General assessment

The extreme turbulence encountered by the world's major financial markets in May seems now to have receded, although many of the underlying problems are still unresolved and confidence is not yet fully restored. The London Economic Summit recognised the importance, for the world recovery now under way, of the maintenance of financial stability. Against this background developments in the world and domestic economies and the significance of recent monetary developments are discussed.

Instability in world financial markets . . .

Financial markets throughout May were characterised by unusual volatility, with exceptional swings in bond and equity prices. There were also very sharp but transient movements in some bilateral exchange rates and, at times, strong upward pressure on interest rates. The markets' nervousness stemmed largely from developments in the United States and had its roots in the exposure of many US banks to the domestic energy sector, weakened by the fall of oil prices in 1982–83, and to Latin American countries with major debt problems. These worries have interacted with a pervasive perception that the balance between US fiscal and monetary policy might be unsustainable. Inflationary fears associated with the structural budget deficit and with rapid growth of domestic credit and activity in the US economy in the first quarter, when GNP growth reached nearly 10% at an annual rate, occasioned sharp interest rate increases. US prime rates rose $1\frac{1}{2}$ percentage points between the second half of March and the first half of May and the three-month eurodollar rate moved in parallel.

For a fuller account, see Operation of monetary policy, page 171.

The rise in US rates, which affected all maturities, put upward pressure on the dollar despite continuing growth in the already large external current account deficit. This upward pressure was also transmitted to interest and, perhaps, inflation rates elsewhere. In the face of this further escalation in the debt service burdens of some major debtor countries, doubts about the maintenance of their interest payments intensified, as did the pressures on some banks in the United States. Special difficulties, domestic in origin, at Continental Illinois compelled it to request assistance from other major banks and from government agencies. Prompt and decisive action by the US authorities, supported by the major banks, stabilised the situation and successfully calmed market fears. The US authorities have thus demonstrated their commitment to the stability of the system, although they have warned that support will not necessarily be extended to every individual bank.

A first step to reduce the Federal budget deficit over coming years is expected to be taken by Congress this summer. Further timely steps of this kind should help to consolidate confidence at lower levels of interest rates. Although fairly strong growth in the US economy seems set to continue, early indications point to some slowing in the second quarter towards a more sustainable pace. US inflation in the middle of 1983 was reduced to $3\frac{1}{2}$% by a number of special factors, the reversal of which has fed fears of a rekindling of inflation. The underlying rate of cost and price increases, however, remains steady at about 5% and shows no tendency to quicken.

... has not dampened hopes for world recovery.

The recovery in world activity has been proceeding reasonably steadily, with output growth in the past six months rather better than expected. This can be traced in part to exceptionally fast growth in the United States, and in part to slightly better than expected growth in other OECD countries. The prospect, if business confidence can be maintained, is for continuation of growth, but at a slower overall rate, and with some convergence between the United States and other economies. The US economy is much more fully employed than Europe and capacity constraints are more likely to be encountered there. In a number of European countries, where stringent policies are now leading to a reduction in the rate of inflation, nominal targets already fixed should allow growth to increase. Developing countries have benefited from last year's increase in commodity prices and the continuing growth in world trade, and some are beginning to import more while managing to reduce their current external deficits further. There has been no change in official OPEC oil prices in the last year. Spot prices, although more sensitive to developments in the Gulf, have also been no higher on average in April and May than in the previous year.

The UK recovery broadens ...

But for the loss of coal production resulting from the miners' dispute, total output might have continued its growth at an annual rate of around 3% in the first quarter of this year. While exports and investment rose, consumption is recorded as having fallen. Thus the impetus to growth apparently shifted away from consumption rather more sharply than expected. On the other hand the path of retail sales in April and May, though erratic, suggests some recovery from the first quarter setback to consumption which, as in a number of recent years, may prove to have been largely temporary.

See page 164.

See page 159.

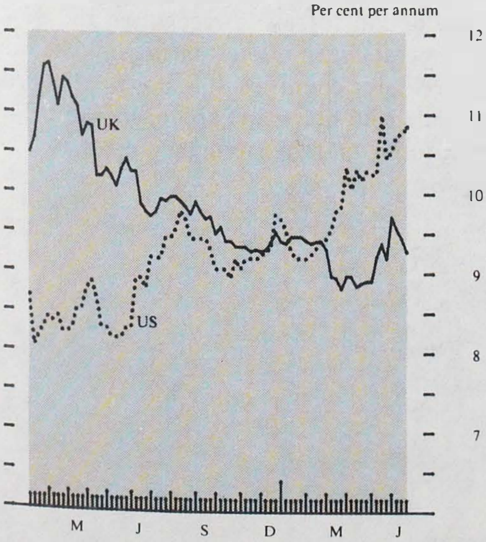
UK exports have grown strongly since last summer, with non-oil export volume showing an underlying rise of almost 10% between the third quarter of 1983 and the first quarter of 1984, in response to the recovery in the world economy and perhaps a rise in the relative profitability of exports. The bulk of the increased exports went to Western Europe, reflecting the importance of these neighbouring markets and their gradual revival over the past year. Exports to North America have grown far more rapidly but are much smaller. Although UK export performance faltered at the end of the first quarter, the prospects now seem encouraging. If demand continues to grow in Europe, and if, as forecast, OPEC imports stop falling (once they have been brought into line with lower oil revenues), growth in our export markets will not slow much in the coming year, although the pace of world activity, so heavily dominated by the United States, may do so.

