General assessment

Reporting of economic and financial developments

This issue incorporates a considerable reshaping of the standard reports in the first part of the Bulletin. *The general object is to give greater emphasis to monetary developments and to make the discussion of them more informative.*

General assessment *(now placed first instead of later) discusses some important issues which are treated in more detail in the separate reports that follow.*

Main economic and monetary developments *(formerly economic commentary) summarises economic trends and treats monetary matters in that general context.*

Operation of monetary policy *(formerly part of the financial review) focuses on the operations of the Bank and their impact on domestic financial markets.*

International financial developments *(formerly part of the financial review) now has some additional material on global balance of payments developments.*

This assessment singles out for discussion a number of issues which arise from recent events. The two economic developments this year of most significance appear to be the levelling-out of the trend of output, after its steep fall during 1980; and the decline in the exchange rate, in place of the rise of the last two years. Some aspects of these two developments call for discussion before considering the evolution of monetary policy.

The exchange rate

Since the end of the year, the US dollar has risen against the main European currencies by a fifth or more. Earlier, when the dollar strengthened last year, sterling tended to appreciate with it against other currencies. In the recent phase of dollar advance, sterling has kept closer to the EMS currencies, like them depreciating against the dollar (and some other currencies). Taking all main currencies together, sterling's effective exchange rate fell by 9% between December and August, so reversing part of its rise in the previous two years (24% since the second half of 1978).

Given that sterling's recent performance has mirrored the dollar's strength, the most important influence has probably been the high rates of interest in the United States. The rise in rates there, and the higher rates this has induced in other countries, has left interest rates in this country relatively low in international terms. Another important factor has probably been the weaker trend in dollar oil prices; a possible further influence may have been an erosion (though the statistics are lacking) of the massive surplus on current account which built up last year.

The harmful effect of a decline in the exchange rate is that it adds to the pressures on prices. It is sometimes argued that since many commodity prices are quoted in terms of dollars, it is the scale of depreciation against the dollar, not against currencies in general, that matters. This view is, happily, disputable—as is argued in the note on page 365. Aside from any repercussions on wages, the 9% fall in the effective rate might, taken by itself, mean that, by the end of the next two years, prices could be 2%–3% higher than they would have been if the exchange rate had remained at its end-1980 level. Against this—thanks to smaller wage increases combined with a significant rise in productivity— labour costs have risen very little this year; and the rise of retail prices has not so far shown signs of acceleration in face of the decline in the exchange rate. While the latter has reduced the likely extent of any further slowing down of retail price increases this year, next year progress should be resumed.

The helpful effect of the decline in the exchange rate has been on cost competitiveness— which, largely as a result, may have improved by something like 10% since the beginning of this year. Thus, part of the loss of competitiveness over the previous two years has been reversed: that loss was very large, amounting, on what seems the best way of measuring it,[1] to a good 50%.

(1) The index used measures how far labour costs per unit of output have risen faster in this country than in competitor countries, costs being expressed in a common currency.

The preservation of this better competitiveness depends mainly on the behaviour of wages. Even if productivity in UK industry grows as fast as abroad— a better performance than in past years—the gain will be eroded if wages now advance more rapidly than in other countries. It is, indeed, important for the recent gain in competitiveness to be not merely retained, but further improved, since without this, strong economic growth is likely to be difficult to achieve. It was for this reason that the previous issue of the *Bulletin* emphasised the need for wage awards to be small or, preferably, negligible.

In the recent wage round, financial pressures on companies contributed to a marked slowing down of wage increases. The financial pressures will remain severe. It is not impossible, therefore, that the wage round now starting could see a further deceleration as marked as in the last one. In the public sector also there will be a need for continued restraint.

The decline in the exchange rate must for many firms have gone some way to restoring a margin of profit in exporting and in meeting foreign competition on home markets. In the longer term— provided always that the competitive advantage is successfully preserved—trade volumes will be affected. Such effects, however, take a period of years to work through in full. The earlier loss of competitiveness was significantly affecting trade last year, although the effects on the trade balance were masked by the growth of markets abroad, recession at home, and rising terms of trade. Export volume, and shares of export markets (in volume, though not in value terms), had begun to fall; and imports were also affected (see the March *Bulletin*, page 16). Though this year's statistics have been interrupted, these trends in trade are likely to continue for some period ahead: the improvement in competitiveness this year, having reversed only part of what was previously lost, should moderate—but not reverse—an unfavourable effect still to show on trade and output.

The trend of output

The second major development this year has been the levelling out of output, after falling steeply since the end of 1979. Industrial output in the second quarter of this year was slightly below the first; and in June was back to the first quarter level. It has, thus, been roughly flat for the first half of the year.

If one looks at a chart with the picture of previous post-war recessions in mind, the levelling out of output could be regarded as the hopeful precursor of a strong and early upturn. In most post-war recessions, the stock cycle played an important role. In the down phase, stocks were run down, reducing the demand for output; and when this ceased, it helped output to recover. But the automatic rebound from stock depletion, though sometimes important, was rarely a main source of recovery from past recessions: the process has been more complex.

