General assessment

Despite further widespread progress in reducing inflation, the prospect for continued growth of the world economy at a satisfactory pace has been threatened by the large and growing external imbalances of some major industrial countries which have led to calls for protection. The lack of progress in resolving the debt problems of developing countries has also cast a lengthening shadow over the world economic and financial outlook. Two significant and welcome international policy initiatives have been taken addressing these problems, the first results of which have been gratifying. Internationally, therefore, the future is in some ways less dangerous than might have been feared some months ago. While UK recovery looks set to continue, and inflation to fall, there must be concern that the continuing adverse trends in labour costs at home may prevent the United Kingdom from taking full advantage of the improved external environment. The monetary policy dilemmas created by these developments, among others, are also discussed in this Assessment.

Recent international initiatives should foster continuing world growth . . .

In late September Ministers of Finance and central bank Governors of five major industrial countries (the G5) met in New York and resolved to intensify their individual and co-operative efforts to achieve a sustained non-inflationary expansion. They agreed that exchange rates should better reflect fundamental economic conditions, in particular that some further orderly depreciation of the dollar would be desirable. Their statement represented an important change in attitude, especially on the part of the United States. The dollar fell sharply even before any of the intervention which the announcement portended had taken place; subsequent large-scale intervention had, by the end of September, taken the shift in the yen/dollar rate to 10%. The Japanese authorities followed their exchange market intervention with monetary action which had the effect of raising interest rates by about one percentage point at most maturities. By the end of November the yen had risen a further 7% against the dollar and the bilateral rate stood 30% above its February low.

The US participation in this initiative involves a reaffirmation of the Administration's resistance to protectionist measures; at the same time the United States is increasing pressure on other countries to be less restrictive of imports (Japan had already taken some steps in July), and is likely to match other countries' export support measures if they are not cut back. Both the US Administration and the Congress have subsequently shown

increased determination to take the cumulatively substantial action necessary to reduce the federal budget deficit; this could contribute to a further reduction of the dollar's misalignment. In mid-October the Japanese government took modest fiscal action to stimulate domestic demand; its impact on the external balance is likely to be small, though helpful. A greater contribution in the longer term will be made by the appreciation of the yen, if it is sustained. Meanwhile, policy in Europe has been less active, but nevertheless supportive of the realignment of exchange rates, with the deutschemark up 13% against the US dollar between the G5 meeting and the end of November, at which time it was 38% above its February low.

The second initiative, unveiled in Seoul early in October, was the package of American proposals for a fresh effort to deal with the debt and adjustment problems of a number of less developed countries. This again reflects a significant shift in US attitudes—in favour of greater official involvement in international debt problems and an enlarged role for the World Bank. Additional loans by the World Bank and other international agencies, linked to the determined pursuit by debtors of growth-oriented structural adjustment, would be designed to create conditions in which commercial banks would be willing to see their exposures to these countries again rise modestly. Appropriate adjustment policies by the debtor nations should help to restore confidence in their prospects and to bring to an end the outflow of capital from them, without resort to arbitrary (and evidently not always effective) controls. In these circumstances the resumed flow of finance could serve as a basis for much improved long-term growth. The President of the World Bank and the Managing Director of the IMF have joined in urging that the initiative be translated into positive and concrete action as soon as possible. There have subsequently been expressions of broad support from a number of governments and groups of commercial banks.

. . . although commodity prices have weakened again . . .

The problems facing debtor countries have been aggravated by the renewed weakness of non-oil commodity prices which, relative to the prices of manufactured goods, stood in the third quarter some 15% below the peak of the first quarter of 1984. Prices of some metals have fallen further with the recent suspension of the operations of the International Tin Council's buffer stock manager, which has given rise to expectations of a sharp fall in tin prices when trading resumes. In response to a tight stock position and unusually cold weather, spot prices for North Sea crude rose about 8% in SDR terms from their summer lows, but after the early December meeting of OPEC ministers prices fell sharply.

