General assessment

Growth seems now to be re-emerging among the industrial countries and the omens for its continuation are fairly good, although significant risks remain despite the further international action taken to reduce them. The environment is also improving for many developing countries, although some, particularly oil exporters, are obliged to undertake painful adjustments in the face of lower oil and other commodity prices. Output has picked up in the United Kingdom too, in response mainly to a strong increase in personal consumption induced by rising real incomes. The supply response, however, has not so far been sufficient to avert a surge in imports, leading, despite better non-oil export performance and rising invisible earnings, to a marked deterioration in the current account. Prospects for the economy next year are nevertheless encouraging, provided there can be better containment of costs and a fuller supply response by industry, signs of which have recently begun to emerge. This Assessment considers these developments and their implications for monetary policy, the conduct of which continues to be complicated by extensive technological and structural change in the financial system, among which the reforms in securities trading which took effect in October are a notable recent example.

Growth has resumed in most industrial countries . . .

It now appears that output growth has resumed in the industrial world, after a lull in the early part of the year. The main impetus is coming from stronger personal consumption, with the momentum of nominal earnings growth largely maintained despite the fall in inflation due to lower oil and commodity prices. And, after a lag during which savings rose, expenditure is now adjusting to the faster growth of real incomes. Interest rate reductions earlier in the year are also contributing to the increase in consumer demand and, together with higher profits, point to the prospect of a further pick-up in private investment.

Prospects for the world economy are discussed on pages 472–3.

The improvement in the terms of trade of the major industrial countries, which is not only due to the fall in oil prices, tended, in the first instance, to widen payments imbalances between them, because Japan and Germany, which were among the largest gainers, already had large and rising surpluses. The stimulus to domestic demand from lower import prices may, however, also be most pronounced in these countries. This will make for a more generalised pattern of growth than in the earlier stages of the recovery and should thus help to limit any further widening of these payments imbalances, which should also be responding to exchange rate movements. With both the price level and the

rate of inflation in many of the industrial countries lower than previously expected, the non-accommodating stance of policy allows some expansion in real demand and is another factor contributing to the sustainability of output growth.

The effective appreciation of the yen in the year to mid-September has already had some effect on the volume of Japanese trade, with exports subdued and imports significantly higher, with associated depressing effects on manufacturing profits and investment and on employment. The Japanese fiscal package in September, followed by a supplementary budget in October, increased outlays on public works with a view to stimulating domestic demand. At the same time the United States passed a budget for 1986/87 which is within the range permissible under the Gramm-Rudman deficit control programme. The cut in the Japanese discount rate at the end of October and the joint US/Japanese policy statement have helped to stabilise the yen/dollar exchange rate. It remains to be seen how far these helpful steps will go towards completing adjustment of the large payments imbalance between these countries. The adjustment process will no doubt take time, but it is important that it should proceed steadily, and be seen to be doing so. Some limited encouragement may be derived from the apparent stabilisation of the US trade deficit in the three months to October.

. . . and oil exporters adjust

Developing countries have in general benefited from the falls this year in interest rates and in the value of the dollar, in which much of their debt is denominated. The impact of the fall in oil prices has been more mixed, and many have suffered from the weakness in other commodity prices during much of the year, with the result that an increased volume of commodity exports to industrial countries has been exchanged for a diminishing quantity of manufactured goods. Overall, therefore, while for many developing countries the environment has been mildly favourable, a number of countries—particularly some oil exporters—have faced a significant deterioration in their economic prospects. The countries so affected have adjusted with varying degrees of resolution. After lengthy and difficult negotiations, Mexico has successfully agreed a programme with the IMF, and the commercial banks' contribution of their share of the country's overall financing requirements is being assembled. These arrangements should improve immediate perceptions of the debt situation. The agreements contain novel features which reflect the particular problems confronting Mexico thus exemplifying the case-by-case approach to debt negotiations. The case of Nigeria is somewhat similar; an adjustment programme is being implemented with financial support from the World Bank and international commercial banks. Seven countries are providing, through a bridging loan, temporary liquidity for the second-tier foreign exchange market which is central to the scheme. The IMF is expected to endorse the programme.

