General assessment

This assessment seeks to set out the considerations relevant to appraising the stance of monetary policy, both over the past year, and as foreshadowed in the target ranges announced for the year ahead. Monetary trends have been satisfactory in that the growth of the targeted aggregates was held within the target range—though the fall in the exchange rate, after a period of stability, caused a reversal of part of the earlier fall in interest rates. In interpreting developments, account needs to be taken both of various changes in the economy which have affected monetary behaviour, and of monetary factors which have affected the course of the economy—interactions which have recently been especially important.

Careful review is needed at the present juncture since developments have at several points been unexpected, and the behaviour of the economy thus difficult to interpret. Consumer demand has been unexpectedly strong; the decline of imports in the second half of last year in face of strong domestic demand—and the modest growth of output—was also unexpected. Questions arise too as to why world economic recovery has been delayed; how far the delay will now be made good; and how the debt problems of developing countries will affect it.

The main Budget changes are summarized on page 12.

It is also appropriate to take stock after the Budget of 15 March. The target range for M_1, sterling M_3 and PSL_2 is 7%–11%, as envisaged last year. This is against a background in which the PSBR is also projected to be in line with last year's Financial Statement—after a year of substantial shortfall. These developments would be consistent with continued expansion of demand and the maintenance of the downward trend of inflation. The Budget cut in personal taxation will contribute to the former, while changes in indirect taxes and related measures, being smaller than a year ago, together with the reduction in the national insurance surcharge, will help the latter.

The exchange rate and prices

Attempts at explaining exchange rate changes have not been particularly successful; it is not possible, therefore, to isolate with any confidence the factors underlying the depreciation of sterling that occurred at the turn of the year. They appear, however, to have included expectations of a significant fall in oil prices; sharp corrections in the exchange rates of other major currencies, amid changing views about the future path of US interest rates; and, to some extent, uncertainty over the timing of the next general election. As always, exchange markets have attempted to anticipate future developments; and the markets' changing perceptions of the relative importance of different factors have led to considerable volatility.

As has been made clear, the exchange rate is a factor that is taken into account in judging the tightness of monetary policy. The fall in the exchange rate made the impact of monetary policy on the economy appear less severe; and the somewhat slower monetary growth since the summer therefore seemed not inappropriate. Provided that wage moderation is sustained and that the competitive gain is not eroded, the lower exchange rate should considerably ease the difficulties of industry in competing in export and domestic markets. It will tend to raise consumer prices, but this influence should be partly offset by the effects of a lower dollar price of oil.

The precise effect of the fall in the exchange rate is, however, difficult to read. There is some evidence that, with exchange rates and costs as they were in 1980, the United Kingdom was an easy market to sell into; and that the profit margins of importers and foreign suppliers were high. These margins contracted sharply in 1981—with the consequence that the decline in sterling at that time had a smaller inflationary effect than would have been predicted from earlier experience. It is not clear how far circumstances in the wake of the recent decline in sterling will favour a substantial further contraction. If foreign suppliers' margins do narrow again, the inflationary effect will again be mitigated. UK exporters' margins, on the other hand, were very low in late 1980, and since then the improvement has been modest. In order to restore profit levels, foreign currency prices of exported goods may therefore now be cut less than usual in response to the lower exchange rate.

If the fall in the exchange rate has smaller than usual effects on the sterling price of imports and the foreign currency price of exports, it may also have a somewhat smaller effect on both import and export volumes than experience before 1980 would suggest. The recent depreciation should, nevertheless, clearly have a helpful effect on trade volumes by the end of the year.

It is also not clear how far prices will be moderated by the unusually rapid growth in productivity. In the past, industrial prices appear to have followed the underlying trend of costs rather more closely than their actual movements; and cyclical fluctuations in the rate of growth of productivity (above or below the trend rate) have thus been reflected predominantly in profits—which is the main reason why profits are so variable through the economic cycle. The growth of productivity has, however, been unusually and unexpectedly fast, and economic recovery might accelerate it even further. Under present conditions of vigorous competition, some of the benefits of quicker productivity growth may be passed on to consumers, which would further moderate the increase in prices.

Conventional calculations, based on the share of imports in final expenditure, would suggest that a depreciation of, for instance, 10% would add about 2% to the price level twelve months later. The factors discussed above might, between them, offset a part of this. Among the various price indicators, depreciation is likely to have the largest effect on the retail price index. While this indicator is sensitive to import costs it is also affected by special factors such as seasonal food and mortgage rates, and may at times exaggerate trends. Retail prices are now about 5% higher than a year ago. This annual comparison, having fallen fairly continuously through last year, is likely to show some rise later this year. Other indicators will be less affected. The GDP deflator provides a broad measure of

Price and cost indicators

Percentage increases

In year to:	1980 Q4	1981 Q4	1982 Q4
Retail prices index	15¼	12	6¼
GDP deflator (factor cost)	18¼	7¼	6¾
Domestic expenditure deflator (market prices)	16¼	8¾	5¾

domestic costs: in the latter part of 1980 it was 18% higher than a year earlier; since then it has risen at about 7% a year, and may rise a little less this year. The deflator for domestic expenditure—which includes import costs and provides the broadest measure of domestic prices—may show little, if any, acceleration.

