General assessment

Activity in the UK economy has been more buoyant than expected, with output responding well to the earlier increase in demand and unemployment continuing to fall. Growth seems set to continue, although there is some concern about the recent strength of domestic demand and rapid credit growth, as well as about the last two months' trade figures. The prospects overseas are a little less encouraging than previously, as regards both growth and inflation. The period of exchange rate stability initiated at the Louvre and reconfirmed at the Venice summit should assist adjustment of payments imbalances but only if other internationally agreed policies are implemented effectively. Developing countries continue to face a difficult environment, with debt negotiations entering a new phase as major banks have announced higher loss provisions on their lending to problem countries. This Assessment considers the implications of this unusually mixed set of developments for the conduct of monetary policy.

Growth continues, with strong productivity rises in manufacturing . . .

The economy continues to grow strongly, with activity tending to exceed expectations. GDP may have risen by as much as 4¼% in the year to the first quarter and the momentum appears to have continued in the second. Although all sectors have shared in the rise, manufacturing output has been particularly buoyant and there has been a sharp increase in construction activity.

There have been signs this year that output was responding better to the earlier strong growth of domestic demand, which had last year been met to a considerable extent by imports and the running down of stocks. While demand faltered a little in the early part of this year, output made progress in displacing these sources of supply. An improved supply response also seemed detectable in the trade statistics, which were better in the early months of 1987 than many expected, reflecting a 10% fall in manufactured imports in the first quarter while exports remained buoyant. However, the trade figures in May and June, taken together, were disappointing, leaving some uncertainty about the underlying trends. Nevertheless some rebound in imports was to be expected, and the current account was in broad balance in the first half of the year.

The pick-up in activity has been accompanied by a significant, and at times sharp, fall in unemployment, which is now some 290,000 lower than a year ago. Some of the fall appears to be due to the Restart scheme and other special measures, but some of it also reflects higher underlying employment associated with higher output. The manufacturing sector has been experiencing a very strong rise in productivity, which in the three months to May was 6¾% higher than in the corresponding period last year. It seems likely that this reflects in part an improvement in underlying performance. Productivity growth in the economy as a whole also reflects the relative steadiness of output growth in the service sectors, where productivity traditionally increases more slowly.

Recent trends in productivity are discussed in the note on page 336.

. . . and the pattern of demand improving . . .

The buoyant output indicators of recent months have been accompanied by upward revisions to most forecasts of GDP growth for both this year and next. The average of independent forecasts for 1987 is now slightly above the 3% Budget projection, and some commentators expect growth to exceed 3½%. Moreover, the forecasts are suggesting more balanced growth this year than last, with investment recovering in response to higher utilisation of capacity, and consumption a less dominant source of growth. Despite lower interest rates, first-time buyers may have been having to save more in order to finance house purchase, as house prices have continued to rise and mortgage lenders have raised downpayment requirements. And, at least in the early part of the year, the growth of labour income fell back a little, whereas the personal sector's investment income, much of which accrues to pension funds and thus tends not to be spent, was particularly strong. Although consumption growth seems now to have resumed, most forecasts still point to some slowdown in output growth next year, partly reflecting declining North Sea production and partly the cloudiness of prospects for the world economy.

. . . but potential inflationary pressures persist . . .

It remains as important as ever that this relatively encouraging prospect should not be put at risk by inflation. Having risen to around 4¼% during the summer, the twelve-month rate of retail price inflation is still widely expected to fall back to below 4% before the end of the year. However, the underlying increase in domestic costs in the economy as a whole has been distinctly faster than the average of other major countries for some time. Moreover, the prices of oil and other internationally-traded commodities, expressed in SDRs, have firmed and this has raised manufacturers' input prices, although the impact has been partially offset by the strength of sterling, and companies seem well placed to absorb some of these increases. There are signs too that tighter labour market conditions are having some effect on wages. Settlements appear to have edged up fractionally in the second quarter, both in manufacturing and private services. This may in part reflect the rise in the twelve-month increase of the RPI, but there is evidence that recruitment of labour is becoming less easy in the service sector.

