General assessment

The pace of world recovery this year has until recently exceeded expectations, and financial markets have again proved volatile. Publication of figures indicating a slowdown in US growth in the third quarter was followed by a reduction in US interest rates. A number of possible future developments are discussed as background to the evolving financial conditions at home, together with their implications for the real economy.

Developments in the United States . . .

After particularly rapid growth, at an annual rate of 8.3%, in the first half of the year the expansion of activity in the United States slowed in the third quarter. Three-month eurodollar interest rates subsequently eased sharply from a peak of about 12% in the late summer to about 9% in late November, when the Federal Reserve reduced its discount rate and prime rates were cut. Rates in other countries have typically moved much less over the period, and narrowing differentials contributed to a temporary easing of over 4% in the dollar's effective exchange rate. The US current account deficit, running at an annual rate of over $100 billion, may also have been a factor. On one or two occasions actual or feared exchange market intervention, particularly by the Bundesbank, has restrained, or reversed, dollar strength.

If the recent pause in US expansion heralds a reduction of output growth there to a more sustainable pace, it would be a welcome development. The persistent growth of both the external current account deficit, to which the growth of domestic demand contributes, as well as the increasing fiscal deficit, which faster output growth should have tended to reduce, have unsettled financial markets. The two deficits are inter-related in several ways; injections of demand through the fiscal deficit have spilled over into demand for other countries' exports; the fiscal deficit, amounting to as much as two thirds of annual domestic private saving, has been accompanied by an investment boom, putting upward pressure on interest rates and resulting in heavy borrowing from abroad which in turn has financed the current account deficit. This borrowing has been on such a scale that the recorded US position is soon likely to be one of having net liabilities to the rest of the world, possibly even by the end of this year.

Several factors seem to have contributed to the buildup of these imbalances. The mix of domestic economic policies is widely thought to be one element, with monetary policy bearing the brunt of the anti-inflationary effort, and fiscal deficits putting upward pressure on interest rates and the dollar. In addition, there appears to have been a major shift in international portfolio preferences toward US dollar denominated assets

since the end of the 1970s, which has tended to strengthen the dollar while mitigating the rise in dollar interest rates. The size of the portfolio switch between currencies cannot be measured by the scale of capital account inflows to the United States as the latter include repatriated dollars. There is some evidence that the short-term element in inflows to the United States has been large, though the net bank contribution has fluctuated over the last three years.

... leave world recovery delicately poised

It remains to be seen whether the slowing in US growth in the third quarter is only temporary, or is the beginning of a longer period of growth at more sustainable rates, or represents an abrupt fall-off in US activity which might bring problems for recovery elsewhere. Although growth in the other main industrial countries has been rather better than the sluggish upturn expected, this is largely a result of the stronger than expected US performance, which has generated marked export recoveries among those industrial and developing countries which are major suppliers of the US market.

The growth of European economies as a whole, which has also increased, has been buoyed up less in this way, and there are signs in some that recovery is fragile, while in others it is not yet clearly established. Countries which have managed to bring inflation down markedly have benefited from a consequent rise in domestic demand as saving ratios fell (the United Kingdom has been among the outstanding examples). Others, which have not yet made much progress in reducing inflation, have tended to lag behind the general recovery.

Part of the reason for hesitant recovery in other countries is that the general level of world interest rates has been kept up by US rates and this has offset some of the stimulus from the upsurge in US imports. This is particularly so for real interest rates. For the past eighteen months short-term nominal rates in other currencies have remained relatively steady in the face of fluctuating US rates but the continuing reduction in the relevant inflation rates suggests that real rates have generally risen. The fact that real interest rates are higher in the United States than elsewhere is consistent with a market view that the real exchange rate for the dollar will at some stage decline, increasing US competitiveness so as to correct its external deficit. This expectation has not been borne out to date; rather, as discussed above, a persistently heavy demand for dollars has maintained the dollar's strength.

In mainstream forecasts the dollar's (nominal) effective exchange rate is now expected to fall by varying amounts over the next twelve months centring on a range of perhaps 5% to 10%; this is associated with a forecast of cost increases in line with those of competing countries and thus for a similar gain in competitiveness, and a consensus for output growth of 3%–4%. Given recent fluctuations in US growth rates, interest rates and the dollar, all these forecasts are more uncertain than usual. If the interest and exchange rates were both to tend to fall this could encourage a decline in both real and nominal interest rates elsewhere.

Meanwhile, monetary conditions at home have permitted some fall in UK interest rates . . .

Domestic monetary conditions developed satisfactorily until mid-October and sterling interest rates fell back further, almost to their levels of the early summer. Both M0 and £M3 remained within their prescribed target ranges, having grown at 6.1% and 9.3% per annum respectively since February. In banking November, however, although M0 continued to grow at a modest rate, £M3 rose sharply, taking its annualised growth rate since February outside the target range at $12\frac{1}{4}$%. It is likely that some part of this rise was erratic. There was a substantial buildup of liquidity ahead of the sale of British Telecom shares which will have affected all the monetary aggregates except M0. As this sale was heavily oversubscribed, and many unsuccessful applicants will not have been able to reinvest their returned cheques by the December make-up day, the December money supply figures are also likely to be distorted.

During the autumn, considerable pressure arose from the public sector's financing needs, with an erratically high PSBR in banking November. The success of the funding programme, through sales to non-banks of both gilt-edged and national savings instruments, ensured that the PSBR was, nevertheless, fully funded. Bank lending to the private sector, which was low in banking July and August, was subsequently much higher when retail sales and imports again rose. It is too early to say whether the revival of bank lending to the personal and corporate sectors reflects a change in the underlying trends.

