General assessment

Demand continues to grow at a fair pace in the major overseas economies. Weak commodity prices have boosted real incomes in these countries, contributing to strong growth in private consumption, with the result that their real domestic expenditure was some 3½% higher in the third quarter of 1986 than a year earlier, much in line with previous expectations. But an unusually high proportion of this demand was met from imports from outside the area, while their exports were, on the whole, weaker than forecast, so that output growth was more modest at 2½%. Exports of manufactures to the developing countries appear to have been affected unexpectedly rapidly by these countries' need to adjust to the fall in their real incomes brought about by weak commodity prices, while exports of manufactures from the newly-industrialising countries of the developing world continue to grow rapidly. The shortfall in output in the major economies has thus been particularly concentrated in their industrial sectors, with industrial production in aggregate little changed from a year earlier. Growth has been concentrated in other areas, including services. Meanwhile inflation remains subdued: while the bulk of the downward influence of the earlier collapse in oil prices has already come through, prices of other primary products have continued to fall, overall, and in January were, in SDR terms, around 15% lower than a year earlier. Moreover, wage rises remain modest and there has been a widespread and welcome rise in profitability. Against this background, the Assessment considers the problems posed by continuing large payments imbalances among the largest economies. In this country the economic recovery is re-emerging if anything more strongly than elsewhere, and perhaps in a less lopsided way than some of the statistics suggest; its implications for monetary policy are also considered.

Payments imbalances pose a continued threat to trade expansion . . .

The developed countries as a group have enjoyed such extensive terms of trade gains over the last year that their collective current account position has improved despite strongly adverse trends in trade volumes. However, the pattern of current balances between the developed countries shows no improvement in SDR terms, with the US current deficit and German and Japanese surpluses still very large. These imbalances are symptomatic of the difficulty of co-ordinating policies between major countries. They will inevitably be unwound in due course, but the manner of their unwinding poses important problems for policy makers in these countries as elsewhere, and may demand some difficult adjustments by producers and consumers.

The imbalances, coupled with stagnant industrial output, have led to renewed protectionist pressures, not surprisingly concentrated in the country with the largest deficit. The new Congress will consider a series of trade bills this year. A more immediate danger lies in agricultural and related trade where long-standing conflicts have worsened with the cumulative effects of incompatible and market-distorting agricultural policies in virtually all developed countries. For several decades the world has gained greatly from a relatively open trading system, particularly in manufactures. The need now is to maintain that system, to roll back the restraints that have recently been reintroduced on trade in manufactures, and to work towards a liberal trade regime in areas such as agriculture and services where it has for many years applied only in limited degree.

The need to reduce the risk of increasing protection highlights the urgency of tackling international imbalances through other means, including appropriate fiscal and exchange rate adjustments. If either has to carry the whole burden, the size of adjustment required of it will be correspondingly increased. A substantial reduction of the US fiscal deficit has a vital part to play in this process. Apart from achieving a more sustainable fiscal position, and hence reducing real interest rates, it would also reduce the external deficit by restraining domestic demand. President Reagan's recent budget proposals for the 1988 fiscal year have the objective of reducing the federal deficit in line with the Gramm-Rudman-Hollings formula. But it seems likely that Congress will object to the proposed pattern of expenditures, and negotiation about the details of the package could be lengthy. It would damage confidence if such negotiation were to call in doubt the shared determination to bring the deficit onto a firmly downward trend.

. . . and fiscal policy in surplus countries remains cautious

It is widely argued that less restrictive fiscal stances in Germany and Japan would also help by boosting their domestic demand and hence their imports, including those from the United States. Both countries have had considerable success in reducing inflation and fiscal deficits, and the level of spare capacity in both countries suggests that the inflation risks of some fiscal relaxation would be limited. Policy makers in these countries, however, stress the importance of achieving sustainable fiscal positions in the medium term, given likely adverse demographic trends and the need to avoid damaging confidence which is still fragile. The Japanese budget for fiscal 1987/88 in fact projects the smallest overall increase in public spending for many years. A major overhaul of the tax system is to be introduced which is designed to be revenue-neutral overall. Assuming that the proposals are approved by the Diet, cuts in direct taxation will precede the new revenue-raising measures, and the package should, if anything, be modestly expansionary in 1987/88.

In Germany, no fiscal action to boost domestic demand and imports is planned for 1987. The German authorities argue that downward pressure on the current account surplus is already being exerted by the present growth of net import volumes. The federal borrowing requirement for 1987 is now projected to be slightly lower than the likely outturn for 1986 as planned expenditure has been cut by a greater amount than the downward revision of revenues. Although tax reforms are being examined, these are unlikely to come into effect during 1987. The authorities have, however, indicated that they would be prepared to re-examine their fiscal stance if growth were seen to be slowing significantly in 1987 (possibly by bringing forward tax cuts scheduled for January 1988 amounting to some DM 9 billion, equivalent to about ½% of GNP): a number of forecasts suggest that this is a growing possibility.

