General assessment

The dollar price of oil has risen 50% since June but is less than half what it was a year ago. Over the year the US dollar has fallen 20% in effective terms to a point 30% below its February 1985 peak and 4% below its value in June. Since then the Federal Reserve System's discount rate has twice been cut by half a percentage point. American hopes that others would follow their lead in reducing interest rates have not yet been fulfilled. The consequent strength of the yen and the deutschemark contributed to a perceptible weakening of sterling in July. This Assessment considers the implications of these developments for the prospects for the UK economy and as a background to the evaluation of the stance of monetary policy.

While the oil price fluctuates, US interest rates, the dollar and inflation fall . . .

The continuing fluctuation of oil prices reflects the market's uncertainty as to future OPEC strategy. The sharply lower prices, resulting from OPEC's decision last year to attempt to increase its market share, remained well above the marginal costs of most non-OPEC producers and so had little immediate impact on the level of their output. It had been foreseen that intensifying financial pressures were likely to persuade OPEC members to undertake some restriction on output if it could be agreed. Nevertheless, the OPEC agreement in early August to restrict production, by four million barrels per day, for two months from September, took the market by surprise and drove spot oil prices sharply up again. A price of $15 a barrel may offer the prospect of a smoother path in the medium term than would a significantly lower price. In the short term a lower oil price would cause financial problems for some of those involved in oil production and related activities, while setting oil output and consumption on paths whose divergence would threaten future price stability. Doubts remain, however, about the longer-term implications of the agreement. Moreover, world oil output has been very high in recent months, boosting stocks on land and at sea. The release of these stocks could dampen much of the effect of OPEC's agreement to restrict production.

By the time the US dollar started to fall in early 1985 a very widespread consensus had emerged that it was substantially misaligned against other major currencies, notably the yen and the deutschemark, and the initial phases of the process of adjusting international currencies were marked by occasional concerted interventions. This consensus has weakened with the decline of the dollar since early this year. The downward trend in the dollar has, however, continued, partly in response to hopes of a reduction in the fiscal deficit and more recently to the reduction of short-term interest rates, which was itself a response primarily to a slowdown in domestic output growth during the first half of the year. The continued weakness of the trade account was also a factor.

The substantial movements in the oil price and the US dollar are likely to have significant implications for the international economy. The expectation in industrial countries of beneficial effects from the oil price fall rests largely on the fact that it brings with it increases in real income which should stimulate real expenditures. The lower oil price also presented the United States with an opportunity to make necessary improvements to its competitiveness, through a lower dollar, with less inflation than otherwise. Cutting interest rates was one way of ensuring that this opportunity was taken. The consequent combination of a lower dollar and lower dollar oil prices has sharply reduced price pressures in many other industrial countries. Together these developments should generate a better balance within the United States economy and, despite the differential direct effect of oil trade, between the United States and other major countries. This will have beneficial effects on confidence generally, reinforcing the effects of higher real incomes on aggregate demand which will be further strengthened, as a result of lower prices, particularly where fiscal policy is set in a nominal framework.

. . . and developing countries adjust . . .

While oil-exporting developing countries clearly lose in the short run from lower oil prices, other non-industrial countries benefit. Many developing countries have substantial dollar-denominated floating-rate debts so that they gain both from the weaker dollar and from the fall in dollar interest rates. Despite weak commodity prices generally, many oil-importing developing countries have managed to improve their external positions this year, while achieving modest output growth and possibly some improvement in living standards. But the problems of a number of heavily indebted oil exporters, of which Mexico is a leading example, have intensified. Progress in such cases requires that debtors allocate their resources efficiently in areas that offer the best opportunities for substantial growth. Continued financial assistance is necessary for the achievement of this aim, and requires the support of all creditors. The official sector has provided an interim financing facility for Mexico, and a parallel arrangement has been prepared by a group of commercial banks. Longer-term credits from the IMF and IBRD have been approved in principle, as has a rescheduling agreement with the Paris Club; and for their part, the commercial banks are continuing discussions on a medium-term scheme. A comprehensive response to the exceptional problem faced by Mexico has thus been set in train.

. . . but recovery hesitates . . .

In practice, the impact of these substantial changes in relative prices on industrial economies has so far been mixed. Consumer prices in most industrial countries have hardly risen this year, so that the twelve-month increase now averages about $1\frac{1}{2}$% across the seven largest economies. Even in the United States, wholesale prices of finished goods have fallen despite the dollar's depreciation. Further falls in non-oil commodity prices have also helped: for example, in the year to end-August the

Economist index of non-oil commodity prices, though little changed in dollar terms, fell 12% in SDRs. Information available at this stage suggests that output in the major countries has been less buoyant in the first half of the year than had been predicted in forecasts made earlier in the year. Nevertheless, subsequent indications have, in some cases, fostered hopes of an imminent resumption of faster growth.

