The economic scene: a global perspective

*The **Deputy Governor** looks at some of the underlying problems in the world economy which have brought us to our present less than satisfactory position;*[1] *he considers how far we have been able to overcome them; and he discusses how much more needs to be done to ensure that the rest of the 1980s are more healthy and prosperous than the past few years.*

Some underlying issues

The world economy now seems to be coming out of its worst recession in the post-war era. This should fill us all with a sense of relief. At the same time, however, there are important respects in which the legacies of the two oil shocks, and of even earlier economic developments in the fifties and sixties, remain with us.

Among these I would pick out two important groups: those relating to structural questions, both in the industrial world and also in the developing countries; and those which might be called systemic questions linked, for example, to the operation of the international monetary system, to structural change in domestic financial sectors and to the arrangements for international trade.

Consequences of the oil price shocks

The first two post-war decades were a period of remarkably rapid and sustained growth in the world economy. Output in the major industrial countries increased on average at $4\frac{1}{2}$ per cent a year, and while there were cyclical fluctuations around this trend, on the whole they were relatively modest. In these comfortable conditions, it is not surprising that rigidities developed both in industrial and financial structures and in the attitudes of individuals, trade unions and company managements; and that, in the public sector, spending plans came to be framed in the confident expectation that an expanding economy would provide the resources to finance increased real outlays.

When the first oil shock came, relative prices were slow to adjust to the sudden terms of trade loss implied by the rise in oil prices. In particular, wage earners, accustomed to steadily increasing real incomes year after year, resisted cuts in their living standards. Powerful inflationary pressures became embedded in the economic and financial system; this prolonged and reinforced the initial impact. Company profitability suffered and uncertainty—about prices, interest rates, exchange rates and indeed official policies—increased.

This was a difficult period for the operation of financial markets which had evolved in a more stable economic environment. Meanwhile, as growth slowed, public sector spending moved increasingly out of line with revenue, and public borrowing increased sharply. In addition, a number of countries adopted deliberately expansionary fiscal policies in an endeavour to support activity, increasing borrowing further. At the same time, monetary policy was generally accommodating.

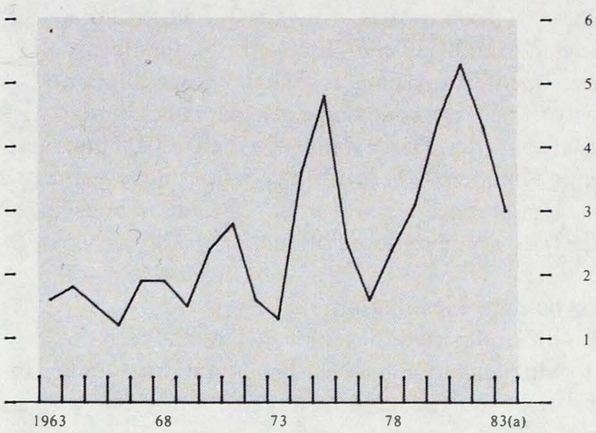
If the slackening in growth had been no more than a normal cyclical fluctuation, the problems might have been less severe. But in the event, trend growth rates seem to have been slowing in the early part of the 1970s and maybe again after 1979. As a result of these developments, the ratio of public sector debt to GNP in the major industrial countries taken together began to rise strongly from the mid-seventies, after nearly three decades of decline.

In short, the first oil shock radically altered the premises upon which the economic behaviour of governments, wage earners, companies and financial markets were based. Their responses provided the impetus—if one was needed—to the inflationary process which became so firmly entrenched in the course of the 1970s. This posed difficult questions for the conduct of macroeconomic policy to which I shall want to return in due course. The point I would emphasise here is that by the time the external shocks arrived, many economies had become less capable of adapting to them and, by the same token perhaps, less responsive in terms of real output to the kind of demand stimulus which had been a major tool of macroeconomic policy in the post-war years. At the same time, both the magnitude of the shocks and the rapidity with which they were transmitted between countries increased significantly.

