General assessment

In the operation of monetary policy, regard has continued to be paid to a range of considerations—notably, the course of 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. This assessment discusses exchange rates and interest rates abroad, and the development of the economy at home, as the context in which monetary policy has operated.

Weaker commodity and oil prices

One important development has been the weakening in commodity and oil prices. With weaker demand throughout the world and financial policies generally remaining restrictive, commodity prices in general are now somewhat lower in terms of an average of industrial countries' currencies than they were in the summer. More recently world oil prices have started to fall: in dollar terms, the average fall since November has so far probably been less than 10% (and for many countries the effect has been partly offset by the strength of the dollar). This is far from reversing the price increases of 1979–80, whose repercussions are discussed in the article on page 56. Nevertheless, it represents an important change.

Within industrial countries, the impact of the lower commodity and oil prices is comparable in its demand effects to a modest reduction of indirect taxation, and the general rise in prices will accordingly be somewhat smaller than it otherwise would be. Any effects on economic growth may, however, be small—if only because the effect of higher real spending power at home will in part be offset by lower demand from producer countries. Given also lower oil production, the OPEC current account surplus, still substantial in 1981, could well be eliminated. Non-OPEC countries will be variously affected. Most will see their current account benefit as oil import bills are reduced.

World exchange rates

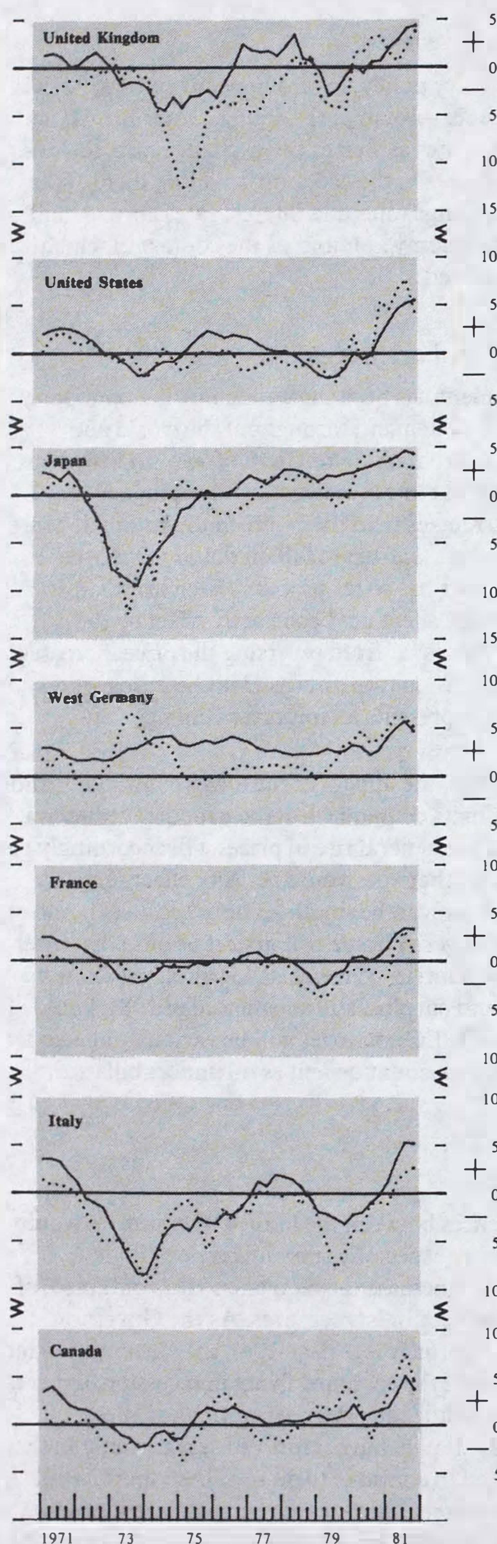
Persistent major imbalances between the industrial countries would be a cause of concern, more especially since at a time of high unemployment this would increase the dangers, so far contained, of a greater drift towards protectionist measures. As the Governor noted in his speech of 1 February (see page 104), the current account of the United States, despite the economy being in recession, appears to be moving into deficit, while the external positions of West Germany and, especially, Japan, have improved substantially in the past year and are expected to continue to do so. These shifts, while possibly reflecting earlier exchange rate movements, might at some stage provoke further exchange rate changes to correct the emerging imbalance. Recent realignments within the European Monetary System have also been of that corrective nature.

In recent years, however, many even of the larger exchange rate movements cannot be regarded as of a sort likely to promote long-term balance; indeed they have frequently been subject to short-term reversal. In 1980 the yen rose by some 18% against the

Interest rates *are high after rough allowance for inflation.*

Quarterly averages Per cent

...... Short rates roughly adjusted for current inflation(a)
—— Long rates roughly adjusted for current inflation(b)



Sources: National sources, *International Financial Statistics*. For the most recent quarters Bank forecasts of prices are used.

(a) Adjusted rate is the three-month money market rate *less* the change in prices over the year starting two quarters before, and ending two quarters after, the current period.

(b) Adjusted rate is the government bond yield *less* the annual rate of change in prices over the two years starting a year before, and ending a year after, the current period.

