General assessment

Although the assessment of underlying trends has been complicated by the miners' dispute and the dock strikes, the economic recovery seems to be continuing, possibly at a slower rate, and inflation is less than many had forecast. Financial markets, already unsettled by the industrial disputes, were also confronted by erratic movements in the monthly monetary figures. Financial sentiment has continued to be rather volatile in the United States in recent months. Economic growth there in the second quarter again exceeded expectations; more generally, activity in the main industrial countries has quickened and broadened, though has remained slow in Europe. Strong productivity growth and weak commodity prices are both helping to restrain inflation in industrial countries. This forms the background for discussion of domestic monetary policy and economic prospects.

Strength of demand in the United States raises interest rates and the dollar . . .

In the United States real domestic demand grew at an extremely rapid annual rate of over 10% in the first half of 1984. Although this was met in part by increased net imports, output also continued to grow rapidly. Its $4\frac{1}{4}$% rise in the first half means that further growth this year will take GNP above the January Budget forecast, which was for $5\frac{1}{4}$% growth between 1983 and 1984. Demand for credit by the private sector was thus strengthened at a time when the public sector's credit demand was also high. The ensuing pressure led banks to raise their prime rates, even though the narrower monetary aggregates grew well within their respective target ranges (and M3 only just above) during the first half-year. Fears arose that the demand for credit might become even larger in the future, fears which in turn contributed to a further weakening in bond prices in the period to mid-July.

With US interest rates rising to internationally attractive levels, and demand (but not prices) rising much more strongly than elsewhere, the US exchange rate rose sharply in July. Despite relatively modest wage growth, this has added to the cumulative loss of competitiveness which, together with the strong rise in US domestic demand, has led to a massive US deficit on current account. Athough US import demand remains a major source of world recovery, the pressure on international interest rates is a negative factor and the huge counterpart capital inflow would be inappropriate as a persistent feature of the world's richest and most highly developed economy. The high exchange rate has, however, at least for the time being, helped to hold down the rate of US inflation. Perhaps of more significance for

the medium-term prospect is the contribution of restraint in nominal wage increases and some recent improvement in productivity growth.

The spurt in growth is beginning to bring some sectors of the US economy up against capacity constraints, and fears have been voiced about a resurgence of inflation next year. Since mid-summer, however, there have been signs of some slowing-down in the pace of the US recovery, as is also suggested by the leading indicators. The consensus forecast is for growth in 1985 at about half the likely 1983/84 rate. Such deceleration would be particularly welcome in so far as it reduces the perceived risk of inflation, and pressure on world interest rates. The last few months have seen considerable swings in market sentiment; a combination of hopes for growth at a more sustainable rate, continuing low inflation, lower-than-expected monetary numbers and reassuring congressional testimony by Mr Volcker, led to sharp rises in bond and equity prices at the end of July and in early August. In this volatile atmosphere the US dollar also fell from its earlier peak, only to reach new highs in September.

. . . and contributes to growth elsewhere—but commodity prices, and inflation, fall

Low inflation and high nominal interest rates in the United States imply that real interest rates there have again risen, with effects on real rates throughout the world. This has made holding stocks of commodities more costly and thus put downward pressure on their prices. Although US imports have been buoyant, European demand has not been so strong; and supplies of some commodities may have increased in response to the sharp price rises seen in 1983. Some producers' financial difficulties, themselves attributable in part to the strong dollar and high US real interest rates, may also have increased pressure on them to export raw materials. As a result of all these factors non-oil commodity prices have fallen this year in terms of all major currencies.

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The indebted Latin American countries have benefited financially from the higher volume of their exports, particularly to the United States, but have suffered from weak prices and from the effects of a strong dollar and high interest rates on the cost of servicing their debts. The debt problems of the region, however, have generally been contained, and Mexico's adjustment performance has been rewarded by a multi-year rescheduling of a major part of its debt. The balance of the consequences of US developments has been more favourable for a number of Asian countries. The pattern among the industrial economies is also uneven. Japan has gained much more than Europe from US growth and now has a trade surplus amounting to 8% of its national income: much larger, in proportionate terms, than the US deficit. Heavily indebted sectors of the US economy have also been affected by high interest rates, again underlining the fragility of institutions lending heavily to them, or using deposits to finance fixed-rate loans.

