General assessment

The Economic commentary (page 467) contains a fuller description of economic developments in the United Kingdom and abroad

The performance of the UK economy in 1982—as is true also for the world economy—has been disappointing as regards output while encouraging as regards inflation. Prospects for the UK economy for next year depend significantly on whether there is much recovery in the world economy. They also depend on making further progress in reducing inflation. The final section of this assessment discusses monetary policy in this country against that background.

Uncertain world prospects

Recent forecasts for world growth have proved over-optimistic—which makes future developments difficult to predict with confidence. Most forecasts, for instance, made last year foresaw an expansion of output in the major industrial countries in 1982 (the OECD forecasts, shown in the table, are typical). The outturn is likely to be a small fall. Inflation, however, has also slowed down more than expected.

Errors in world forecasts 1982[a]

Forecast changes in OECD output from 1981 to 1982 compared with outcome (expressed as contributions to percentage change in GNP or GDP).

	As forecast July 1981	Probable outcome(b)	Error (+ = over prediction)
Consumer spending	$1\frac{1}{4}$	$\frac{1}{2}$	$+\frac{3}{4}$
Fixed investment	$\frac{1}{4}$	$-\frac{1}{2}$	$+1$
Stockbuilding	$\frac{1}{4}$	$-\frac{1}{4}$	$+\frac{1}{2}$
Exports to non-OECD	$\frac{1}{4}$	$-\frac{1}{4}$	$+\frac{1}{2}$
Final expenditure	$2\frac{1}{4}$	$-\frac{1}{4}$	$+2\frac{1}{2}$
less imports from non-OECD	$\frac{1}{4}$	—	$+\frac{1}{4}$
GNP/GDP	2	$-\frac{1}{4}$	$+2\frac{1}{4}$
Consumer prices(c) (percentage change)	9	$7\frac{1}{2}$	$+1\frac{1}{2}$

(a) OECD forecasts for the major seven economies (United States, Canada, France, Italy, Japan, United Kingdom and West Germany).

(b) Bank estimates.

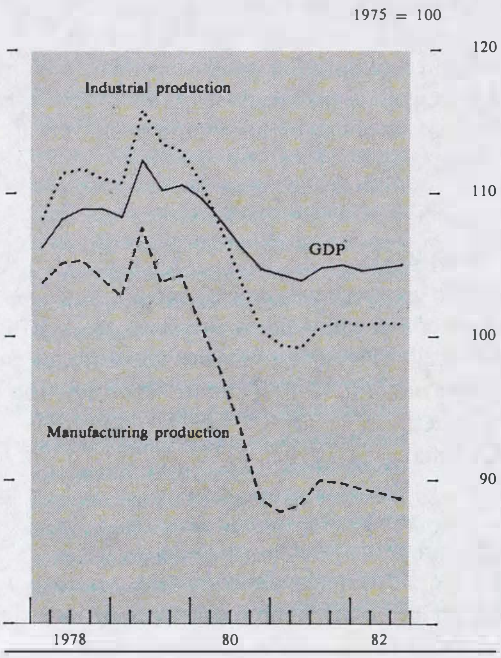
(c) Expenditure deflators.

The mistaken forecast of an upturn can be attributed to the interaction of several factors. Insufficient allowance was probably made for the effect of high interest rates on the growth of industrial economies. The impact of that slower growth on the price and volume of developing countries' exports, and the effects that and high interest rates had on their debt problems, were therefore also not fully foreseen. The consequential cut-back in their imports from the industrial countries must in turn also have helped to lower investment, consumer demand and stockbuilding in the OECD area.

Looking to the future, areas of particular uncertainty are the strength of recovery in the United States; the future of world oil and commodity prices; and the scale of demand coming from the producers of oil and commodities. One possibility set out later in this *Bulletin* (page 468) is for a relatively restrained recovery in which activity in industrial countries next year rises by 2 per cent, still insufficient to prevent a continued rise in unemployment; but it is possible to imagine an even more muted recovery.