The downtrend in world commodity prices over the past eighteen months has contributed to a fall in inflation in major industrial countries from 4.6% to 3.6% per annum. It has also raised the real incomes of industrial countries as a whole, since they can now obtain more commodity imports for a given volume of industrial exports. Developing countries have experienced a corresponding income loss. Since marginal savings rates in industrial countries are likely to be higher than in developing countries, the net overall effect on demand

worldwide may have been slightly deflationary. The initial effect on the supply side of industrial countries has been to raise profits, which should provide an incentive, and enhance the means, to produce more, invest more and employ more. This process, added to the expansionary effect of lower import prices on their domestic demand, should mean that the immediate improvement in industrial countries' trade balances will, as time passes, be progressively offset by higher net import volumes, to the benefit of developing countries.

. . . with implications for costs and prices in the United Kingdom; where competitiveness and longer-term growth require lower wage settlements

In the case of the United Kingdom, producers' fuel and material prices actually fell by over 5% in the year to November. The fall in the prices of imported materials has been a direct benefit to the trade balance and continues to be an important restraining influence on output prices. The twelve-month change in the retail price index peaked at 7% in the summer, is now 5½% and should be nearer 4% in the first half of next year if the exchange rate is broadly maintained. Given the interest rate rise at the start of the year, and the treatment of mortgage interest in the RPI, it is not surprising that the index adjusted to exclude this element rose less, and later, than the full index. Without the mortgage element inflation peaked at 5½% in September and is also set to decline steadily into next year.

There is, however, so far no evidence of any similar easing in the growth of labour costs. The twelve-month growth of underlying earnings recorded in September, at 7¾%, was slightly up on the 7½% at which it had been stuck for over a year. At the same time productivity growth has slowed somewhat, even allowing for problems of measurement, to a level below that of our major competitors, other than the United States. The current level of wage settlements suggests that the terms of trade gain in UK real income is likely to be transferred progressively from profits to labour incomes over the next year or so. In the process, real earnings may, for a while, grow at a rate not seen for a number of years, with an effect on private consumption and activity which is likely to be offset by weaker growth in other components of demand—particulary net exports.

With the slower pace of world recovery, the growth in world imports is likely to have fallen quite sharply from the exceptional 9% rate seen last year, probably to below 5% this year. Although the shift in the pattern of growth away from the United States, to Western Europe in particular, is likely to be relatively advantageous to the United Kingdom, the outlook for UK exports is less encouraging than it was a year ago, before the sharp surge in non-oil exports in late 1984 and early 1985. The reason lies in a loss of competitiveness since the middle of last year of about 9% in terms of relative export prices, in turn due predominantly to the continued rapid growth of labour costs in this country.

Wage setting behaviour . . .

UK wage behaviour is out of line with that of other industrial countries. Settlements at the 5%–7% level, which together with 'drift' of 1%–2% a year produces 7%–8% annual earnings

growth, have persisted now for three full years despite high and rising levels of unemployment. Such inertia in the trend of nominal wages used to characterise the unionised sector of the US economy under multi-year contracts specifying such increases. There, however, this rigidity has broken down in recent years; in the US recession of 1981–82 several such contracts were overridden by agreement between management and unions in the face of the damage being done to employment. More recently the prospect of insolvency has led firms to impose unilateral wage reductions in some cases, while a few unions have allowed new members to be hired at lower rates than those paid to established employees. The annual rate of increase of private sector nominal earnings in the United States has fallen from over 9% in 1981 to about 3%. This flexibility has been associated with a substantial rise in US employment, largely outside the manufacturing sector, and a significant fall in unemployment.

The continental European pattern has been for wages to follow prices more closely and promptly than in the United States, but with a somewhat greater tendency for the rate of increase of *real* wages to reflect the level of unemployment. A much weaker unemployment effect in the United Kingdom is confirmed by the fact that since 1980 the real income of those in employment has risen by an average of around 2% per annum, faster than in the previous five years, despite the much higher level of unemployment, and considerably faster than in any other industrial country but Japan. Nothing short of a major break in attitudes is likely to change this pattern of behaviour. Despite the insistent calls of the Confederation of British Industry for such a change, 75% of senior directors surveyed for The Financial Times in mid-October expressed satisfaction that their settlements were not too high. Given the stability of wage costs in competitor countries, and in the absence of faster productivity growth, only a significant reduction in the level of pay settlements can improve competitiveness while progress in eliminating inflation is maintained. This is essential if employment is to rise at the rate necessary to make inroads into unemployment, which seems to have stabilised at a high level. This is particularly true of the manufacturing sector, where since 1980, despite its exceptional exposure to international competition, earnings have consistently risen faster than in the rest of the economy, and which has not shared in the rise in employment elsewhere.

