General assessment

Recent developments in the domestic economy present difficulties of interpretation on both the real and the financial side. Recovery from the coal dispute, the end-year surge in exports, and the bunching of investment in the first quarter of this year all make it difficult to assess underlying trends in output and productivity. The swing in the exchange rate over the last year, and the recent divergence of input and retail price indices, contribute to uncertainty about underlying movements in nominal income. This Assessment considers these factors, as well as developments in financial markets, as they bear on the interpretation of the divergent monetary aggregates.

Growth at home has been more rapid . . .

On the limited information so far available, output growth in the economy as a whole this year has been well maintained, and there is evidence that it may have gathered pace in the last few months. Provisional figures for the output measure of GDP in the first quarter suggest continuing underlying growth of about 3% per annum. Industrial production, which accounts for rather more than a third of GDP, has been rising quite vigorously since the autumn (at an annual rate of 6% between the third quarter last year and the first quarter of 1985). Although much of this reflected the strong recovery in North Sea oil output after unusually large interruptions last summer, estimated growth of manufacturing output, which showed something of a pause in the second half of 1984, also regained some momentum around the turn of the year. About a third of the $\frac{3}{4}$% rise in GDP(O) in the first quarter may be attributable to the ending of the coal strike. Coal output is expected to return to 90% of pre-strike levels by the autumn; recovery to more normal working in other industries which had been affected by the strike is also in train. The resultant unwinding of the strike effects should contribute up to 1% to GDP growth between the first and third quarters of this year. The greater part of this is likely to be felt in the second quarter, with GDP perhaps as much as 4% higher than a year earlier.

Some of the pickup in the output of production industries which were not affected by the strike appears to be associated with the improvement in non-oil exports since the autumn, in sharp contrast to the disappointing performance earlier last year. This is consistent with the tenor of the Confederation of British Industry's April quarterly survey of manufacturing industry which highlighted the contribution of exports to recent growth, though, as to their timing, movements in net exports and manufacturing output recorded in the official statistics are not easy to reconcile.

Respondents to the CBI survey were also more optimistic about export orders, even though the survey was conducted when sterling had already recovered the ground lost during the winter, and the slowdown in US growth since last autumn was already becoming apparent. Non-oil export volume rose rapidly in the fourth quarter and the resulting high level was sustained in the first. Meanwhile the trend in non-oil import volume, even after allowing for the distortions in the normal pattern of delivery last autumn as a result of the introduction of modified arrangements for the payment of VAT, has been relatively subdued. This improvement in trade performance may be attributable in part to the lagged effects of the large improvement in UK price competitiveness brought about by sterling's depreciation since 1980. However, the timing and profile of the trade response have not been typical of previous experience, coming rather later than might have been expected and making it difficult to form a judgement on short-term prospects. While the CBI survey points to a high level of export deliveries over the next few months, sterling's effective rate has regained its level of a year ago and UK unit labour costs are continuing to rise far more quickly than those of our major competitors.

. . . with investment particularly strong, but unemployment still rising

Provisional estimates of capital spending in the first quarter suggest that there was an exceptional surge of fixed investment both in manufacturing (volume up 14% on the previous quarter) and in other industries. The great bulk of the quarter's increase in manufacturing investment was through leased assets; leasing activity was nearly double that of the previous quarter. It had been widely expected that some investment would be brought forward in anticipation of the further scaling down of investment allowances at the end of the financial year, but the size of the increase exceeded most expectations. The latest survey of investment intentions by the Department of Trade and Industry suggests that investment will be 8% higher this year than last. If correct, this would imply a fall back of the rate of investment for the rest of the year from the first quarter level to one averaging about 2½% above a year earlier. On provisional figures, manufacturers and distributors destocked in the first quarter, having accumulated stocks in the previous quarter. It is unclear how far this destocking reflects a response to the unexpectedly heavy demand for investment goods, and how far it represents a resumption of the previous trend towards lower stock levels.

Consumers' expenditure apparently grew little in the first quarter, with retail sales dipping initially after the Christmas surge. Poor weather early in the year and changes in the timing of winter sales may have been partly responsible; indeed retail sales have picked up quite sharply in recent months. There are however some indications that the high level of personal debt in relation to income, and more recently higher interest rates, have had a dampening effect on the flow of personal borrowing and, perhaps, expenditure. Against this, the boost to earnings associated with the end of the coal dispute will no doubt have added to consumer demand in the second quarter.

Prospects for the world economy are discussed on page 198.