The impetus to faster world recovery must clearly originate not from the developing countries, but from the industrial countries. The single most helpful development in this respect—as the Governor suggested in his Mansion House speech (page 502)—might be a substantial further fall in US interest rates. That would not only help to stimulate investment, consumption, and activity in the United States, but would also facilitate lower interest rates in other industrial countries; and would ease the constraints on developing countries. It is, however, uncertain how far lower interest rates in the United States will prove possible. The appearance of an over-expansionary policy would clearly risk reawakening inflationary fears, all the more because of the uncertainty about the longer-term fiscal balance. But innovations in the financial system as a result of competition and legal changes, have led to a more interpretative approach to monetary targets in the formulation of monetary policy. The shift in emphasis to a more flexible approach appears to have been accepted in financial markets.

UK output *has shown little movement up or down for the last year.*



Exports of manufactured goods

1975 prices; 1980 = 100

	1981 H1	1981 H2	1982 H1	1982 Q3(a)	Percentage change; 1981 H2 to 1982 Q3
United States	99	91	83	83	−10
Canada	105	105	102	104	− 1
France	101	106	99	100	− 7
Italy	101	114	111	100	−13
Japan	108	114	104	100	−12
West Germany	103	110	112	106	− 4
United Kingdom	94	100	98	94	− 6

(a) Bank estimates except for the United Kingdom.

Prospects for the UK economy

Though many forecasts earlier this year predicted some rise in output in this country, it has shown little movement either up or down for the last year. This is true of GDP, of total industrial production and, within that, of manufacturing production: of the major sectors, only the extraction of North Sea oil and gas has performed strongly. Against this, the pace of inflation has fallen more rapidly than was earlier expected; the annual increase in the retail price index, which was 12% in January, may fall to around 5% by next spring.

Consumer demand has recently strengthened, rising $1\frac{1}{2}\%$ in the third quarter, reflecting stronger demand for durables, especially cars. That was associated with higher personal borrowing generally, in part a response to the abolition of hire-purchase controls. The increase in expenditure seems, however, to have been met from stocks rather than output. In so far as any decline in stocks was involuntary, this would promise a future response from output—and imports—of consumer goods.

Industrial investment was somewhat lower in the second and third quarters than in the previous six months (dipping in the second and recovering in the third quarter). The earlier surprising resilience of investment in the face of excess capacity and financial pressures does not appear to be being fully sustained. The failure of output to recover in the last year may have been a more potent influence than the stimulus that declining nominal interest rates provided.

The course of exports has also been disappointing. The volume of exports (excluding oil and erratic items) in the third quarter was 4 per cent lower than in the first half of the year. This reflected the unexpected weakness of demand worldwide: most industrial countries have recently experienced large falls in their exports of manufactures.

Given the uncertainties in the world scene next year, the pace of expansion in this country must also be problematic. It will depend to some extent on the room for tax reliefs in the next Budget, and the course of domestic interest rates. Given some recovery in the world economy, there should be a modest growth also in activity in this country next year; without it, the strength of our recovery would inevitably be much diminished.

Growth will depend, too, on how far this country's industrial cost position can be improved. Lack of competitiveness resulting from excessive increases in labour costs has depressed output severely in recent years. The position improved last year as a result of the moderation of wage increases at a time when the exchange rate had fallen. In the first part of this year competitiveness showed no further improvement, since in other countries also the pace of increase of unit labour costs has moderated.