Meanwhile, the persistence of large external imbalances has kept exchange rates near the centre of attention. After a period of relative stability following the Baker-Miyazawa accord of last October, the dollar weakened again from mid-December. The associated strengthening of the deutschemark exacerbated strains within the exchange rate mechanism of the EMS; and the French franc, already unsettled by domestic political and industrial

difficulties, came under further downward pressure. Despite significant intervention and some rise in French interest rates, a realignment became necessary; this took the form of modest revaluations of the deutschemark, guilder and Belgian franc against the other participating currencies with effect from 12 January. Despite the deutschemark revaluation, calls for a reduction in German interest rates persisted and the Bundesbank announced that, with effect from 23 January, it would cut its short-term lending rates by ½% in order to contribute to stability in the foreign exchange market and the EMS. The authorities' continuing concern at the underlying strength of monetary growth and the effect of recent exchange market intervention on liquidity, however, was reflected in their announcement, at the same time, that banks' reserve requirements would be increased and their rediscount quotas reduced from the beginning of February. The US and Japanese authorities reaffirmed their willingness to co-operate on economic and exchange market issues in a communique on 22 January, following a further bilateral meeting between Treasury Secretary Baker and Finance Minister Miyazawa. Exchange markets are nevertheless likely to remain nervous until there is clear evidence that adjustment of the US and Japanese current account imbalances is under way.

The oil price responds to OPEC agreement, but sterling rises little

At its mid-December conference in Geneva, OPEC agreed to limit its overall output to 15.8 million barrels per day for the first half of this year. This cutback is designed to underpin the return to a fixed pricing structure based on a reference price of $18 per barrel. An agreement of this nature remains in OPEC's interest, and may become easier to enforce over time as the demand for oil rises. It remains uncertain, however, whether and to what extent these production and pricing objectives will be achieved, especially in the short term. The new agreement specifying both output and prices risks reawakening tensions over differentials within the cartel. Iraq has refused to participate in any production cutback and other important OPEC producers may also exceed their quota allocations. On the other hand, the continuing hostilities in the Gulf may restrict both Iranian and Iraqi exports, and several non-OPEC producers have indicated broad support for the agreement. In the event, the oil market has responded quite sharply, driving the spot price of Brent crude above $18 for the first time in ten months. Although this is somewhat below the level that might be expected if the new OPEC target price structure were in place, and is not fully reflected in forward prices, it represents a rise of $3.50 per barrel since early December, a doubling of prices in dollar terms over their mid-July low and a near 90% rise in SDR terms. Sterling strengthened only slightly on the news of OPEC's agreement. Electoral uncertainties and market concerns about strong growth in domestic demand, and its effect on the current account of the balance of payments, may well have muted the exchange rate response.

At home, investment and profit growth have probably been stronger than recorded

Any assessment of these latest events must be coloured by perceptions of current developments in the UK economy. These are particularly unclear, given the different rates of growth

suggested by the various measures of GDP. The output measure (GDP(O)), which is the most reliable short-term indicator, presents a buoyant picture: the third quarter estimate showed a rise of 1¼% to a level nearly 3½% above that of a year earlier. Moreover, this series indicates that output grew fairly steadily throughout 1986. Perhaps most encouraging of all, the large rise in activity in the third quarter is shown as being well spread across the various sectors of the economy.

On the other hand the expenditure and income measures both suggested that GDP hardly changed in the third quarter of last year. In recent years these measures have tended to display more erratic quarterly movements than the output measure, and it is probable that their recent growth understates the underlying trend. As recorded, expenditure has been heavily directed towards consumer spending. Private consumption is estimated to have risen by about 5% in the year to the third (and fourth) quarter, but total investment by only 1½% and public current expenditure by 2¼%, while stockbuilding is reckoned to have fallen. Moreover, a large portion of the rise in consumer spending appears to have gone on imports, the volume of which is estimated to have risen by nearly 10% over this period (mostly in the third quarter of 1986).

This picture has to be adjusted if it is to be reconciled with the stronger growth represented by GDP(O) and the true picture may be one of less lopsided growth in demand. For while it is possible that real personal disposable income and consumer spending have grown even faster than recorded, it is likely that the underestimate of business income and spending is proportionately greater. Domestic output of capital goods recorded a rise of 1¼% in the third quarter, while imports of capital goods rose by 10%, and exports fell. This contrasts with the 1% fall in industrial investment indicated by the expenditure breakdown. Similarly if incomes have also been underrecorded, the greatest effect is again likely to be in the business sector, where recorded profits (other than from the North Sea) recovered in the third quarter from their unexpected fall in the second, but still seem low given the apparent movement in profit margins.