As foreshadowed in the March *Bulletin*, the better underlying export trend and the sharp increase in industrial investment in the past two quarters have imparted a broader base to the recovery and augur well for its durability. In the longer term, much will depend on achieving a further improvement in profitability, which is still low in real terms, and a further reduction in the rate of increase in labour costs. In manufacturing, unit wage and salary costs are currently less than 4% higher than a year ago. But on average unit labour costs have not risen at all in competitor countries and have actually fallen in several major ones. In every case the contribution of productivity gains has been large as economic activity has recovered.

Although increased productivity may make it more difficult to reduce unemployment in the short run, it provides the firmest basis for raising living standards and, in the longer run, employment. The faster growth of activity does now seem, on the best available estimates, to be resulting in increased employment in the economy as a whole, although not yet enough to halt the rising trend of unemployment. When employment rises it is usual for some of the extra jobs to be filled by people who had not previously been counted as unemployed.

Retail prices have for some months been running just over 5% up on a year earlier, with no tendency to accelerate. Domestic costs have risen at about the same rate; but import and export prices have both risen rather faster (at 7%–8% per annum), reflecting in part the slight fall of sterling in effective terms. Wage settlements continue at around the level established in the previous pay round. With sustained productivity growth, however, and the final 1% of national insurance surcharge to be removed in the autumn, the rate of retail price increase may, by the end of the year, be not far from the $4\frac{1}{2}$% earlier projected.

US and UK money-market rates[a]



(a) 3-month domestic rates.

. . . and monetary developments remain consistent with targets.

Monetary policy so far this financial year has had to be conducted against the difficult and shifting background of events in world financial markets described earlier. The sharp increases in US interest rates and bond yields precipitated a rise in sterling money-market rates in May which was not clearly dictated by domestic monetary developments. While US prime rates rose $1\frac{1}{2}$ percentage points UK base rates increased a half-percentage point, reversing the decreases at the time of the Budget. Sterling's effective exchange rate remained steady in the opening months of the year despite the slowly widening interest rate gap in favour of the dollar, but weakened from 83 to 80 between end-February and end-April as the eurodollar interest rate climbed and the adverse differential became more pronounced. Since then sterling's effective rate has remained about $79\frac{1}{2}$–80. This relative exchange rate stability in effective terms has occurred against a background, observable over the previous twelve months, in which changes in US interest rates are by no means fully reflected in UK rates.

The targetted aggregates, M0 and £M3, have been growing fairly steadily at annual rates of 4%–6% and 8%–10%

respectively since last autumn. In the first three months of the current target period (beginning in mid-February) they have been within or near the prescribed ranges of 4%–8% and 6%–10%. M0 grew at an annual rate of $4\frac{1}{4}$% and £M3 at $10\frac{1}{2}$%. The growth of building society shares and deposits, however, has been rather higher, so that the behaviour of M2 and PSL2 (up $17\frac{3}{4}$% at an annual rate) has been less reassuring; moreover, until May the growth of bank lending exceeded market expectations.

The growth of the monetary aggregates is currently being affected by a substantial concentration of public sector borrowing in the early part of the financial year. Unlike a year ago, when the surge in the PSBR was mainly unexpected, the pattern this year was entirely predictable. On the basis of measures announced in the Budget, almost all the forecast PSBR of £$7\frac{1}{4}$ billion is likely to occur in the first half of the financial year, with the major offsets from the acceleration of VAT payments on imports and from asset sales due in the autumn and beyond. At the same time the recent turbulence in financial markets, and an unusual bunching of gilt-edged maturities in June, have affected net funding, though gross gilt sales have even so been at a rate above that expected to be necessary over the year as a whole. The more expansionary public sector position in the early months of the target period may, by improving the liquidity of other sectors, have some offsetting effects on other monetary counterparts. Nevertheless, because of these factors, the pace of growth of broad money is likely to be faster in the early part of the current target period than is to be expected over the period as a whole.

The conditions exist for further progress in fostering non-inflationary growth both at home and abroad. The most immediate threat to such progress has come from the possible consequences of financial instability. It is therefore encouraging that the Heads of State and Government attending the June Economic Summit in London so clearly recognised the damage that a further general rise in interest rates would do to both developed and developing countries. It is also to be hoped that progress will be made with pragmatic approaches to the problem of debt rescheduling and the strengthening of an open trading system.