In the present situation, policy has sought long-run effects and has aimed at being counter-inflationary rather than counter-cyclical; and its effects on costs and prices have already been noted. In this recession, as in previous ones, the rundown of stocks has been a major factor on the downswing. But the subsequent phase may

prove more complex, for reasons suggested in earlier *Bulletins*. When the stock rundown slows, as is now likely and may now be happening, that will be a plus factor, which is, however, likely to be accompanied by influences telling the other way. Consumer demand, which last year benefited from high wage increases and the effects of the high exchange rate, is now less buoyant. The economy has not grown rapidly for a long time, so that investment (despite the second quarter figures) may be weak. There are also the probable effects, just discussed, of the loss of competitiveness on exports and imports. It is impossible to be certain whether the positive or negative forces will prevail.

Any prolonged flat trend in output could bring greater financial difficulties for companies. By the early part of this year these had eased more rapidly than was expected. In the last quarter of last year and the first quarter of this, the rundown of their stocks, along with other cut-backs, seems to have enabled companies to eliminate their previous financial deficit. With depletion of stocks now likely to ease, but with profits undoubtedly still low, some deficit might re-emerge, which might in turn increase the pressure for bank loans. A recovery of demand, on the other hand, might reveal a potential gain in productivity much greater, as a result of efforts at efficiency, than may now be generally expected. Companies' profits and competitiveness would benefit; and in the early stages of a cycle this might possibly even reduce their need to borrow.

The evolution of monetary policy

Developments in the economy exert various influences on the monetary variables. The pattern that emerges provides the context in which monetary policy operates and of which account needs to be taken in framing policy.

By the end of last year— as preceding issues of this *Bulletin* have noted—the signs were of a stringent financial climate. Taking 1980 as a whole, recession, together with the high exchange rate and high wage settlements, had left companies in large financial deficit—while consumers' real purchasing power had increased, and the personal sector had developed a large financial surplus. Lending by banks to companies in effect provided a channel whereby that surplus was on-lent to companies—all the more important given the practical inaccessibility, at that time, of the capital market. This combination helped to explain why the growth of broad money was rapid, in circumstances where other indications—the slower growth of narrow money, the strength of sterling and the progress made in slowing down inflation—suggested that financial conditions were tight. Financial conditions this year are discussed more fully in the report that follows on economic and monetary developments.

In the first six months of the current target period, sterling M_3 has grown very rapidly— by perhaps 17% at an annual rate. This outcome was the result, in the first place, of the Civil Service dispute, which may have temporarily doubled the scale of public borrowing. It appeared inappropriate to aim to finance by funding this displacement in the pattern of the year's borrowing. In the event, debt sales to the public have exceeded by perhaps £1½ billion what it is reckoned the public sector borrowing requirement would have been in the first six months of this target period in the absence of the distorting effects of the dispute.

It has, however, been impossible to estimate accurately how far the abnormal scale of public borrowing has inflated the money supply. This is because the interruption of tax payments will also have affected, to an extent difficult to gauge, other counterparts of broad money, in particular bank lending. For most of the summer it was judged that, apart from the dispute, sterling M_3 was growing within the target range of 6%–10%, but the underlying position has become increasingly difficult to assess. The annual rates of growth of the other monetary aggregates (apart from M_1 and the monetary base) have also been rapid, having also been inflated by the effects of the strike.

Bank lending to firms appeared to be rising again this spring, after falling off during the winter. The figures were then distorted downwards as payment of taxes was delayed, an effect now likely to be unwound. Even apart from this, the trend may remain strong—possibly because companies' financial position (for reasons already touched on) could worsen again in coming months. At the same time, bank lending to persons has been rising rapidly, perhaps partly for temporary reasons. If both trends persisted, they could make it more difficult to achieve the target for sterling M_3.

While this must be a concern for policy, it will continue to be difficult to decide on these grounds alone the appropriate response, because of the great difficulty of discerning what is the underlying trend of monetary growth. This uncertainty will be as great in the period when the effects of the Civil Service dispute are being unwound as it has been while they were building up; and will thus continue for many more months—possibly, indeed, beyond the end of the present financial year. Given the course of developments this year, the exchange rate has inevitably tended to become a more important consideration.

There has been a period of greater unease in financial markets—due perhaps to the uncertainties in exchange markets, the rise in interest rates in the United States, less confident expectations regarding inflation, and uncertainties resulting from the Civil Service dispute. This put some upward pressure on interest rates here. In this situation the Bank has sought through its operations to maintain reasonable stability in the very short-term rates which it affects directly. In the face of the weakening of sterling in early July, the necessity for some increase in rates was accepted: thereafter market pressures, mostly making for higher rates, were again resisted.

The Bank's new arrangements for monetary control (see page 347) were preceded by a period during which techniques were gradually modified; and they went into effect on 20 August. From that date money market operations have been conducted by reference to a band, which is not disclosed, for very short-term interest rates. The same announcement effect which formerly followed a change in MLR will, therefore, not apply under the new arrangements. These will permit greater flexibility in the determination of short-term rates. Decisions as to the band will be taken in accord with the same range of considerations as would have determined decisions about MLR, so that the new arrangements imply a change in techniques, rather than in the objectives of monetary policy. The new style of report on the operation of monetary policy later in this *Bulletin* (page 326) is designed to provide the detailed account required to illustrate how the Bank's more flexible tactics with regard to interest rates have worked.