General assessment

As expected, the effects of lower oil prices are at this stage more apparent in lower inflation performance and nominal interest rates than in faster growth of activity. It now seems that the industrial economies were growing less rapidly at the turn of the year than had previously been thought, and that oil producers are cutting back their expenditures more rapidly than consumers spend their gains. For the United Kingdom this general experience combines with a continuing rapid growth of nominal earnings and liquidity to present an awkward background for monetary policy. This Assessment discusses these issues together with those raised for financial supervision, both domestically and internationally, by institutional changes and new financial instruments.

The first effects of lower oil prices are now emerging . . .

Some of the effects expected from lower oil prices have begun to emerge. With the average dollar price at which oil is traded now more than 50% lower than last December, a powerful downward push is being given to world inflation. Consumer price inflation in the past twelve months has already fallen close to zero in Germany and Japan and has also fallen rapidly in France and Italy which had earlier suffered from relatively rapid inflation. Inflation in the six largest foreign industrial economies taken together has fallen to an average of only 2¼%. The falls in Germany and Japan also reflect the anti-inflationary effects of currency appreciation, particularly against the US dollar. The offsetting effect of dollar depreciation on US inflation,and thus on the average inflation of industrial economies, is likely to be limited, as the size of the United States makes for a slower and probably less complete response of domestic prices to the exchange rate than in smaller and more open economies. Retail price inflation has fallen quite markedly in the United Kingdom too, though at 2¾% it remains slightly above the average rate in the countries mentioned and the gap is greater in terms of unit labour costs.

Even before the latest evidence of lower inflation, interest rates had started falling. The largest falls from last autumn's levels occurred in bond rates in a number of centres: more modest reductions in short-term rates followed in a series of loosely concerted moves, at times smaller than the markets may have been expecting. More recently the downward pressure on interest rates has moderated and, indeed, reversed a little at the longer end. In the process, real interest rates appear in several cases to have fallen quite sharply at the longer end, as is also true of the yields on indexed gilts in the United Kingdom, but less so, if at all, at the short end. There are, however, difficulties in identifying an appropriate measure of short-term inflation expectations in the wake of the 'one-off' reduction in oil prices which may make recent price movements an unreliable indicator.

The negative effects of lower oil prices on activity in the energy sector precede its positive effects elsewhere; consumers see the benefits only when falls in spot prices work through to retail prices, and even then may adjust their spending fairly slowly, while industrial investment plans also take time to prepare. Meanwhile planned oil exploration in high cost areas, of which the North Sea is only one, has been cut back, and development plans are being reconsidered or postponed. Lower investment has implications for supply and prices in the longer term. Some marginal production in the United Kingdom has already been suspended, and coal producers are also having to adjust to a weaker market. A sustained fall in the price of oil might induce some switching from coal and gas back to oil in electricity generation, although political and social factors may exert a restraining influence. Fuel switching by industry and households may also give a modest boost to oil demand, while the greatest scope for an expansion, in both the short and medium term, is likely to be in road transportation, which absorbs much more oil than any other activity. There has already been some strengthening of oil demand in the United States and Europe, and projections for the second half of the year suggest that consumption may grow at a rate only a little below that of economic activity. Nevertheless the prospective short-term supply-demand balance is likely to continue to favour buyers for the time being unless OPEC members, and perhaps also other countries which have aligned themselves with OPEC in the past, can agree on limiting production. Spot prices have fluctuated sharply in recent weeks and great uncertainty continues to surround their future trend.

. . . and activity in the major countries has been subdued

There remains a reasonable prospect that lower oil prices, if they persist, will stimulate world activity this year, but it was not to be expected that this would yet be evident. Indeed the few indicators so far available for the first quarter of 1986 suggest a subdued picture for activity in the industrial countries, continuing the comparatively weak development seen in the previous quarter. Domestic demand expanded fairly steadily in the OECD majors as a group, but this was not true of the aggregate of other countries. The commodity producers amongst them were adjusting to earlier income losses and worsened perceptions of their creditworthiness. In consequence, major countries' aggregate net exports have fallen by about ½% of their GDP in the last twelve months. Their tradable output has been particularly sluggish and their GDP growth has, on the whole, been modest and concentrated in non-traded sectors, with at best only small reductions in unemployment.

Progress towards a more balanced pattern of international growth, with Japan and Europe taking up some of the momentum from the United States, is proving limited, and the contribution from this source to a more sustainable pattern of external payments balances has been small. While this problem has been aggravated by the oil price fall, there has been a further adjustment between the major currencies in a direction which should in due course help to bring a large reduction in trade imbalances. It will, however, take time for the substantial adjustments that have occurred between the real exchange rates of the dollar, the yen, and the deutschemark to have a substantial corrective effect on the US current account deficit. This deficit, still running at an annual rate of $130 billion or so in the first half of the year, needs to be financed and borrowing worsens the overall position as net interest payable abroad grows. On the other hand, the US fiscal deficit is planned to fall in nominal terms while the combination of lower inflation and unchanged nominal targets for monetary and fiscal policies in other major countries should give a powerful boost to their demand, thereby speeding the correction of bilateral imbalances. Protectionist pressures in the United States are nevertheless again an active threat.