Productivity has grown rapidly in most industrial countries. Whereas in the United States this reflects the usual cyclical gains in a recovery, elsewhere it has occurred despite the relative

sluggishness of growth. In this their experience parallels that of the United Kingdom in 1982 and 1983. Investment, largely of a labour and energy saving kind, has been higher than would have been expected on the basis of output growth and measured capacity utilisation. Labour shedding, together with modest wage increases, has actually brought unit labour costs down in terms of local currencies on average in the year to the first quarter of 1984. Last year's rise in commodity prices raised OECD inflation rates in the early part of this year, but, on average, inflation has reverted to the 4½% rate widely seen last year; in particular the rate of inflation is again falling in those major OECD countries in which it has been highest.

UK monetary and fiscal policies are on course . . .

The rise in US interest rates was associated with continued confidence in the dollar so that the already high yields in New York became even more attractive to asset holders. Financial markets in London proved sensitive to US developments; both the sharp rise in yields here up to mid-July, and their decline thereafter, owed much to developments in US interest rates and the dollar. The July dock strike, coming on top of the continuing miners' strike, served to increase market nervousness. And although the authorities had earlier drawn attention to the front-end loading of the PSBR and a bunching of maturities in June, which were likely to cause some temporary overshooting of the target path for the broad monetary aggregates, the money market was concerned by what were interpreted as signs of fiscal and monetary expansion, notably in the erratically high June figures. In these circumstances sterling fell 2½% in effective terms, and market interest rates led base rates up by a similar amount.

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By the time the monetary figures for banking July were published, the markets had already made some recovery in the wake of US markets and as a result of the ending of the first dock strike. Following the erratically high June figures, those for July showed that the broad aggregates £M3 and PSL2 had actually fallen. This brought the cumulative growth of £M3 since the start of the target period back to 9% per annum (where it stayed in August), well within its 6%–10% target range, while the growth of M0 has remained comfortably within its 4%–8% range since March. In the two weeks following the publication of the July figures the banks, with encouragement from the authorities' money-market operations, reduced their base rates, in line with market rates, from 12% to 10½%. The authorities were able to take advantage of the improved conditions in July and August to sell both gilts and national savings on a scale that matched the high PSBR of the first half of this financial year. Given the unusually heavy front-end loading of the PSBR, this means that funding is comfortably ahead of that likely to be needed over the year as a whole. There is thus some margin in hand against any pickup in private sector credit demand in the months ahead, when a number of special factors will be operating. Shares in British Telecom are to be sold in the autumn and importers will need finance to cover their retimed VAT liabilities at the end of the year.

Despite its small fall in July, PSL2, which includes certain building society deposits, rose at an annual rate of 15% between

February and August. High demand for mortgages has been a major factor in this growth but may now be slowing a little. The societies' new commitments fell sharply in July and August after rising for several months. The rise in mortgage rates may itself weaken demand, but the growth of retail deposits, which exceeded net advances in the first quarter, fell thereafter, and by August barely covered a half of advances. This led the societies to draw down their liquid assets, as well as to raise wholesale funds, even before the rise in bank base rates in July left building society rates far out of line. The Building Societies Association advised that the mortgage lending rate be raised by 2¼% to 12½% per annum and the net ordinary share rate by 1½% to 7¾%, from 1 August, but most of the major societies established their own independent rate structures at a slightly higher level. In early September, a number of societies also improved the terms on premium accounts. This further weakening of the arrangements for fixing building society rates reflects increased competition in their markets, a development consistent with the proposals for the societies in the recent Green Paper, which also envisaged them undertaking a somewhat wider range of activities.