. . . adds to the problems of monetary policy

There are, at present, several difficulties for the conduct of monetary policy. First, structural changes in the monetary system have continued to affect various monetary aggregates in differing degrees. Inevitably this has complicated the interpretation of monetary conditions. The growth of £M3 had risen from 12% in June on the twelve-month comparison to over 14% by September; whereas there was no such acceleration in broader measures of liquidity such as PSL2 (on its own or together with building society term shares) which had been growing for some time at the higher rate. Narrower measures of money, such as M2 or M0, had shown steady or declining growth. The exchange rate had generally remained firm. Against this background, it was decided that the above target growth of £M3 could be tolerated provided other monetary indicators

remained consistent with the ultimate objective of declining inflation and sustainable growth. The rise in £M3 growth over the summer had coincided with a period of heavy debt maturities and the authorities had not sought to achieve the target range by further overfunding. These changes were formally recognised in the Mansion House speeches, in which the £M3 target was suspended for the current financial year, while the continuing relevance of broad money was reasserted. It was announced that debt sales would be designed to fund the PSBR outside the banking system over the year as a whole. It was also recognised that these developments involved placing a greater weight on short-term interest rates in the conduct of monetary policy.

Second, the declining velocity of broad money implies a potentially worrying buildup of the liquidity of the private sector. There are reasons for believing that this liquidity is willingly held at current prices and interest rates. Were that willingness to start to weaken, it is likely that it would be signalled by a faster growth in asset prices or a weakening of the exchange rate. In fact, there are few signs at the moment of untoward developments in asset prices. Although house prices have on average been rising faster than retail prices for some time, there has been no sign of any relative acceleration. The stock market, on the other hand, has been buoyant: the FT500 share index rose by about 20% in the year to November, while turnover was boosted by takeover activity which reached a record level, with £2¼ billion spent on acquisitions of non-financial companies in the third quarter. Profits have, however, also risen strongly, so that the price/earnings ratio at about 12½ is not much more than half that seen in 1972 and slightly lower than two years ago. In real terms, moreover, the index itself remained 30% below its 1972 peak and its rise was not out of line with comparable markets abroad even before its sharp fall in early December.

Finally, the persistence of upward pressure on wage costs, discussed above, accompanying as it does high levels of unemployment, produces acute dilemmas for policy. There have been calls from industry for urgent action by the authorities that would lead to a reduction in the value of sterling, especially against the currencies of key competitors, like the deutschemark. In fact, the sterling index and the deutschemark rate are now lower than their levels of eighteen months ago. The entire loss of UK competitiveness over this period can thus be accounted for by faster increases in our prices and costs than in our competitors' expressed in the respective currencies. Although a lower exchange rate might provide short-term relief from competitive pressure, it is unlikely to offer a lasting solution, for experience in this country has repeatedly shown that such competitive advantage as has been obtained from time to time when sterling has fallen against other key currencies has largely been eroded, after a period of a few years, through the impact on inflation. The relief offered to companies' financial positions has been pre-empted by domestic wage and cost increases, instead of being used for investment or in other ways which might validate higher real wages, and has thus proved temporary. This experience over many years has made inflation expectations and nominal interest rates sensitive to exchange rate weakness. An exchange rate that can be relied on to be broadly stable over

the medium to longer run provides a more favourable environment for employment, investment and, in the end, living standards, provided that the paramount need to exercise restraint on domestic cost increases is respected by all concerned.

Although the prospect is for a continuing fall in inflation, so that the twelve-month rise in the RPI in the middle of next year will be about half of that in mid-1985, there is, as yet, little sign of further abatement of domestic cost pressures. At the same time the level of unemployment argues against any tightening of fiscal policy. Thus, unless relieved by a break in the pattern of behaviour, the burdens placed on monetary policy are likely to be considerable. While developments abroad have led to a more helpful configuration of exchange rates they also call for persistence in maintaining firm monetary conditions at home.