General assessment

Events since December have been dominated by the plunge in crude oil prices and the repercussions in world financial markets. The fall reflects the incompatibility of OPEC price and output objectives and the abandonment of the former's primacy, against a background of short-run inflexibility of oil demand and non-OPEC supply. The outlook for oil prices remains highly uncertain, depending crucially on whether OPEC reasserts supply restraint. If they stay low, the industrial world stands to benefit significantly in terms of non-inflationary growth, with lower inflation expectations signalled by falls in interest rates in most centres, and gains for the major countries most reliant on oil imports reflected in appreciation of their currencies. Non-oil developing countries will benefit too, but heavily indebted oil exporting countries face serious problems. The United Kingdom will also benefit on balance from cheaper oil, despite being a substantial oil exporter in the medium term, which implies immediate losses to oil producers' incomes, government revenue and the trade balance. The Assessment reviews real and financial developments in the domestic economy in the light of these external developments and considers their implications for prospects and policy at home, where markets have responded favourably to the recent Budget.

The sharp fall in oil prices since November . . .

Crude oil prices fell sharply following the decision at the OPEC ministerial meeting early in December to seek to establish and maintain a 'fair share' of the world oil market for OPEC suppliers. At the end of March spot prices for North Sea oil stood some 65% below their November peak in SDR terms. Relative to the price of industrial countries' exports, the oil price was then somewhat below its level immediately before the 1979 OPEC rise. In retrospect it is remarkable that prices had held up for so long; some spot prices were briefly above $30 per barrel as recently as November. The mounting evidence that OPEC members were exceeding their agreed quotas, while non-OPEC supply was rising and global demand stagnating, was reflected in only modest discounts on forward markets. OPEC producers were also increasingly resorting to 'netback' deals, which relate the price of the crude to the selling price of the final products rather than the official OPEC price (which remains $28 per barrel for Arab light).

The experience of recent months illustrates the virtual rigidity in the short term of both oil demand and non-OPEC market supply in the face of price movements. This is in marked contrast to their longer-term responses. Since the OPEC price rise in 1973 there have been very significant savings in the use of energy in general and oil in particular, while non-OPEC reserves have been more intensively exploited. Oil consumption per unit of GDP in industrial countries has fallen by nearly 40% since 1973, and free world consumption has fallen by nearly 7%, while non-OPEC output has increased by nearly 60%, reducing OPEC's share of free world oil production from two thirds to two fifths.

Oil price prospects remain highly uncertain and depend much on how producers react to the price fall. Capacity exists to produce at least 12 million barrels a day more than is currently being consumed (a potential excess of over 25%). Most of this supply is available at a very low marginal cost of extraction. In the very short run the price would probably need to fall well into single figures, and appear settled there, to discourage higher-cost supply enough to establish equilibrium. If a low price were seen as temporary, some producers might be induced to hold back output in expectation of a price recovery, thus damping the fall. In the longer term, development of new sources of supply could be discouraged even if prices were expected to recover partially from their present level. Moreover, oil demand will strengthen as users respond to lower prices, particularly where substitution for coal is possible. Much of the market share lost by oil since the early 1970s would, however, be difficult to regain even in the medium term, since so much investment has been committed to energy conservation and alternative fuels. Energy users and planners may well assume that the relative price of oil will tend to rise again.

Potential output overhanging the market would seem to preclude any very significant recovery in prices unless some supply restraint is also expected. A low price has a serious impact on countries that are heavily dependent on oil revenue, most of which are members of OPEC. Most other producer economies are less adversely affected, and some even benefit. Production in those countries that typically act independently of OPEC is, partly for technical reasons, unlikely to fall enough to affect the situation materially. Any short-term restraint on supply therefore depends on the willingness and ability of other countries, mainly members of OPEC, to restrict output. The members differ in the period over which they expect to be significant oil exporters, which makes for different preferences as to present and future prices. Those with the higher ratios of reserves to production might not choose to support an attempt to restore the previous high price since this would diminish the long-term demand for their product. This makes reaching any agreement difficult, as evidenced by the inconclusive OPEC meeting in March, though it remains in the collective interest of OPEC members to do so. Whether or not such an agreement is reached, it is hard to envisage any supportable combination of price and output that would avoid some degree of difficulty of financing or of real adjustment for most countries predominantly dependent on oil for export revenue.

. . . has helped interest rates to fall and offers substantial benefits for the industrial world . . .

For the major industrial countries, however, the fall in the oil price is beneficial. For example, at a price of $15 per barrel rather than $30, their consumer price level might be as much as 3% lower than otherwise after three years. The reduced inflation prospect encouraged the German authorities to cut their interest rates in March, and this was quickly followed in Japan and in the United States, where long bond yields had been brought down by market forces from over 10% last October to below 8%. The fall in long real interest rates, together with nominal objectives for public expenditure and fiscal balances, should help to raise the GDP of OECD countries by perhaps as much as 3% more than otherwise over the next three years or so. Obviously, oil-using industries will benefit more than those specialising in supplying oil producers, whether at home or abroad. Some oil companies, particularly small ones concentrating on exploration and extraction, without significant downstream diversification, and other companies specialising in related activities, could suffer, as could banks exposed to them.

