General assessment

Growth in the last twelve months has been more satisfactory in the United Kingdom than abroad. The Budget has set the scene for continued growth and facilitated a reduction in both public borrowing and interest rates which, together with the gain in competitiveness since 1985, should ensure that growth is quite well balanced. While developments abroad are likely to contribute to the restraint of inflation at home, they are in other respects less helpful. World growth has been disappointing and forecasts have been revised downwards: slow growth aggravates trade frictions, which have been much in evidence, and places heavy demands on exchange rates in the adjustment of external imbalances. There was agreement at the Louvre that a period of relative exchange rate stability was desirable. This Assessment discusses the implications of these developments for the pattern of UK monetary policy-making.

Growth continues more steadily in the United Kingdom than abroad . . .

The economy has been growing at an annual rate slightly in excess of 3% and the indications are that it will continue to do so through at least the next twelve months, with further falls in unemployment and a better balance of demand. For while consumption, both public and private, may grow more slowly than last year, investment should make a more positive, and net trade a less negative, contribution to growth. Sterling's effective exchange rate had fallen by 12% from its 1985 average by the end of 1986 and there has been a substantial improvement in competitiveness which seems to have led to a better trade performance. Although there has been some strengthening of the exchange rate this year, it has been associated with reductions in interest rates—which will benefit the corporate sector.

The outlook also depends on external developments. The unexpected slowdown in growth abroad in the second half of last year may have contributed to the slowing of the growth of UK exports in the first three months of this year after they had risen strongly in the second half of 1986. There are, however, signs that UK export markets will grow rather more rapidly than world trade in general this year, unlike last, and this, combined with the still considerable improvement in competitiveness—if it can be maintained—should mean respectable export growth. Nevertheless, the dangers of a more pronounced slowdown overseas, perhaps associated with increased protectionist pressures, and consequent detrimental effects on UK growth, should not be overlooked.

After a surge in the second half of last year, imports of manufactures fell back sharply in the first quarter. This reversal, combined with a continued rise in imports of raw materials, suggests a growing response of domestic output to buoyant demand. Growing domestic demand will, however, tend to increase imports. The extent to which this happens will obviously be a vital factor affecting the current balance. In the Budget forecast the current account was shown as being in deficit by some £2½ billion this year, around £1 billion more than forecast at the time of the Autumn Statement. In part, the change reflects revisions to past data, particularly a downward revision in

invisible receipts. But the surplus on invisibles is still expected to rise quite strongly again this year, as the lagged effects of sterling's fall boost net exports of services and the sterling value of earnings on the United Kingdom's large (net) stock of external assets. Moreover, the current account surplus of £600 million in the first quarter suggests that the outturn for the year will be closer to the Autumn Statement figure.

. . . while inflation is restrained and the balance of demand improves

Slower growth outside the United Kingdom has also contributed to a further unforeseen weakening in world commodity prices (other than oil prices, which appear to be holding up). Taking these factors into account, as well as the recent appreciation of sterling, the fall in mortgage interest rates and the non-indexation of specific duties in the Budget, the rate of increase in the RPI is likely to peak around mid-year and then fall towards the end of the year, possibly to below the rate of 4% in the Budget forecast. The prospects for underlying inflation beyond that horizon depend on various factors, not least the trend in labour costs. The policy dilemmas considered below would be lessened if UK wage increases were soon to converge on the low rate achieved by our main competitors. The lower level of private sector settlements seen in the past half year offers some encouragement, but the news from the public services is less reassuring.

Industrial investment should increase as a result of the prospect of further rises in output, to which industry's improved competitiveness will contribute, provided that exchange rate stability can be maintained. Last year, recorded capital spending was weak, particularly in manufacturing: there is likely to have been transitional weakness reflecting the accumulated effects of the bringing forward of projects in earlier years to gain maximum benefit from capital allowances before these were phased out. High real interest rates and uncertainty about the sustainability of demand may also have been inhibiting factors. In this respect the Budget measures, which may strengthen output and profit prospects, and associated interest rate reductions, should contribute towards a moderate recovery in fixed investment this year. This is consistent with the improvement in confidence now revealed in CBI surveys.

UK monetary conditions . . .

