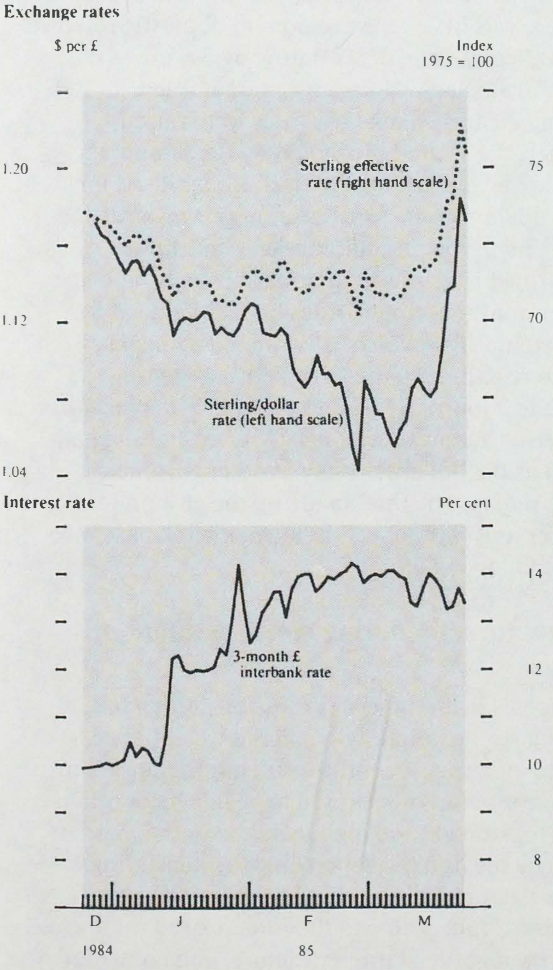
General assessment

Recent developments at home and overseas have been dominated by the further climb of the US dollar to a peak at the end of February. Questions remain about the sustainability of the economic recovery both in the United States and elsewhere. Despite wide exchange rate swings, there are signs of a satisfactory convergence of growth and of inflation among major countries, for which firm policies in Europe and elsewhere can take some credit. After drifting down in the autumn, sterling came under particular pressure in January and its depreciation appeared to threaten the effectiveness of domestic policies against inflation. Determined action to reassert the anti-inflationary thrust of policy was taken and backed up in the Budget. As a result, sterling recovered, and there is a prospect that the inflationary consequences of its earlier weakness will be limited, while underlying growth continues. This Assessment considers the forces behind these developments.

Interest and exchange rates



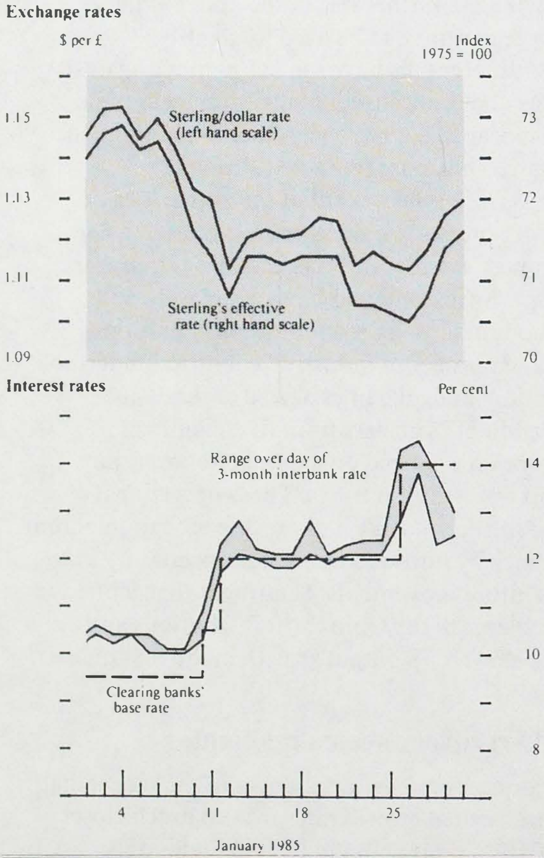
Exchange markets have again been turbulent . . .

The factors underlying the further rise of the dollar at the beginning of this year continue to be hard to identify. Short-term interest differentials have tended to move against the dollar. Concerns about the sustainability of the US trade and fiscal deficits appear to have grown rather than diminished, but sentiment towards the dollar remained strong. The apparently relentless rise of the dollar put the authorities of other countries under pressure to raise interest rates in a way not required by domestic considerations and also raised fears of US protectionism. As it seemed to be based mainly on sentiment and not on underlying economic considerations, the central banks of a number of industrial countries undertook concerted intervention along the lines agreed at the January meeting in Washington of Ministers from five major economies. Intervention occurred on a number of occasions over the period and was heavy at times. These operations appear to have had the desired effect of breaking the momentum of the dollar's advance by introducing greater uncertainty as to the direction of its future movements. Sentiment then shifted in response to the problems of the Ohio thrift institutions and early indications of slower US output growth in the first quarter.

