

Financial Aspects of the International Economic Situation

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SUMMARY: The article identifies three particular problems in the world economy: pressures towards protectionism; strains in the international financial system; and the need to restore a more satisfactory pattern of growth. The response so far to financing problems has been ad hoc and pragmatic. In the future more permanent arrangements should be established for securing the co-ordination of sensible plans by borrowers and prudent lending by banks. There may be a shift towards official funding of payments imbalances. But financing initiatives, though vital, may not be enough. A recovery in OECD growth is essential. The article stresses the need to develop further, and make more concrete, the initiatives taken at the Versailles summit on policy co-ordination between major countries.

Background

1. In the last decade, the world economic system has come under severe strain. Even before the first oil shock, there were signs that growth in the major economies was faltering, that inflation was accelerating and that unemployment rates were beginning to rise. At the same time, and perhaps partly in consequence, the fixed exchange rate arrangements which had played a key part in regulating the international economy over the post-war years became unsustainable. Attempts in some countries to support growth with strongly expansionary policies may well have contributed to the severity of the oil price shock when it eventually came. More fundamentally, however, it seems fair to say that, over the two decades up to 1973, oil became in some sense too cheap. The decline of 30% in the real price over that period meant that there was little incentive for the conservation, and the development of new energy supplies, which might have allowed strong growth in the world economy to be sustained. Correspondingly, oil supplies became increasingly concentrated on OPEC. After a period when a measure of adjustment to the first oil shock was achieved, the world economy was called on to absorb a second huge increase in oil prices.

Lecture given by Mr C.W. McMahon, Deputy Governor of the Bank of England, to the Danish Economic Association on Monday 21 February 1983.

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Background

1. In the last decade, the world economic system has come under severe strain. Even before the first oil shock, there were signs that growth in the major economies was faltering, that inflation was accelerating and that unemployment rates were beginning to rise. At the same time, and perhaps partly in consequence, the fixed exchange rate arrangements which had played a key part in regulating the international economy over the post-war years became unsustainable. Attempts in some countries to support growth with strongly expansionary policies may well have contributed to the severity of the oil price shock when it eventually came. More fundamentally, however, it seems fair to say that, over the two decades up to 1973, oil became in some sense too cheap. The decline of 30% in the real price over that period meant that there was little incentive for the conservation, and the development of new energy supplies, which might have allowed strong growth in the world economy to be sustained. Correspondingly, oil supplies became increasingly concentrated on OPEC. After a period when a measure of adjustment to the first oil shock was achieved, the world economy was called on to absorb a second huge increase in oil prices.

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2. There were important differences between the world's reactions to the two shocks. After the first, the policy response was diverse, with some countries trying to curb the inflationary effects, but many — including quite a high proportion of the smaller industrial and developing countries — seeking to sustain output by stimulating domestic demand. In the event, spending by the oil exporters increased much more rapidly than many had expected — the OPEC surplus was pretty well eliminated by 1978 — and this offset to a significant extent the initial deflationary impact. By the late-'seventies, GNP in the industrial countries was again growing quite strongly. But inflation had risen sharply, to over 10% on average in the major countries, and much higher rates outside them.

3. By contrast, and with a rare degree of unanimity, the industrial countries have been primarily concerned since the second oil shock to contain inflationary pressures, and to limit public sector deficits. In both developed and developing countries, the level of accumulated internal and external debt has increasingly been seen as a constraint on policy. The OPEC surplus has again been eliminated, but this time more because of weakening activity in the oil consumers and a consequent sharp decline in the demand for oil. The counterpart of this reduced surplus has been seen chiefly in a narrowing of the overall deficit of the main developed countries. But the very factors which have brought this about have contributed to the difficulties of restoring external balance elsewhere. The deficits of most LDCs, and indeed a number of smaller OECD countries, increased further in 1979 and 1980 and remain large. With inflation now much lower, this has meant a much faster build-up in the real value of debt than in the mid-'seventies.

Problems

4. All this is familiar enough. But it seems worth recalling because some of the main problems we now face have arisen very much from the developments I have described. I want to concentrate on three of these problems: the pressures towards protectionism in the world trading system; the present strains in the international financial system; and, perhaps most crucially, the matter of how a more satisfactory pattern of growth might be restored. I shall want to emphasise, too, what seems to me a critical point — the extent to which these three areas of concern are interrelated.