At this stage it is impossible to see very clearly how far the apparent pickup in demand and activity in recent months represents a quickening in the underlying pace of economic growth. The rebound after the coal strike and the end-financial-year surge in capital spending are both temporary influences. Prospects for net exports, and activity more widely, depend on the growth of world markets, which is uncertain, as well as on competitiveness, which must have deteriorated recently. Nevertheless the output recovery has for some time been rather stronger than had earlier been thought, and the trend shows no immediate signs of slackening, even though it is now entering its fifth year.

Given the continuation of output growth, the 15,000 average monthly rise in seasonally adjusted adult unemployment in the first five months of this year is puzzling and, in an obvious sense, disappointing. But rather more encouraging is the implication that the apparent slowdown in productivity growth towards the end of last year has been partially reversed. This seems to be the case in manufacturing where, despite output growth, the fall in employment has been resumed this year, having been checked for several months towards the end of 1984.

Domestic cost pressures remain a source of concern . . .

The level of wage settlements seems to have edged up somewhat during the present pay round, although underlying average earnings, after correction for the effects of the coal strike and other special factors, seemed in April to be still about 7½% up on a year ago, as in each of the previous nine months. In manufacturing, underlying earnings growth increased a little in March, reflecting in part higher overtime worked as output rose; the 12-month rate reached 8¾%, a little higher than in previous months, and was maintained at that rate in April. Despite the apparent growth of productivity in the first few months of 1985, no reduction is implied in the 12-month increase of manufacturers' unit labour costs, which have risen faster than in any of our major industrial competitors and have been a cause for concern since the latter part of 1984. There has however been some lessening recently in the pressure from raw material and fuel costs, which actually fell in March, April and again in May, reflecting both sterling's appreciation since January and weak commodity prices. While the full effect of these reductions is unlikely to be seen in output prices quickly, the 12-month change in manufacturers' selling prices had already declined to 5½% in March (from an average of just over 6% in the previous six months), and has since remained at that rate.

. . . and the RPI and nominal income have exceeded expectations

Although industrial cost pressures have been contained, the 12-month change in retail prices rose to 7% in May, partly reflecting the timing of mortgage interest rate changes. This compares with the official forecast at Budget time of a 6% figure for the second quarter. Despite the higher figures recently, stable commodity prices and the strength of sterling strongly suggest a moderation of inflation later in the year. There is a notable consensus among independent forecasters on this point.

Nominal income is estimated to have grown through 1984 at the relatively subdued rate of around 7%, largely on account of the coal strike. Some acceleration in the 12-month rate was to be expected in the spring, as the underlying pace reasserted itself and activity rebounded; on a similarly unadjusted basis the 12-month change may currently be running nearer to 10%. Provided the recent faster rate of RPI increase does not rekindle cost pressures, and assuming that output growth settles down later in the year, the pace of income growth should gradually subside in coming months.

Interpretation of the divergent monetary aggregates . . .

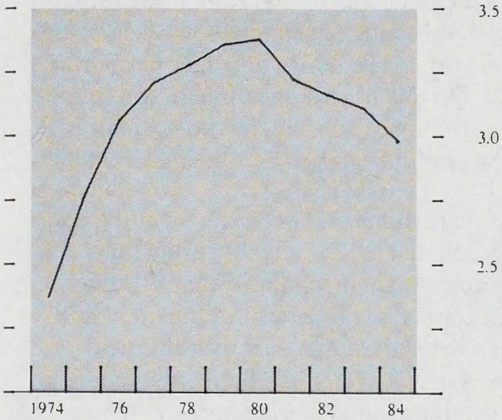
Interpretation of the monetary aggregates has been particularly difficult in the recent period with different measures, including the target aggregates M0 and £M3, apparently giving different messages about monetary conditions and their impact on the economy. M0 has continued to grow steadily at around $\frac{1}{2}$% a month, near the middle of its target range, but the growth rate of £M3 has increased sharply, taking it well above target.

. . . has been complicated by developments in competition for deposits

An important influence on the monetary aggregates has been the increased competition for deposits between, and among, banks and building societies in the last few years. This competition, which has involved both the payment of higher interest on deposits and easier access to them (including in many cases withdrawal on demand and chequing facilities) has particularly affected some of the narrower monetary aggregates. Funds have been drawn into these more attractive accounts from both non-interest-bearing accounts and less liquid deposits; as a result of these developments non-interest-bearing M1 will have been reduced, and interest-bearing M1 and M2 increased, to an unknowable extent, diminishing, for the time being at least, their usefulness as monetary indicators. M0 has been less affected than these other measures of narrow money and was, for this reason, adopted as the target measure of narrow money in the 1984 Budget.