Unemployment is beginning to fall . . .

If this interpretation of recent developments is correct, the growth of activity would be expected to have a favourable effect on employment and unemployment and this is consistent with the evidence from the labour market, although that is, so far, somewhat mixed. Total employment (including self-employment) continued to rise in 1986, initially at a rather slower rate than that recorded in the previous two years but with some pick-up in the third quarter. Unemployment, as measured by the seasonally adjusted level, excluding school leavers, fell in each of the five months to December by an average of 21,000 per month. The Restart scheme and other special employment measures have undoubtedly assisted this trend. It seems likely that, without these measures, unemployment would have been, at worst, flat over the past few months, in contrast with the previous persistently upward trend.

. . . as output growth is set to continue . . .

Output has thus been growing less rapidly than domestic demand in the United Kingdom as in other major economies. The

associated decline in the non-oil trade performance may well have restrained sterling's response to the rising oil price. In the past, periods of rapid expansion of UK domestic demand have led to sharp rises in import penetration which have not subsequently been entirely reversed. However, it is probably too early to conclude that this unwelcome ratcheting pattern is repeating itself. Domestic producers may have failed to anticipate the exact timing and strength of the expansion of home and foreign demand. The composition of the recent growth in manufactured imports, where capital and intermediate goods have shown the greatest gains, together with a sharp rise in imports of raw materials, suggests an imminent domestic output response. Indeed manufactured exports rose strongly in the fourth quarter and it would be disturbing if the growth of imports did not decline in response to improved competitiveness brought about by earlier depreciation; signs of a slowdown did emerge in the fourth quarter. Part of the recent growth in imports may reflect purchases brought forward in anticipation of sharply higher prices; since the second quarter those of imported finished goods have risen nearly 7½%.

This helped to boost the twelve-month increase in the retail price index to 3.7% in December, but the path of mortgage interest rates has been the dominant factor and the immediate prospect is for recorded inflation to remain about 4%. The rise in oil prices and the weak exchange rate response reverse last year's situation when inflation prospects were initially improved by a fall in the oil price at a virtually unchanged exchange rate. Manufacturing unit labour costs, on the other hand, have decelerated markedly and, indeed, were virtually flat between March and September. That easing of labour cost pressures reflected the recovery in productivity growth as output picked up, but the CBI estimates that wage settlements in manufacturing subsequently fell by about 1% in the later months of 1986. This suggests that, at least in manufacturing, settlements may now be responding to the lower rates of retail price inflation in the summer.

. . . and the thrust of policy is maintained

M0 continues to show the acceleration which began in the summer and, though the November and December increases were exceptional, appears to be firmly in the top half of its target range; in part this may also reflect the strength of consumer spending, with the negative impact of October's rise in interest rates on the growth of M0 yet to come through.

Interpretation of the broad monetary aggregates has been complicated over the last two months by the impact of the sale of British Gas, which probably resulted in some temporary addition to both bank deposits and bank lending in the period leading up to the sale, and some running down thereafter; and by the financing of particular takeovers and mergers which directly inflated November bank lending (and probably bank deposits) and which may not immediately unwind. Despite these influences, the growth of broad money has been modest overall in the last few months, largely because of overfunding at a time when the PSBR was negative. Non-oil revenue has been notably buoyant, more than compensating for overruns of expenditure; this provides additional grounds for believing, as suggested earlier, that the growth in income and expenditure in recent

months has been underrecorded in the official estimates. Bank lending, however, has continued to grow rapidly, with some easing of the pace of lending to households being more than offset by increased lending to businesses.

The expected slowdown in mortgage lending that has occurred may in part reflect seasonal factors, as well as constraints felt by some building societies in relation to the scale of their liquidity and wholesale borrowing. These factors may dampen the response of the societies to the opportunities to undertake some unsecured lending that have been opened up by the building society legislation which came into force at the beginning of this year. These new opportunities made it inappropriate for the authorities to maintain their guidance (introduced in 1982) to both banks and building societies restraining, in certain circumstances, increases in the amounts lent on first mortgages. The lending opportunities opened up by the new legislation and by the withdrawal of guidance will not, however, attract mortgage interest tax relief. The banks have also been reminded, in a prudential context, of the need to maintain credit standards in their lending to the personal sector.

Despite the restoration of somewhat firmer monetary conditions with October's rise in interest rates, sterling's recovery has been more modest than might have been expected given the stronger oil price, and this, together with the comparative buoyancy of M0 and the strength of bank lending, suggests the need for continuing caution in the conduct of monetary policy. On the other hand, lower interest rates would assist in the process of strengthening the economy's supply potential and a low PSBR is one among several possibly helpful factors. But progress on this front must depend also on the course of inflationary pressures; sustained productivity growth at rates recently achieved in sectors producing traded goods could make a crucial contribution here.