The rise in house prices, which, despite some moderation, remains at a twelve-month rate of over 14%, is likely to be a factor sustaining inflationary expectations. House prices may have a significance for wage bargaining beyond their direct contribution to the RPI as an element in housing costs, through their implications for downpayments and the size of mortgages to be serviced, and possibly through the adverse impact of large regional house price differentials on labour mobility. Although higher house prices do not represent an unqualified increase in real wealth—because they also mean increases in the cost of accommodation—they do increase homeowners' ability to borrow relatively cheaply for other purposes.

. . . and monetary policy necessarily remains cautious

The perception of improved supply conditions in the UK economy—and the consequent promise of better profitability, cost containment, and trade performance—contributed to a strengthening of sterling and higher financial asset prices in the first half of the year. Economic policy as seen in the Budget, and views on prospects for policy after the election in mid-June, will also have played a role. The strengthening of sterling helped at that time to validate lower inflation expectations (which it may also, in part, have reflected) and falling interest rates reduced retail price inflation as measured.

Sterling drifted lower for a while after the election: the result seems to have been discounted by the market and there was no renewed surge of funds into sterling as some had been expecting. As a result of modest intervention to steady the market there was an underlying fall in the reserves in June—the first such fall since last October. The rate subsequently recovered for a time as the dollar rose against the deutschemark and the yen and oil prices strengthened. In the domestic markets sterling's easier tone and worries about inflation dispelled hopes of an early cut in banks' base rates, leading to some firming of short-term rates, and bond yields also rose.

The growth of credit and broad money continues to be rapid, in contrast to that of M0, which remains within its target range. The broader measures were affected by intervention as well as by the bunching of debt maturities. The PSBR was underfunded by some £2 billion (seasonally adjusted) in the first quarter of the financial year, but this should be offset later in the year. While fairly rapid growth of liquidity and credit can be attributed to structural change in the financial system, the acceleration of credit extension in mid-year posed the question whether demand in the economy might begin to outpace supply, and reinforced the need for caution on the part of the authorities. In view of these concerns the authorities initiated an increase in interest rates on 6 August.

Mixed developments abroad . . .

The prospects for the UK economy depend to a substantial degree on developments abroad. There are risks that hesitant growth of overseas markets may weaken the demand for our exports, and that firmer prices of raw materials on world markets may worsen our terms of trade and inflation pressures; and imbalances in current accounts threaten the stability of exchange rates and the free expansion of world trade. While the position varies as between countries, the overall picture is somewhat darker now than it appeared last autumn, with lower growth foreseen, and with commodity prices having already risen more than expected. In the first quarter of this year, output in both the United States and Japan was rising at nearly 5% while growth in continental Europe was weak—GNP in both Germany and Italy actually falling. US growth moderated in the second quarter, and was more evenly spread between sectors. Recent indicators suggest that, in the major countries taken together, the central prospect for this year continues to be for growth of around 2½%, little changed from the Bank's earlier forecast. The OECD subsequently forecast growth slightly slower than this, based on its gloomier forecasts for Japan (which did not incorporate the recent fiscal package) and for Germany, where prospects are perceived to have weakened this year.

See the May 1987 Bulletin, *pages 187–8.*

Inflation in the major overseas economies has risen since the turn of the year; twelve-month consumer price inflation has increased from around 1% in January to 2¾% currently. In part this is because the decline in the oil price in the early months of 1986 has dropped out of the comparison. The more recent firming of oil and non-oil primary product prices is probably also a factor. At their half-yearly meeting in Vienna at the end of June, OPEC Ministers left the current pricing structure unchanged, but set a lower production limit for the fourth quarter than was envisaged last December, although the maintenance of discipline may still encounter various difficulties. Non-oil commodity prices have risen by some 14% in SDRs (20% in dollars) from their trough in August of last year, partly under the influence of strikes and other special factors. Meanwhile, earnings growth in most industrialised countries remains low. Thus the outlook for inflation is rather uncertain and, like that for growth, varies between countries. The earlier fall in the dollar accounts for a more marked rise in inflation in the United States than elsewhere this year.