OPEC's prolonged October meeting in Geneva did little more than extend, for a further two months, the August decision to reinstate production quotas which had been effectively abandoned at the end of last year. Oil prices then drifted lower. The surprise dismissal of Sheikh Yamani, accompanied by a call

from his successor for an urgent meeting to find a formula for raising oil prices to at least $18 per barrel, initially confused the markets but then led to a strengthening of prices. While Saudi Arabia remains unwilling to resume its role of swing producer, however, the future price of oil continues to be highly uncertain. With oil stocks at a high level following a surge in their production during the late summer, OPEC may find it difficult, despite the seasonal strength of consumption in the next few months, to create conditions in which prices can quickly be bid up significantly.

See the note on pages 472–3 for details of the oil price assumption in the Bank's latest forecast

Sterling was under pressure until interest rates were raised . . .

Against this background, sterling has been under pressure for much of the period, as hopes of further interest rate cuts in Germany or the United States receded and disappointing trade figures for August and, to a lesser extent, September were published. By mid-October the pound was 16% lower in effective terms than a year earlier, a fall estimated, if anything, to exceed that required to offset, over 2–3 years, the effect on the current account of halved oil prices and threatening to exert more than offsetting upward pressure on retail prices. After taking account also of the growth of money and credit, it was judged appropriate to raise interest rates. The authorities' action was delayed until a time when markets were relatively stable and the message of a 1% rise would be clear. The rise in base rates and the US/Japanese accord helped sterling recover by about 3% from its low point, but it has more recently slipped in reaction to renewed doubts about OPEC, political factors at home and continued worries about the trade deficit.

. . . while at home, too, economic activity has revived . . .

After having been sluggish on the whole in the previous twelve months, output moved ahead quite sharply in the third quarter with a rise in GDP provisionally estimated to be 1%. Here, as overseas, the main source of higher demand has so far been personal consumption, responding to rising real incomes and facilitated, in the UK case, by the willingness of banks and building societies to supply credit. Exports also rose while, in contrast, investment and stockbuilding were apparently subdued. Recorded unemployment has been falling since July partly owing to greater economic growth and partly to the government's employment and training programmes. Too much should not be read into one quarter's figures, but the evidence points to the emergence of a domestic supply response to stronger export and consumer demand. Much of the latter has nevertheless spilled over into higher imports, with adverse consequences, in the short run, for the balance of non-oil trade.

Manufacturing output is estimated to have risen $1\frac{1}{4}$% in the quarter after dipping in the previous twelve months; the movement appears to have produced a sharp improvement in output per head and the first quarterly fall in manufacturing unit wage and salary costs for three years. The increase in these costs was 6% in 1985, rose to a peak of 8.3% in the year to the first quarter of 1986 and seems to have fallen back to 4.4% in the year to the third quarter. If better cost performance could be maintained, it would greatly ease domestic inflation pressures and help competitiveness. The presumption at the moment must,

however, be that—just as the first quarter deterioration in productivity growth reflected temporarily lower capacity utilisation—much of this latest improvement represents better utilisation rather than a change in underlying trends.

So far there seems to be little, if any, let-up in the underlying increase in average earnings (up $7\frac{1}{2}$% in the year to September in the economy as a whole, and slightly more in manufacturing). While the comparatively few major settlements in industry since midsummer have averaged just under 6%, those in the non-industrial public sector, where earnings drift is smaller, are picking up, generally from a lower level, suggesting a convergence of earnings growth in the public and private sectors. Although the contribution of public service settlements to overall average earnings does not have the same direct effect on costs and competitiveness as do settlements in the trading sector, they impinge on the public finances and increase fiscal demands on the private sector. Any convergence should be towards a lower rate of earnings growth, so the greatest need is for pay moderation in industry; and it should not mean a freezing of regional and occupational differentials, which must be allowed to vary if they are to contribute to the efficient allocation of labour.

. . . and growth seems set to continue

Despite providing for some increase in both the volume of public expenditure and pay in some areas, the Chancellor's Autumn Statement envisages a rise in general government expenditure of no more than some 1.3% per annum in real terms between 1985/86 and 1987/88, without treating privatisation proceeds as negative expenditure. This increase is less than the average growth of spending in the previous three years, and only half the growth of GDP; it remains below the growth of GDP even if the effects of the coal strike are excluded. For the present year, buoyant non-oil tax revenues are enabling the PSBR projection to remain unchanged at £7 billion despite higher expenditure and a larger loss of North Sea revenue than expected last March. The PSBR for 1987/88 is also to be held to the 1986 MTFS figure of $1\frac{3}{4}$% of GDP.

