General assessment

The events in the financial markets last October can now be seen in greater perspective. An article on page 51 addresses questions they raised about market structure both here and elsewhere, while a number of reports have already been published in the United States. This Assessment deals with macroeconomic themes and suggests that in that context the fall in the dollar is more important than that of equity prices, at least for the United States' trading partners. It may further the adjustment of international imbalances but is likely to contribute to a slowing of world growth which has implications for the UK economy. The growth of domestic demand here, which has exceeded that of output, has been sustained by a downward trend in the personal sector's saving ratio, and has contributed to a deteriorating trend in the trade balance.

Further falls in the dollar late last year . . .

Activity in the seven major industrial countries in the third quarter was stronger than expected, growing at the most rapid rate for over three years. Early indicators for the period following October's stock market crash suggest that much of this momentum has been maintained, and that activity is holding up quite well. It is far too early to measure reliably the macroeconomic effects of the fall in share prices; some of them may take a long time to be felt, and they will in any case be difficult to disentangle from other factors. Nonetheless, surveys of business confidence in the major economies suggest that spending plans have not been substantially curbed. In part this reflects the willingness of authorities to supply liquidity and reduce interest rates to offset any tightening effects of lower share prices. In the United States, however, where equities are more widely held, there is evidence that consumer spending has weakened recently. This is a helpful sign for the resolution of current account imbalances, as slower growth in consumer demand in the United States should help to dampen imports and free resources for the production of exports, and also for investment in additional capacity in the tradables sector.

Following the collapse in equity prices, foreign exchange markets have undergone a further turbulent phase, with the dollar falling 10% to the turn of the year. This may have stronger and more immediate effects on the world economy than the preceding share price fall. The G7 communiqué issued before Christmas had little immediate impact on markets, but strong, visible and co-ordinated intervention by the Federal Reserve and other central banks in the New Year underlined their commitment, and succeeded in stabilising the dollar. The speed of correction of imbalances has been slower than desired, with terms of trade effects continuing to mask the improvement in volumes. The weaker growth of domestic demand in the United States now in prospect, coupled with the recent additional sharpening of competitiveness, should lead to volume effects beginning to dominate movements in the US trade account during 1988 provided the dollar remains broadly stable through the year. The November trade figures (published in mid-January) were better than anticipated and the dollar recovered by over 2% on the news. But the dollar depreciation in the closing months of 1987

may give additional negative J-curve effects in the months ahead, and experience suggests that a rapid turnround in the nominal deficit is unlikely. Sustained evidence that imbalances are lessening is needed for markets to become more settled.

. . . highlight the need for policy changes

A further sharp fall in the dollar would pose dangers to the world economy. Exchange rate changes alone cannot correct trade imbalances without risk of misalignment, entailing an uncertain climate in which price signals are difficult to interpret and it is hard to make sound investment decisions. Supporting fiscal, monetary and structural policies help to reduce these costs and to provide more balanced adjustment. In the current conjuncture, a better balance of demand growth between the United States and some major surplus countries would reduce the possibility of a recession which would be harmful for developed and developing nations alike. Given the low unemployment and high capacity utilisation there, a major concern in the United States is that there should be a sufficient rise in saving to allow resources to be available to meet additional net external demand. Although the likely slowdown in consumer spending would help, there is limited room for manoeuvre in the economy, given continued, if somewhat reduced, pressure on resources from the public sector. In these circumstances a further fall in the dollar might be largely dissipated in inflation, although encouragingly there are few signs of a pick-up in inflation to date.

Modest growth prospects for Germany have been dampened further by the rise in the deutschemark. Higher demand growth there would raise world activity both directly and indirectly by reducing the external constraints on other European economies, and would also reduce the risk of dollar overshooting. Monetary policy moves following the stock market collapse have helped, but fiscal policies are barely stimulative at present when cyclical factors are allowed for. Although the German authorities are concerned at the rise in the fiscal deficit, much of this can be accounted for by low growth and the erratic decline in the Bundesbank's profit transfer. The recent announcement of the intention to claw back next year part of this overshoot is not conducive to domestic demand growth. In contrast, the Japanese economy is currently very buoyant, although as in Germany further sharp exchange rate appreciation could dampen activity and investment growth. Structural adjustment of the Japanese economy is proceeding, helped by last year's stimulatory budget, but exports remain quite buoyant. There remains scope for further helpful import liberalisation in Japan. This is also particularly the case in Taiwan and Korea, who have a part to play in the promotion of balanced growth and in reducing the protectionist pressures evoked by their large trade surpluses.