Recovery in the United Kingdom has also paused . . .

Although the longer-term effects of the fall in oil prices will be different in the United Kingdom as an oil producer, the subdued pattern of activity seen in the major overseas economies has been paralleled here, with the published indicators pointing to a slowdown in output growth from the middle of last year. This has been associated with weaker non-oil trade performance (non-oil exports of goods have been flat at best while imports picked up in the second half of last year), but it has also reflected weaker investment after the surge at the beginning of 1985. Manufacturing output has been most affected by these developments, and in the first quarter of 1986 was 1% lower than a year earlier. This fall has been unevenly spread, with output of electrical engineering (down by over 8%), motor vehicles and chemicals falling sharply, while that of other sectors on balance rose. In reaction to this, employment in manufacturing began to fall more rapidly in late 1985 and early 1986. There was again a surge in industrial investment around the end of the financial year, though on a smaller scale, and to a lower level, than in the previous year, with more of the increase financed by companies themselves and less by way of leasing. The rise in investment spending seems to have been partially offset by destocking of manufactures. The latest DTI survey of industry's investment intentions implies that investment in the rest of the year will be somewhat higher than in the same period last year. Consumer demand seems likely to be buoyed up more strongly as retail prices rise more slowly than earnings.

Sterling has been more resilient in the face of the oil price fall than many had thought likely. Crude oil prices in sterling terms have fallen nearly 60% since last autumn, whereas sterling's effective rate has depreciated by less than 5%, having recovered some of the ground lost around the turn of the year. This suggests that the outlook for inflation in the next eighteen months is rather better than thought earlier, whereas that for competitiveness and net exports is rather worse. The effects of falls in oil and raw material prices are now coming through into output prices. With earnings growth here seemingly less responsive to lower inflation than in other countries, real wages have been rising quite strongly and this should maintain aggregate demand growth in the rest of the year, but with some shift in the balance between consumption on the one hand and investment and net exports on the other. And with productivity growth in manufacturing continuing to slow from the rapid rate of increase seen earlier in the recovery, unit labour costs in the tradables sector are rising more rapidly even than those of the more inflation-prone of our main competitors. Their manufacturing unit labour costs rose at an average annual rate of less than 1% in the second half of 1985, with Italy's rising at less than 4%, while in the United Kingdom the rise exceeded 5% per annum. The comparisons are no more reassuring if allowance is made for relative positions in the business cycle.

... leaving awkward questions for policy ...

Policy-makers are therefore faced with some awkward choices. The short-term prospects for inflation are good (provided sterling remains firm and oil prices low), but output growth appears to have hesitated and unemployment is again rising. Domestic demand is, however, likely to be buoyed up by consumption, and non-oil exports should benefit from the expected pickup in world activity, although the continued brisk rise in unit labour costs poses a worrying threat to our international competitiveness. The continued rapid growth of liquidity and credit, together with some evidence that house prices have been accelerating, not only in the South East, also suggests a continued need for caution.

It would not be appropriate to focus solely on the retail price index when assessing progress against inflation. The index includes an important mortgage interest rate element, which largely accounted for last summer's temporary rise in inflation, and is also heavily influenced by import prices. Trends in these components are unlikely to continue to be as favourable as in the recent past. One alternative is to look at the GDP deflator, an index of all home costs; this rose by $5\frac{1}{4}$% in the year to the first quarter of 1986, which, despite the temporary restraining impact of falling North Sea prices and profits, exceeded the $4\frac{1}{4}$% rise in the RPI figure for the twelve months to March. Industrial selling prices rose by $4\frac{1}{2}$% in the year to May while (as already mentioned), unit labour costs in manufacturing are still rising at more than 5% per annum. Many industrialists see their own wage settlements as satisfactory, because with materials costs falling and domestic competitors' wages also rising, they have been able to pay the higher rates while still widening their margins. Individual employers may be responsible for relatively little of the total labour cost incorporated in the final selling price of the products to which they contribute. They thus see little prospect of increased sales if they alone resist pressure for higher wages. If, however, labour markets are, for this reason, insufficiently promptly responsive to lower inflation, lower taxes, rising unemployment and pay developments abroad, a non-accommodating policy remains necessary to keep downward pressure on settlements. To the extent that pressure is exerted through the exchange rate it depends on (among other factors) relative interest rates at home and abroad.

... as liquidity is still rising faster than incomes

Narrow money, as measured by M0, has continued to grow steadily towards the lower end of its target range of 2%–6%. This indicator therefore is a source of some reassurance. The resilience of the exchange rate, which has strengthened 3% in effective terms since early March, despite the continuance of low oil prices, is also consistent with the sustained anti-inflationary thrust of policy.