Similarly, in the developing countries, the period of sustained world growth during the fifties and sixties provided an environment in which expectations of continuing improvement in living standards were established. When oil prices rose there was in many cases an understandable reluctance to adjust to a rate of domestic growth which subsequent experience suggests would have been prudent. Many developing countries continued to expand at much the same pace as previously. Thus, GNP in the non-oil developing countries, after increasing at a little over 5 per cent per annum in the decade 1963–73, was still rising by only a little under 5 per cent per annum over the following decade.

(1) In a speech to the Sixteenth World Congress of the International Union of Building Societies and Savings Associations, in Melbourne, on 3 October 1983.

Chart 1
Non-oil developing countries: current account deficit as a percentage of GNP



(a) Partly forecast.

But with much slower growth in their markets, and weaker terms of trade, the current account position of the developing countries deteriorated and substantial debts were accumulated. In this respect, there are obvious parallels with the position of public sectors in the developed countries whose governments were also, partly because of political constraints, unable or reluctant to cut back on the growth of spending.

Changes in the international financial system
A second group of longer-term issues relate to the international financial system. After the first oil shock governments proved slow to realise the magnitude of adjustment which would prove necessary in due course; but equally slow to provide through official channels the extra funds that were undoubtedly necessary to finance the new international imbalances in the short term. The commercial banks were, however, eager to expand their international, and especially their sovereign, lending, which was perceived by all too many at the time as being virtually risk-free.

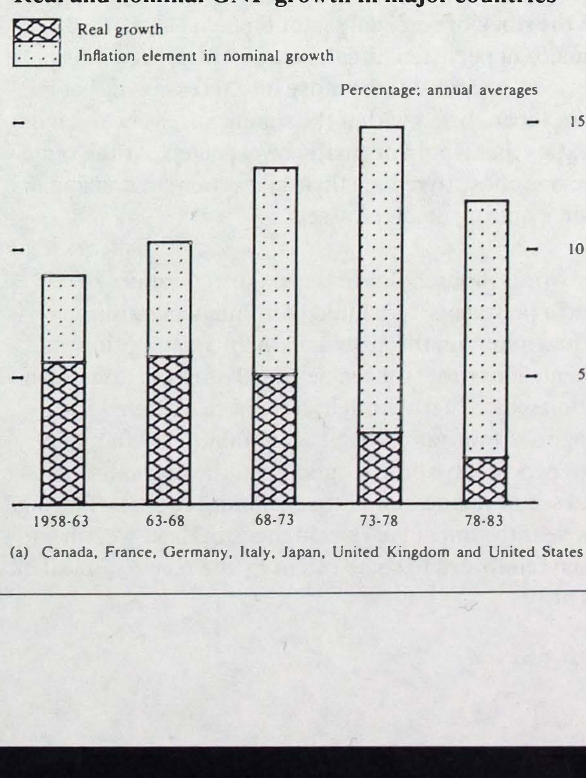
At the time, the availability of finance probably helped to sustain activity; but in retrospect, some of the lending can be seen as resting on a false prospectus. It could only be validated as long as major governments postponed the unpleasant business of tackling world inflation. The extent of the adjustment required of many oil-consuming countries was probably underestimated—and perhaps no longer fitted readily into the framework or time scale of IMF lending programmes, even after the introduction of the Extended Fund Facility.[1]

On the trade side, an increasing degree of liberalisation characterised much of the first two post-war decades. This liberalisation no doubt contributed to strong and sustained growth and a steady increase in the degree of integration and interdependence in the world economy. Over much of this period, international trade grew almost twice as fast as total output in the OECD area. More recently, however, as growth rates have declined and pressure has developed to support depressed sectors of industry, it has proved impossible to maintain the momentum towards liberalisation.

Indeed it has proved increasingly difficult to prevent the spread of protectionist measures. These have in general been introduced in more subtle ways than before and with an emphasis on bilateral and discriminatory as against multilateral restrictions. Their scope and their effects are, not surprisingly, difficult to quantify. But it is clear that such measures—let alone a further proliferation—could impair the sustainability of the economic recovery that we are now observing. In particular, additional trade barriers could pose severe problems for those heavily indebted countries that are dependent on exports at the lower end of the manufacturing range, the category that is most often subject to trade restraints of some kind or other. In the present financial circumstances anything which threatens their export revenues and hence their ability to meet debt servicing commitments has to be taken seriously.

