General assessment

In the ten days to 16 October the US equity market fell by 16%. In the following week, the New York market fell a further 13% while markets in London and Tokyo fell by about 20% and other equity markets moved by similar amounts. These falls seem to have been triggered by disappointing US trade figures, and by comments and actions by the US and German authorities that were interpreted by the markets as casting doubts on the sustainability of the dollar exchange rate within the Louvre accord arrangements. Once the falls had begun they brought into focus a deeper underlying concern about the persistent US trade and fiscal deficits.

The level of equity prices in many markets, and also of real estate prices, especially in Japan, had been a cause of concern for some time. To this extent some correction was not qualitatively inappropriate, and the falls reduced indices in several centres to about their levels late last year. But the pattern, speed and magnitude of the collapse was out of all proportion to the quantity of new information relating to any relevant fundamentals.

Both long and short-term interest rates had risen earlier in the year, reflecting inflationary worries and some concern about the growth of liquidity. The deflationary implications of the loss of wealth for a global economy already growing quite modestly, together with the damage done to the confidence and liquidity of markets, made it appropriate for the world's monetary authorities to adopt a supportive stance, and in some cases short-term interest rates have been allowed to fall by as much as 1½%. This partly reverses the earlier rises, and a flight to the comparative security of government bonds has had a similar effect on long rates (and raised the value of private holdings of government debt).

This Assessment considers the international background to these developments and the domestic context of the British authorities' response.

Modest growth has continued overseas . . .

The Bank's forecasts for the world economy are summarised in the note on pages 496–7.

In Japan and North America, as in the United Kingdom, output grew robustly in the first half of 1987, while growth in continental Europe, particularly Germany, was below expectations. Latest Bank projections suggest a continuation of growth in the major countries but at a slightly more modest rate, significantly lower than that recently maintained by the United Kingdom. While next year's tax cuts should stimulate the German economy, growth there seems unlikely to exceed 2¼%, after a disappointing outturn this year. Domestic demand in Germany is likely to continue to be stronger than output, but while this should help bring about some reduction in nominal current account imbalances, it may well be insufficient to stimulate the other key European economies. Recent fiscal policy developments in Japan have made a more positive contribution. In Japan, domestic demand is buoyant and will be further bolstered by tax cuts and by increased government spending and support for private investment, while tax reform is reducing private savings incentives. After a pause at the turn of the year, imports are again rising strongly.

The prospective weakening of growth is partly attributable to the fall in asset prices, as reduced wealth affects consumer demand and, despite offsetting declines in interest rates, the higher cost of equity capital is likely to discourage investment. The falls were,

however, greater in the United States, where demand and output have been growing relatively strongly, than in Germany and Japan. Thus the relative impacts are likely to be in the direction required to reduce current account imbalances.

About a half of the 3% rise in US short-term interest rates earlier in the year has now been reversed. Before the equity market collapse, upward movements in short-term rates had also occurred in other major centres, and sharper rises in bond rates. Special factors accounted for some of the earlier rise, but there also seems to have been an increased expectation of inflation. The recovery in oil and some non-oil commodity prices had resulted in upward pressure on import prices for the industrial countries; in the United States, concerns that dollar depreciation might feed through more fully than hitherto to domestic costs may have influenced markets; and elsewhere continued rapid monetary growth, associated in part with central bank support for the dollar, may have been a factor. Nevertheless, there are few signs of a significant general pick-up in underlying inflation rates.

. . . and proposals have been made for enhanced policy co-ordination among the major industrial countries . . .

Progress to date in reducing the trade imbalances between the major economies has been disappointing, because improvements in trade volumes have been overshadowed by adverse terms of trade movements. The US trade deficit in the first eight months of the year amounted to $114 billion, somewhat higher than in the same period last year. In July the deficit reached a record level and the improvement in August was smaller than had been hoped. Nevertheless G7 Finance Ministers and central bank Governors agreed in Washington in September that it would be helpful to allow further time for the lagged effects of past exchange rate changes to work through, and reaffirmed their commitment to stabilise exchange rates, by further intervention if necessary. The communiqué recognised the continuing need for supportive policies to foster sustainable non-inflationary growth and to reduce imbalances between the three largest economies. Recent Japanese fiscal measures have been helpful, and in the United States the recent signing of new legislation designed eventually to achieve a balanced budget should help consolidate the progress made in the last fiscal year. The markets are looking to further progress to bring the structural claims of the public sector of the United States more closely into line with the comparatively low rate of saving typically seen in its private sector. However the deflationary effect of the fall in world securities markets sharpens the dilemmas of US fiscal policy and enhances the need for an internationally balanced programme.