The growth rate of broad money, however, as measured by £M3 has remained well in excess of that of money incomes in the past six months, and that of PSL2, now redefined to include building society term shares, also exceeded 15% per annum over that period. Fast growth of broad money and liquidity in recent years is not a development unique to the United Kingdom. Several other countries have latterly experienced falls in the velocity of circulation of corresponding aggregates, but in general they have been less pronounced or sustained than in this country. In particular the recent fall in the United States was temporarily reversed in 1984 but resumed last year. To an extent in practice hard to measure, the behaviour of velocity in many developed countries has been the outcome of institutional change, although the process of financial reform has recently gone further and faster here than in most other countries. It has meant, in this country, an accumulation of liquid assets, possibly in response to the substantial real returns that, for the first time in many years, they now offer.

The reasons why liquidity has been rising for some time include the removal in 1980 of official restraints on the growth of banks' business and the phasing out of building society mortgage rate fixing arrangements over subsequent years. These developments accompanied increased competition between financial intermediaries in respect of both lending and deposit-taking. To the extent that the previous restraints led, in effect, to a rationing of loans, especially those to consumers and house buyers, their removal will have involved markets clearing at higher interest rates without affecting total expenditure. Credit is then allocated by price rather than being rationed by lenders. But it is also possible that the same markets could clear at lower nominal interest rates, without the inflationary consequences that might otherwise ensue from greater liquidity, if inflation expectations were reduced leaving real rates little changed. A switch from bank borrowing to the capital market would also be helpful; the revival of bond and equity issues in the past twelve months is an encouraging indication of what could happen there, although a slowdown of bank borrowing has not yet been in evidence. The recent creation of the sterling commercial paper market may change the form in which some liquidity is held and hence reduce the amount of credit and liquidity flowing through the financial institutions—and thence the conventional money and credit aggregates. But in itself it should not change the volume of underlying liquidity and credit in the economy.

On balance there is little indication as yet that liquidity is unwillingly held at current real interest rates, or that monetary conditions are loose. The acceleration of house prices in some regions in the past few months, following a period of about three years in which their growth was fairly close to that of average earnings, is not paralleled in other asset prices—for example, equity prices, which, having risen relatively strongly for a rather longer period, have retreated since April. Nevertheless it remains possible that, at some point, the process by which liquidity holdings have been built up could be reversed and that where held by industrial and commercial companies the funds could help to finance high pay settlements; that where held by financial institutions they might be switched abroad; and that where held by households they might seep into additional consumption.

Supervision and surveillance

In an environment where credit is allocated by price and perceptions of creditworthiness rather than by rationing in accordance with official restraints or interest rate cartels, the concerns of macroeconomic policy and prudential supervision are likely to be affected. Increased competition within a rapidly expanding market produces a greater risk of overexposure. This could prove potentially destabilising, as lending and hence spending may come to depend more than before on sentiment in the lending institution, which itself may vary with business confidence. Greater burdens will therefore be placed on official supervision to ensure the viability and probity of the many varieties of financial intermediary competing in the market. The strengthening of supervision now being implemented by the Bank in advance of forthcoming banking legislation and, in non-banking fields, through the financial services and building societies bills should be significant steps along this road.

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The need for supervision, as well as the formulation of monetary policy (and the statistics on which both are based), to take account of the effects of financial innovation, deregulation and structural change was discussed in a recent study published by the Bank for International Settlements.[1] It is clear that the United Kingdom is not alone in having to adapt to changing circumstances, although London's role as a central international market means that the extent and pace of change, in the past few years and in immediate prospect, are perhaps greater here than anywhere else. The BIS study also addressed the implications of recent innovations—specifically 'securitisation'—for prudential policy. In the same context, the Basle Supervisors' Committee had already in March published a paper on banks' off balance sheet risks, which was followed closely by the issue by the Bank of a detailed consultative paper on the same subject. There is now widespread recognition, both in London and internationally, that there should be adequate capital to cover such risks and that supervisory procedures should be adapted accordingly. For higher standards in one country to render the international financial system more secure, rather than merely to divert business to other centres, requires that supervisory standards be sufficiently homogeneous across different countries. A similar argument points to the need for consistency in the regulation of different types of institution within any one country. The degree of understanding, co-operation and progress that is now beginning to be achieved in these matters is encouraging. Consistency in both the respects mentioned above combined with fair treatment for foreign institutions in the various centres would ensure a 'level playing field' for international competition in the provision of financial services.

Financial innovation and supervisory issues are discussed in the speeches by the Governor and the Deputy Governor which are reproduced on pages 225–9 and 242–4 respectively.

(1) *Recent innovations in international banking*, BIS, April 1986; prepared by a study group established by the central banks of the Group of Ten countries.

A further element contributing to a more stable international financial environment would be more effective orientation of national economic policies towards objectives that are both mutually obtainable and sustainable in the longer run. In particular, the competent authorities of the major economies, whose policies are capable of inflicting great damage or benefit on others, need to avoid incompatible aims, not least because they are liable to cause unsustainable swings in real exchange rates which undermine the effective planning of investment and production. The steps towards the more explicit surveillance and alignment of policies in the major countries announced at the Tokyo Summit last month are therefore to be welcomed.