Consumer demand and the saving ratio

Consumer spending was unexpectedly strong in the second half of last year, and was nearly $2\frac{1}{2}$% higher than in the first half. None of this rise can be attributed to a rise in real incomes after tax, which indeed declined slightly. (Average earnings rose $1\frac{1}{2}$%–2% in real terms between the two half-years; but there were fewer people in employment, more in receipt of social security, and other incomes probably rose less than prices.) But there was a further drop in the saving ratio—which, from a peak of over 16% in the second half of 1980, fell to 13% in 1981 and to perhaps 9%–10% in the fourth quarter of 1982.

See economic commentary, page 8.

A lower rate of saving means, in general, that people acquire net financial assets at a lower rate. In terms of gross flows, they went on making contributions to pension schemes and life assurance funds, while at the same time increasing their liabilities by borrowing from banks, building societies and other credit institutions. In some cases—where people could have borrowed more in the past if they had wanted to—the higher borrowing is to be seen as a result of decisions to spend more. In other cases, where access to credit was previously effectively restricted, higher spending was made possible by the abolition of hire-purchase controls and the easing of terms in the summer, and (probably more important) by the readier availability in particular of mortgage finance. The additional mortgage finance was worth considerably more than the increase in the stock of privately-owned houses, and much of it probably financed additional spending on durables. Easier access to mortgage and other credit was thus one reason for high spending and low saving.

A second reason was the fall in inflation. Prices nearly doubled between 1975 and 1980, greatly reducing the real value of personal holdings of financial assets. High rates of saving in the late 1970s and 1980 can be partly explained as an attempt to restore real asset holdings. By last year, with inflation considerably reduced, the need to save for this reason had lost some of its force. The fall in inflation also brought a fall in interest rates and so—to holders of liquid assets—a fall in real income as usually measured. A drop in income is usually not immediately reflected in an equivalent cut in spending and so results in a fall in saving. These two 'inflation' effects might account for a third of the fall in the saving ratio.

Factors of this sort may explain a good deal of what has been happening to saving over the last two years. Some of the factors at work towards the end of last year were probably temporary, and the saving ratio may not fall further. Personal post-tax real incomes are likely to show some rise—to which the Budget measures, particularly the raising of personal allowances by $8\frac{1}{2}$ per cent in real terms, will now contribute. Consumers' expenditure should therefore continue to rise, though less fast than at the end of last year. For similar reasons personal debt may continue to rise, though less rapidly than recently.

The course of output in the United Kingdom, and the world

The statistics of output and expenditure are never fully consistent or reliable. It appears however that, in addition to the surge in consumer demand last year, investment rose, while exports fell in the second half-year. This year investment is likely to continue rising, while exports should in due course rise in response to world recovery and the competitive edge in export and import markets provided by the lower exchange rate. Equally important, the impact on output of the surge in consumer demand was in effect temporarily diminished, and should now come through more strongly. Initially demand was largely met by drawing on stocks—which should soon cease to fall or possibly start to be rebuilt. When that happens, it too will help to raise output. This combination of influences seems likely to produce a moderate growth of output through the year. The rise in imports at the beginning of this year suggests that some sorts of stocks have now ceased to be run down so rapidly.

UK output and expenditure

Percentage contributions to change in GDP(a)

	1981		1982	
	H1	H2	H1	H2
Consumer spending(a)	+ ½	—	—	+1¼
Public consumption	− ¼	+ ¼	+ ¼	+ ¼
Investment	−1½	—	+ ¼	+ ½
Exports	− ¾	+1	—	− ½
Final expenditure	**−1¾**	**+1¼**	**+ ½**	**+1½**
Effect of stock changes	− ¼	+2	+ ¾	−1
Total supply	**−2**	**+3¼**	**+1½**	**+ ¼**
of which:				
Imports	−1	+4	+ ¼	−1
GDP expenditure estimate	−1	− ¾	+1¼	+1½
GDP output estimate	−1	+ ¾	+ ¼	+ ¾

(a) At factor cost; figures may not add due to roundings.

There was also an unexpected delay to recovery in most other major countries. In the United States, final demand was on a weak or declining course through most of last year, with falls in both investment and exports. But it picked up significantly in the final quarter (although a renewed reduction in stocks prevented any effect on GNP in the fourth quarter). Preliminary indications are that there has been some recovery in output in the early part of this year.

