General assessment

This assessment discusses developments in the economy of which monetary policy will need to take account. World expansion appears less assured in the light of recent developments in the US economy—developments which have also reduced interest rates abroad and thus strengthened sterling. The earlier fall in the exchange rate, while helping to improve the competitive position, has had an adverse effect on prices; but the trend of domestic costs has been favourable. After allowing for the temporary effects of the Civil Service dispute earlier this year, the effect on the broad monetary aggregates of public sector transactions was not expansionary: the underlying expansion of the broad aggregates thus reflects the rapid growth of lending to the private sector.

Economic prospects at home and abroad

After unexpected strength early in the year, the US economy seems to have moved, in the current quarter, into a recession which could last well into next year. Despite its effect on the federal budget deficit—now put at over double the earlier target for the fiscal year 1982—recession has already brought an easing of interest rates, with a fall since August of some 6% at the short end.

Growth in other industrial countries, which has recently been very slow, should be faster next year. Though imports by industrial countries have not grown much this year, UK export markets have benefited from the growth of OPEC imports, and next year, given economic recovery in Europe, they may expand faster—in itself a helpful factor for recovery here.

After the decline of the last two years, the rise of output in the third quarter suggests that the worst of the recession in this country may have been passed. The upturn very probably stems from the much slower reduction of stocks (as shown by provisional estimates) compared with recent quarters; and if the run-down of stocks slows further, or stocks increase, there could be some further buoyancy from this source. Both consumer demand and investment demand are likely to remain rather weak: the outlook for sustained growth is likely to depend in large part upon improved competitiveness.

Costs, prices and competitiveness

The competitiveness of manufacturing industry has benefited from this year's depreciation of the exchange rate—however unwelcome its consequences for inflation. But it has also benefited from the encouraging stability in unit labour costs this year, which has resulted both from the greater moderation in wage increases, and from a rapid improvement in output per man-hour. Because of the fall in the exchange rate, the other major part of industrial costs—the cost of fuel and raw materials—rose steeply until August, but has since steadied. It will take some time for the effects of higher fuel and raw material costs to come through in final prices—during which time the past stability in labour costs will, however, continue to help in restraining price increases. The net effect is likely to be a temporary setback in the slowing down of the rise of retail prices: but progress should be resumed next year.

The further prospect is for rather modest increases in industrial costs over the next six to twelve months. Commodity prices are weak, and oil prices, after their recent realignment, may prove steadier. With demand conditions remaining relatively slack, wage increases in the new pay round may be modest—a hope supported by the settlements so far made. Labour costs could continue stable or growing only slowly. One important question is whether productivity in manufacturing industry can be further improved. Many firms take the view that there is a large potential for further gains when demand revives. If so, further recovery might itself help in reducing inflation—thereby further increasing competitiveness—and leave room for some restoration of profitability.

In the last two years, costs have risen faster than selling prices, so reducing profit margins in industry. Together with reduced capacity utilisation, this has lowered the real return to industrial and commercial companies. There was a fall from over 5% before tax in 1979, apart from North Sea operations, to a rate estimated at barely 2% in the first half of this year. Just as some cost increases were previously absorbed, companies may now find opportunities to widen their exiguous profit margins. Profits and their share in national income could grow from the very depressed levels of the first half of the year even apart from economic revival.

Labour costs in most other countries have continued to rise, so that with their recent stability in this country, and with the fall in the exchange rate, manufacturing industry has been able to improve its competitive position substantially, reversing part of the severe loss of competitiveness suffered in previous years. The need for improvement is indicated by the latest trade figures.

The volume of exports rose appreciably between January/February and September/October (by 5% excluding oil)—if anything, faster than the growth of UK markets abroad. But exports were exceptionally low at the beginning of this year: a more secure comparison may be with the first quarter of 1980. Between then and this autumn, whereas UK export markets grew (perhaps by 3%), export volume (excluding oil and erratic items) fell by 5%—a loss of market share almost certainly due in part to the worsening in competitiveness in previous years. Although this past worsening may continue to affect exports for some time, it has now been partly reversed by the recent gain in competitiveness.