. . . as is inflation, but growth prospects are uncertain

The increase in mortgage rates affected the retail price index for August and accounts for the increase in the twelve-month change from 4½% in July to 5% in August. These inflation figures are lower than had been suggested by many private sector forecasts. Industry's buying prices for fuel and raw materials were flat between January and August. Whereas slow increases in unit wage costs in manufacturing industry had earlier helped to keep price inflation down, they seem to have been higher in recent months. One element in this is an apparently sharp slowdown in the previously rapid rate of manufacturing productivity growth. It is difficult to assess the magnitude of this change given some uncertainty about the path of manufacturing output. Although reportedly little affected by the miners' dispute, the official figures show no further growth in the first half of this year. Successive CBI surveys, as well as signs of an end to the five-year decline in employment in the sector, may, however, cast some doubt on this picture.

Resumption of the downward trend of inflation would contribute to demand and activity, including that in manufacturing, but even setting the most recent figures on one side it might prove difficult to sustain productivity growth at the exceptional rate of the last three years. This makes it all the more desirable that the wage round just starting should lead to lower settlements than in recent years. Real earnings of those in work have risen almost continuously even through the earlier phase of the recent cycle in which settlements, and inflation, fell rapidly. Over the last five years average real earnings of the employed have risen by about 7% while employment has fallen by about 5%. This is in marked contrast with US experience. There real earnings have fallen somewhat and employment has increased by almost 5% in the same period.

Average earnings have been growing at an underlying annual rate of nearly 8% this year, 3% faster than retail prices. This exceeds the rate in major competing countries, where (as

mentioned above) in their own currencies, unit labour costs are falling. Although the gap in productivity growth is not large, even if the figures are taken at face value, and despite cuts in the national insurance surcharge (the final 1% of which will go in October), unit labour costs in manufacturing rose here by 4% over the year to June. Thus, despite sterling's decline in effective terms, any gain in cost competitiveness in the last year has been small.

Provisional balance of payments figures for the second quarter indicate a current account deficit of about £300 million, followed by a very preliminary estimate of a small surplus in July. Recent trade figures are difficult to interpret because of the miners' and dockers' disputes. The former particularly affects the net oil surplus—and largely accounts for its falling by £800 million from its first quarter level of over £2¼ billion. Partly because of the way in which imports and exports are recorded, the July dock strike had an initially favourable impact on reported net exports. Allowing for these effects suggests an underlying current account position weakened by adverse trends in net non-oil trade, and an overall surplus that is rather small considering the high level of UK unemployment relative to other countries.

The industrial disputes have directly reduced growth this year from the rate of about 3% achieved last year. Some eventual slowing had been widely expected and there are signs that even after the disputes are settled underlying growth will not recover to its previous rate. Net non-oil trade trends are not encouraging. And the fall of consumption in the first quarter might have raised fears, related perhaps to the consumer debt accumulated since the abolition of controls in 1982, that its growth had ceased. While the rise of almost 1% in consumer expenditure in the second quarter should have reduced such fears, it is unlikely, with the saving ratio now close to 10%, that private consumption will lead the rise in activity. Total industrial investment rose at an annual rate of over 20% between the third quarter of 1983 and the first quarter of this year; since then momentum has been better sustained in manufacturing than in distribution and services. Reported investment intentions suggest that this slowing will continue into next year. As in other industrial countries, profits have continued to rise strongly, in line with the roughly 25% per annum trend growth of the last two years. This has enabled companies to finance their additional investment, and modest increases in dividends, while maintaining a considerable cushion of liquidity; at the same time bank borrowing remained quite buoyant.

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This reflects a pattern of company behaviour which might be characterised as constructive caution. Monetary policy might be similarly described. Although the path has not been smooth the target aggregates are on course and, as explained, the financial position is comfortable. In the months ahead market sentiment is likely to be more sensitive to industrial developments, and financial developments in the United States, than to domestic monetary factors.