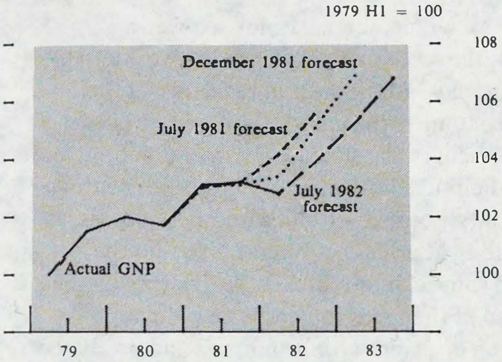
General assessment

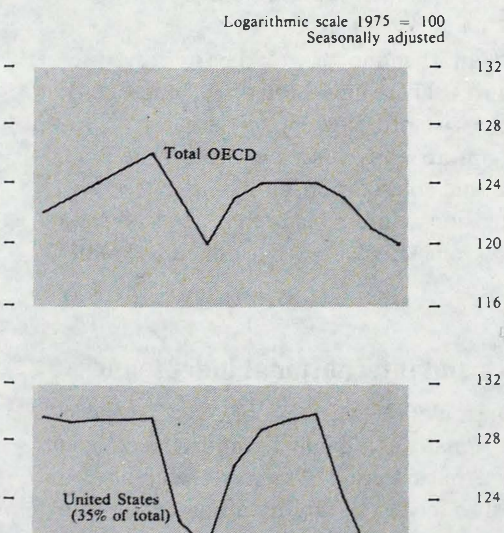
Hopes of world recovery this year have clearly been set back. At the same time there has been significant progress in reducing the pace of inflation—in many countries rather faster than expected—and interest rates have fallen considerably, more especially in the United States. Both developments should to some degree have favourable effects on economic activity. This assessment aims to evaluate these trends as the background to monetary policy in this country.

The forecast recovery of **GNP in major OECD countries** *has been repeatedly postponed.*



Source: OECD *Economic outlook.*

Much of the weakness in **industrial production** *has been in the United States.*



Industrial countries—prospects of recovery

There are no clear signs yet of recovery in industrial countries: output in the first half of this year has been slightly below last year's level, and only slightly above the level of two years ago. Most world economic forecasts suggest modest expansion next year—though a forecast of an upturn has (as the chart shows) been repeatedly moved further into the future.

Much, but by no means all, of the unexpected weakness of demand has occurred in the United States, whose second recession in two years went deeper than foreseen. High real interest rates there no doubt contributed to this latest phase of recession, leading to cutbacks in inventories, industrial investment and spending on housing and cars. The dollar exchange rate has also been very strong—in part a further effect of high interest rates in the United States. This has made the United States a less competitive supplier of tradeable goods even to meet its own demand, and in turn has helped to deepen its recession (while supporting demand elsewhere). Economic activity, after falling sharply for two quarters, rose in the second quarter of this year (and possibly also in the third). Interest rates fell sharply in July and August.

The fall in US rates has in part been associated with a helpful shift in the balance between fiscal and monetary policy—whose relationship has been complicated by factors special to that country. In mid-August Congress passed measures designed to reduce the fiscal deficits over the three fiscal years 1983–1985 by a total of $130 billion. The effects on the economy of a cut in the deficit will be complex. While higher taxes are likely to reduce spending and have a contractionary impact, the agreement to take budgetary measures has helped sentiment and has encouraged the fall of interest rates. Furthermore, markets have interpreted Federal Reserve actions and statements as indicating that, in determining policy, it would take account of a wider range of factors (including current financial and economic disturbance and uncertainty); that it would be less concerned if there were temporarily a rather faster growth of the money supply; and that it would welcome a lower level of interest rates.

Another reason suggested in the United States for the fall in interest rates has been the growing belief that economic recovery is likely to be subdued—so that some of the pressures that strong recovery would place on interest rates are now unlikely to arise.

Real interest rates are shown in the chart on page 335

A third factor has been the falling off in the rate of inflation. This means that the fall in real interest rates has clearly been much less than the fall in nominal rates; and real interest rates remain high. Nevertheless, it is likely that the recent strengthening of demand will continue, and there will be some expansion of activity in the United States in the remainder of this year and next.

Economic developments in other countries are also discussed on page 333

In most other industrial countries demand has been disappointingly weak. The change in conditions has been particularly marked in Germany; but in France and Italy and most smaller European countries, industrial production is flat or falling. Business confidence has deteriorated; business investment has fallen off; exports have been declining; and unemployment has continued to grow. In Japan, exceptionally, growth has continued, supported now by domestic demand; but the rate of growth has been modest by Japan's standards and has been insufficient to prevent a weakening of the labour market. Most countries hope for resumed expansion next year, though there is little expectation that it will be strong.