. . . but the prospect for heavily-indebted countries remains difficult

Recent financial developments are likely to have dampened expectations of a somewhat stronger growth in markets for LDC exports next year. The decline in interest rates since mid-October has, however, reversed some of the increase since the beginning of this year, and many countries will continue to benefit from structural reforms and more realistic exchange rates introduced under recent IMF/IBRD programmes. While a number of the major debtors have benefited in recent months from the recovery in prices of oil and some other commodities, other countries,

particularly Latin American and African exporters of foodstuffs, are likely to have experienced a further deterioration in their terms of trade. In recent weeks, metal prices have also fallen sharply in reaction to events in financial markets and debtor countries remain particularly vulnerable to any failure to resist protectionist sentiment.

Such concerns underlay discussion of the debt strategy at the IMF/World Bank Annual Meetings. While the existing approach to the debt problem was reaffirmed, it was recognised that the external environment faced by debtors remains difficult and that, as a result, the pace of adjustment and structural reform was likely to be slower than had earlier been hoped. This brings into sharper focus the need to provide adequate medium and long-term financing from both official and private sources. Proposals to modify the IMF's own lending facilities, so as to allow more for contingencies beyond the debtor's control, go part of the way to meet the problem, although access criteria could be difficult to define and the IMF's resources would only meet a small proportion of likely demand. While US support for an increase in the capital of the World Bank will provide a boost to a continued and more rapid expansion of multilateral development lending, a higher volume of private sector financing will be required. For this to be forthcoming, debtor countries will have to show greater receptiveness to foreign direct and portfolio investment than hitherto, while adopting financial policies which limit or even reverse capital flight. Among creditors, a willingness to restructure their claims, and so expand the range and marketability of debt instruments, would help to secure a more appropriate distribution of risk and timing of returns. While creditors maintain their strong opposition to debt relief to middle-income countries, the case for conditional relief for the poorest debtors has been generally acknowledged. It nevertheless has so far proved difficult to create a consensus for the proposals presented by the Chancellor for a reduction in interest rates on lending to countries in sub-Saharan Africa, despite the fact that such a step is much the most effective way of relieving their debt burden while improving cash flow.

At home, output has been growing rapidly . . .

Output is estimated to have risen by around 4% in the past twelve months. The unusually large recent divergence between the output and expenditure measures of GDP somewhat obscures the picture, but the weight of evidence from other indicators supports the view that the (higher) output measure is probably more accurate. This means that growth in the United Kingdom has for some time been rather faster than the average of OECD countries, and markedly faster than that of the continental economies which are now our major trading partners.

The recent rate of growth has exceeded the average rate achieved in the previous five years—itself the longest spell of rising output since the war. The past year has seen a particularly good supply response to higher demand and one that has been achieved in part through a sharp fall in unemployment, which fell by some 400,000 in the year to September. Normally in a period of expansion people are sucked into the labour force and employment rises more than unemployment falls. On this occasion, however, employment has risen by only some 300,000 full-time equivalents. Despite the strong rise in output it has not

quite kept pace with domestic demand, as is evident from the deterioration in the balance of (non-oil) trade in goods and services in real terms.