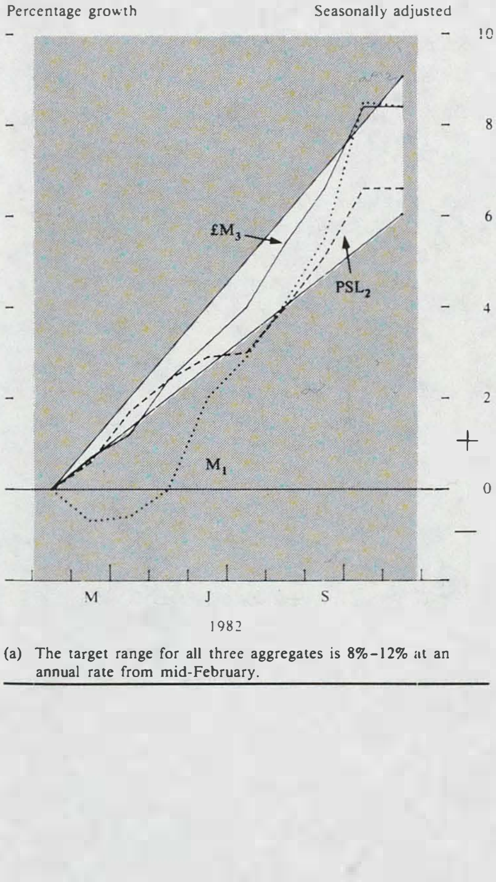
The restoration of competitiveness on an enduring basis entails, essentially, continued productivity improvement and moderate wage increases, both being judged against developments in other industrial countries. In present conditions this requires that money wage increases are reduced to very small dimensions. Though few settlements have yet been made in the present wage round, their scale has been disappointing, since if continued it would provide little contribution to improving competitiveness next year. The arguments invoked in wage claims could have the result that only limited assistance to competitiveness would come from the recent fall in the exchange rate; that could help only if there is no subsequent acceleration of wage increases. Continued failure to make the adjustments needed to improve competitiveness substantially is bound to hold back the United Kingdom's growth in the period ahead.

The task for monetary policy

Operation of monetary policy on page 478 contains a fuller discussion of UK financial developments

Although the various indicators of monetary tightness have given divergent—and changing—readings, monetary developments have on balance been satisfactory. Monetary growth had been accelerating in the summer months—notwithstanding unexpectedly slow growth in output and prices, and thus in money incomes. But the trend seems now to have somewhat moderated. The exchange rate (on a trade-weighted basis) remained relatively stable for most of the period, but declined in late November. The indications from the growth of the monetary aggregates in the summer of somewhat lessened monetary tightness have not been supported by other pointers. Inflation has continued to fall; asset prices (apart from those directly linked to interest rates) have been rising only modestly; and the financial position of industry has remained difficult.

Monetary aggregates *remain within their target paths*[(a)]



(a) The target range for all three aggregates is 8%–12% at an annual rate from mid-February.

Bank lending to companies, while appearing to vary considerably during the last year, has remained high—no doubt largely reflecting their difficult financial position. The rate of bank lending to persons has also remained very high. Several of the clearing banks have taken steps to reduce their mortgage lending, but actual lending flows may have only just begun to fall; and, at the same time, the building societies have been receiving record inflows and making record mortgage commitments. Offsetting this, monetary growth has been restrained by continuing external outflows. Bank lending to the public sector has been subdued because the public sector borrowing requirement so far this financial year has been smaller than expected, and somewhat more than matched by sales of debt outside the banking system.

Appropriate monetary restraint was compatible, until interrupted in November, with a continued fall in interest rates. Bank base rates declined progressively from the peak of 16 per cent reached in October last year to 9 per cent in early November. But in late November the fall in the exchange rate unsettled domestic markets, causing the banks to increase their base rates. Inflationary expectations—even allowing for the fall in the exchange rate—must also have been substantially revised downwards in the course of this year, so that the fall in real interest rates so far has probably been much less marked.

The note on page 483 discusses estimation of real interest rates

There has been a notable shift in the composition of debt sales in recent months. With interest rates falling, both national savings and certificates of tax deposit have become more attractive; and sales of these recovered sharply in the latter part of the year. Net sales of gilts to the non-bank private sector have, by contrast, been

The speech by the Deputy Governor reproduced on page 506 comments on this issue

somewhat lower, with new issues concentrated on indexed stocks and shorter maturities—with the aim of leaving more room for a recovery, perhaps now in sight, of the corporate debenture market.

The main monetary aggregates, despite some acceleration in the summer, remain within their target path. The monetary base (largely currency in the hands of the public) has consistently grown more slowly, owing mainly to structural changes—a reminder that, in this country as in the United States, these may shift the relationship between monetary aggregates and broader financial and economic developments. For the future, there will be a need to ensure continued restrained growth in the monetary aggregates as a basis for maintaining financial confidence, and making further progress in reducing the rate of inflation.