The US dollar fell a further 6½% in effective terms between early December and the end of March; unlike the fall following the G5 meeting last September, this one owed little to official intervention in the exchange market. Some weakness was occasioned by interest rate expectations as US growth seemed to be slowing and fiscal and inflation prospects improving. There was also, however, a continuation and reaffirmation of the policy of the G5 (and other countries that joined in the intervention at that time) to promote a more sustainable pattern of exchange rates and thereby to protect the open trading system. The dollar fell particularly against the currencies of the major oil importing countries; this should, in due course, do much to establish a more balanced and sustainable pattern of non-oil trade between industrial countries. In part, however, it reflects the fact that with lower oil prices the Japanese and German current account balances will gain proportionately more than that of the United States, at least initially.

Lower oil prices, lower interest rates, a weaker dollar, and higher exports to a more rapidly growing OECD area should ease the financial problems of many non-oil developing countries. In contrast, oil exporters with large external debts inevitably face serious problems. Mexico, whose economic position was deteriorating even before the oil price falls of the last few months, is only the most conspicuous example; Nigeria, Indonesia and Egypt are among the others. Clearly, such countries have to adjust in due course to any permanent reductions in their foreign exchange earnings, but in some cases consideration may have to be given, within the framework of Secretary Baker's initiative, to easing the transition.

. . . with the prospect of lower prices and higher activity in the United Kingdom too

As a significant net oil exporter, the United Kingdom might be thought to lose from the oil price fall; but this is not in fact the case. In 1985, at the prices then ruling, oil contributed only 6% to UK GNP, 16% to exports of goods and services, and 10% of current account receipts. The immediate impact of lower oil prices is to worsen the terms of trade and so reduce national disposable income, in particular cutting the flow of income from oil exports (most of which accrues in the first instance to oil companies and the government). On a long-term view, however, the United Kingdom should probably be regarded as a net importer of oil: while many industrial countries have negligible reserves of oil, the ratio of oil reserves to oil consumption in the United Kingdom is very much lower than for OPEC; indeed it is lower than for the world as a whole. If the price stays down, oil imports will be obtainable at lower resource cost than would otherwise have been the case, freeing productive resources to meet other domestic demands, whether directly or through non-oil trade. Whether the recent fall in prices should be judged beneficial therefore depends on the expected future path of prices and the rate at which the future is discounted; and is, on balance, likely to be favourable.

Because the United Kingdom produces substantially more oil (in relation to GDP) than most other industrial countries, successful adjustment to lower oil prices is likely to require some exchange rate depreciation in order to improve the competitiveness of the non-oil sector. This has occurred, with sterling's effective rate falling some 7% between the third quarter of last year and the end of March alongside a 60% fall in sterling oil prices. Calculations reported elsewhere (see page 25) suggest that this combination is likely to reduce the overall UK price level while the current account need be worsened only temporarily. The immediate loss of oil export earnings, and of markets in oil exporting countries, some of which have spent disproportionately on UK goods, will increasingly be offset by the effects of more rapid growth of UK markets in industrial countries, and by improved UK competitiveness in those markets.

Adjusted for the effects of the miners' dispute, the average measure of GDP rose by 1½% in the first half of 1985. There was then a pause before a resumption of growth in the fourth quarter. The slower growth in the second half was accompanied by a change in the pattern of demand, with the contribution from net exports fading and being only partially replaced by higher consumer spending and, latterly, by a greater buildup of stocks. The rate of inflation gradually declined in the second half of 1985 owing to weak commodity prices and the appreciation of sterling during much of 1985. The 12-month increase in the retail price index fell from 7% in mid-1985 to just over 5% in February this year. The underlying growth of nominal earnings in the whole economy has remained remarkably stable at 7½% since mid-1984, with rather more than half the pay settlements agreed during this period being between 5½% and 7½%, according to the CBI's *Pay Report*. Over this period unemployment has continued to rise, reaching 13.3% in February.

In the United Kingdom, earnings in the manufacturing sector, which is particularly exposed to international competition, have been rising at 8%–9% per annum since 1982. This is more than twice as fast as in the United States, Germany or Japan, even though UK productivity growth is not exceptionally high by international standards. The faster growth of UK labour costs over this period has been more than offset by exchange rate movements, and the recent fall in the rate will have improved competitiveness further. This gain, however, remains vulnerable to pay pressures. With inflation abroad likely to fall more rapidly than in the United Kingdom, as a result of recent exchange rate movements, the new competitive advantage, with the associated hopes for falling unemployment, could be eroded rapidly unless the increase in nominal wages is significantly reduced.