See Economic commentary, pages 315–19, for a fuller discussion

In fact it now appears that activity began to slacken in a number of the major economies towards the end of last year. The reasons for this relatively sluggish picture are, however, still far from clear. It may reflect weaker demand from non-oil developing countries, constrained by the erosion of their export earnings as rapidly increasing output of primary products depressed their prices. Retrenchment by countries heavily dependent on oil exports has also been comparatively quick to emerge while demand in the industrial countries has been slower to respond to lower oil prices than many had expected. Consumption in the main economies grew at an annual rate of $3\frac{1}{2}$% between the fourth quarter of 1985 and the first quarter of 1986. This was little faster than in 1985, and with income rising at an annual rate of over 5% the personal saving ratio in the main economies rose from 9.4% to 9.7%. Private fixed investment fell, after seasonal adjustment, at an annual rate of nearly 5% over the same period. Some of this fall will represent cutbacks in investment related to oil production. The slow response of those whose real incomes have benefited most from the lower oil prices may reflect uncertainties as to their durability, so hampering or delaying decisions to buy investment goods and consumer durables where energy prices are an important factor. It may also reflect the fact that oil price falls have in some cases been partly offset by higher indirect taxes and by attempts by oil companies to recoup some of the decline in their earnings on crude oil production by raising margins on sales of petroleum products. Oil users have responded to what cuts there have been in final prices by boosting oil demand sharply. Some of this increase may, however, reflect a rise in stocks or a temporary switch to oil in a period before other energy prices have fully adjusted.

The process of adjustment of US trade flows to a lower dollar has also been slow, although this may not be altogether unexpected. In the year to the second quarter of 1986, in which the dollar fell by 20% in effective terms, import volumes rose by nearly 8% while export volumes fell by nearly 4%. In part this apparent perversity may simply be due to lags, but two other factors are worth noting. While the dollar has depreciated considerably against major currencies such as the yen and the deutschemark, there has been very little movement against the currencies of several South American countries or of a number of newly industrialised countries on the Pacific rim (some of which link their currencies to the dollar) which are left out of the effective rate calculations. Growing exports from these countries may have offset falls in those from Japan and Europe. Second, some exporters to the United States, concerned to protect their market share, have so far absorbed most of the effects of the lower dollar in their profit margins, which were high when the dollar was at its peak, rather than in their sales volume. In due course, both the supply of and demand for imports from these sources may fall.

. . . and policies remain cautious in industrial countries

In the face of these doubts and uncertainties, governments in most major countries have persisted with their cautious policies, showing little disposition to amend the prevailing framework of monetary and fiscal targets. There have been two reductions in the US discount rate since June, but others have hesitated to follow. In several countries concern about rapid growth of key monetary aggregates has been a factor contributing to caution. Lower than projected growth of activity and prices was not a sufficiently strong factor to outweigh these concerns. The authorities in the major countries for the most part remain hopeful that the pause in growth is virtually over and that the output projected in 1985 for 1987 will, largely as a result of lower oil prices, be bettered, implying sharply faster growth in the next 12–18 months. A number of countries are in a position to take expansionary measures if these hopes are confounded by developments in the second half of this year.

Sterling weakens though the oil price recovers . . .

Between the end of July and the end of November last year sterling fell 3% in effective terms while the price of oil was unchanged when measured in the currencies making up the basket used for the calculation of the effective exchange rate. Sterling fell only a further 6% between November and March while the foreign currency price of oil fell 64%. Apart from the rise in UK base rates in January, there was not much movement in relative interest rates at this time. Since March the oil price has strengthened, albeit erratically, while, on balance, sterling has fallen, weakening quite sharply in July before steadying as the oil price firmed after the OPEC meeting in August. The net effect of these movements is to bring the relative change in sterling and the sterling price of oil since the third quarter of 1985 back to the position about six months ago. The falls in sterling, by about an eighth, and in the sterling oil price, by about a half, in the year to August would, in themselves, change the prospects for the price level two or three years hence very little. The effect on the government's finances, though adverse, is also likely on balance to be small over this period. The gain in competitiveness, however, should not only stimulate non-oil output considerably, but should in particular expand the volume of non-oil net exports. The fall in the oil price reduces North Sea profits, a considerable part of which accrues to foreign investors. Thus North Sea profits due abroad will fall, while sterling earnings on our other net foreign assets are increased by the depreciation of the pound against the Japanese and European currencies. Taken together these three factors should in due course more than offset the effect on the current account of reduced net oil export revenues. These effects, will, however, take some time to materialise, particularly as much of sterling's fall is relatively recent.