In industrial countries as a whole, there has not yet been a sustained recovery from the second oil shock; and there is a risk that prolonged recession may sap the natural resilience of their economies. For these economies, the fall in commodity prices has been an important ingredient of the slowing down of inflation; and in this respect has been helpful. But commodity prices are at lower levels than are likely to be sustained—for in a number of cases producers have been selling at prices below cost—so that the reduction of inflation to some extent represents a drawing on the future. The prolongation of the recession has been inducing widespread moves among both industrial countries and producers of commodities to cut back capacity. If continued, this could lead to lack of capacity and upward price reactions later. Resumed economic expansion next year should therefore be in the interest of stability in developing and developed countries alike.

If recovery were delayed, another danger would be increased resort to restrictive trade measures. There have been disturbing signs that industrial countries, faced with prolonged weak demand conditions, are becoming more ready to seek to protect their producers from international competition; and—influenced in some cases by political tensions—more ready to embark on trade wars. Protective measures, once in place, prove difficult to remove.

Developing countries and international indebtedness

An important new dimension of the world problem is that the worse financial position of many companies in industrial countries, and the much weaker external situation of many developing countries, is now seriously affecting the ability of some important borrowers to service debt. This has led to a general increase in caution among both lenders and borrowers; whether or not appropriate in individual cases, this could force borrowers to cut back their expenditure even more.

There is a chart of real commodity prices on page 333

Developing countries have been affected much more seriously than in previous recessions since the war. Weak world demand has greatly reduced their growth, and real commodity prices are now lower than at any time in the last thirty years.

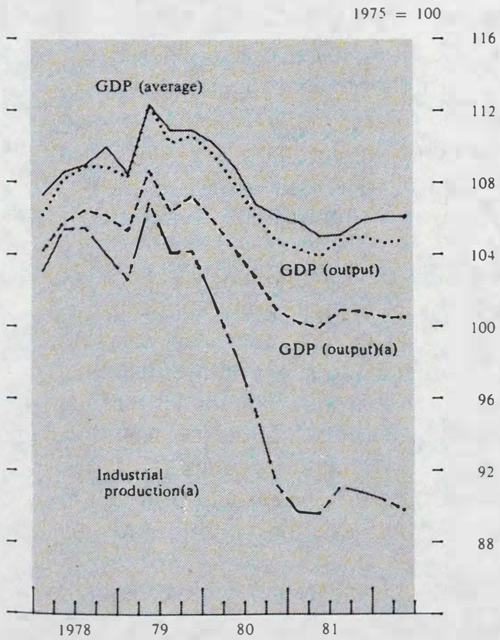
World payments patterns are shown in the chart on page 356

The position of developing countries needs to be seen in perspective. In earlier decades they normally ran payments deficits required for their development and financed by capital flows from developed countries. While the rise in the price of oil in 1973–74 resulted in greatly enlarged deficits for the non-oil developing countries, the international banking system successfully recycled the funds needed to finance them. The higher borrowing of developing countries did not in most cases result in unmanageable debt-service ratios, in part because maturing capital repayments could normally be rolled over.

This position has been undermined—by the second increase in oil prices (now partially reversed, but only in small part); by the fall in the real price of their own exports; and by the steep rise in the real burden of interest on their enlarged volume of debt. Developing countries' vulnerability to higher interest rates has been increased through their having borrowed largely on non-concessionary terms from the banking system, often on shorter maturities.

In present conditions most developing countries are forced to restrict imports very heavily; financial necessity and prudent self-interest both dictate it. Even so, these countries are likely to have to continue to borrow on a substantial scale, preferably at longer term. The need is to see that this takes place as smoothly as possible. For this to happen, the role of the banks needs to be complemented by larger financing from official sources and international financial institutions. Recent experiences have illustrated that the IMF has a key part to play. The way back to restored credit-worthiness lies through the sometimes necessarily stringent conditionality attached to Fund programmes. An expanded role for the Fund seems likely to be an essential element in the world financing picture in the years to come. Drawings on the IMF and the accompanying programme of measures to secure financial adjustment normally take some time to put in place. Two recent cases, however, have shown that the co-ordinated action of central banks can, at short notice, make interim finance available, if the circumstances make it appropriate. The provision of adequate finance through these various channels serves the interest not only of developing countries, but also of the developed countries: without it, recessionary tendencies would be unnecessarily exacerbated.