Developments in the payments imbalances between the three largest economies have not been consistently encouraging. Although output grew rapidly in Japan in the first quarter, this was not true of domestic demand, which was also weak in Germany. Thus the German and Japanese trade surpluses have remained very large, and progress in reducing the US deficit has been limited and uneven.

. . . provided the background to the Venice summit . . .

With a view to reducing the risks in the current situation, Heads of Government meeting at Venice reaffirmed and extended their commitment to economic policy co-ordination; but the actual implementation of the agreed policies remains of prime importance. These policies include further reduction of the US Federal budget deficit and a preparedness to adopt measures to bolster domestic demand in Japan and Germany. The Japanese government anticipated this conclusion by announcing, immediately prior to the Venice summit, a ¥6 trillion package (about 1¾% of GNP), although the overall effect of the package remains unclear. The German government has announced a budget for 1988 which would allow the Federal deficit to widen only slightly (relative to GDP)—to some DM 29 billion from an estimated DM 26 billion this year—despite the DM 14 billion of tax cuts due at the start of 1988.

Since the summit, the pattern of exchange rates has been broadly stable, although the dollar strengthened from June to early August. Wider interest differentials in favour of the United States, prompted by the earlier period of dollar weakness, may have been a factor, together with concern that Japanese assets were overvalued, and the prospective consequences of higher oil prices. The importance of greater stability of major country exchange rates was endorsed at the Venice summit and is to be welcomed, since it allows time for resources in the United States to be shifted into the tradables sector, and for Japan and Germany to become less dependent on externally-led growth. With the present broad constellation of rates, it seems likely that further progress in narrowing the external imbalances will require considerable changes in the relative growth of domestic demand in the three major economies, while aggregate growth in the industrial economies must be maintained if the problems of the LDCs are not to be aggravated.

. . . and a further step in bank treatment of LDC debt

Prospects for a selection of developing countries are discussed in the note on pages 340–43.

Developing countries continue to be confronted with a difficult environment. Given the adverse effects of sluggish growth in industrial countries on their exports and terms of trade, adjustment by those LDCs with serious debt problems has tended to involve little, if any, growth of living standards. After five years of austerity, and prospects of little improvement, at least over the next few years, willingness to undertake further adjustment has been eroded in a number of heavily-indebted LDCs. Yet most still see their interests as lying in continued co-operation with creditors, with a view to maintaining access to world credit markets, and few are at the moment seeking to disengage from IMF-type conditionality.

For their part, the banks have become increasingly unwilling to countenance new money packages and reschedulings without the assurance of firm adjustment policies within the discipline of an IMF programme. The recent Argentinian rescheduling was indicative of the more innovative and flexible packages the banks are likely to seek. The announcement by Citicorp on 19 May that it was setting higher loss reserves against its loans to problem countries marked an important development in banks' attitudes and may presage a harder line in future discussions with debtors. Other US banks rapidly followed Citicorp's lead. The UK authorities welcomed the subsequent announcements by major British banks: higher provisions by these banks—made on a country-by-country basis according to the exposure of the individual institution—reflect a realistic reappraisal in current circumstances of the quality of their sovereign claims. The implications for the LDCs are not clear cut, but to the extent that the switch to greater provisions enables some banks to divest themselves of LDC credits to holders who are willing to take an equity stake in the countries concerned, the latter may see some advantage, at least in cash flow terms.

The immediate prospect for the domestic economy has some encouraging features, with better supply performance offering the chance of continuing growth at a rate sufficient to reduce unemployment. However, this prospect depends importantly on the containment and further reduction of inflation. Although the exchange rate has remained stable, there are some signs of potential inflationary developments in the domestic economy. There are also some developments abroad which threaten to detract from satisfactory growth and to contribute to inflationary pressures. Against this background, the authorities need to maintain the cautious approach displayed by their recent action to tighten monetary policy.