. . . although the trade balance has tended to deteriorate

The trade figures continue to pursue an erratic course and the underlying trends remain difficult to read. It nevertheless seems clear that the trade balance has deteriorated, although not rapidly, and not as much as predicted earlier in the year. Growth of non-oil export volume (up nearly 10% in the year to the third quarter) seems to have resumed after a pause, although at a slightly slower pace than seen towards the end of last year; but import volume, although highly uneven, is tending to rise somewhat faster (12% on a year earlier). Imports of capital goods and semi-manufactures have been a significant element in the rise of manufactured imports for some time, but the latter has been broadly spread, and there has been a shift recently towards stronger increases in imports of most finished manufactures, including consumer goods as well as machinery and equipment. Imports of cars, however, grew only modestly in the year to the third quarter, as there was a good response of domestic production, which accounted for a rather larger share of registrations in the first three quarters of the year than in the corresponding period last year.

The deterioration in the trade balance this year can be explained to some extent by the fact that domestic demand is growing distinctly faster than demand in the United Kingdom's overseas markets. The deterioration in competitiveness since late last year (about 7% in relative cost terms) is probably also now having some effect, although competitiveness is still around 6% better than before sterling's fall last autumn. Some part of the trade deterioration may also be attributable to the buoyant growth of domestic demand in relation to that of potential domestic supply, despite the improved supply response seen from manufacturing industry in the past twelve months.

Consumption remains a strong element in domestic demand . . .

Although there are doubts about the accuracy of some of the main measures of expenditure, it seems certain that personal consumption has continued to make the largest contribution to the growth of domestic demand. The precise source of the recent strength in consumption is, however, not entirely clear. Despite rapid earnings growth and the tax cuts in the Budget, the rise in measured real personal disposable income has barely kept pace with that of output (owing to seemingly erratic movements in dividend and interest income, and declining employers' pension fund contributions), and the personal saving ratio is estimated to have reached 8½% in the second quarter, having fallen fairly steadily from over 14% in 1980. About half this fall is due to lower employer contributions to pension funds, which are treated as part of the personal sector, in response to large actuarial surpluses at a time of rising profits and falling inflation; and the rest seems to reflect a lower rate of saving by households. These estimates assume, as is customary, that the exceptionally large balancing item in the personal sector accounts does not reflect either overstated consumption or, rather more plausibly,

understated income (on this last assumption it is not clear that the saving ratio has fallen much recently). In any case, some fall in the saving ratio is consistent with the view that high saving in the 1970s was in part a response to high inflation, and that the ratio would fall when inflation came down.

Despite the effect of lower equity prices on pension fund surpluses the fall in the saving ratio (whatever its precise size) is unlikely to be reversed in the near term. It is true that the personal sector's debt/income ratio has been tending to rise for some time, and that there must be limits beyond which individuals cannot continue to accumulate debt without serious risk of default. But with lower interest rates since the early 1980s, income gearing is not exceptionally high; and, notwithstanding October's dramatic events, which may eventually be reflected in higher pension fund contributions, capital gains from rising equity and house prices have meant that the personal sector's balance sheet has tended to strengthen on the whole rather than weaken in the past few years. Admittedly, the distribution of liabilities between households probably does not match that of assets at all closely, and heavily-indebted households may tend to have few financial assets; if so, individual borrowing constraints will be reached earlier than the aggregate balance sheet would suggest. Nevertheless, if inflation remains low, the personal saving ratio is unlikely to revert to the heights it reached a few years ago, nor is the growth of debt likely to come to a stop soon.

. . . but investment has also picked up

Having disappointed expectations for some time, industrial investment picked up sharply in the second quarter to a level some 12½% higher in real terms than a year earlier. This recovery reflected both a strengthening of confidence in the further growth of demand and the continuing strong performance of company finances, allied with the fact that more firms are now seeing capacity beginning to constrain output. Manufacturing output growth over the past year—nearly 6%—has significantly out-paced that of the capital stock and has been associated with a perceptible tightening of supply conditions. The widespread recognition that capacity has to be expanded if output growth is to be maintained is encouraging. There is, however, some danger that the recent stock market fall, and the associated rise in the cost of equity capital, together with the enhanced possibility of slower growth abroad, will sap the confidence needed to build ahead of demand.

Some cost pressures have re-emerged . . .