What were the overall effects of these longer-term influences? I spoke earlier of the satisfactory economic growth performance of the 1950s and 1960s. In retrospect, however, it is now clear that the quality of this growth was deteriorating, while the effectiveness of conventional policies in securing real growth was diminishing. Even before the first oil shock, the industrial countries were beginning to show signs of accelerating inflation and rising unemployment. Thus, over the five years from 1958 to 1963, nominal demand in the major countries grew by 42 per cent and two thirds of this reflected growth in real terms. Ten years later, between 1968 and 1973, nominal demand grew by 69 per cent but the proportion represented by real growth had fallen to little more than one third. After the first oil shock the split between real growth and inflation became even less favourable. But it is important to

Chart 2
Real and nominal GNP growth in major countries[a]



(a) Canada, France, Germany, Italy, Japan, United Kingdom and United States

(1) See article on page 546.

remember that those financial earthquakes of our time—the breakdown of Bretton Woods and the two oil shocks—were as much effects of deepseated troubles already present as they were causes of further difficulties.

Recent history and present prospects

Coming nearer to the present, the last few years have been a period of peculiar difficulty. Our economies had to absorb a second huge increase in oil prices and inflation went close to the peaks of the mid-1970s once again. Expectations of growth have had to be revised down sharply. Last year, for example, OECD countries' GNP was only 2 per cent higher in real terms than in 1979, while consumer prices were up by nearly 35 per cent. Over the same period unemployment rose by over 10 million, to 30 million. And we face a pattern of accumulated debt which poses serious problems for many countries and companies and for the international financial system.

Response of the personal sector

The housing sectors of the major economies have not, of course, been immune from the economic slowdown. Real personal disposable incomes rose only slowly between 1979 and 1982 which, of itself, would have depressed expenditure on housing. At the same time, however, two important financial influences were at work.

In the first place, monetary policy has been generally tight in order to combat inflation, while fiscal deficits have been affected by the recession and by various structural factors. Partly in consequence, interest rates, both nominal and real, remained high even as the recession deepened. You will not need to be reminded that residential investment is one of the more interest rate sensitive components of demand.

In the second place, the personal sectors of a number of the major economies have been going through a process of financial adjustment. Research suggests that this was, in part at least, a legacy from the inflationary conditions of the 1970s. This period had seen a substantial erosion of the real value of the stock of personal sector financial assets, a consequence of persistent inflation and widespread falls in equity prices. As a result, the move into recession did not (except in Japan) bring with it the significant cyclical fall in saving ratios that would normally be expected. At the same time persons chose to reduce their investment in housing in favour of acquiring financial assets.

In other words, households in the major economies indicated a preference to rebuild their financial positions rather than maintain the growth in their consumption and investment. This process even persisted after the downturn in inflation which of itself might have been expected to encourage a slower rate of asset accumulation. After 1979 there appears to have been a build up in the real value of personal sector financial wealth, excluding equities. During the past year the impact of this on their total net wealth will have been reinforced to some extent by the recovery in stock market prices.

To some extent, high interest rates will have encouraged this shift in household financial behaviour. The combined effect, together with the normal impact of recession, was a substantial fall in private residential investment in the major industrial countries. Between 1979 and 1982 this amounted to over 20 per cent. By contrast, other forms of fixed investment, if anything, rose slightly over this period. Obviously there was a wide range of experience among individual countries. Hardest hit were the United States and the United Kingdom, where declines in housing investment of 30 per cent or more were recorded. In terms of housing starts the falls were even more dramatic.