See the note on page 331 for greater detail of the analysis

. . . improving competitiveness while growth has paused . . .

Given the sluggish first half growth abroad, the main force making for greater activity here was the increase in real personal disposable income as the gap widened between price rises and earnings growth, which, in the economy as a whole, continues at about 7½% per annum. Here, too, consumer demand, though strong, has not responded immediately; savings may have risen in the short term, but consumption is likely to pick up further in the second half of the year. In itself this would have an adverse effect on net exports; indeed imports of consumer goods rose sharply in the second quarter. Considering non-oil trade as a whole, however, although the effects of the more recent gains in competitiveness will not yet be apparent, import volumes have grown quite modestly while exports have grown more strongly in recent months.

Thus the United Kingdom shared in the general sluggishness of world growth in the year to mid-summer, which has been associated with a renewed rise in unemployment this year, and a consequential cyclical fall in the growth of productivity. Strong consumption growth is generally expected to lead to the resumption of reasonable growth abroad. The improvement in UK competitiveness means that industry is well placed to take advantage of this development provided that the advantage is not eroded too rapidly by rising relative UK costs.

. . . and inflation falls although cost pressures persist

The slower growth of productivity was particularly marked in the manufacturing sector; when combined with only a small slowdown in the underlying rate of increase in average earnings in the sector (to 7¾% per annum), this pushed up the measured increase in manufacturing unit labour costs above an uncomfortable 8% per annum. Even allowing for measurement problems and the cyclical element in productivity, unit labour costs here have risen some 5%–6% more rapidly over the year than those of our major competitors. The recent reduction in inflation, as measured by the retail price index, to below 2½% owes a certain amount both to the delay in sterling's response to lower oil prices and to lower interest rates. Nevertheless the retail price index excluding mortgage interest payments was only 3¼% higher in August than a year earlier, and is likely to fall below 3% by the end of the year.

Several aggregates are still growing rapidly . . .

It remains important that policy should continue to exert downward pressure on the sources of inflation and that monetary conditions should not become lax. These conditions are, of course, notoriously difficult to judge. The movement of the exchange rate since June might possibly be regarded as indicative of laxity but, as has been said, its movement over the last nine months has not fully offset the effect on inflation of lower oil prices (which its own weakness must to some extent reflect). A number of the monetary and liquidity aggregates, by no means only the broadest, have been growing rather rapidly. At 18.5%, the growth of £M3 in the year to August remains well above its target range and PSL2, which has grown somewhat more steadily, has risen by about 15% in the past year. Possibly more disturbing is the persistently high level of lending to the private sector by banks. Nearly £2½ billion was lent in August, much of which went to persons rather than companies and was related to house purchase, a market of which banks have increased their share. But house prices, which had been rising very rapidly, have very recently shown some sign of decelerating, and share prices have fallen back from the peaks reached earlier in the year.

. . . but real interest rates are high

Against these indications M0 growth, though rising, remains low, nominal GDP is, if anything, below the level expected at the time of the Budget and interest rates remain high. A note on page 359 addresses the problems of measuring *real* interest rates in the United Kingdom, Germany and the United States. It seems that short-term real rates have, in recent years, been higher in all three countries than at any time since the 1960s. It is, however, particularly difficult to assess inflation expectations at present; the recent falls in consumer and wholesale price inflation, largely brought about by falls in the prices of oil and other primary products, may conceal the persistence of underlying inflationary pressures in industrial countries. Of the various ways of gauging differences in these pressures between countries, consumer price increases give the most favourable picture of the United Kingdom's relative position. This is of some relevance when judging relative interest rates. An implication of weaker sterling is that while, thanks to the oil price fall, progress in reducing underlying UK inflation need not suffer, the gap between UK and European (and Japanese) inflation rates is liable to widen for a while, which would warrant the maintenance of a nominal interest rate differential.

It is not easy to weigh these two sets of considerations, but on balance it would seem that financial conditions have not eased and, given the level of sterling, and of domestic cost pressures, there would seem to be little scope for unilateral relaxation. Projections of a resumption of stronger growth as recent developments in real incomes and competitiveness bear fruit appear well-founded, but the recalcitrance of pay settlements continues to frustrate hopes of longer-term reductions in unemployment.