The Industry Act forecast foresees inflation rising next year towards what may, on the basis of recent domestic cost performance, be its core rate—close to 4%. This would be almost twice the average of equivalent rates among our most important competitors. Real GDP is expected to grow by 3%, as manufacturing output responds more fully to the continued growth of demand. The current account is, however, projected to move into deficit of £1–2 billion next year; in part this reflects temporary J-curve effects as sterling's recent depreciation worsens the terms of trade. The extent and duration of the deficit depends on industry's response to its present trading opportunities. It would be most regrettable if uncertainties about sterling slowed industry's supply response. A delayed response to improved competitiveness could feed exaggerated perceptions of underlying adverse trends in UK trade performance.

Earlier easing of monetary conditions has been reversed

Monetary conditions continue to be difficult to assess with any precision, on account of the far reaching structural changes which have been taking place in the financial system in recent years. In

The arguments are set out fully in a recent lecture by the Governor at Loughborough University, reproduced on pages 499–507.

particular the changing relationship between measures of money and incomes has made it difficult to set and meet monetary targets for broad money, and to interpret the path of its development. There has, however, been no change in policy, which continues to be to bear down on inflation, giving due weight to the growth of both narrow and broad money, credit and liquidity, alongside other factors, notably the exchange rate.

Interpretation of the monetary aggregates is being further complicated by certain temporary and transitional factors—the impact in late November of the approaching sale of British Gas, which may imply some temporary additions to bank lending and deposits in anticipation of the sale; and the publication for the first time of the monetary statistics on a calendar month basis, described in a note on page 519. As explained there, the interpretation of most monetary statistics will for some time be subject to a greater range of uncertainty than hitherto. Seasonal adjustment poses particular difficulties, and the method of seasonal adjustment of the monetary aggregates will be reviewed.

The interest rate rise in October represented a firming of monetary conditions. After relatively fast growth in the three months to September, the growth in M0 slowed in October, but at 4.9% its 12-month increase remains above the middle of its target range. The 12-month increase in £M3 has fallen slightly since September. Liquidity constraints have begun to oblige building societies to cut back their lending and this has probably been only partially offset by bank lending for house purchase. The rise in house prices seems to have stabilised since the summer. Equity prices have not emulated the large increases seen in the early part of the year. Forward-looking real pre-tax interest rates have risen to around their levels of the early spring. Sterling's comparative resilience after mid-October also evidenced some tightening of conditions.

Dealing costs in securities markets have been cut and liquidity improved

The reforms on The Stock Exchange which took effect on 27 October, have, together with the simultaneous halving of stamp duty to $\frac{1}{2}$%, cut dealing costs substantially. In both the equity and gilt-edged markets many institutions are doing a large part of their business directly with firms in the market as principals. This, together with greater competition among the increased number of committed market makers, has led to a reduction in effective commissions. On a purchase and resale of £500,000 worth of one of the most heavily traded (alpha) stocks the total transaction cost can now be less than 1% compared with $2\frac{3}{4}$% pre-Big Bang. Even in the gilt-edged market, which has long been exempt from stamp duty, dealing costs have fallen significantly. A switch of £500,000 worth of gilts could now cost as little as $\frac{1}{16}$%–$\frac{1}{8}$%, compared with over $\frac{1}{3}$% previously. The reduction in transaction costs will encourage more active dealing by investors. The liquidity of the markets is likely to be substantially improved, although it is too early to draw firm inferences because of an initially relatively cautious approach by the market makers.

In the short term, the increase in market-making capacity, with inventories of stock financed by bank borrowing, may have

added a little to bank lending. In the more important case of the gilt-edged market, where banks have transferred stock to their non-bank security-trading affiliates, any effect on money of the statistically recorded bank lending will have been offset by recorded sales of debt to the non-bank private sector. In the longer term, the benefits of a more liquid capital market, with higher turnover, are likely to encourage greater reliance on the capital market and less on the banking system, which should reduce monetary growth.

The resumption of steady economic growth abroad, and a more competitive exchange rate, present great opportunities to make progress in overcoming some long-standing problems in unemployment and a declining non-oil industrial base. The Chancellor has painted a picture of non-inflationary growth which is, or ought to be, within our grasp. Monetary policy continues to have an important part to play in securing its achievement. It will also be important for industry and the City to work for this common objective through greater efficiency and investment for the future, as well as by better control of costs.