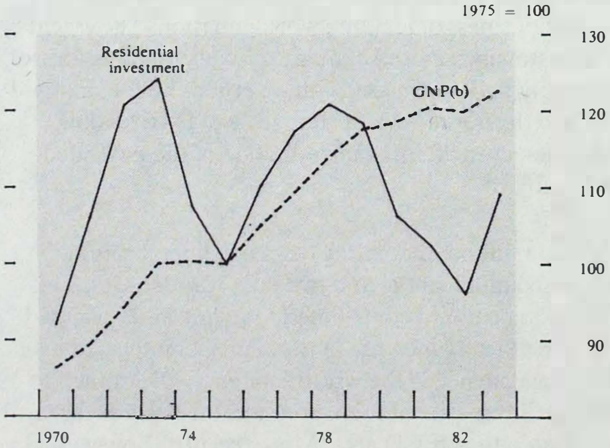
Progress on reducing inflation

Over this difficult period the major success has been the extent to which inflation has been brought down as policy in the industrial countries has been directed firmly, and with a striking degree of unanimity, towards this end. From an average of nearly 13 per cent in mid-1980, the rate of consumer price inflation in the major countries had fallen below 5 per cent by the middle of this year. This should help to provide the basis for a resumption of growth; and recently there have indeed been encouraging signs that the recession may be easing.

The clearest indications have been in the United States and Canada where output has risen strongly since the beginning of the year and where confidence seems to be growing. But there have also been some promising developments elsewhere. In Germany the gloom about industrial prospects seems gradually to be giving way to cautious optimism, and growth in Japan, although relatively modest by past standards, has nevertheless been maintained. In the United Kingdom there has been a quite marked revival in consumer demand.

The housing sectors of the major economies appear to be playing their part in this revival. Leading indicators such as starts and building permits bottomed out in the course of 1982, and the more comprehensive measure, private residential investment, began rising in the final quarter of

Chart 3
Housing and the economic cycle in major countries[a]



(a) Canada, France, Germany, Italy, Japan, United Kingdom and United States.
(b) Partly forecast.

the year in most of the major industrial countries. This upswing continued in the first quarter of 1983 and, taking the major countries as a group, housing investment had risen by more than 10 per cent from its low point last autumn. Preliminary estimates for the second quarter suggest that it has grown further.

Although residential investment is a relatively small component of GNP in the major countries—just over 5 per cent on average in the 1970s—it has an influential role in the course of the economic cycle, particularly in the upswing, because of the speed at which it can revive. It has been a fairly common feature in the post-war period that private consumption and residential investment have led total demand out of major cyclical troughs. The present upturn appears to be no exception to that general rule, with, on this occasion, additional impetus coming from stockbuilding. All of this still, however, leaves open the question of how far the corner has really been turned. What we have seen so far is the first phase. The next—and undoubtedly crucial—step is the transition to a pattern of economic growth that can be sustained over the longer run. This will depend especially upon a robust recovery in business fixed investment.

The short-term prospects

Many of you will, I am sure, be familiar with the general picture presented in recent forecasts by the various international institutions. Broadly, they suggest that output growth in these countries may run at an annual rate of a little over 4 per cent in the second half of this year before settling down at about 3–3½ per cent through 1984; and that unemployment will cease to rise, but may not come down significantly. Residential investment is expected to contribute further to this recovery, but may lose some of its momentum by the second half of next year. In this environment inflation in the major industrial countries is seen as remaining subdued, possibly edging up a little from its present rate of under 5 per cent; oil prices seem unlikely to increase very much, certainly not in real terms; and in the foreseeable future real non-oil commodity prices, even after the recent revival, may remain lower than at the last peak in 1979. For OPEC, a weak external position is likely to mean continuing restraint on imports. More important, however, the recovery is likely to leave the developing countries, and particularly the major debtors, under severe pressure.

Underlying present expectations of recovery is, I think, a judgement that some of the imbalances exacerbated by the oil shocks have been eliminated, or at least contained. I have already mentioned the behaviour of households who held back from spending in an effort to restore their financial positions. To a significant extent this was directly paralleled by the behaviour of companies which reacted to weak profits and low demand for their products by cutting back on fixed investment and stocks and also by slimming down their labour forces. It is to be hoped that this financial adjustment on the part of households and companies is now largely complete. From the point of view of households this seems to be the case. In a number of countries saving ratios have recently fallen back and consumer spending has picked up. And, as we have seen, so has investment in housing. For companies, however, the picture is less clear-cut. Company profits appear to have picked up, destocking is ending and investment, in some sectors anyway, is showing signs of increasing again; but we are still waiting for investment intentions to be translated into actual spending.

