General assessment

Since the spring the US dollar has fallen against most other currencies while dollar interest rates have also declined and economic growth in the United States slowed further. The expansion of activity in Europe and Japan was insufficient to offset this. At home, output recovered from the coal dispute and price rises, though not wage increases, have abated. Against this background the movements of sterling and the monetary aggregates, and their influence on the conduct of policy, are discussed.

World growth slowed in the spring . . .

The recovery in the world economy slowed in the first part of 1985. Growth in the United States was around 1½% per annum in the first half of the year, well below the 3½% to which it had fallen in the second half of 1984, but may now be picking up somewhat. The slowdown does not, as yet, appear to have been offset by faster growth elsewhere. The Japanese economy is expected to recover substantially from a surprisingly subdued first quarter, but even so growth there in the first half of 1985 is likely to be below the rate of 5½%–6% recorded throughout 1984. Recovery continues to be fairly muted in continental Europe, with Germany having suffered a setback around the turn of the year (partly associated with the exceptionally harsh weather) and growth in France remaining sluggish. Latest estimates suggest that GDP grew at an annual rate of only 1% in the major continental European countries in the first half of this year.

Personal consumption and business investment in the United States have remained fairly strong, stimulated perhaps by lower real and nominal interest rates partly induced by a relaxation of US monetary policy. The uncompetitive position of the US economy as a result of the earlier appreciation of the dollar has, however, had the result that net trade has exerted a powerful drag on US output growth so far this year. In Japan and many European countries, by contrast, growth has been restrained by slower expansion of domestic demand than in previous recoveries. This may partly reflect the fact that monetary and fiscal policies have remained restrictive, or at least cautious, despite further successes on the inflation front and the increasing current account surpluses in Japan and Germany.

. . . as the dollar weakened and inflation fell further in industrial countries . . .

Since its peak at the end of February, the dollar has depreciated by about 10% in effective terms but remains at much the same level as a year ago and very high by earlier standards. Although the timing of the turnround may have been due in part to concerted intervention by central banks, the fall in the dollar

also reflects the recent easing in US monetary policy in the face of the slowdown in domestic activity. A similar period of falling US interest rates late last year did not, however, check the rise of the dollar to its February peak. A more fundamental dollar adjustment may therefore require the reversal of the global shift in wealth holders' preferences towards dollar-denominated assets manifest since 1983.

In the recent period of dollar depreciation the currencies of most other major countries have appreciated by varying amounts, with the exceptions of the Canadian dollar (which is influenced most directly by developments in the United States) and the Italian lira (which fell in the July realignment of EMS currencies). The Japanese yen weakened much less than the European currencies over the period of dollar appreciation (at least from mid-1982); and the yen has not since appreciated, in effective terms, by as much as most European currencies. In consequence, Japan's competitiveness relative to European countries, which has been sustained throughout by very muted rises in domestic costs and prices, will have been further enhanced; the yen has depreciated by some 11% against the deutschemark and 14% against sterling since late February. This could be disquieting since the growing Japanese current account surplus, which is as large a proportion of GNP as the US deficit, also contributes to protectionist pressures.

In addition to improving industrial countries' current accounts, the weakness of oil and commodity prices has also facilitated continued progress against inflation, as have very subdued unit labour costs. Restrictive (or at least fairly cautious) anti-inflationary monetary or fiscal policies have also contributed, and the fall in the US dollar means that inflation performance in Europe and Japan is likely to improve. In the light of recent evidence that the world economic recovery has faltered, and given the reductions in US interest rates, calls for an easing of policies in Japan and Europe (especially Germany) are likely to intensify. Countries may, however, continue to rely for recovery largely on the reduction of supply-side rigidities rather than on the adoption of more expansionary policies explicitly designed to encourage domestic demand. In this context, some comfort is taken in many countries from the stimulus provided to corporate profitability and investment by recent restrained real wage growth. This has been a factor behind the rapid recovery of business investment in the United States and Japan. The extent to which this experience is repeated in Europe is now one of the most important questions bearing on the continuation of the world economic recovery.

. . . with mixed effects on developing countries

Prospects for developing countries are discussed on page 372.

Prospects for the developing countries remain mixed. Those with large debts were forced to cut back imports (with adverse effects on the industrial countries) earlier in the world recession. In the two years from mid-1981, developing countries in aggregate reduced their import volumes by around 10%, and their combined current account improved from a deficit of about $80 billion in 1981 to a deficit of under $40 billion in 1983. As recovery in the world economy took the growth of world trade to 9% in 1984, the non-oil developing countries are estimated to have expanded export volumes in

aggregate by as much as 12%–13%, while import volumes grew by about 8% from their lower base, and gross external debt as a proportion of exports fell back by around 2½%. This year, those countries specialising in exports of oil and primary products will have suffered from a worsening in their terms of trade, and the demand for developing countries' exports in general will have been adversely affected by the slowdown in industrial countries. The debt burden, however, has been eased a little by the reductions in US interest rates and the fall in the dollar. Further progress in reducing the external debt burden is possible, but it will depend on a combination of continued growth in these countries' export markets (with no further restrictions on their access to them), further declines in dollar interest rates, and a willingness to persist with adjustment policies, even though the pressure these have put on living standards may not be fully reversed for some time.