US dollar, a gain lost by last summer. The deutschemark was then 30% lower against the dollar than a year earlier, a change which has also since been partly reversed. A related problem is that very short-term movements of exchange rates have increased, with daily movements of up to 2% between major currencies not infrequent.

Part of the instability of exchange rates is a natural feature of exchange markets in today's uncertain conditions with floating rates. Much, however, reflects the interaction of the monetary policies pursued by different countries, in which developments in the United States have played a large role.

High world interest rates

Though below their recent peaks, interest rates remain high in most countries, certainly in nominal, and probably in real terms. Without knowing how rapidly people expect prices to rise over the years ahead, it is impossible to assess accurately the level of long-term real rates. Rough inflation adjustment (as in the chart) suggests that over the last decade real interest rates have been sometimes negative, sometimes positive—though not perhaps as high as they are now in most countries. Their significance varies with the extent and effectiveness of tax deductibility in different countries. Nevertheless, they suggest that monetary conditions may be more generally stringent than is, in some cases, indicated by the growth of the monetary aggregates. The latter can at times be a misleading indicator of how strict monetary policies are—though estimated real interest rates are clearly also an imperfect indicator for this purpose.

It is possible that interest rates in the United States may stay high in real terms even though nominal rates may ease with inflation. Upward pressure on rates could result from a combination of large federal deficits and an economic recovery later this year. In those circumstances, with a tight monetary policy, short-term rates of interest might remain high; and the financing of the fiscal deficit might help to keep up longer-term interest rates. It is clear, however, that the US authorities are aware of the disadvantages of high interest rates. They had a sharp effect on activity in the United States last year, contributing particularly to the fall in housing activity (housing starts were halved) as well as to the fall in automobile sales.

Interest rates in other countries will, of course, depend in part on their inflation performance. Nevertheless, the rise in rates in the United States has still appeared to present these countries with a difficult choice— to accept either higher interest rates themselves, with harmful consequences for economic growth, or a fall in their exchange rates, with harmful effects on inflation. Activity in the United Kingdom, and some other European countries, has in the past seemed less sensitive to interest rates than in the United States. Nevertheless, other countries have understandably been reluctant to match high US rates. With recovery here still in its early stages, any sizable rise in rates would increase the difficulties of companies and tend to make economic growth this year less likely.

Developments in the UK economy

The economy entered 1982 with the recession of the last two years having run its downward course. By the middle of last year GDP had been reduced, but to an extent difficult yet to estimate exactly. The output measure indicates a drop of 6% from its level in 1979. In the absence of trade figures for much of last year, the expenditure measure can only be estimated, but the decline was probably less.

The fall in the average measure of GDP may be put at 4%–5% over the period. As the run-down of stocks which accompanied the recession spent much of its force, there was some recovery in demand in the second half of last year. In the latest six months, however, the trend in industrial output (other than energy) has been hesitant and difficult to discern, in part because of severe weather conditions in December and January.

Along with the disadvantageous effects of recession—on output, unemployment, investment and profits—there have been encouraging developments also. Wages have increased markedly less than in preceding years, and productivity has improved—particularly in manufacturing. As a result, unit labour costs in manufacturing seem to have risen in the course of last year by only 2% to 3%—a performance not seen here for many years, and matched last year by few other countries. Along with the fall of some 10% in the effective exchange rate, this brought some recovery in industrial competitiveness, which had earlier deteriorated sharply. There was a temporary rise in retail price inflation in the latter part of last year, reflecting the fall in the exchange rate as well as increases in local authority rents and rates, in mortgage rates and in some nationalised industry charges. But the prices of the main categories of manufactured goods in the index, apart from foodstuffs, rose by under 4% in 1981. Though trends in foreign trade are clouded by the interruption to the trade statistics, and imports rose sharply, exports were higher than expected. These developments in general place the economy in a better position to respond favourably to a revival of demand.

This year the difficulties in forecasting are the greater because, while the fact of recession last year is clear enough, its exact scale is not. A fall in activity should be reflected equally in the figures for total output and expenditure; in fact (as already noted) there is an unusually large divergence in their estimated movements up to the first quarter of last year. This large uncertainty about the starting point of recovery partly explains the spread of views among the various forecasting teams (see table). But there is nevertheless considerable agreement between them, with most forecasts suggesting a continued increase in GDP this year. Developments could be affected by the course of world oil prices, and by interest and exchange rate developments.

The Budget has reduced taxation somewhat, with income tax allowances raised slightly more than in line with inflation and indirect taxes slightly less. But the main tax change was the reduction of the national insurance surcharge in the private sector. One convenient way to analyse the Budget is to take as a starting point what would have been required to increase income tax allowances and indirect taxes in line with inflation—and to treat anything beyond that as a Budget change. On this basis, the effect of the tax changes and of the Budget increase in spending was to raise the public sector borrowing requirement (PSBR) in 1982/83 by £1¼ billion from what it would have been on unchanged policies. After taking into account the revenue effects of the forecast economic expansion and the effect of the measures announced last December, the PSBR is expected to be reduced in money terms from £10½ billion in 1981/82 to £9½ billion in 1982/83. As a percentage of GDP it will be reduced more sharply (as it was in 1981/82). From this aspect, the Budget continues to reflect a cautious fiscal stance. As a result of the Budget changes, prospects for output are somewhat higher, and for inflation somewhat lower, than they would otherwise have been.