In recent months interpretation of M2 has been hindered by frequent changes in the terms of certain building society accounts as competition for funds among the societies has intensified; increased competition is again reflected in the terms of Building Societies Association pronouncements on interest rates, with a 1% reduction in rates 'suggested' for 1 December. Meanwhile growth in PSL2, stimulated by the considerable flow of mortgage lending, shows no sign of having disturbing consequences either in the housing market or in the economy more generally. Looking more widely, the rate of inflation, as measured by the annual increase in retail prices, has moderated since the spring and, aided by the recent reduction in mortgage rates, seems likely to end the year close to $4\frac{3}{4}$%. Real interest rates remain fairly high by historical standards; and underlying growth in real expenditure and output seems if anything to have slowed during the summer months. The exchange rate has fluctuated, largely under the influence of developments abroad, including the renewed weakness of spot oil prices, as a result of which it is now 4% lower in effective terms than at the end of August.

. . . but the pace of domestic recovery slowed in the summer . . .

Although demand and output continue to be affected by the coal dispute and there remain some doubts about the accuracy of the output statistics, it now seems clearer that the underlying pace of recovery at home slowed somewhat, earlier this year, possibly to a smaller extent in the service sector than in the production industries. Employment is continuing to rise, but

more slowly, and, partly because of the growth of women's part-time service jobs, the effect on registered unemployment, which has also continued to rise, is small.

Among factors behind the sluggishness of domestic output has been the modest performance of exports relative to imports. Some of the deterioration in the trade balance in the past six months is accounted for by higher imports of fuel to replace lost coal output, but the balance of non-oil trade has continued to deteriorate in a period during which export markets have been growing markedly faster than those at home. Competitiveness has probably changed little, with the depreciation in the sterling index over the past twelve months offsetting the rise in relative UK costs and prices. Some fall in UK market share is usual when world trade picks up sharply, and non-oil export growth may now be improving again, having slowed around mid-year. But against this export performance has to be set a sharply rising trend of non-oil imports, and a still modest level of manufacturing output.

Despite the slowdown projected in world trade, more particularly in the growth of US imports, the United Kingdom's main export markets are likely to remain quite buoyant on the whole next year, offering potentially encouraging export opportunities. Although the sterling value of UK non-oil exports to the United States increased by about 30%, and their volume by perhaps half as much, in the year to the third quarter of 1984, they are still little more than a quarter of those to Western Europe. Thus a decline in US growth presents a smaller threat to better UK trade performance than the possibility of a further deterioration in our relative costs. Other countries are on the whole now managing to contain the rise in their industrial costs, and particularly their labour costs, to very low levels. Producers at home must aim to emulate this if they are to compete effectively.

The true rise of industry's costs is somewhat obscured by uncertainty about the precise level of output and productivity. It is nevertheless hard to escape the conclusion that, with sluggish output, the pace of productivity improvement has slowed appreciably, whereas average earnings continue to rise at near their previous rate. The rise in unit labour costs must therefore have increased, perhaps to about 6% in manufacturing over the past year. Raw material and fuel costs have also been rising quite strongly since the summer (despite easier spot prices in world commodity markets) as more of the effects of sterling's earlier depreciation have fed through. In November these costs stood 9% above a year earlier. So far these cost pressures have affected output prices only to a limited extent, and consumer prices apparently not at all; producers, and in particular distributors and retailers, must therefore be shaving their profit margins. These circumstances highlight the need for moderation in the growth of earnings to facilitate a faster growth of employment. Reducing UK consumer price inflation to its present rate has been a considerable achievement, but it is still above that of our strongest trading competitors, notably Germany and Japan. And whereas our own inflation, as measured by the retail price index, has been stable at $4\frac{1}{2}$%–5% for some time, the average of other major countries is continuing to fall.

. . . and hopes for revival rest on better inflation performance

The economic recovery is therefore poised no less delicately at home than overseas. The fall in nominal and real interest rates could contribute in several ways to a renewed expansion of economic activity. Spread across the whole spectrum of financial markets, it would stimulate private sector expenditure both directly and indirectly. Most important, perhaps, it should provide an additional boost to the recovery in business fixed investment, by improving the balance between the rate of return on, and the cost of, capital. In addition, more buoyant share markets should enhance the opportunities for companies to raise equity finance and thereby strengthen their balance sheets. This too would help provide the necessary underpinning for sustained growth of fixed investment, itself a condition for a prolonged, non-inflationary economic recovery. Business investment as a whole, is tending to run well ahead of last year's levels, and of survey projections made in the first half of 1984. Distribution and services investment, however, levelled off after the first quarter, while manufacturing investment, which in relation to output is about 15% below its previous peak, has risen more strongly and more consistently in recent quarters.

Lower real interest rates increase the attractiveness of acquiring real, as opposed to financial, assets for households as well as business; and this effect would be supplemented by wealth effects, to the extent that bond and equity holders perceive that the capital value of their financial assets has risen. There would also be income effects with rises in borrowing households' uncommitted incomes being offset by rather larger falls in the incomes of depositors (as the personal sector is a net holder of financial assets). The impact on expenditure of this last offset is, however, likely to be relatively small, and on balance spending on consumption, and investment in housing, would both be likely to rise.

The lower level of interest rates is thus a positive factor, and if cost pressures were to be better contained (and the coal dispute brought to a satisfactory and timely end) the omens for continuing recovery would seem good.