Neither the recent growth of demand nor that of productive capacity can be estimated with much precision. A range of indicators of industrial conditions appear to confirm a tightening of supply constraints this year, yet, after an apparently sharp deterioration early in the spring, the indications of some subsequent moderate tightening have been tempered by the strength of investment and the evidence of continuing optimism about immediate prospects for output and new orders. On balance, supply constraints remain less acute than at the cyclical peak of 1973. Skill shortages have emerged as a frictional difficulty in some sectors and regions, but, more generally, labour market conditions, which are much slacker than in previous peaks, are not yet perceived to have tightened significantly. More

firms are reporting plant capacity to be a constraint on output than at any time since 1973, but the proportion has not risen since April even though there has been a further fall in the proportion of firms working below a satisfactory level of operation. Productivity growth has been particularly buoyant over the past year and, with a somewhat faster expansion of productive capacity now occurring, pressure of supply constraints is apparently being maintained at an acceptable level.

Pay settlements and earnings growth have risen somewhat over recent months, although some increases appear to have been productivity-linked, and have added little to immediate inflationary pressures. The growth in unit labour costs has remained very modest overall and has slowed in manufacturing, so that costs there may now be no more than 1½% above their level a year ago. Rather less encouraging for inflation generally has been the strong growth in raw material prices this year. If output and productivity growth moderate as expected, the scope for absorbing higher material prices would be still further reduced, leaving producers either to accept a squeeze on their margins or to pass on increased costs in higher prices. There is a danger too that recent high productivity and profit growth may induce employers to be too optimistic in making new pay awards. It is thus particularly important at the present time that settlements are based on a realistic view of underlying productivity improvements (probably about 2½% per annum in the economy as a whole) and that any recognition of recently faster productivity growth be conditional on continuing results, as it might be with profit-related pay. Settlements should also reflect the fact that policy will continue to press down on inflation, and the current rate of inflation should therefore not be built into new awards.

. . . leaving awkward choices for monetary policy when the stock market fell

Sterling has recovered the ground it lost temporarily after the election and in late October surpassed its May peak of 73.8 in effective terms. The foreign exchange market has responded to the signs of improvement in the fiscal position and in the supply response of the economy, with faster growth in output and productivity. Sterling did not react strongly to the bad August trade figures; nor had it strengthened on the rise in interest rates in August, but more recently the level of UK interest rates has been a source of attraction. The August rise was undertaken to reverse some of the interest reductions which were made earlier in the year in response to the pressures in the exchange market but which were not fully warranted on domestic grounds.

With continuing rapid growth of broad money, domestic monetary developments, like those in the real economy, continue to argue for caution in the conduct of policy. The growth of M0 has shown signs of acceleration since earlier in the year, though it remains within the target range. The underlying expansion of credit remains strong—abstracting from large month-to-month fluctuations—with a major contribution from lending to persons, particularly on mortgages (where the banks' market share has risen again this year at the expense of the building societies'). In the latest quarter, industrial and commercial companies have also borrowed heavily from banks, as well as raising a record amount from the capital market. While companies' liquid assets,

including broad money holdings, have also risen rapidly, a significant proportion of the borrowing is likely to have financed takeover and merger activity both at home and abroad. The rapid rise in foreign currency borrowing, largely by OFIs, which accompanied the rise in the exchange rate in the early part of the year has begun to reverse in the last few months.

Before the equity market fall, policy was again facing much the same dilemma as earlier in the year, with domestic evidence arguing against any easing, while external factors and the desire for exchange rate stability pointed to a need for either lower interest rates or heavy exchange market intervention. The sharp fall in equity prices helps to ease this dilemma since it implies a tightening of monetary conditions, by raising the cost of equity capital to firms and, through the effect of wealth reduction, by depressing consumption demand by households. It is far from easy, with little relevant recent experience to draw on, to judge just how powerful these last effects will be in the United Kingdom. They are certainly likely to be less strong than in the United States, where personal ownership of equities is larger and more widespread, but they are unlikely to be negligible, particularly when account is taken of the impact on confidence of a fall as sharp as has taken place. That conclusion, alongside the desirability of imparting a calming influence to financial markets and institutions, lay behind the decision to reduce money-market and base rates by ½% on 23 October, and again on 4 November.