. . . but the world recovery seems resilient

Growth in the major economies slowed down in the second half of last year, while individual growth rates moved much closer together, as did inflation rates with the United States only fractionally below the average of 4%. Despite this partial convergence in economic performance there has been no gain in exchange rate stability, perhaps because there are still some significant divergences in the mix of fiscal and monetary policies. Monetary policy in the major economies continues to be aimed at putting downward pressure on inflation while allowing for faster output growth; most countries which have targets met them last year. But the extent to which fiscal policy is supportive of monetary restraint varies between major countries. The US economy now appears to be growing at a more sustainable rate, though in a rather unbalanced way. US

The markets in January



domestic demand continues to grow more rapidly than output, under the influence of continued, if smaller, fiscal stimulus and, more recently, of lower interest rates. In Europe, by contrast, growth has accelerated, although in many cases not sufficiently to prevent unemployment rising. Domestic demand in Europe remains weak, but net exports have increasingly supported activity. Commodity prices have been weak over the past year and labour costs in manufacturing continue to grow very slowly (or to fall) in many industrial countries, though not in the United Kingdom.

The further rise in the dollar will have added to the debt servicing problems of heavily indebted countries, as will the recent firming of dollar interest rates, already high in real terms. Most of their liabilities are denominated in dollars, whereas the dollar prices of their exports have been weak, partly in reflection of dollar strength. On the other hand the continued growth of the US economy has led to sizable increases in export volumes, particularly for debtors in Latin America and South East Asia, while import volume growth appears to have slowed again. Most of these countries have continued to make good progress in reducing their external imbalances, but problems have arisen in a number of cases as a result of continued failure to meet the domestic performance criteria agreed with the International Monetary Fund.

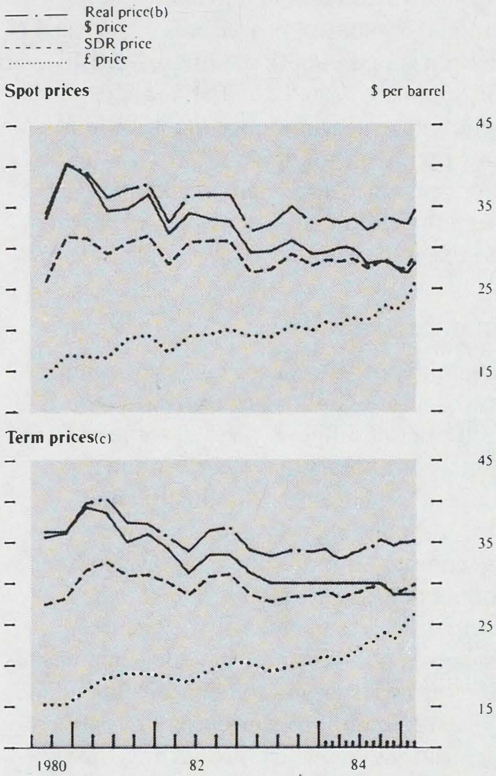
Confidence in sterling was weakened in January . . .

Movements in sterling occurred in several fairly distinct phases and comprised some depreciation against the deutschemark and other non-dollar currencies as well as rather more against the dollar. Initially there was little repercussion on domestic interest rates, but with the effective rate depreciating by 3% in the first two weeks of January, short-term market interest rates increased by 2% and clearing bank base rates were raised by $2\frac{1}{2}$% in two stages, the second prompted by the temporary reintroduction of MLR on 14 January. Sterling stabilised for a short period but downward pressure re-emerged towards the end of the month, and in the difficult market conditions prevailing the clearing banks raised their base rates by a further 2%, to 14%. Three-month interbank rates briefly went even higher; gilt-edged yields, however, hardly moved at all. The dollar continued to rise through much of February taking the dollar/sterling rate to a low of $1.036, at the end of the month. By the time of the Budget, however, on 19 March, sterling had recovered to $1.13 as the dollar fell against other currencies. Sterling's effective rate had by then made up the ground lost since late December and was not set back when bank base rates were cut by $\frac{1}{2}$% the following day.

. . . by various factors, including concern about oil prices . . .