5. A major risk in our present situation must be the pressure towards protectionism. We all know that protectionism is damaging, and that resort to it by one country is likely to provoke reactions elsewhere. Yet in a world of slow growth and high unemployment, the idea of trying to protect domestic markets from foreign intrusion may

look dangerously attractive. The difficulty is sharpened for many developed countries by the long-standing need to undertake structural adjustments in parts of their industry. Such adjustments are in the end inevitable; the aim must surely be to see that they are carried through without undue disruption. In this process, both the developed and developing countries — which in many cases now provide the main source of competition — have a part to play. But some of the pressures towards protectionism have arisen because of interactions within the group of industrial countries. The impact of policy on exchange rates has in some instances been such as to bring about sharp movements in competitive positions. No-one, I think, would argue that any of the various statistical measures of competitiveness can successfully capture the many influences on trade performance. But the shifts in some cases — notably, in the last year or two, between the US and Japan — have been so marked as to impose obvious and severe strains on particular sectors of industry. In such cases, appropriate macro-economic policy certainly has an important part to play in avoiding or easing protectionist pressures, though it may not be sufficient on its own. Moreover, trade restrictions put in place in response to imbalances in macro-economic policy are likely to be difficult or uncomfortable to remove even when a better balance is restored. There is a danger of a kind of ratchet effect, with successive swings in exchange rates provoking new protectionist measures in each country in turn and leading to a cumulative build up over time. Furthermore, and of special concern in present circumstances, growing protectionism would be likely to damage the export prospects of debtor countries and thereby hinder their efforts to achieve a sustainable financing position.

6. The second issue I mentioned — the strain on the international financial system — continues to be a matter of anxiety to all of us and has required the Bank of England to take on a particularly active role. In many respects, the commercial banks can record a notable success in responding to the greatly increased demand for credit in the mid-'seventies. Without that response, the business of coping with the higher cost of energy would, for many countries, have been much more painful. And for the world as a whole, the downturn in activity would almost certainly have been sharper and perhaps more prolonged. But the banks were seeking to operate in an environment where, although balance sheet growth was quite readily achieved, the assessment of risk had become altogether more difficult. As deficits widened further after 1979, the pressures and the risks increased. Over the ten years up to 1982, the total debt of developing countries increased from around \$80 bn to around \$540 bn and within this bank lending increased from around \$20 bn to around \$240 bn. In retrospect, it is perhaps hard to avoid the conclusion that, in some cases, in some degree, lending was carried too far.

7. The third, and maybe least tractable, element in our present economic difficulties is the prolonged period of unsatisfactory growth we have experienced and the associated very high and still rising level of unemployment. The slowdown has been widely felt. It has an importance not just in itself but also because of the effect it must certainly have had on industrial confidence, and in turn on investment and capacity. Some degree of recession was no doubt an inevitable, or at least a likely, cost of bringing down inflation from the intolerable rates to which it had risen. And it may be true, of course, that even without the disruptions of the last decade we could not have looked forward to a continuation of growth at the pace we enjoyed in the 'fifties and 'sixties. There is a plausible case for saying that the world economy during that period was enjoying especially favourable circumstances. I do not believe we now have any very clear view about the potential non-inflationary rate of GNP growth. But it is hard to believe that whatever it is, it is not substantially greater than the kind of growth rates we have seen over the last few years.

8. In looking at these problems, it may help to have in mind some more general developments in the world economy. The steady and apparently predictable growth over the post-war period almost certainly encouraged comfortable but increasingly rigid habits of mind to develop both in personal and company behaviour. The "real" economies of some of the more mature developed countries, certainly, became less flexible and less able to cope with any external shock. At the same time, international trade was growing — about half as fast again as GNP — and financial markets were expanding rapidly, allowing increasing mobility of capital internationally, a mobility which was further promoted by the widespread relaxation of exchange controls. This position of rigidity in domestic economies, and increasingly close links through international trade, and even more through financial markets, has meant that disturbances are now transmitted faster and more widely than before. At the same time, the interdependence imposes severe constraints on the scope for action by individual countries.

Prospects

9. How far, then, can we look forward to a resolution of these problems in the period ahead?

10. I am sure we have all absorbed the general shape of the forecasts which have emerged from the main international institutions over the last couple of years. There has, indeed, been a striking degree of unanimity in the picture they have shown. Their basic message has, I think, been that an upturn in activity is to be expected, resting

largely on conventional cyclical effects — for example from stockbuilding — but also on the notion that declining inflation and lower interest rates, in both nominal and real terms, would provide a stimulus to private sector spending. I would not really want to quarrel with this analysis as representing a “best guess”. But it is worth noting that the timing of the upturn has been put back in successive forecasts and worth asking why this has happened. It is, of course, notoriously difficult to predict accurately a turnaround in economic activity, whether at the national or at the global level. But it should perhaps not be ruled out that more fundamental factors have been involved in delaying recovery. Amongst these I would mention the low rates of return now being earned in the corporate sectors of many countries; the uncertain, but possibly powerful and long-lasting, effects of exceptionally high real interest rates; the cumulative direct effect of fiscal policies which, with the primary objective of containing budget deficits, have tended to involve cut-backs in spending growth or increases in average rates of taxation; and finally, the feedbacks which have already been felt from over-extended debt positions.