Before the end of last year, some unease was occasioned in the markets by a softening of the exchange rate, the rising rate of growth of unit labour costs, and domestic monetary developments, particularly the growth of the broad aggregates and private sector borrowing. Against this background, when the exchange rate came under growing pressure in early January from the sharp fall in the oil price, short-term interest rates were raised by 1%. Subsequently, steps were taken to consolidate the new level of rates in the face of persistent, and occasionally very strong, upward market pressure (largely oil-related). After several weeks of such resistance the pressure ceased following the publication in February of the January money, bank lending, and reserves figures, which were much more favourable than market commentators had expected. A pause in the decline of oil prices, good figures for public borrowing, and interest rate reductions abroad, all led to a stabilisation of sterling and later to pressure for interest rate reduction. In the first week of March there were official interest rate reductions in Germany, Japan and the United States; moreover, bond markets worldwide were very strong. These developments, which largely reflected reduced inflation expectations, helped to induce a marked fall in yields on long gilts, which fell below 10% per annum and stayed there for the first time in over a decade. There was also a parallel continuation of strength in equity prices in the United Kingdom, as abroad.

The Budget

A lower sterling oil price as the dollar fell reduced oil revenue in 1985/86 by about £2 billion. At a price of $15 in 1986/87 oil revenue would be about £5½ billion below earlier forecasts. In each year, however, other revenues are likely to exceed earlier expectations, by about £1½ billion and £3½ billion respectively. Given also that expenditure has turned out slightly lower than forecast, this means that the 1985/86 PSBR is likely to match the 2% of GDP projected in the 1985 MTFS. For 1986/87 a fiscal adjustment of £3½ billion had been seen as possible, with the PSBR again held to 2% of GDP. The changes in oil and other revenue prospects meant that the earlier PSBR objective would have been compatible with a fiscal adjustment of about £1½ billion. In the event, the Chancellor of the Exchequer responded to the uncertainties of any oil revenue projection by reducing the planned 1986/87 PSBR from £7½ billion to £7 billion in the Budget of 18 March. There were conflicting indications from oil revenues and privatisation receipts; an increase in the latter might suggest some reduction in the planned PSBR. Oil revenues are somewhat similar; a fall in the oil price, which reduces receipts, thus suggests a somewhat higher planned PSBR. The £1 billion of fiscal adjustment was used to finance the 1% reduction in the basic rate of income tax. Of special relevance to the financial community is the halving of the stamp duty on share dealings to be financed by a reduction in exemptions for some other securities transactions. This brings London into line with Tokyo and should enable it to compete with other centres for internationally mobile business. As in the case of the new Personal Equity Plans, it should both foster wider direct shareholding and stimulate the volume of transactions.

The money figures published a week before the Budget suggested that conditions, as reflected in both the broad and narrow aggregates, had improved considerably, and the PSBR for the first eleven months of the financial year was, at £2.8 billion, far better than the markets had expected. Although oil price uncertainties remained unresolved, the market response to the Budget and MTFS was such as to warrant acceding to the pressures, evident in the previous week, for a 1% reduction in base rates. Given the steady growth of broad money at about 14%, as velocity has declined over the last five years or so, the reinstated target range for £M3 at 11%–15% seems realistic and implies no relaxation of policy. The same is true of the recognition that, while deviation from its indicated path may, together with other data, signal the need for a change in interest rates, the response would not necessarily bring broad money back within the target range at all quickly. The target range for M0 was, as foreshadowed last year, set at 2%–6%.

Prospects

Growth in 1986 is likely to be spread more broadly across categories of demand than had previously been foreseen. Consumption growth is likely to be sustained by growth of pay considerably more rapid than the 3%-4% now expected for the retail price index, as lower prices of oil products offset the higher sterling price of other traded goods. The lower exchange rate also initially improves competitiveness: if this is maintained by a reduction in the rate of growth of unit labour costs, through lower wage settlements, to bring it into line with that of our competitors, it should tend to switch demand to net exports. Greater utilisation of capacity and lower interest rates should encourage investment. There is thus a prospect that both output and employment, aided by the latest Budget measures, will rise more strongly, and prices less, than earlier thought likely.

The Budget also reflected growing interest in relating workers' remuneration to the profitability of the companies for which they work. A suitable scheme, in which the profit-related element did not enlarge the total, might contribute some very necessary flexibility to the labour market, enhancing the prospect of non-inflationary growth and, ultimately, the stability of a high level of employment. Grasping the opportunity presented by lower oil prices depends on conserving the competitive advantage conferred by the lower exchange rate. In this context, and while present arrangements persist, it is crucial that wage bargainers recognise that foreign competitors also gain from lower oil prices, which will have fallen even further in foreign currencies, and will be reducing their pay settlements in line with their falling (if not vanishing) inflation rates. The object of monetary policy must be to eliminate inflation here too.