Economic activity *has levelled off after some recovery last year.*



(a) Excluding North Sea oil and gas.

The UK economy

In this country as in others there has been practically no growth in output this year, but at the same time a specially marked falling off in the rate of inflation.

The steep decline of output that started in the second half of 1979 came to an end in the middle of last year and gave place to a slight rise up to the turn of the year. Subsequently output appears to have run just about flat—for reasons which can be identified only in broad terms (for estimates of national expenditure are insufficiently firm and many movements have been erratic). The slight pick-up in output last year occurred primarily because the depressing effect of the previous large run-down of stocks came to an end; this had supported output despite a very large rise in imports. This year, stocks appear to have levelled out. Last year, too, there was a rise in exports—a rise which seems not to have continued this year, in part at least because of unexpectedly weak growth abroad. (Changes in the recording procedure, however, make export figures difficult to interpret.) Investment demand, which had been declining from its 1979 peak, also started to rise last year, but fell back in the second quarter of this year when industrial investment turned down.

Last year import penetration (especially in manufactures) increased sharply, thus helping to depress domestic output; this year, import penetration seems to have shown little change. This could in part be a result of the marked improvement in competitiveness in the course of last year (changes in competitive conditions appear to affect imports quickly). This year the rise in wages has been slower than last year, and productivity (though less rapidly than in 1981) has continued to improve. But the same has been true of other countries, so that this country's competitiveness has not improved further. This underlines the need to keep cost increases to a minimum. Output would benefit very directly from positive increases in competitiveness.

Looking ahead, it remains likely that there will be a rise in activity next year. Present indications suggest that consumer spending, and possibly investment and exports, should start to rise again, even if only modestly.

On the usual twelve-month comparison the rise in retail prices, which was 12% in December last, had fallen to 8% in August, and is likely to fall substantially further by the end of the year. The main reasons for the slower rise in prices have been the slower rise in labour costs—and in taxes, local authority rates and nationalised industry prices; and the weakness of world commodity prices. Also contributing have been the firm exchange rate, the fall in mortgage rates (the effect of the $1\frac{1}{2}$ point reduction announced in August is still to come), and smaller rises than usual in the price of seasonal foods. Aside from companies engaged in North Sea activities there has been some recovery in profit margins—which may well have been associated with the marked rise in productivity. It is specially satisfactory that prices slowed down so much at a time when firms have been able to make much-needed improvements in profit margins.

Changes in import penetration

Percentages seasonally adjusted

	Imports as a proportion of total final expenditure	Manufactured imports as a proportion of domestic sales of manufactures
1979 H2	23.8	44.0
1980 H1	23.6	43.8
H2	22.5	41.0
1981 H1	22.2	41.3
H2	24.7	48.5
1982 H1	24.0	47.7(a)

(a) Provisional.

Monetary developments in the United Kingdom

Monetary developments have followed a reasonably satisfactory course this year. The growth of the monetary aggregates has remained under adequate control; and at the same time, rates of interest have fallen appreciably from the high levels ruling towards the end of last year. Both control of the aggregates, and a lower level of interest rates, are clearly desirable.

One factor that has complicated monetary policy has been the growth of bank lending. It was lower in the three months to August, but still about £$1\frac{1}{4}$ billion a month, compared with some £$1\frac{3}{4}$ billion a month in the earlier months of the year. Business demand for bank loans fell away sharply—though there are signs in most recent data of a modest revival. (Its high level earlier probably reflected very high tax payments—and thus an unusually low PSBR—in the spring months.) On the other hand, bank lending to persons, chiefly in the form of mortgages, has continued to grow.

The need at times to 'overfund' the PSBR in order to contain the growth of sterling M_3 in the face of high bank lending was discussed in the June *Bulletin*. There was considerable overfunding

Funding, bank lending and growth of sterling M_3

£ millions, *seasonally adjusted*

	Mid-Feb.–mid-May	Mid-May–mid-Aug.
Total impact of public sector (overfunding –)	–1.6	—
of which, central government:		
borrowing requirement	*–0.1*	*+3.2*
debt sales	*–2.4*	*–2.4*
Sterling lending to private sector(a)	+5.2	+3.9
External flows	–0.8	–1.1
Sterling M_3(b)	+2.0	+2.6

(a) Including Issue Department purchases of commercial bills.

(b) Not the total of previous items because some items (notably the change in non-deposit liabilities of the banks) are left out.