11. However, even granted that the forecasts — which typically now show growth in the major economies of up to 2% this year with perhaps some acceleration in 1984 — represent a plausible central estimate, it seems to me that there is a great asymmetry in the risks involved: in the sense that if growth were to turn out, say, 1% weaker than the forecasts suggest, the consequences would be far more difficult than if it were to turn out 1% stronger. It is not hard to think of reasons why, in the event, things may develop less favourably. There could be a failure of industrial confidence because hopes of sustained recovery have been abandoned; real interest rates, though lower, may still be too high to make investment look attractive; the uncertainty of prospects may encourage a rise rather than a fall in personal saving. More generally, we are now in many respects in an unfamiliar environment, which makes it hard to predict how individuals, companies and indeed governments are likely to behave. A weaker outlook would carry a new group of borrowers to the brink; it might push some over. Short of this, financing constraints could still contribute to a worse outturn than we now expect. Besides any question about the distribution of their assets, considerations of capital adequacy may limit the overall expansion of the banks' balance sheets. Each \$10 bn less financing might knock 4% off LDC imports and ½% off world trade. That in its turn would tend to depress activity and exacerbate financial strains.

Financing

12. How might we seek to respond to the present difficulties? As the Governor at the Bank of England observed in his recent speech to the Overseas Bankers Club in

London a crucial element must be the concertation of action between the various groups involved — in particular between the major debtors, the international financial institutions, governments and central banks and the commercial banks. The borrowers must recognise the need for, and be willing to undertake, the economic adjustment required to maintain or re-establish their creditworthiness. Some borrowers, of course, have managed their response to the second oil shock and the changed economic environment with sufficient promptness to retain the confidence of their bankers. Some recent IMF figures show that, excluding oil and net interest payments, the current balance of the oil importing countries amongst the LDCs has actually improved quite markedly over the last three years. But within this, many have been less successful and for some the loss of financial confidence has gone so far that they have been forced to undertake debt restructuring. In these cases, adjustment is needed not only as a counterpart to future financing but also to support those existing debts which have been rescheduled. It should be recognised that rescheduling of itself does not make the problem go away; it simply provides a breathing space in which a borrower can adjust and seek to restore confidence through an improved external position.

13. In many cases, the first step towards adjustment is the working out of an economic programme with the IMF. This is often indispensable, and the earlier it is taken the better. The involvement of the IMF is, of course, nothing new. But its role has changed somewhat. The magnitude of some recent difficulties has been such that an adjustment package can no longer be put in place without a firm commitment from the banks that they will play a part, alongside the IMF and other official sources of finance, but in line with their own much expanded involvement in international lending. The role of the IMF has been crucial, both in devising programmes with borrowers and in working to ensure that adequate finance is available. The recent agreement to increase quotas by nearly 50%, and the expansion of the GAB, will have a welcome and major effect on the adequacy of the resources available to the Fund to meet the financial requirements of members in difficulties. But IMF resources can now only be a part of the financing picture and, for this reason, the IMF has been much more active than in the past in seeking support for programmes from the banks.

14. The new environment has faced the banks, too, with difficult decisions — notably the question of how to reconcile the commitment of new money with the provisions a prudent banker may wish to make against rescheduled debts. But the dilemma may be more apparent than real. It can be prudent to recognise, through provisions, that the quality of assets has deteriorated; and at the same time be justifiable to commit additional funds, where these support a programme of adjustment which aims to

improve the quality of existing assets in the longer term. It would be wrong in present circumstances to think of this as a once-for-all process. Banks will need to continue to review their provisions, to reflect the progress which the borrowers make in their adjustment.

15. Governments are also playing their part, through their enlarged contributions to the IMF which I have already mentioned: for it should be remembered that this will constitute a substantial new commitment of funds by governments. Central banks have also been able to help. Liquidity crises, by their nature, are liable to break very suddenly. A loss of confidence for whatever reason can stem the expected inflow of funds to a borrower and a withdrawal of existing finance can seriously exacerbate the problem. There can be a delay extending to weeks or months before confidence is restored, perhaps through agreement on a carefully structured Fund programme. In these circumstances, there may be a need for bridging finance, which can be drawn in some combination from the banks themselves or from official bodies.

