9.7.82

THE GOVERNOR

GR 9/7.

THE WORSENING WORLD SCENE

attached to JCRDm 9/7 /DG

As you will see, the attached is a draft of a note in preparation for the Deputy Governor. In view of the discussion last night in your room, I thought it would be useful if I let you have a copy before the weekend. Having been at the Panel all day, I will not be able to read through the text before letting you have it and I hope you will forgive errors.

9th July 1982

J C R Dow

(Typed from Mr Dow's manuscript and
circulated in his absence)

1754

CONFIDENTIAL

9.7.82

THE DEPUTY GOVERNOR

Copies to: Mr Holland
Mr Clews

THE WORSENING WORLD SCENE

1 You asked me to undertake any necessary editing of the draft provided by RDC. I should say that I found it a very useful assembly of material, all the more impressive for having been produced in haste; and have done little to it beyond wielding a blue pencil.

2 I am not sure whether you will think it is what you wanted. In my view it is probably useful for further circulation in the Bank; and in redrafting I have also had in mind that it might possibly be useful to show the Chancellor.

3 In redrafting I have not left a space for the anecdotal material now provided by BQ on three grounds: that BQ's material is of a different character, difficult to assimilate; that it is highly sensitive; and that it will already have been seen by those most concerned. There could be a cross reference to BQ's material in the cover note to RDC's piece if you circulate it.

4 The statistical material annexed to RDC's note might need some tidying up. The charts on successive forecasts do not seem to me to demonstrate very clearly the point to be made. Output forecasts only need be shown. The chart on financial liabilities might also be shown (but not the last one on forward indicators). I have already simplified the UK simulations in this redraft.

9th July 1982

J C R Dow

(Typed from Mr Dow's ms
but circulated unseen)

DG 9/7 15

DRAFT (9.7.82)

CONFIDENTIAL

THE WORSENING WORLD ECONOMIC SCENE

Most forecasts suggest that there will from now on be a modest recovery in industrial countries. But such hopes have been repeatedly disappointed, and the latest forecasts are already being revised down again, and there are increasing indications of worsening financial conditions in various countries. In this developing situation it would now be useful to try to produce a hard and fast view of prospects. The purpose of this note is to consider the possibility, in the light of the indicators now available, that financial conditions may choke off the recovery that seemed to be in prospect, or might even provoke further recession.

Policy background

2 It is natural to concentrate on the United States, whose large economy is being particularly severely hit by high interest rates, and whose financial climate appears to be deteriorating. But the world's problems do not arise solely from faulty US policies. Governments of all major countries have shared in the consensus that policy after the second oil shock should be non-accommodating. This has meant not simply that fiscal policy has not been stimulative, but has to some extent been positively restrictive: automatic stabilisers have tended to be overriden, and in some of the major countries' contractionary measures have been taken. Monetary policy also has been relatively tight. Quantitative monetary targets were intentionally not relaxed to accommodate externally generated inflation. Real interest rates have everywhere been positive (against predominantly negative real rates earlier); and this has not been solely a response to conditions in the US. There has been as yet no convincing recovery from the second oil shock and the longer recovery is postponed, the more the natural resilience of our economies is diminished. This is an important background aspect of the present situation.

Forecasts

3 The down-grading of successive forecasts can be seen clearly from the charts attached. The fall in output in the major economies over the

past year was not foreseen. The depth of the second recession in the United States has come as a particular surprise, but forecasts for other countries have also been shaded down. Comparing, say, the estimated outturn for the past year with the OECD's forecast of December 1980 (a fall of 1/2% against forecast growth of 2 1/2%) about half the discrepancy is attributable to consumption and about half to various forms of investment (implying somewhat higher proportionate errors for investment than for consumption).

4 Although the consensus of forecasts is for modest positive growth, this is only weakly supported by the forward looking indicators (business surveys, etc). Although the US composite index of leading indicators has ended its long decline, and similar indices for European countries and Japan generally show some upward movement it is hard to detect more than a levelling out of output. In many countries stocks remain high, and orders low; and business sentiment is not improving.

<u>Financial conditions in the major economies</u>

5 Present high nominal and real interest rates are not readily explicable. But they undoubtedly have played a role in sapping recovery. Many years of high and variable inflation have made private sector borrowers increasingly unwilling to commit themselves to long-term fixed interest debt. But increasing reliance on variable rate bank finance has left corporate borrowers still more vulnerable to increases in interest rates. At the same time, the banks may have become more vulnerable to default on the part of particular corporate borrowers. It would not then be surprising if recent interest rate levels prompted doubts whether some existing borrowers could continue to service their debt, and increased caution on the part of lenders and borrowers with respect to new borrowing and to new investment. Nevertheless, though some borrowers have clearly overborrowed, the hallmark of corporate behaviour since the mid-1970s has been caution. Indeed the apparent unwillingness of companies to incur financial deficits seems to have been one factor in the slow growth of investment (and of output) over this period. Company stock levels appear to have been subject to much more vigorous control than earlier. The proportion of capital outlays financed by internal funds has remained high (see table), and the stock of financial liabilities has tended to fall reltive to the stock of fixed capital (see chart).