Chief among the forces behind the weakness of sterling has been the continuing strong dollar (which has a weight of 25% in the effective rate index). A second consideration appears to have been market fear about oil prices. The real level of official oil prices, already regarded as too high by many in the markets, was raised further by the dollar's appreciation, intensifying doubts about the sustainability of OPEC pricing and output arrangements. These doubts came to the fore in late January, as OPEC met to review its official price structure, and contributed

North Sea oil prices[a]



(a) BNOC contract price for marker crude.
(b) Dollar price deflated by price of industrial countries' exports (estimated from October 1984 onwards).
(c) Implied prices, apart from dollar price.

to the weakening of sterling which triggered the second 2% rise in interest rates. Sterling only strengthened appreciably after the subsequent agreement by the majority of OPEC ministers, which diminished fears of a sharp fall in oil prices, and was unaffected by the announcement in mid-March that BNOC is to be abolished.

Whereas there may have been grounds for fearing the impact of a sharp break in oil prices, it is less clear why a weakening in the dollar oil price, which broadly compensated for dollar strength, should have affected sterling more than other currencies. The effect on the UK economy of a modest fall in the price of oil should not be exaggerated. The impact on the current account could be absorbed by the surplus (after allowing for the effects of the coal strike) which has benefited in recent months from improved non-oil trade performance. The prospect of declining government oil revenues in the longer term has already been recognised in framing longer-term plans for taxation and public expenditure. The fact that the sterling oil price (and thus oil revenue) is considerably higher than when these plans were formed thus suggests that the public sector too could absorb some fall in the oil price at an unchanged exchange rate. In this case there would be favourable effects on both inflation and activity at home and abroad; any change in sterling necessary to improve the trade account would be small in relation to the fall in oil prices, and would bolster oil revenues.

. . . and about domestic monetary conditions . . .

While these external factors played an important, and at times dominant, role (as they had during much of the depreciation earlier in 1984), around the turn of the year the markets came to view domestic monetary conditions as having, on balance, become looser. Interpretation of the money supply figures through this period has been hampered by the distortions, some purely statistical, others more fundamental, caused by the effects of the sale of British Telecom last November. Ahead of the due date exceptional liquid balances were built up, pushing the growth rate of £M3 above its target range in November. In December this effect was partially unwound, but M0 was then taken almost to the top of its range by unusually high bankers' balances associated with BT subscription monies. Public expenditure and borrowing, running well ahead of earlier expectations, were now found more disturbing, as were particular aspects of the Public Expenditure White Paper and bank lending figures, which also appeared to undergo a general reappraisal. In addition the impression gained ground, fuelled by conflicting press reports on the Government's attitude to the exchange rate, that its commitment to the further reduction of inflation had been weakened, and that it was, instead, intent on lowering interest rates, being prepared to take a risk on the exchange rate and any inflationary consequences.

. . . eliciting a firm response from the authorities

In order to demonstrate as clearly as possible that there had been no weakening in the Government's resolve, the authorities acted quickly to ratify the initial 1% rise in base rates on 11 January and signalled a further $1\frac{1}{2}$% rise on 14 January by reactivating MLR at 12% for that day against a background of acute market uncertainty. This was an appropriate occasion on which to exercise an option which remained available to the authorities under the monetary control procedures introduced in August 1981. It had been stated then that, although MLR would no longer be continuously posted, the Bank might nevertheless in some circumstances announce the minimum rate at which, for a short period ahead, it would lend to the market. Two weeks later acute pressure re-emerged and market interest rates responded quickly—the authorities again endorsing a market-led rise in base rates, to 14%.

Credit is expanding more rapidly . . .

Bank lending in sterling to the private sector has accelerated sharply since last summer; although the reasons for this are not altogether clear, a number of different factors, some structural and some largely temporary, have been influential. Much of the increase in lending has been to industrial and commercial companies. Although their financial position overall remains strong, companies individually appear to have had very varied experiences during the recovery. Growth rates and financing needs have differed substantially between industries and regions, between larger and smaller companies (the latter have tended to grow faster and to be more dependent on bank finance) and between companies oriented towards exports and overseas operations (on which profits have been particularly buoyant) and those selling on the home market goods with a large import content (on which margins may now be under pressure). These differences may gradually diminish as the recovery broadens. Other influences may be more short-lived, such as those associated with the accelerated payment of VAT on imports and with the apparent holding back of equity issues in the latter part of last year until the British Telecom issue had been digested. The subsequent spate of issues has, however, not slowed companies' bank borrowing perceptibly: acquisition and merger activity has been very buoyant and, where cash rather than equity has been offered, this may in part have been financed by borrowing from banks.

Lending by banks to the personal sector has generally been on a more modest scale than in 1982 and 1983, although there was some acceleration towards the end of the year as they increased their mortgage lending on competitive terms. Increased competition between mortgage lenders in recent years has been an important structural development in the financial sector which has weakened effective rationing and led to a greater availability of loans. The fact that structural developments of this kind have been occurring, and are continuing, may help to explain why expenditure so far in this recovery has been relatively unaffected by what have been, at least by earlier standards, high real interest rates. On the other hand, the establishment, or re-establishment, of higher gearing in the personal and company sectors might eventually raise the sensitivity of expenditures to interest rates.