16. There have recently been occasions when it has seemed right for the Bank for International Settlements to organise temporary support, generally with the backing of a number of central banks. I believe this has had a helpful effect on confidence. But there are obvious constraints on the BIS which need to be recognised. The resources of the BIS are very largely the national reserves of the subscribing central banks, implying the need for a high degree of liquidity. It can thus only undertake short-term bridging finance, and there must be a firm prospect of this being repaid. It is crucial, therefore, that adequate and unencumbered collateral should be available, or that there should be a clear commitment of Fund or other resources out of which the bridging loan can be repaid.

17. It is true that the response so far to debt problems has been pragmatic and ad hoc — it had to be; but it is noteworthy that the interdependence between the various parties involved was so quickly recognised. Success in containing the situation has depended crucially on the willingness of each one to take on its particular role.

18. I want to stress “pragmatic” and “ad hoc”. The question naturally arises as to how things might develop in the longer term — whether, for instance, we can eventually return to where we were. I would doubt whether we can: the relationship between the various parties has now changed, and the change is a reflection of the different balance which has evolved between authorities, borrowers and markets over recent years, not just the result of some temporary conjuncture. Banks are now a major source

of funding for many countries, whereas before the 1970s financing was predominantly official rather than private. This could not quickly be changed, if only because of the substantial stocks of private debt which have accumulated. But I doubt, at the same time, whether we can indefinitely continue as we are at present. There are, for example, important questions about the appropriate role for the IMF. We cannot expect the Fund to continue to bear the weight of decision taking and co-ordination that it has carried in recent months, and though the immediate objectives have been secured we should not be complacent about the difficulties still to be faced. It must inevitably become more difficult for the IMF — or indeed central banks and governments — to encourage banks to provide funds to an extent which they might not spontaneously choose. And there must be a limit beyond which central banks and other bank supervisory agencies will not go in accepting temporary relaxation of capital requirements.

19. In short, we will need to evolve more permanent arrangements for organising financing and securing the co-ordination of sensible economic plans on the part of borrowers and prudent lending on the part of banks. An element of this may be a shift in financing back towards official funding of payments imbalances; almost certainly there will also be a move to disengage the authorities from direct involvement in individual decisions of commercial banks.

OECD recovery

20. But these various initiatives on financing, though vital, may not on their own be enough. A large part of the deterioration in the debtor countries' external position can be attributed to the sharp increase in oil prices and its direct effect on their import costs, and to the slackness of output in the major countries, which has affected both the growth of the developing countries' export markets in volume terms and also their export prices. On the first of these, the prospective fall in oil prices should provide some help, at least to the borrowing countries in aggregate, although it could have unwelcome consequences for those few debtor countries which are net exporters of oil. But even for Mexico, we do not think that a limited fall in oil prices would have a decisively adverse effect on their adjustment plans. A fall in oil prices should also make some contribution to a revival in the industrial countries. It is on this that a satisfactory resolution of the present debt problems must eventually depend.

21. I think there has been a growing recognition of this linkage between financial difficulties and the real economy. On the financial side, steps have been taken to try to ensure that the system remains as robust as possible under the present conditions

of strain. On the real side, if all goes as predicted, we may indeed look forward to some easing in the situation. But it also seems to me necessary to keep clearly in mind the risk that growth may not materialise, or may not materialise as strongly as we perhaps now expect. This kind of worry has been touched on recently both at the G10 Ministers meeting in Paris during January and at the Interim Committee earlier this month. In those meetings, the major countries have understandably been concerned to maintain and reinforce the successes, particularly against inflation, which the present stance of policy has brought. There is a continuing will to persevere with those policies. But within that broad framework, there may be scope for some limited flexibility; and where such scope exists, it would seem worth using so far as it may diminish the risk of a more severe crisis later on. *How* any opportunities might best be exploited is clearly for consideration; but I would recall one of my earlier remarks — that the various parts of the world economy have become increasingly interdependent. To me, this seems to argue strongly for developing further, and perhaps making more concrete, the initiatives taken at the Versailles summit last year on policy co-ordination between the major countries. No country, not even the United States can now ignore the effects either of its policies on other countries, nor the effect of their policies on its own economy. Perhaps if we can explore and understand further the linkages between us we may arrive at least at the beginning of wisdom. We may be able at last to start fashioning a way out of the interlocking downward pressures that beset us without rekindling the inflationary fires we have been working so hard and so long to subdue.