There are, however, various areas where more effective international co-operative action could improve the prospect for success of domestic policies in different countries.

First, exchange rates. As I have said before, the uncertainty created by the volatility of exchange rates has been inimical to growth. Few would claim that there has been anything optimal about recent exchange rate movements. And the feeling that other currencies are undervalued—especially if it is felt that they have been deliberately undervalued—can powerfully increase pressures for protection.

At their meeting in Versailles, Heads of Government explicitly recognised the responsibility of reserve currency countries, in the interests of stability, to maintain the internal and external value of their currencies and, on a multilateral basis, to strengthen co-operation with the IMF in its task of exchange rate surveillance. These commitments must be built on, and the promised co-operation made a reality.

The second area where there is pressing need for more co-operative international action is in the field of trade. We must hope that the forthcoming GATT Ministerial meeting will address itself seriously to the increasing manifestations of protectionism now appearing—as if the experience and lessons of the 1930s had never been.

My third point concerns the international financial institutions. They are there to see that countries are not unnecessarily driven by financial difficulties to actions which would damage world trade or the structure of international credit. These institutions have a unique role in assisting countries to adopt appropriate adjustment policies. Their share in financing will need to increase relative to that provided by commercial banks, and they must therefore have sufficiently large resources to meet that enlarged share. I share the Chancellor's sense that, at the annual Bank/Fund meetings in Toronto, the urgency of this need was becoming more widely recognised; and I hope it is not just optimism that gives me confidence that this momentum is being maintained and strengthened. Rapid agreement in this area would do much for confidence.

A recovery in which inflation continues to decline

It is time to bring the strands together. I have sought to show that our problems, severe as they are, must be seen in a long perspective and in the context of a world of increasing interdependence in respect of trade, of capital flows, and of the international exposure of banks.

We are embarked on a major struggle of adjustment directed both to the control and defeat of inflation and to the recovery of our economies. Inflation has yielded ground and there are encouraging signs of other adjustments. But within this country, as in others, we cannot relax our efforts to defeat inflationary expectations and to improve the efficiency and flexibility of our economy. There is no panacea, no magic answer. In particular, it would be folly to retreat from continued commitment to price stability. This time we need, as Anthony Solomon of New York has recently reminded us, a recovery in which inflation continues to decline. It is our task to help in achieving that.