General assessment

The main focus of attention in the last quarter has been on the domestic economy. While the Budget itself was broadly neutral, it had been preceded by a ½% rise in interest rates in February and a significant rise in sterling at the beginning of March, and was in turn followed by two ½% reductions in interest rates. Together these developments represent a tightening of monetary conditions appropriate to the inflation risks associated with the continuing strength of domestic demand. This Assessment discusses the evolution of domestic monetary policy against the international background of slightly slower growth and continuing unease in financial markets.

Developments in the world economy offer some reassurance, even though financial markets have been unsettled at times . . .

See the Economic Commentary pages 163–8 for more detailed discussion of developments in the major overseas economies.

Although real GNP in the major economies rose less rapidly in the fourth quarter of last year than in the third, growth is now known to have remained strong, confirming the buoyancy suggested by earlier indicators. The first signs are that some of this momentum has carried over into the early part of this year, without being accompanied by higher inflation, although it is unlikely that growth at the rate attained in the second half of last year will continue throughout 1988. The pattern of demand observed so far this year has moved in a generally helpful way. In Japan, buoyant domestic demand, supported by the continuing effects of last year's fiscal measures, has contributed to strong growth. And in Germany the economy may be rather less depressed than suggested by the more gloomy forecasts, though business sentiment remains quite weak and appears vulnerable to further losses in competitiveness. Domestic demand in the United States rose more slowly in the first quarter than in the previous one largely on account of a lower contribution from stockbuilding.

Against this more favourable background, share prices in many countries rose, with the Japanese market reaching new peaks. Moreover the dollar recovered some of its earlier losses, initially in response to further co-ordinated official intervention. More recently, however, markets have been unsettled by the US trade figures for February and by renewed tensions in the Gulf, demonstrating that underlying sentiment, particularly regarding the dollar, remains fragile.

In the United States, the balance between maintaining output growth, particularly achieving the necessary rise in production of tradable goods, and avoiding a rekindling of inflation is a very fine one. The perceived risks have shifted since the turn of the year as some recent indicators have been interpreted as suggesting that demand may be rising too rapidly for inflation to

remain low. The labour market has tightened and the level of capacity utilisation has remained high, especially in export sectors. Encouragingly, however, earnings are showing little indication as yet of a worsening trend, nor are prices generally, although the 0.5% rise in consumer prices in March has aroused some concern.

. . . but further policy action may be required to assist international adjustment . . .

See the note on the Bank's forecasts for the world economy on pages 177–9.

Latest Bank and IMF forecasts suggest that growth of output in the major economies may fall off significantly in the course of the year. In part this slowdown reflects expected developments in the United States, notably weaker growth in personal consumption than in 1987 and a further negative contribution from stockbuilding following the rise at the end of last year. Activity in the United States is, however, likely to be sustained by higher net exports. Growth will probably be only modest in Germany, where the external sector is projected to exert a markedly depressing influence; in Japan, however, the recent domestic demand-led boom is expected to continue. Inflation rates are likely to remain moderate in the major countries. Both forecasts envisage further progress in the reduction of the current account imbalances of the major countries as a proportion of GNP, although Germany's may change little and so remain proportionately the largest of the three. In fact, the more significant counterparts to the expected reduction in the US deficit are likely to be seen in emerging or increasing deficits in some less developed countries, in Canada and in some European countries.

Thus, although the present scale of these major imbalances is widely recognised as unsustainable, current policies are leading to some correction, with domestic demand in the United States rising more slowly than in Germany and much less than in Japan. But this process may not prove strong enough; it is desirable that it should be reinforced by appropriate policy measures in order to avoid unnecessarily sharp adjustments in exchange rates. Such policy reinforcement would involve the maintenance of domestic demand growth in Japan, measures to raise it in Germany, and efforts to tackle the structural problems there which the German authorities have identified as a constraint. In the United States further measures to reduce the federal budget deficit and to promote private savings might become a reality under the next Administration.

While the imbalances remain, they are a source of tension. Another phase of sharp volatility in financial markets could have damaging effects on business confidence. In addition such volatility might exacerbate the fragility which has become apparent in the US financial system in recent years. It was against this background that the Finance Ministers and central bank Governors of the Group of Seven, meeting in Washington in April, re-emphasised their common interest in stable exchange rates and agreed to continue to co-operate closely to that end.