Imports also were exceptionally low around the turn of the year, so that the 20% growth in volume between January/February and September/October greatly exaggerates the deterioration. On what may be the sounder comparison of early 1980 with this autumn, the volume of imports (excluding oil and erratic items) grew by only a little more than 4%—an increase, nevertheless, in import penetration which again probably reflects in part the past erosion of competitiveness.

Pressure towards monetary expansion coming from bank lending

The interruption of tax payments during the Civil Service dispute, as is well known, inflated government borrowing in the months to October, an effect which is now being reversed. This temporary distortion obscures important developments best seen by considering the likely trend in the financial year as a whole. The dispute has increased, to varying degrees, the rate of growth of all the monetary aggregates except the monetary base. In the year as a whole, the growth of the wider aggregates is likely to be less than

their annualised rate of growth to date. On present trends, the public sector borrowing requirement (PSBR) could be at least fully matched by sales of debt; so that the pressure towards monetary expansion can be seen to be coming not from the public sector, but from the expansion of lending to the private sector.

In the three months to mid-November, up to a third of the £4½ billion expansion of bank lending was to persons. The banks have increased their share both of the mortgage and the consumer credit markets; but that explains only part of the increased bank lending to persons. The most rapid expansion has been in mortgage lending. This has not, however, been associated with increased activity in the housing market: housebuilding remains at a low ebb, and house prices weak. Consumers may be borrowing on the security of their houses to maintain spending in face of the rather steep decline in their real incomes this year. In present circumstances it seems somewhat unlikely that they will feel able for long to continue to increase debt so rapidly.

Bank lending to companies, though earlier increasing less rapidly than lending to persons, has accelerated in the latest three months. Previously, two temporary developments had greatly helped companies' cash position—the enormous run-down in stocks (worth £5½ billion in the year to last June); and the hold-up of tax payments during the Civil Service dispute (worth a similar amount in the period to mid-October). With these temporary effects ceasing or going into reverse, the cash position of companies could again come under pressure, even if profits improve. Capital issues have been larger than for some years, but could hardly be expected to have met the whole of these financial needs; and without additional accommodation from the banks, companies might well find it difficult to maintain or expand activity.

The effects of high bank lending on the growth of sterling M_3 can be mitigated, at least for a time, by 'overfunding' of the PSBR—a development which has necessarily to be accompanied by action to offset the resulting drain of cash from the banks. In the first half of the financial year, when the PSBR was abnormally high, debt sales were maintained at a normal level—so that, without official intervention, the cash holdings of the banks would have increased sharply. The arrangements previously adopted to provide the banks with cash were therefore put into reverse—notably by the authorities running down their holdings of eligible bank bills, thereby draining the banks of cash. During the second half of the financial year, the opposite will happen. The PSBR will be abnormally low; and, even with more moderate debt sales, the PSBR will be overfunded in that six-month period.

Monetary policy influenced by a range of considerations

The review of the operation of monetary policy (page 466) describes in detail how the various developments discussed above have borne on monetary policy in recent months. At the time of the steep rise in short-term interest rates in September and early October, the authorities were concerned that a further fall in the exchange rate, following the decline that had already taken place earlier in the year, would have serious adverse implications for inflation. A failure to respond rapidly to downward pressure on sterling appeared likely to risk accelerating sterling's fall, and an increase in the general level of short-term interest rates therefore seemed appropriate. Moreover, while the domestic situation produced conflicting evidence, there were signs that the underlying growth of the money supply and, more markedly, of bank lending to the private sector was

accelerating. Thereafter, in the period since early October, interest rates abroad have fallen; the effective exchange rate has strengthened; heavy sales of gilt-edged stocks have been made; and there has been a decline in domestic short-term interest rates—which, given the many uncertainties, the authorities have been concerned should not be too rapid.

Monetary policy has thus continued to have to pay regard to a range of considerations: the target aggregate, sterling M_3, and the other monetary aggregates, as well as the exchange rate, the rate of inflation and developments in the economy affecting them. Though there is not a target level for the effective exchange rate, it has appeared important to continue to seek to moderate its fluctuations.