Some immediate problems

Altogether, though we may permit ourselves some cautious optimism, we cannot be sure that all the impediments to a sustained economic revival have been fully overcome.

Real interest rates

One of the most striking features of the present situation is the apparent height of real interest rates, even with recession still as deep as it is.[1] There are, certainly, difficulties of measurement, especially for long rates. But on any plausible expectations for inflation real short rates seem now to be of the order of 3–5 per cent in most of the major countries. Nominal interest rates have fallen from their peak of mid-1982, but so too has inflation. This is to be contrasted with the 1970s when real rates were often negative, to the extent of 5 per cent or more on occasion. This raises several important issues, not only for financial markets and those, such as yourselves, intermediating between savers and borrowers, but also for the course of economic recovery. What lies behind this shift back to significantly positive real rates? Are real rates too high? What is going to happen to them?

With respect to the rise in real rates, a first factor, particularly at the short end, has no doubt been the efforts made by governments and central banks to curb deeply entrenched inflationary pressures through the imposition of restrictive monetary targets. With inflation proving intransigent, and nominal income continuing to increase strongly, this meant that high—indeed rising—interest rates were necessary to contain monetary growth. At the long end, too, the experience of inflation has no doubt been a powerful factor. Savers may not yet be fully confident that the success in bringing inflation rates down will be maintained; here the difficulties in interpreting monetary developments may compound the uncertainties, especially when monetary aggregates are growing outside their target ranges in a number of countries.

But developments on the demand side may have been just as important, in particular the increased absorption of funds by public sector borrowing. I have discussed earlier some of the factors underlying these wider public sector deficits. In terms of the international implications, the problem is most acute in the case of the United States. There, it may be less the present than the prospective size of federal deficits, even if activity continues to revive, which gives reason for concern. Finally, I am myself in no doubt that interest rates along most of the spectrum incorporate a high uncertainty

(1) Real interest rates over the past thirty years are discussed in the note on page 471.

premium, the unwelcome fruit of the extreme volatility we have been through.

Are real rates currently too high? Certainly we would all like to see them somewhat lower. But it must be realised that the 1970s were an exceptional and unsatisfactory period. Rates of monetary growth and inflation were rapid, at least until the end of the decade, as governments tried to reduce, or at least stem, the rise in nominal interest rates by adopting accommodating monetary policies. Savers were understandably slow to adjust their expectations to these developments and tended to underestimate inflation. They were in effect fooled. But this episode illustrates that it is not possible to fool all the people all the time. Savers become more aware of the need to protect their assets against the ravages of inflation. Even before the shift to a restrictive policy stance there were signs that real rates too were no longer falling and in some cases were beginning to rise. In the 1960s real rates were positive, usually in the 2–3 per cent range, and not very much below the real rates of growth of the period. Indeed, in a more stable and healthy environment such a relationship might be expected. It reflects a natural balance between the conflicting interests of savers and borrowers. Excessively high real interest rates will deter borrowers and tend to reduce the demand for credit. Excessively low rates will equally drive savers to find alternative savings media, including of course precious metals.

This suggests then that—over the long run—real rates should be positive but somewhat lower than current levels. Indeed some reduction in real rates may be necessary if the emerging world recovery is to be sustained. The required adjustment may, however, be complicated by the tendency of monetary aggregates to be boosted by financial deregulation at a time when monetary policy is geared to the attainment of money targets. And, as the experience of the 1970s illustrates, it would be wrong to use monetary policy to try to achieve this directly. Rather, a better balance between monetary and fiscal policy must be achieved in some countries. More generally, we must wait patiently for markets to be convinced that inflation in the major countries is not going to pick up again (which means I suppose that real rates measured by the public's present expectations may sadly not be as high as official comment sometimes suggests).

