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THE GOVERNORS

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JULY

Without, I hope, treading on other people's toes, herewith some comment on the summer forecasts and the situation generally.

1 The summer forecasts are little different to those of the late winter. They foresee a moderate recovery in world trade that is rather strongly associated with a recovery in the USA, which in turn is scheduled to begin almost at once. They foresee a weak recovery in the UK that is a little weaker than it was. Unemployment goes on rising, inflation goes on gradually falling, yet the external current surplus shrinks. Bad enough, but hitherto acceptable.

2 'On the ground', however, summer feels quite a lot different to late winter. This is because the international economic and monetary situation has become more, not less, deflationary. Early recovery in the USA is less confidently expected. Dollar interest rates have recently been rising instead of falling and deflationary stress within the American and Canadian financial systems, long expected by some, is now widely reported. There are further signs, too, of deflationary stress within the international credit structure as the effect on borrowers of very high interest rates and lower export revenues inexorably affects the willingness or ability of lenders to go on lending and the capacity of borrowers to go on borrowing. Not surprisingly, in these circumstances, the CBI reports that the better industrial mood of late winter is not being sustained and that export markets are not coming up to expectations. Only in the field of residential construction is the outlook perhaps better than expected.

3 This sharp increase in the 'downside risk' to the forecasters' central view of moderate but early recovery* has been accompanied by signs of growing political impatience and an increasing politico-economic tension, mainly but not exclusively within and between the USA and the other main industrial countries. Coincidental outbreaks of physical warfare in the South Atlantic and Middle East have added to this general condition of tension.

4 Nearer home, the disappointingly slow pace of recovery is quite possibly beginning to be accompanied by some undershooting of the 'desired paths' set out in the recently reformulated MTFS. Money GDP was supposed to grow by just under 10% in 1982/83 and it seems to me questionable whether this is now happening. Furthermore the monetary aggregates are for the time being either within the lower half of the target range or below it. Bank lending to business seems for the moment to have fallen away rather dramatically from the levels seen during the winter. There remains concern about the growth of mortgage credit; but if it were not for external constraints and the desire in that context not to risk upsetting 'market opinion', the general case for quite a large cut in short-term interest rates, or alternatively for a modest fiscal adjustment, would be getting strong <u>even within the numerical confines of the MTFS</u>.

5 One response to this developing situation would be to go on as we are, saying in effect that this is how the world now is and that there is no way in which we can opt out of its current difficulties, even in part. The main features of 'going on as we are' seem to be:-

(i) Allowing our own interest rates to move slowly down whenever a tactical opportunity allows this to happen without external damage to market sentiment and to the ERI;

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*As a sample, not untypical of the recent flow of news, last Wednesday's FT referred to growing economic difficulties in Spain and S Africa, falling orders for European steel, a fall-back in the spot oil price, falling exports in Japan, and economic collapse in Bolivia.

(ii) Doing what we can to ensure that difficulties in the international credit markets are met to the maximum by orderly deflationary adjustments exemplified by packages of IMF credits, appropriate domestic measures and reschedulings, rather than by piecemeal contractions, exchange disorders, and defaults;

(iii) Joining in a protest movement against the macro-economic policy derangement in the USA that is in part responsible for the high interest rates in that country, and hoping that somehow or other those interest rates will fall sufficiently far sufficiently quickly for the growing deflationary pressures, in the world at large, to stop growing.

6 An alternative possible response would be retain features (ii) and (iii) above but to abandon feature (i) in favour of a more or less concerted cut in European, Japanese, and other 'non-American OECD' short-term interest rates, combined with willingness to accept a further appreciation of the US $, but one which would be mitigated by co-ordinated tactical interventions in the exchange markets.

7 Another alternative response would be to retain what one could of (ii) and (iii) while abandoning (i) in favour of sharp unilateral interest rate cutting and acceptance of, say, an early 10% depreciation of the ERI for sterling. Alternatively, reductions in taxation could be substituted for unilateral interest-rate cutting; and might or might not have a less depressing effect on the ERI.

8 It is already July and the inclination must be to stick with the first course rather than go for either of the alternatives, at least until the autumn. Events are heavily in charge by now and it seems much too late in the day to be organising collective defences. The time to have done that would have been late in 1981, when the risk of an American recovery being aborted or delayed first became clearly apparent, and before the Americans themselves got into such disarray. Collective action now, moreover, could mean ganging-up against the Americans at a time of their maximum difficulty and their evident readiness to

indulge in protectionist measures of their own if they judge competition to be unfair. Nonetheless it is worth asking whether these considerations are indeed valid or whether they represent a counsel of timidity, or despair. Given a strong political lead on the part of the French, the Germans and ourselves, would it really be difficult to organise quickly a co-ordinated interest rate, exchange rate, and intervention policy? Is it really the case, especially after the recent EEC Council communique, that the political lead would be difficult to get? Could the Americans seriously object? In any case, 'going on as we are' might not prove to be an altogether tenable course for very long. Orderly processes of debt rescheduling etc might not suffice to avert the onset of crisis conditions in credit markets. Alternatively, the pressures of public protest might force one or other of the developed countries to go for abrupt unilateral action. The situation is sufficiently tense for 'anything to happen any time'.

Volcker

9 Among the various countries who might be tempted into unilateral action, our own is perhaps likely to prove the most susceptible. By the autumn we will be $2\frac{1}{2}$ years from the start of the slump, within 12 months of the most probable date for the next General Election, and three or four months further on from victory in the South Atlantic. If a readily perceptible upturn is by then still elusive, if unemployment is still rising quite fast, if the MTFS objectives are being undershot, and if interest rates are still at or only a little below present levels, will it suffice to blame it all on 'world conditions' and take no special monetary or fiscal action? If it will not suffice, how much exchange depreciation would we be prepared to accept as the foreseen accompaniment of substantially lower short-term interest rates or lower taxes? What would be the market management problems in trying to carry through such a policy? To what extent might we be emulated by other countries, particularly in Western Europe? Would this lead very quickly to a more collective approach? These are pertinent questions which seem to me to require urgent answers rather than be left on the table until October.

10 Hitherto, the policy of 'going on as we are' has meant taking maximum comfort, in private and in public, from the fall in inflation, from the rise in output per man hour in manufacturing industry, and from the more 'realistic' attitudes which are said to be widely prevalent. These things are indeed cause for comfort. But the prospect ahead of us suggests more the discomfort of an economy locked into very high (and rising) unemployment, growing import penetration, corporate anaemia, and a ruling Party for whom 'there is no alternative'. That being so, the practical question is whether the economic strategy again requires tactical adjustment, this time to combat the unwanted effects of international deflationary pressures.

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