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Ratio of internal funds to capital outlays:
private non-financial corporations

	1973	1974	1975	1976	1977	1978	1979	1980	1981
United States	.76	.62	1.09	.90	.90	.86	.86	.91	.88
Japan	.48	.24	.40	.50	.60	.73	.41	.38[a]	..
Germany	.71	.65	.89	.85	.86	.99	.85	.78	.80[b]
United Kingdom	.99	.71	1.07	.99	.95	1.00	.80	.83	1.15
France	.59	.47	.62	.58	.57	.67	.67	.56	.5[c]

Source: OECD CPE82)1

(a) OECD estimate.

(b) Preliminary estimate H1 (not sa).

(c) H1 sa

6 In addition to any increased risk of default by borrowers, financial intermediaries will have been subject to increased risk in the maturity transformation part of their business. The most obvious cases are among the US Saving and Loan Associations, stuck with low fixed interest assets to be financed at short term. But others have suffered from the unexpected height of interest rates and unexpected twists in the yield curve.

United States

7 The problems of the United States, though paralleled elsewhere, are greater in degree. A combination of factors makes a solution hard to find, at least within the short term. Though it is easy to criticise after the event, monetary policy has probably proved too ambitious and too rigid, both in the sense that targets have been too low on average, and overzealous efforts have been made to adhere closely to them month by month. (They would clearly have had more success - brought down inflation with less impact on real activity - if targets had brought about a decisive change in inflationary expectations.) Whether or not the size of projected budget deficits ought in the long run to have much effect on interest rates (and it may be enough in the short run that sufficient people believe they should) prolonged wrangling between the Administration and Congress has added greatly to uncertainty.[as must public criticism of the Fed by the Administration, and differences within the Administration.]

The dangers are increased by the existence of S and Ls who clearly cannot survive an extended period of high interest rates (but to whose fate the Administration seems curiously insensitive) and a more than normally regionalised and localised banking system. Weak activity is hitting profits; and the strength of the dollar is eroding the competitiveness of US industry (and the profitability of sectors exposed to competiton). The swings in US interest rates must be adding to uncertainty and discouraging both consumers and corporations from acquiring real assets with financial liabilities.

8 It is not obvious that a solution to the problem of high and variable US interest rates is in sight. [The tentative budget compromise has not so far had the effect that some had hoped for. While the markets remain sceptical of the effects of policy it would be hard for the Fed obviously to relax its targets.] The kind of conditions that have prevailed over the past two and a half years may well continue; and the prospect of even a muted recovery must be in doubt.

International Lending

9 The problems of international lending have been well rehearsed. For many developing countries and a number of smaller developed countries, increased balance of payments deficits since the first oil crisis have led to increased international indebtedness not only in money but also in real terms. An increasing proportion of ldc debt (and virtually all the developed countries' debt) has been on commercial terms, primarily from the banks. Within the total of bank finance some developing countries including some heavy borrowers have had increasing recourse to short-term debt. Debt service ratios have increased considerably. While debts have increased reserves in real terms have tended to fall.

10 Even in conventional forecasts, the ldcs are unlikely to see any marked improvement in their financial situation. While the world economy remains sluggish, commodity prices (and hence the ldcs' terms of trade) are likely to remain low. Their export markets will be weak and protectionist measures against manufacturing ldcs could

intensify, If the world economy performs less well than indicated in the conventional forecast, the ldcs could well provide a channel though which a cumulative loss of confidence could develop. They would become less able to service debt: more rescheduling would be necessary; banks' credit ratings would be further downgraded; and lending by the banks would become more cautious, domestically as well as internationally.

Effects on the United Kingdom

11 The conventional forecasting machinery can be used to estimate some of the effects on the UK of a deterioration in the world economic and financial environment. To illustrate the possibilities it is assumed that growth in OECD countries is from now on 1% slower than indicated by the present forecasts - which might well be the result of a failure of the United States to show much recovery. This would slow down the growth of world trade, and hence of UK exports. But commodity prices would be lower which benefit UK consumers and help to maintain consumer demand. The new effect on UK output might therefore be fairly small. The table below (derived by use of the Bank model) suggests that GDP would be only 1/4% lower than otherwise in 1983 and 1/2% lower in 1984.

Impact on United Kingdom of lower world activity

		As forecast June 1982	Lower World Activity[a]
GDP Output % Change	1982	0.5	0.5
	1983	1.3	0.9
	1984	1.5	1.0
Manufacturing output % Change	1982	1.3	1.2
	1983	3.0	2.3
	1984	1.9	1.1
PSBR(b)	1982/3	9.1	9.2
	1983/4	8.9	9.4

[a] For assumption see text

[b] At present tax rates and present spending objectives.

12 Many effects cannot however be captured by a model. Much would depend on how the slower world growth came about. Interest rates might be yet again unexpectedly high, and might be a cause of slower growth: or a collapse of confidence might itself reduce activity. Much could also depend on confidence effects both on UK financial institutions and non non-financial concerns. Losses, or prospective losses, on international lending could engender greater caution on the part of UK banks in their domestic lending. Increased financial uncertainty and the sight of company collapses abroad could lead UK companies to cut back on their spending, if sufficiently widespread, might also lead to greater financial caution on the part of consumers.