The spread of forecasts for 1982[(a)]

Percentage changes

	Change in GDP (Year on year)		Rise in retail prices	
		Margin of error		*Margin of error*
			(Q4 to Q4)	
Post-Budget HMT forecast	+1½	±*1*	9	±*2*
Pre-Budget independent forecasts				
View of seven forecasting bodies(b)	−0.8 to +1.7		9 to 11	
			(Year on year)	
Two more divergent views	−2.9(c)		11.3(c)	
	+2.5(d)		7.6(d)	

(a) The forecasts are not all on a strictly comparable basis—in particular, different measures of GDP are used, and some of the prices forecasts are for slightly different periods from those shown.

(b) NIESR, LBS, Phillips and Drew, St James's Club, ITEM, Cambridge Econometrics, OECD.

(c) CEPG.

(d) Liverpool.

The fall in the PSBR

	PSBR		North Sea revenue(a) (£ billions)
	Per cent of GDP	£ billions	
1978/79	5½	9.2	0.6
1979/80	5	9.9	2.3
1980/81	5¾	13.2	3.9
1981/82	4¼	10.5	6.4
1982/83	3½	9.5	6.2

(a) Royalties, corporation tax from North Sea oil and gas production, petroleum revenue tax and supplementary petroleum duty.

Monetary policy in the year ahead

Monetary policy has continued to be moderately restrictive. The broad monetary aggregates expanded rather less rapidly over the six months to mid-February than in the previous half-year and the growth of the narrower aggregates has continued moderate (see page 22); interest rates have remained quite high; and the effective exchange rate has been firm.

A main counterpart to the strong growth of the broad aggregates—which took the growth of sterling M_3 above the target range—was the growth in sterling bank lending to the private sector. While lending to persons increased steeply in proportionate terms, the bulk of the increase reflected a rise in lending to business. The rate of increase of personal lending may ease off to some degree, but this may be less likely for lending to business. The rapid run-down of stocks had previously eased firms' financial position. But with the flattening out of the recession, and with profits, though recovering, still low in real terms, corporate borrowing needs increased. The effect on capital markets of a long period of inflation was to leave firms without ready access to other sources of borrowing. There has thus been a powerful rationale underlying borrowing from the banks by business. The reaction of capital markets to the Budget measures, including those relating to the tax treatment of capital gains, may in time place companies in a position to raise more funds in the capital market. But, despite the relief to their cash flow from the reduction from next August of the national insurance surcharge, their need to borrow from banks could remain high, at least in the early phase of recovery.

As in the United States, the gathering pace of innovation under the spur of competition is leading to new channels of finance and new financial instruments. A statistical series for any monetary aggregate, compiled on static definitions, is thus liable to shift in meaning. The incursion of the banks into the field of housing finance appears in part to have been associated with a diversion of deposits from building societies, which has had an important effect on sterling M_3. But each of the aggregates now seems liable to be affected by financial innovation to greater or less degree (page 21). Such developments make it desirable to pay regard, not simply to one aggregate, but to a number. The range of 8%–12% now set for monetary growth, unlike previous years, applies both to narrow money (M_1) and to the broad aggregates (sterling M_3 and PSL_2).

To maintain control over the growth of the monetary aggregates, it will continue to be necessary to finance the public deficit in appropriate form. The decision to remove the previous restriction on those entitled to buy indexed gilt-edged stocks will allow a programme of funding in which conventional gilt-edged, indexed gilt-edged, and national savings will each play a role.

The exchange rate is both an indicator of monetary policy and one of the channels by which the effects of policy are transmitted to the economy; a fall in the rate brings inflationary effects, while a rise tends to blunt industry's competitiveness. While clearly affected by many factors other than relative interest rates, the behaviour of the exchange rate is therefore a consideration which must be given due weight in implementing monetary policy.

If interest rates in the United States continue to be unstable, sympathetic movements in interest rates in other countries may to some degree be inevitable. But none of the major countries has

followed recent fluctuations in US rates at all completely (page 20). Interest rates in the main European countries have tended to move together. Formal and close concertation on interest rate policies would be difficult to operate because of the differing market factors and political sensitivities to interest rates in the various countries. But to the extent that it is possible to maintain a degree of parallelism among interest rates in European countries, this should ease conflict between internal and external considerations, and help to keep interest rates lower.

While the techniques of monetary policy have to be adapted in the light of developing circumstances, the task of policy in this country remains unchanged. The approach of guiding policy by reference to a number of considerations does not indicate a less firm and coherent policy stance than concentration on a single indicator. The policies pursued by the authorities last year in reflection of this broader approach have in practice been generally accepted in financial markets. Inflation should now be significantly reduced in response to continuing steady downward pressure. The aim of policy must be to persist in this path and provide conditions for a faster growth of output in the future.