. . . and broad liquidity is growing faster than £M3

In January and February £M3 grew at an annual rate of 6%–7%, bringing its growth over the first 12 months of the target period down to 9½%, while cumulative M0 growth has been at 5½%—more comfortably within its target range. Aggregates which include building society liabilities have continued to rise more rapidly than the target aggregates. PSL2 has been rising at an annual rate of over 15% for the last year, matching the rate of building societies' mortgage lending. Some part of this growth, however, is due to a change in the pattern of building society liabilities: term shares, which are excluded from the definition of PSL2, have been run off to be replaced by other deposits which come within it. Allowing for this effect, PSL2 would have grown steadily at around 12½%. Nor is there any evidence of house prices accelerating beyond their recent average 10% rate of annual growth (which may be overstated by failure to allow fully for quality increases) and they are not above their historical trend relationship with average earnings. The article on housing finance (page 80) suggests that the rise in the ratio of the personal sector's broad liquidity to its nominal income is in large part the result of structural changes and may not represent a serious inflationary threat in itself, particularly while post-tax real interest rates remain significantly positive. Several features of the Budget should prove particularly helpful in this monetary context. The £7 billion PSBR planned for 1985/6 proved reassuring to markets and its achievement does not involve either implausible restraint on public expenditure or increased reliance on asset sales. The approval of short-term capital market borrowing by companies could help to relieve pressures for bank lending, while fuller capital gains tax indexation should encourage equity issues with similar effect.

Underlying growth of the economy has been faster than expected . . .

Recent information on the real economy suggests a rather stronger performance than appeared to be the case from the statistics available a few months ago; underlying activity now seems to have regained some momentum since last summer. Retail sales have continued to run well ahead of the previous year; with some increase in car sales, consumer spending revived at the end of 1984. Non-energy stocks rose sharply in the fourth quarter, largely as a result of stockbuilding by retailers. At the same time, fixed investment by construction, distribution and financial industries rose further while manufacturing investment was maintained at a substantially higher level than in 1983. The foreign trade picture also appears rather better now. Despite a deterioration in the terms of trade, in value terms the trade balance as a whole improved in the fourth quarter, a reduced deficit in manufacturing trade and a larger oil surplus more than offsetting a deterioration in other visible trade. The invisible surplus was sufficient to take the current account out of deficit in the fourth quarter; had it not been for the coal strike the current account surplus would probably have been similar to that of 1983.

Output growth now seems to have slowed, as a result of the coal strike, from 3% in 1983 to 2½% in 1984; but for the strike, which interrupted growth in the second quarter, the figure might well have risen to the 3½% now projected for 1985 in the aftermath of the strike. Manufacturing, which, like services, has been little affected by the strike, seems to have maintained a faster rate of growth than most other sectors, at least in the first three quarters of the year. Revised figures for manufacturing production have also improved somewhat the picture of manufacturing productivity and unit wage costs. A slowdown in productivity growth and an acceleration in unit wage costs in 1984 is still apparent but labour costs now stand to benefit from the reduction in employer's national insurance contributions for lower paid employees. Manufacturers' costs, including labour, raw material and fuel, now appear to have risen by rather less than their selling prices (on home and foreign markets combined) during the year to the third quarter of 1984. This widening of margins contributed to the financial strength of the company sector. There are signs, however, that manufacturers' raw material and fuel costs accelerated in the fourth quarter as sterling depreciated further, while the rate of increase in their home selling prices and in retail prices remained fairly steady.

. . . but could be threatened by higher inflation

The deterioration of the terms of trade as the exchange rate fell through 1984 meant that the GDP deflator (the broadest measure of domestic costs) rose less than retail prices. In the year to the third quarter of 1984 when the RPI rose 4.7% the GDP deflator rose by only 3.7%. In the fourth quarter the GDP deflator was 4.1% up on a year before while the latest RPI figure, that for February, shows a stronger rise, to 5.4%, largely as a result of the rise in mortgage rates at the end of January. The second 1% rise in mortgage rates, due to take effect in April, will push this figure up further for a month or two. Despite these short-run adverse effects on the RPI, the prompt policy response to the weakening exchange rate, and the demonstration of the government's long-run commitment to stable prices, reaffirmed in the Budget, will have limited the damage caused to inflation expectations.

The firm action taken in January and in the Budget have reasserted the authorities' commitment to their anti-inflationary financial strategy; as a result, the set-back to the planned reduction of inflation should prove both modest and temporary. The principal domestic threat to this prospect would be a significant wage response amplifying this transitory inflationary impulse. Such a response would, against the background of a firm financial policy, administer a severe blow to hopes that the recovery in employment, already under way, might soon begin to reduce unemployment.