This year's Budget marked a further stage in the evolution of the medium-term financial strategy (MTFS), which has now been in place for seven years. Public sector borrowing has been reduced to 1% of GDP—a level judged sustainable in the longer run on present plans for public expenditure and for privatisations, the proceeds of which fall as a share of GDP. Under a policy of fully funding the PSBR (ie financing it by non-monetary means) the expansion of the monetary sector's balance sheet has come to reflect primarily the interplay of market forces between the banks and their customers in the domestic private sector and abroad. It has become increasingly apparent that movements in broad monetary aggregates, which include the bulk of the banks' domestic liabilities, do not, in an environment of financial innovation, necessarily portend movements in money GDP or inflation. As foreshadowed in the Governor's Loughborough Lecture, the practice of setting a target for broad money in the

form of £M3, which antedates the MTFS, was discontinued this year. This does not, however, mean any change in the aims of the strategy, which continue to include the elimination of inflation—by steadily reducing the rate of growth of money GDP. Nor does it fundamentally alter the operation of monetary policy, which has long been based on judgements about the appropriateness of monetary conditions, as reflected in movements in both narrow money (for which a target remains) and broad money, together with other financial indicators, especially the exchange rate, as well as asset prices and real interest rates.

. . . are substantially affected by the exchange rate . . .

Such judgements necessarily depend in part on the wider economic environment. Last year's fall in the exchange rate improved UK competitiveness, fostering the recovery of output and helping to redress the balance between domestic and overseas demand. This depreciation was acceptable, associated as it was with lower oil prices which neutralised its impact on inflation; but had it gone further there would have been inflationary dangers. Thus the Louvre accord, though designed to cope with international problems, came at a very opportune moment domestically, for at home, as abroad, a period of exchange rate stability was called for.

In the period after the accord, and continuing after the Budget, the rise in sterling at a time when M0 was well within its target range suggested lower short-term interest rates. On the other hand broad money continued to grow rapidly. Moreover the economy was growing quite fast, while house and share prices continued to rise strongly. The authorities therefore felt it right to lean against market pressures both by their operations in the money markets and by intervening in the foreign exchange market on a larger scale than has been customary in recent years.

In the short run, such exchange market intervention is likely to add to the growth of broad money, by adding to the authorities' need for sterling finance, some of which may come from the banks. Over a longer period, the operation of the 'full funding' rule should limit the effects of intervention on £M3 as the increase in the exchange reserves is offset by a correspondingly larger volume of sales of public debt outside the monetary sector. But funding policy aims at a broadly even flow of gross sales of public sector debt throughout the year. Rapid additions to the reserves through exchange market intervention may therefore produce a spurt in broad money growth that takes some time to settle back. This effect is likely to be accentuated in the early months of the current financial year by the bunching of both public sector borrowing and gilt-edged maturities.

. . . while exchange rate stability is the subject of growing international concern . . .

The Louvre accord in February and the communiqué from the G7 meeting in Washington in April both reflected a widespread agreement that the substantial exchange rate changes of the previous two years had brought currencies within ranges broadly consistent with underlying economic fundamentals, and that further substantial exchange rate shifts would be undesirable. Indeed, time should be allowed for the transfer of resources to the

tradables sector in the United States, and other sectors in Germany and Japan. Of course, this desire for a period of exchange rate stability reinforced the need for policy adjustments in the major economies. In short, markets might require firmer evidence that effective action was being taken to implement agreed policies; that the US fiscal deficit was being sufficiently reduced; and that domestic demand growth in Japan and Germany particularly (but in other participating countries also) was being maintained at a rate sufficient to provide demand and markets for both US producers and others in a period when domestic demand in the United States might be subdued. In this respect the intention of the Japanese authorities to introduce expansionary fiscal measures is to be welcomed, given the background of their restrictive budget proposals and the previous prospect of rising unemployment with little reduction in their huge current account surplus. A number of recent forecasts suggest that in Germany growth may fall significantly short of 2½%; earlier this year there were indications from the German authorities that if this were to happen they would contemplate further fiscal measures—such measures should be introduced in time to avert any fall in activity.

. . . as growth performance and prospects have seemed disappointing . . .

Looking back, growth in the major economies in 1986 was disappointing; despite a helpful environment of low inflation, falling interest rates and further rises in profits, real GNP rose by a modest 2½% in the seven major countries, compared with earlier expectations of 3% or more. Though consumption was generally buoyant, business investment was weak, hit by the slump in energy-related investment and by the sharp loss of competitiveness in Germany and Japan. OPEC retrenchment was much as forecast, but other indebted developing countries were forced to cut back imports by more than had generally been expected as external demand, finance, and primary product prices fell away. Earlier hopes that the setback to OECD-area growth after the fall in oil prices would prove short-lived have thus not been fulfilled.