The main burden of stabilising exchange rates tends to fall initially on monetary policy, before being shared by fiscal and structural actions. There is little scope for further monetary easing outside the United States, as interest rates have already been reduced and liquidity growth, fuelled partly by intervention, remains strong. Indications that the US authorities would be ready to increase interest rates if the dollar were to come under renewed pressure would help to stabilise it. Expansionary fiscal and structural policies in Germany, and in Japan should that economy slow significantly, would then be the more urgent, to

offset the additional slackening in world activity that any tightening of US monetary policy might induce.

Developing country debtors would benefit from the maintaining of growth and the more stable trading environment, although in the short run higher dollar interest rates, were they to prove necessary, would be damaging. Commitment to sound adjustment measures among major debtors continues to be mixed, emphasising the need for a case-by-case approach. Following an interim financing agreement, Brazil has disappointed the banks by delay in making interest payments, while Argentina's external trade position has deteriorated sharply. Both countries have been unable to tighten fiscal policy as required. In contrast, the Mexican authorities reacted quickly in response to pressure on the peso and their readiness to adopt firm measures may enhance the appeal of the debt conversion scheme recently proposed.

At home, domestic demand has grown strongly . . .

The UK economy is now known to have been even more buoyant last autumn than was thought at the time. GDP growth in the year to the third quarter is now put at 5%, with manufacturing and construction rising particularly fast. Domestic demand was strong in the quarter, notably personal consumption and stockbuilding, the former implying a continuation of a fall in the personal saving ratio to levels not seen for nearly a generation. Exports too were quite strong, reflecting better-than-expected supply performance in the preceding twelve months, manifest in rapid productivity growth and an improvement in export market share. Nevertheless, imports rose even more, and the balance of non-oil trade has deteriorated.

The fall in the saving ratio in the third quarter to around 5% may be in part a statistical aberration, but there is no doubt that the ratio has come down considerably in the past seven years, from a peak of over 15% in 1980. As noted in the November *Bulletin* (page 476), this trend is in part due to lower employer contributions to pension funds, but, even allowing for this effect, the fall in the saving ratio is very marked. The factors underlying the fall are reviewed in the Commentary (pages 19–20); they include, in addition to the slowdown in inflation, the improvement in employment prospects and readier access to credit. As adjustment to these developments becomes more complete the decline may level out and perhaps even reverse soon. In itself the fall is not necessarily a cause for alarm, but the associated growth of debt may raise prudential considerations for banks and other suppliers of personal sector credit. The sharpness and extent of the recent fall in savings raises questions about the appropriate response of monetary and fiscal policy.

See also the speech by the Governor entitled 'Personal credit in perspective', reproduced on pages 48–50.

On latest indicators, output and demand have continued strong, although the momentum of personal consumption seems to have moderated a little. It is not clear that this is due to the stock market collapse, which recent intentions surveys do not suggest is having a marked effect on demand, or on spending plans more generally. More concern attaches to the dollar's fall and its implications for industries exposed to US competition. After a period of comparative stability between February and September, the dollar has fallen sharply. While helping to mitigate

inflationary pressures here as elsewhere (apart from the United States), this poses some problems for UK activity and the balance of payments. Sterling has risen by approximately 25% against the dollar in the past year but, because of its comparative stability against other key currencies, much less in effective terms. By virtue of its construction the effective rate index (ERI) gives a better guide to influences on UK trade as a whole than any bilateral rate. Although UK cost competitiveness based on the ERI has deteriorated by around 10% since the fourth quarter of 1986, it is still not significantly worse than three years ago, itself a large improvement on the early 1980s.

. . . but the dollar's further fall . . .

The large movements between the dollar and third currencies mean that there have been large differential movements in competitiveness both between particular UK industries and as between markets. Quite apart from any accompanying deterioration in overall competitiveness, such shifts have adverse implications for trade and externally-based activity. Large exchange rate movements create uncertainties that impede long-range planning by industrialists even though they can, at a price, insure against many of the effects, particularly in the short term. Sharp and substantial shifts in the profitability of different sectors tend to depress overall activity and investment if the losers react by cutting back more quickly than the gainers expand, and the shifting pattern of demand for labour increases the frictional element in unemployment, and thus wage pressures at a given level of unemployment. In the past two years, UK producers have tended to lose competitiveness against North American producers while gaining it against continental European and Japanese ones. Given these shifts, and the relatively slow growth of our export markets, it is remarkable that exports fared as well as they did in the second half of 1987.

Dollar depreciation also implies negative effects on the UK invisibles account, principally the investment income element. The high proportion of US investments in the United Kingdom's external portfolio means that the sterling value of receipts of interest, profits and dividends will have fallen more in line with the dollar than with the trade-weighted basket of currencies. Such influences are likely to be counteracted in the longer run as UK investments in the United States become more profitable, but the process takes time. Dollar depreciation is also likely to have an adverse effect on net sterling earnings from services like insurance and tourism because the US market for these services is more important to UK businesses than the corresponding market in goods.