Growth of monetary aggregates

Annualised percentage changes (rounded)

	Mid-Feb.–mid-May	Mid-May–mid-Aug.
M_1	—	+18
Sterling M_3	+ $9\frac{3}{4}$	+$12\frac{1}{2}$
PSL_2	+$10\frac{1}{2}$	+ 7

in the first part of the current target period: in the three banking months March-May, net sales of public sector debt to UK non-banks exceeded the PSBR by more than £1½ billion. But in the succeeding three months (to mid-August) the PSBR was almost exactly funded.

Dependence on 'overfunding' has therefore been reduced, though monetary control has continued to rely on fairly heavy sales of government debt. This has not prevented a marked reduction in long-term interest rates—from around 16% last year to around 11½%–12% now. Without an appropriate level of debt sales control of the broad monetary aggregates could not be maintained.

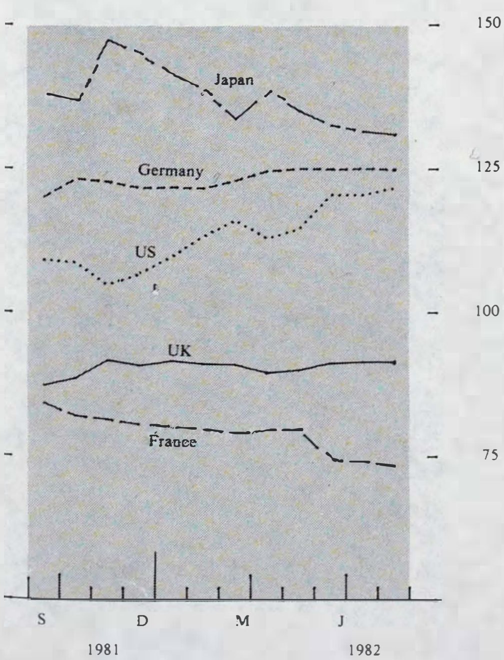
Perhaps partly because of this change in the net position of the public sector since the spring, the growth of sterling M_3 quickened during the summer. The narrower aggregate, M_1, is influenced particularly by the level of short-term interest rates: after earlier stagnation, it too has begun to rise fairly rapidly in recent months, probably under the influence—no doubt not yet exhausted—of the sustained decline in short-term interest rates since last October. Thus, although all three target aggregates grew within the range of 8%–12% a year in the first six months of the target period, the underlying trend is now more expansionary than appeared three months ago.

The growth of sterling M_3 has also been reduced by the private sector having been in balance of payments deficit (its current account surplus having been exceeded by an outflow of long-term capital): this effect on sterling M_3 is shown by the unusually large negative external item shown in the table. The deficit has been matched by short-term capital inflows (to the banks and public sector) which could well change in response to changes in interest rates and other factors. This is a possibility which needs to be kept in mind in assessing the monetary situation.

The fall in interest rates which has occurred has been very considerable. Clearing bank base rates, which were at 16% at the beginning of October last, had fallen to 13% by March, and fell to 10½% by the end of August. The fall in US rates of interest was an important factor especially in the most recent phase of the fall in rates in this country; but domestic factors have probably been more fundamental. The reasons why continued monetary control was compatible with falling interest rates must be sought in the general position of the economy—in particular, less strong demand for bank loans, and, above all, falling expectations of inflation.

Sterling *has been notably steady in effective terms in the last year.*

1975 = 100



Another noteworthy feature of recent developments has been the stability of the effective exchange rate, which has continued to fluctuate within a relatively narrow range somewhat above its level of a year ago. Sterling has indeed been more stable than other major currencies in the last year. It is not clear what accounts for this special degree of stability. The exchange rate is one among other factors to which monetary policy has to pay regard; but its recent stability must be due to a variety of market factors, among which the level of interest rates in this country relative to those elsewhere is only one. (The box on page 334 discusses exchange rate variability in recent years.)

The general picture, in short, is that there has been some modest acceleration in the pace of monetary expansion, which however remains within the target range; the exchange rate has remained firm; and nominal interest rates have fallen. It is true that, with the fall in inflation, real interest rates, while somewhat reduced, remain substantially positive. Nevertheless, the fall in nominal interest rates must itself be helpful. High nominal rates impose in the early years of a loan an immediate burden on borrowers' cash flow, and the fall in borrowing rates must have been beneficial to business. There are good hopes that inflation will recede further in the period ahead; and further falls in nominal rates, if they proved possible—even if they reflected no further fall in real interest rates—could ease companies' financing problems in various ways.