There is, of course, an international aspect to interest rate determination. The linkage is the movement of international capital which in recent years has proved highly responsive to financial conditions in different countries. International financial flows have always been interest sensitive. But this sensitivity has been heightened by the process of liberalisation of capital movements, combined with technological progress in the transmission of information and funds. In effect many domestic financial markets have now become part of a much larger international financial network.

In the early 1970s, the conventional wisdom seemed to be that floating exchange rates would permit countries to run independent domestic policies and insulate themselves from the policies of others, with capital flows playing a stabilising role. In practice, however, capital flows have not always been stabilising, sometimes for prolonged periods. In addition, many governments have not been indifferent to movements in their exchange rates; in recent years, for example, exchange rates have been seen as a significant factor in the fight against inflation. As a result, many countries have felt the need to adjust domestic policies in an attempt to offset the effects of, especially, US policy and financial developments on their exchange rates. Such domestic policy changes have not been altogether successful, witness the substantial appreciation of the dollar since 1980, but the overall effect has been for policy in many other countries to be tighter than domestic circumstances would have dictated. This may have been particularly so for low inflation countries, such as Japan or Germany, where high real interest rates have still not been sufficient to ease materially the downward pressures on their exchange rates.

Exchange rate movements

Closely related to these questions about fiscal and monetary policy and interest rates are the issues raised by the pattern of exchange rates that has evolved over the past three years and which I think gives grounds for concern. The exchange rates of some of the major economies have moved over the past two or three years to levels which seem to be appreciably out of line with trading competitiveness. There may be no universally satisfactory measure of competitiveness but some indication of the present position is given by noting that, after adjustment for exchange rate changes, US unit labour costs have risen by more than 40 per cent over the last three years in relation to those of its major competitors, while on the same basis relative labour costs in Japan have risen about 10 per cent (but from a very low base) and those in Germany have declined by something of the order of 12 per cent. The effects of these shifts are now beginning to show up in trade balances. The United States is moving into substantial deficit while significant surpluses are emerging in Germany and Japan. The longer a pattern of exchange rates such as the present one persists, the greater the risk of instability in future if disparities in competitiveness are to be reduced. It is hard to tell when any adjustment might take place, or how far movements might go. Experience during the era of floating does, however, suggest that the movements are unlikely to be smooth and that there is a considerable likelihood of overshooting and oscillation.

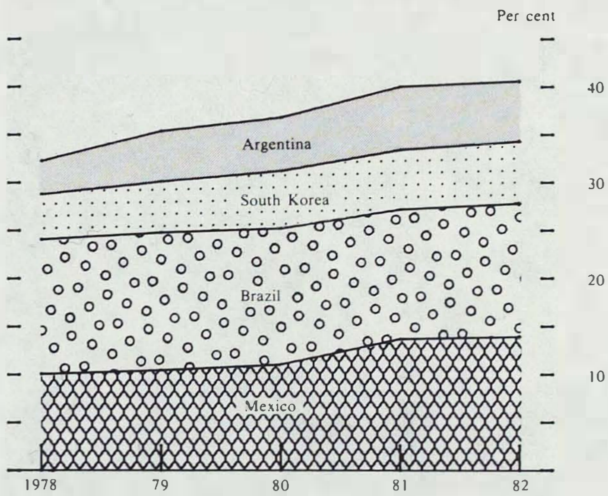
These issues of macroeconomic policy, and particularly the concern about the interaction of policies in different countries, have been behind the initiatives on convergence and surveillance taken last year at Versailles and developed further this year at Williamsburg. While views may differ between the countries involved, and the balance between domestic and international considerations may vary between countries, the principle of consultation has now been recognised and some progress has been made. It is to be hoped that the process can be carried further in future.

International debt problems

The third, and in some ways most pressing, of current problems is the question of how to contain, and in due course eliminate, the debt service difficulties which at present beset some major developing countries.

By 1982, total debt of these countries had reached some $540 billion—over five times its 1973 level—and the ratio of debt to exports had moved up beyond 150 per cent. More important, perhaps, than the overall level of debt was its concentration in a small number of countries. This, combined with a substantial shortening in the maturity of debt in recent years, added to the vulnerability of the situation. This vulnerability was exposed as the recession deepened and interest rates went sharply positive. The debt servicing capacity of a large number of developing countries was undermined by the weakness of their export revenues, the high level of interest rates and the strength of the dollar, the currency in which much of their debt was denominated.