. . . and debt strategy continues on a case-by-case basis

The ministers and governors also reaffirmed their full support for the current case-by-case debt strategy. In fact, pressure on the

most heavily indebted middle-income countries has eased somewhat following the improvement in their terms of trade and the fall in interest rates since last summer. Bank and IMF projections suggest that there is consequently some scope for both a limited growth in their imports this year (even if, as seems likely, new financing remains tight) and some improvement in debt service ratios. Brazil's improving relations with the banks and the IMF, together with its stated willingness to restrict domestic demand and its pursuit of a more competitive exchange rate, are also encouraging signs.

Mexico's attempt to reduce the stock of its debt by inviting commercial banks to swap their claims for bonds at a discount did not, in the event, lead to a significant reduction in the total of debt outstanding and the net interest saving is likely to be small. Nevertheless, the exercise will probably have secured some reduction in the number of banks involved in future concerted loan packages and, judged as an exit bond, it represents a significant advance on that devised for the Argentine package early last year. It has also shown, however, that most banks are unwilling to sell out at anything like the discounts indicated by those secondary transactions taking place for cash, or even by their (generally more modest) provisioning levels. Selling at low prices may not be justified by their current view of the prospects for repayment of the principal.

Rapid growth of the domestic economy continued to the end of 1987 . . .

Until the apparent faltering of industrial output in February, the strength of the domestic economy had exceeded most expectations. GDP grew by a further ¾%–1% in the final quarter of last year, and while there may have been a modest slowing in the first quarter, most of the evidence is against a marked downturn. Domestic demand more than accounts for this growth: consumption remains strong, fuelled by rapidly rising incomes and a continued growth in consumer credit. There is little sign as yet of any increase in the saving ratio from the very low level (4.3%) reached at the end of last year. Possible explanations of the fall in the ratio—of which the most likely is that it is an adjustment by consumers to lower and more stable inflation and better employment prospects—were discussed in the February *Bulletin.* It remains unlikely that the saving ratio will fall much lower and, indeed, it may edge up again in the coming months as Budget tax cuts feed through.

There is also welcome evidence of a widespread, though not universal, resurgence of investment. Investment has been buoyant in the financial sector and in many parts of manufacturing; work on the Channel tunnel will now be adding appreciably to activity, and housing starts have been strong, particularly around the turn of the year. In engineering and related industries, however, investment has been comparatively weak, even though these areas have shared in the general buoyancy of output, profits and capacity utilisation. But the latest survey evidence suggests that engineering is likely to share in stronger investment this year.

Unemployment continues to fall, though at a slower rate, and employment seems still to be growing strongly; ½ million jobs were created in 1987. Fewer young people have been entering the labour force in recent years, but so far this has been offset by

fewer people reaching retirement age. Over the next few years, however, the population of working age will be growing more slowly. Labour productivity growth has continued to be strong, but earnings growth has risen to around 8½% per annum and unit wage costs in the whole economy are growing by about 4½%. With profits also rising fast, total domestic incomes per unit of output are growing by around 5%.

. . . but signs are gathering of reversion to a more sustainable pace . . .

The strength of the exchange rate and the associated improvement in the terms of trade have given a significant impetus to real income growth over recent quarters, in addition to that associated with growth of output. The terms of trade rose by about 3% through last year, adding nearly 1% to real incomes in this country. Fiscal policy has had little net effect: despite cuts in tax rates, the share of tax in GDP has remained unchanged, while public expenditure has fallen in real terms even beyond what would have been expected given the strength of activity in 1987.

The more rapid growth in domestic demand in the United Kingdom than abroad contributed to a deterioration in the trade balance in the second half of last year. Both cost and price competitiveness also deteriorated throughout 1987 as the effective exchange rate firmed, relative unit labour costs in manufacturing were also rising (though on average no higher than in 1986) and profit margins widened. Despite doubts about the effect of new reporting procedures introduced in January and of Channel ferry strikes, it now seems that in the first quarter non-oil imports fell less sharply than exports. It would not be surprising if export volumes were now responding to the earlier loss in competitiveness, but it seems likely, given survey evidence on recent export performance, that the figures overstated the deterioration in the external position.