Output and demand at home picked up in the first half and the rise in unemployment slowed a little

Economic activity seems to have been quite buoyant in the first half of the year. The output measure of GDP provisionally suggests that the economy grew at an annual rate of almost 4½% during the first half of the year. Although this probably owed much to the ending of the coal strike and other special factors, there are indications that the continuing recovery of output has brought about a slight slowing in the underlying upward trend in unemployment.

Demand in the second quarter was sustained principally by a revival of consumers' expenditure, which had declined slightly in the first quarter. A modest rebuilding of stocks by private industry, and improvements in net trade in oil (after the coal strike) and in services, also contributed to growth. It is now apparent that the exceptional surge in non-oil visible exports recorded late last year and in the early months of 1985 has not continued, with some falling back in the second quarter from the high first quarter level, if erratic items are excluded; and, on the same basis, there was no further decline in imports. The phasing out of accelerated depreciation, and the phased reduction of the rate of corporation tax, boosted investment in the first quarter of 1985, which was the last period in which allowances at the old rates could be set against the higher rate of tax. The additional investment was almost entirely financed by leasing; both investment and leasing fell back in the second quarter, investment to a level only slightly lower than in the fourth quarter of 1984, which had not seemed to be depressed. This suggests that investment for the year as a whole is on course to meet the DTI's survey-based projection of 8% growth.

Inflation seems set to fall, but pay increases have risen, and the implication of the monetary indicators has not been clear

The 12-month increase in the retail price index (RPI) peaked at 7% in June and had fallen to 6¼% by August. It is widely expected to fall to about 5½% by the end of the year as the lower mortgage rates announced in August become effective. Excluding housing costs, which are dominated by interest rate changes, the temporary upturn was far less marked, as was

the improvement (¼%) from an April peak of just over 4¾%. The lagged response of consumer prices to the strengthening of sterling since February and the continuing weakness of commodity prices (which together accounted for the slight fall in manufacturers' input prices over the last twelve months) will help to slow the rise of the RPI well into 1986.

Labour costs, on the other hand, picked up less sharply than prices but show no immediate sign of slowing. While the underlying 12-month increase in average earnings for the whole economy has stayed unchanged at 7½% since July 1984, unit labour costs in manufacturing industry appear to have accelerated. Pay settlements in manufacturing averaged 6½% in the six months to June, having crept up from around 6% in the previous pay round; and the underlying 12-month rise in average earnings in manufacturing has edged back over 9% from 8½% at the start of the year. This pick-up in earnings growth has occurred against a background of an apparent fall in productivity growth. On past experience this may well be revised up a little from the 3% per annum to which it is estimated to have fallen from about 5% at the beginning of 1984. It is, however, clear that unit labour costs in UK manufacturing have recently been rising faster than eighteen months ago and distinctly more rapidly than those of our main overseas competitors.

Monetary indicators continued to be difficult to interpret. The growth of M0 remained below the middle of its target range, while M2, which is a comprehensive measure of transactions balances actually larger than £M3, had been growing at less than 7% a year for several months. But £M3 itself, along with other broad aggregates, moved erratically and grew consistently well above its target range. The further decline in the velocity of broad money has exceeded earlier expectations, and may be associated with continuing changes in the structure of the financial system. In these circumstances the behaviour of the exchange rate, which tended to strengthen against the dollar and other currencies for most of the period, necessarily assumed a somewhat greater importance as an indicator of monetary conditions. These uncertainties required a cautious response from the authorities but, against the background of continuing firmness of sterling and increasingly confident predictions of falling inflation, short-term interest rates were allowed to fall (in stages) by a further 1% in July.

Conclusion

A sustainable US current account requires depreciation in the dollar and substantial cuts in the structural components of the US budget deficit. The weakness of the dollar between April and August was too modest and too short-lived to have much effect on the US trade deficit this year, when it is expected to reach around $140 billion, or about 3½% of GNP. Stronger growth in demand outside the United States would also help to reduce the scale of current account imbalances. In Europe and Japan, the overall outlook is for some recovery in activity from the fairly depressed levels seen early in the year, although this is unlikely to be rapid enough to make much difference to relative current account positions in the near future.

Without a sharp improvement in competitiveness, which only a significant depreciation would offer, it is highly likely that

pressures in the United States for protectionist measures, which are already strong, will intensify. Given the higher rates of unemployment elsewhere, and the importance of access to the US market for many indebted countries, the risks of retaliation and disruption of the world trading and financial systems would be considerable. In the absence of a more fundamental budget deficit cutting package, however, dollar depreciation may be limited. The alternative of relief to the US external position from faster growth in Europe and Japan may call for co-ordination of measures to open markets and ease macroeconomic policies in those countries in which cost pressures pose no serious threat. For the United Kingdom the prospects for reduced inflation in the rest of 1985 and into 1986 are good. For longer-term progress on prices, jobs and growth, however, it is essential that wage settlements moderate and the growth of unit labour costs be reduced substantially to the much lower rates of our competitors. Policy will continue to need to be conducted cautiously, as developments in all these fields unfold.