Chart 4
Concentration of debt: major borrowers as a proportion of all non-oil developing countries' debt



Source: IMF World Economic Outlook.

The speed with which debt problems came to a head threatened serious damage to the financial system. After the moratorium declared by the Mexican authorities last August, there was a risk of widening and escalating liquidity difficulties. Thus far, these risks have been contained through the combined efforts of the IMF, the central banks of the major countries and the commercial banks. It would certainly be too much to claim that a clear approach has now been established for handling debt difficulties, but some of the important elements in such an approach may have been identified.

Even so, what I have described can perhaps only be seen as a tactical response to the problems which have arisen. For the future there is a deeper question about the sustainability of present debt positions. It seems difficult or impossible at this stage to reach any firm conclusion—much will depend, in any case, on the performance of the world economy generally. In the meantime, however, various steps are being taken to enhance the capacity of the international financial system to support the severe adjustment which the borrowing countries are necessarily undertaking.

Conclusions

Let me now return to my original theme: the outlook for the world economy. Where does all this leave us?

A central role will, as always, be played by the United States. There are signs that a momentum is building up in the US economy—indeed it has seemed at times that there was a risk of things going too fast. It is quite possible to conceive of a virtuous circle in which strong growth in the United States is sustained without provoking a resurgence of inflation, in which interest rates over time come down and in which a revival becomes established in the other major economies. In this environment the developing countries, with expanding export markets, would be better placed to meet their debt service obligations. And they would, too, benefit to the extent that the dollar weakened. In the circumstances, an outcome of this kind would seem satisfactory and we must hope that it can be achieved.

There must, however, be a risk that after a short-lived flurry, growth in the industrial economies will revert to a rather modest rate, possibly with, or because of, high real interest rates, and that the developing countries will be faced with a harsh economic environment extending not just over the next two or three years but much further into the future. Such an outcome would add significantly to the already difficult dilemmas faced by economic policy makers. It is worth concluding with a few thoughts on this.

In my view, a weak or aborted recovery would reflect the continuous presence of the sort of rigidities I discussed earlier. The challenge will be how best to direct macroeconomic policy to easing these constraints. In some areas, for example, where the rigidities are specific to particular sectors of the economy, the role of fiscal or monetary policy may be very limited. But other problems, for example excessively high real interest rates or real wages, are influenced by economic policy. I think, however, that my general message would be that progress in these areas is unlikely to be helped by abrupt changes in the policy stance.

The implication then is that we may have to face a long and hard struggle on the economic front. The task is one of building on the foundation that we have already established. The main role of policy makers will be to improve expectations to bring a degree of calmness after the febrile volatility of recent years and thereby to contribute to the revival in confidence of consumers, investors and the international banking system. Without this the current economic recovery cannot endure. The onus is therefore upon policy makers to be very aware of the side effects and market implications of any measure they should take. We have only to observe the behaviour of financial markets in the United States to understand this. At the same time, policy should be aimed at nurturing the supply side response, from industry in particular, although we should also see to it that personal tax systems provide the right kind of incentives for initiative and effort. There continues to be a need for structural measures to improve the supply response. This could call for some difficult decisions. 'Adjustment' is not just a term that should be applied to the indebted developing countries, but has relevance in the industrial world, too, especially where old established industries are only surviving by virtue of subsidies and trade protection. The benefits from a better allocation of resources could be immense, especially if our markets could be opened up further for the newly emerging industrial countries.

What could all of this mean for the housing finance industry? Hopefully it could provide a more stable economic and financial environment in which to operate. The past decade of volatility in interest rates, in inflation and inflationary expectations, in housing demand and house prices has not been conducive to running any kind of business, least of all one which is attempting to balance the interests and time horizons of savers and borrowers. The impression I get, however, is that these conditions have encouraged a more market-oriented approach to the provision of housing finance. This cannot be a bad thing. And perhaps this process has further to go.