The broader aggregates too have been affected by competition within the deposit-taking sector. This has been reflected in the relatively rapid growth of PSL2, which was accentuated in the past year by a run-down in building society term shares, which are outside the PSL2 definition, and their replacement by building society liabilities included within it; there are some recent signs that this particular factor may be beginning to be reversed. But it is likely too that a wider effect of this competition has been to increase the attraction of interest-bearing deposits generally, *vis-à-vis* other forms of financial assets, as a home for longer-term savings. The declining trend in the rate of inflation and the emergence of substantial and persistent positive real interest rates on monetary assets will have tended to work in the same direction.

The velocity of £M3[a]



(a) Calculated as the ratio of GDP(E) at current market prices, divided by the mid-year stock of £M3.

Broad money velocity has declined since 1980

These influences, some of which have been present to a greater or lesser degree for a number of years, help to explain a continuous, though somewhat erratic, decline in the measured velocity of all forms of broad money, including the target measure of broad money, £M3. This tendency, and the reasons for it, insofar as they can be identified at any particular time, clearly need to be taken continuously into account in interpreting the behaviour of the various broad money aggregates.

This need was apparent in 1980-81 when £M3—at that time the sole target indicator—overshot its target range by a wide margin. As an indication of monetary conditions, this appeared to understate the severity of policy at that time, for three main reasons. First, a substantial and partly measurable element of the rapid growth in £M3 could be attributed to specific structural developments, most notably the abolition of direct controls. Second, there was at that time a massive financial imbalance within the private sector, with persons in large financial surplus and companies in large deficit, which involved exceptional intermediation by the banking system and associated inflation of £M3. And, most important, there was at that time overwhelming direct evidence from the economy at large that monetary conditions were tight. Specifically, output was severely depressed and the rate of inflation was falling rapidly, with the strengthening exchange rate adding to the pressures on the company sector.

In the face of uncertain prospects for nominal income . . .

In present circumstances there are also grounds, as already described, for thinking that the recent rate of broad money growth may be understating the degree of monetary tightness. But in a number of respects the situation now differs from that earlier period. In particular, the evidence from the economy at large is very different. As discussed earlier in this Assessment, with economic activity into its fifth year of recovery, business sentiment remains buoyant despite the persistence of high interest rates and a stronger exchange rate. But there are reasons for thinking that growth may moderate somewhat later this year and into next. At the same time, while the recent upturn in the measured rate of retail price inflation has been in part erratic, there must be a danger that pay negotiations will be affected, and there are no signs of any easing in the pace of increase of average earnings. As a result of an apparent slowing down in the rate of productivity increase, measured unit labour costs rose sharply in the latter part of 1984 and the present outlook, though somewhat improved, is still not reassuring.

Against this background the Bank is uncertain about how much of the acceleration in broad money reflects an upward shift in the demand for money and thus carries no adverse implications for future inflation. The need for caution suggested by this uncertainty is reinforced by the pattern of the counterparts to £M3, specifically by the strength of corporate demand for credit at a time when the PSBR has been running relatively strongly. The March *Bulletin* suggested that there were a number of temporary factors tending to increase bank lending to the company sector, such as the accelerated payment of VAT on imports; more recently the bunching of investment spending ahead of the reduction in the value of capital allowances at the end of the last financial year has provided a further temporary boost to credit demand. On this basis some moderation in the pace of bank lending is still to be expected, but one cannot be wholly confident of this until it begins to become apparent.

There have been some suggestions that both bank lending and £M3 have been heavily inflated by artificial bill arbitrage transactions involving corporate borrowing of funds through acceptance facilities for immediate redeposit in the interbank market. It has long been recognised that such possibilities exist from time to time, typically when the Bank, in its money-market operations, is leaning against market pressure for a change in the general level of interest rates. But the Bank, despite careful monitoring and investigation of reported instances, has discovered no convincing evidence to suggest that such transactions have in fact been a significant source of distortion to the aggregates.

Bill arbitrage is discussed in a note on page 189.

. . . caution is called for

Taking the picture as a whole, M0 continues to grow at a moderate rate; and the recovery in the exchange rate, in effective terms to around the levels of a year ago, reverses an earlier inflationary influence. On the other hand, while the rate of broad money growth should as always be interpreted with care and should not in current conditions necessarily be taken at face value, it nevertheless suggests the need for some measure of caution in the approach to policy.