The Bank's forecasts for the world economy are summarised in the note on pages 187–8.

The latest forecasts made in the Bank and the IMF suggest that major economies' growth in 1987 is likely to remain at around last year's level. This is a rather disappointing prospect, but at least no further downturn is foreseen and inflation is not expected to pick up significantly from the low levels to which it was reduced last year by large falls in oil and other commodity prices. While the direct effect of these price falls may now be coming to an end, in most overseas countries wage settlements reflect the reduced inflation, and earnings growth is likely to be modest. Only in the United States, where the fall in the dollar is tending to raise import prices, is there much risk of a marked upturn in inflation. Looking further ahead, prospects for the world economy are likely to be governed by the degree of success that is achieved in correcting the payments imbalances between the major economies. The main current account imbalances are forecast to remain large, despite substantial volume adjustments, implying continuing changes in net foreign asset positions on a scale which markets may regard as being unsustainable. Major risks here include an uncontrolled slide in the dollar, a sharp rise in US interest rates, and further shocks to the manufacturing

sectors of Germany and Japan, all of which would damage growth prospects in the industrialised and developing countries. Another risk is an intensification of protectionism, which might be expected to raise inflation, reduce efficiency and welfare and restrict developing countries' export markets—which could aggravate their debt problems.

Modest growth in the industrialised nations this year has already given rise to renewed concern about the debt problems of a number of developing countries. The continued decline in commodity prices during 1986 weakened their underlying position, and in some cases servicing difficulties have been increased by failures to make necessary economic adjustments. As these countries' prospects for growth have diminished, their progress towards creditworthiness in the financial markets has also been impaired. The countries of sub-Saharan Africa have been particularly badly affected and the United Kingdom has proposed that the poorest and most heavily indebted of them be offered special relief. For the middle-income countries the long-term outlook is better, but new finance from the commercial banks is nonetheless proving increasingly difficult to organise. The reluctance of many smaller and medium-sized banks to participate in the new money arrangements for Mexico led to a delay of six months before the agreements reached in principle last September could be signed. In the case of Brazil, its government's decision on 20 February to declare a unilateral moratorium on interest payments on medium and long-term bank debt, and its subsequent freezing of short-term bank credits, have made negotiations with the banks very difficult. Some encouragement can, however, be drawn from the agreements reached over the last few months between the governments of Chile, Venezuela, the Philippines and Argentina and their respective bank advisory committees.

. . . and trade frictions have increased

The US Administration has approached the trade problem on two fronts, aiming for a more appropriate level of the dollar, and promoting an improved international trading environment for the United States. This latter aim has been pursued through a series of bilateral, and industry-specific, initiatives with a number of its trading partners. Some of these were designed to open up markets, particularly Japan, to US and other exports, and have been consistent with the US defence of free trade. Others, such as the US/Japanese semiconductor agreement, are more at odds with the multilateral pursuit of free trade. More recently, problems with its implementation have led the Administration to impose 100% tariffs on a narrow segment of imports of Japanese electronic goods. While the tariffs were fashioned for political impact, rather than direct economic effects, the reaction of foreign exchange and US financial markets gave an indication of the potential speed and strength of second-round effects. Both sides have shown a willingness to discuss, and thus to contain, the semiconductor problem, although the same bilateral pact has been the source of some concern to other market participants, including the EC, and may be considered by the GATT.

Free trade should not be seen as something one country concedes to another but something to be pursued by each country in the interests of its citizens as a whole. Constraints on free trade designed to promote sectional interests also make it harder for

changes in competitiveness to have their effect. Japan's loss of competitiveness has drawn renewed attention to non-price barriers to imports into that market and to foreign participation in major projects there. While the preferences of consumers and companies in different countries will always result in differing levels of demand for imports, restrictions on quantities or participation in markets can lead to retaliation, which would, in turn, threaten the achievement of the world's growth potential. The relatively open trading system that the world has enjoyed for several decades must be strengthened and widened to include, among other things, services.

In order to reduce avoidable risks to the health of the world economy, there is a need for careful co-ordination of macroeconomic policies in the major countries. Moreover, further progress needs to be made in addressing the underlying structural features that impede the reduction of trade imbalances. Liberalisation of goods and financial markets, and measures to reduce excess savings in surplus economies, would be helpful steps. More generally, all can help by keeping up the momentum of structural reform, including the reduction of agricultural subsidies. Confidence in the world business community can only be harmed by a continuation of trade or financial disputes. Continued UK growth at its recent relatively high rate depends on confidence in the expansion of world activity.