Output and expenditure in other industrial countries

Contribution to percentage change in GNP(a)

	1981		1982	
	H1	H2	H1	H2
United States				
Final expenditure	+3½	− ¼	−1	—
Effect of stock changes	+2	+ ½	−2¾	+ ¼
Total supply	+5½	+ ¼	−3¾	+ ¼
of which:				
GNP	*+4½*	*− ½*	*−3½*	*+ ½*
Imports	*+1*	*+ ¾*	*− ¼*	*—*
West Germany, France and Italy				
Final expenditure(b)	+2	+3¾	−1	−1¾
Effect of stock changes	−1½	−2½	+3	−2¼
Total supply	+ ¾	+1¼	+2¼	−4
of which:				
GNP	*+ ½*	*+1*	*+ ¾*	*−2½*
Imports(b)	*—*	*+ ¼*	*+1½*	*−1½*
Japan				
Final expenditure	+5½	+4¾	+2¼	+4¾
Effect of stock changes	—	− ½	+ ½	−1
Total supply	+5¾	+4	+2¾	+3¾
of which:				
GNP	*+4¼*	*+2½*	*+2½*	*+4¼*
Imports	*+1½*	*+1½*	*+ ¼*	*− ½*

(a) At market prices; figures may not add due to rounding.
(b) Figures for final expenditure and imports are both affected by the inclusion of trade between the three countries.

In Europe, West Germany and Italy saw final demand declining until the fourth quarter, though in France it held up better. In all three countries movements in stockbuilding contributed to the fall in GNP in the second half of 1982. But final demand and output may have risen in the last quarter; and forward indicators now point to some recovery continuing.

Developments in Japan have taken a different course. The growth of final demand was better sustained than in other countries till the fourth quarter, notwithstanding a fall, unusual for Japan, in both investment and exports in the first part of the year. In the fourth quarter the growth of final demand and of output slowed sharply. Depending on world recovery, and on fiscal policy in Japan, expansion is likely to be resumed this year, though at a pace very moderate compared with past Japanese performance.

Recession in industrial countries has reduced non-oil trade between them. Trade with developing countries also declined. In the second half of 1982 their imports were 8 per cent lower in volume than a year earlier—a change in trend which made a small but significant contribution to industrial countries' recession. This cutback was a delayed response by developing countries to the stagnation in their export receipts over the last two years, to higher interest charges on their accumulated debt, and to the sharp reduction of the previous net flow of bank lending to them. The lower level of interest rates and of oil prices now compared with the average for last year would, if maintained, lead to an improvement in developing countries' balance of payments of more than \$10 billion—equivalent to around 6 per cent of their imports from OECD countries. Moreover, great effort has been expended by banks, central banks, governments and the IMF in responding to the difficulties of the most heavily indebted countries. But given

See article on international banking markets on page 43.

See the Governor's speech to the Overseas Bankers Club on page 39.

the continuing restraints in their situation, and the major adjustments which many developing countries are having to undertake, it is difficult to judge how soon they will be able to increase their imports from the industrial world.

Conclusions for UK monetary policy

The economy is not a system whose future behaviour can be easily predicted; and preceding paragraphs have indicated various ways in which economic developments have proved unexpected. This review suggests, perhaps, two conclusions. First, unexpectedly fast progress in reducing inflation—though to some extent due to world developments more favourable from this viewpoint than can be sustained—has been achieved, in part, because price determination has shown an encouraging element of flexibility. Second, the review suggests that the underlying trend of demand has not, latterly, been fully reflected in the output statistics.

The aim of monetary policy has been to contribute to the decline in inflation without preventing a recovery of domestic demand. The target range of 8%–12% for the growth of the monetary aggregates in 1982–83 was a revision from the lower range earlier envisaged. This revision was made in view of the apparent change in the relation between monetary growth and nominal income—a change due in part to the process of structural change in financial markets that had become evident. The growth of the aggregates over the last target period was contained within the target range, despite still very considerable lending by the banks. This was made possible by a satisfactory level of debt sales in combination with an unexpectedly low public sector borrowing requirement, probably £7½ billion as against £9½ billion projected a year ago.

See operation of monetary policy on page 19.

The context for monetary policy in the year ahead is likely to be some recovery in economic activity, against the background of a recovery in the world economy and more especially in the United States. The Budget provides for a PSBR of £8 billion in 1983/84—or at 2¾ per cent of GDP, the same as is now expected for the 1982/83 outturn. In recent months the scale of lending by the banks to industry has eased off, perhaps because heavy stock declines helped industry's cash position. With recovery, industry may need to borrow more; and bank lending may remain high, even if lending to persons now moderates. Nevertheless, combined with the prospect of inflation being contained at something close to the present rate, the present background, despite the many uncertainties, should on balance be helpful for the operation of monetary policy. The new target range of 7%–11% should continue to help moderate the growth of domestic costs, while leaving room to accommodate the likely upturn in the economy.