. . . raises questions about the sustainability of rapid growth

These developments imply a slowdown in the growth of demand and raise questions about the supply response. On latest forecasts, the prospects are for output to continue to grow, but at a rather slower, though still satisfactory, rate in the year ahead. This slowdown reflects less a slowing in domestic demand than a further deterioration in the balance of trade. The deterioration is nevertheless considerably smaller than would have been projected on the basis of relationships ruling a few years ago, owing to the improved supply response.

A period of relatively fast output growth is to be welcomed for the contribution it makes to raising living standards, reducing unemployment, and stimulating investment. And the United Kingdom is capable of financing moderate current account deficits for several years; indeed, that is probably a necessary, if modest, contribution to the widely sought improvement in the US external deficit. There must, however, be some question about the sustainability of growth of domestic demand in this country at a rate above that currently being achieved by most other major countries. It will depend on the emergence of a stronger growth of domestic demand in the rest of Europe, as well as on a successful resolution of the major international imbalances; and on a slower growth of domestic costs in the United Kingdom, the underlying rise in which is still excessive in relation to that of most of our competitors and in relation to our inflation objectives. On present cost trends, there is little prospect of a sustained improvement in UK competitiveness, despite the recent strength of productivity growth.

Sustainability of output growth will also depend on the growth of demand at home and that of the economy's capacity to supply coming closer together. There is evidence from the industrial surveys that shortages of some categories of labour are increasingly being felt. So far, the rising pressure of domestic demand has not been reflected in a pick-up in inflation, thanks in part to the continuing strength of sterling, which has substantially offset the rise in prices of materials and helped to contain the increase in producers' margins. The tightening of the labour market may not have been as marked as the half-million fall in unemployment in 1987 might suggest. Exceptional productivity growth has, in fact, allowed output to rise strongly with a relatively modest, but very welcome, rise in employment (and self-employment). Wage developments are, nonetheless, not reassuring, with no evidence of a downward trend in settlements, and some signs of an increase in the services sector, especially in areas not exposed to international competition.

Monetary developments add to the impression of strong domestic demand . . .

Monetary growth remains strong. M0, no doubt reflecting the buoyancy of consumer spending, grew strongly in the second half of last year, though the twelve-month increase remained within the 2%–6% target range. The various measures of broad money, too, continued to grow rapidly. Intervention contributed to changes in the month-to-month growth of broad money. However, over the last three months for which figures are available, taken together, the impact of intervention on money has been largely matched by a combination of funding and a PSBR surplus, in part representing the sale of BP shares. Broad money growth, therefore, has reflected the strength of credit demand from the private sector, which remained at the high level of the summer months. Only part of this can be attributed to personal sector borrowing, particularly mortgage borrowing, while the profile of demand through the year has been similar to last year, but with the banks taking a bigger market share. The remainder reflects other aspects of the strength of the real economy, for example, substantial stockbuilding, as well as position-taking associated with takeover and merger activity, which persisted even after the stock market fall.

For a time after the stock market collapse, monetary policy had to pay particular regard to the fragility of financial markets and to the potential tightening of monetary conditions implied by reduced wealth and costlier equity finance. It was partly in this context that interest rates were reduced by ½% in late October, the beginning of November, and again in early December. Yields in the gilt-edged market were also not prevented from falling quite sharply, notwithstanding the need to reabsorb the liquidity created by foreign exchange market intervention. The arrangements to buy back partly-paid BP shares if necessary had also been designed to avoid further damage to confidence in world equity markets. These arrangements came to their scheduled end on 6 January, having served their purpose without a significant quantity of shares having been bought in.

In these circumstances, it was important that the exchange rate should remain firm to counter any impression of monetary ease. In the event, sterling's effective rate changed little over the three months to end-January, having been stable throughout against the deutschemark.

. . . and place a further premium on non-accommodating policy

The fears that accounted for the response to the events of mid-October have now receded; the latest economic and monetary indicators depict a still buoyant economy amply provided with credit, giving little sign so far that the pressures from domestic demand will abate soon. It was with these considerations in mind that interest rates were raised by ½% on 1 February. Maintaining the anti-inflationary thrust of policy will continue to require a non-accommodating stance in the period ahead. This can only be reconciled with the preservation of international competitiveness if domestic costs in the tradables sector of the economy are strictly contained. It will also be important for the preservation of both internal and external balance that the anti-inflationary burden continues to be shared between monetary and fiscal policy.