With the public sector financial deficit declining, although still positive (unlike the PSBR), and a deteriorating current account, the private sector as a whole must be moving towards financial deficit. This would be consistent with the recorded fall in the personal sector saving ratio. There are, however, such large discrepancies between the national income statistics and those of identified financial transactions that the position of the personal and company sectors individually cannot be discerned with confidence.

Clearly there are temporary elements in the current situation, and the course of the economy over the coming year is unlikely to be as favourable as in the past twelve months. The Budget forecast foresees economic growth falling to 2½% between the first halves of this year and next, with domestic demand (especially consumption) growing more slowly and some deterioration in external trade volumes. Growth at this rate should permit further, though slower, reduction in unemployment, as effects work through the labour market. Retail price inflation, currently 3½%, is likely to rise somewhat, to about 4% by the end of the year.

. . . as sterling has risen . . .

The period before the Budget on 15 March saw the re-emergence in acute form of the policy dilemma which had been an

intermittent feature of the preceding year or so. The new economic information coming forward underlined the continued buoyancy of the domestic economy, providing further reassurance that last autumn's stock market crash was not having a marked effect on activity or confidence, but also suggesting that domestic demand growth was continuing to exceed that of potential supply. Meanwhile, M0 had been growing more rapidly and the growth of broad money and bank lending continued high. These domestic indicators, together with developing worries about wage settlements, high company profit margins and rapidly rising house prices, suggested that monetary conditions needed to be tightened rather than relaxed. But despite February's increase, interest rates were still slightly below pre-crash levels. At the same time strong upward pressure on sterling developed, apparently a response of sentiment to the strength of UK public sector finances. Domestic conditions made it inappropriate to reduce interest rates, and the pound rose above DM3 for the first time in eighteen months.

The tax cuts in the Budget involved no significant change in the ratio of tax to GDP and in that sense represented an unchanged fiscal stance. The expectation of continued buoyant revenue permitted the Chancellor to project public sector debt repayment at £3 billion (¾% of GDP) in 1988/89, unchanged from the outturn projected for 1987/88. The size of the fiscal adjustment was within the range considered prudent by the markets, the pattern of tax cuts was seen as helpful to incentives and supply performance generally, and the boost to take-home pay should help to restrain wage and salary settlements.

The foreign exchange market marked sterling up further after the Budget, leading to a reversal of February's ½% rise in interest rates. There was a further ½% cut at the beginning of April; by the middle of that month sterling had risen about 5% against the deutschemark since the beginning of February while interest rates had fallen ½%.

. . . and monetary growth has remained high

Unlike broad money, narrow money, M0, grew less rapidly in the first quarter than in the previous one. Over the year as a whole, though, it grew by 6.4%, above the top of the 2%–6% target range set in the 1987 medium-term financial strategy, but within target if the distortion to the twelve-month growth rate created by the shifting date of Easter is allowed for. The growth of the aggregates picked up sharply in March. For broad money, this profile largely reflected the pattern of the PSBR. Much of the faster growth in lending in the quarter was to companies, and reflected their substantially higher tax bill this year than last. Consumer and mortgage lending rose particularly strongly in March. Building societies' retail inflows have recovered sharply since the stock market crash in October last, easing their funding position and enabling them to regain the share in the mortgage market lost to the banks last year. Buoyant mortgage lending is likely to continue to sustain the growth of money and credit for a while as borrowers anticipate the curtailing of some aspects of mortgage interest relief. The mild weather may also have produced an earlier than usual pick-up in housing market activity, a further factor contributing to the faster growth of house prices seen in the last few months.

The appreciation of sterling since the beginning of the year, both against the deutschemark and in effective terms, represents a tightening of monetary conditions, which has been in part offset by lower interest rates. A net tightening was a necessary response to concerns about potential inflationary pressure, associated in part with the continuing buoyancy of domestic demand and growth of liquidity. It should exert a cumulatively pervasive restraining influence on wage settlements and profit margins, as well as on many import prices. Experience shows that a firm exchange rate can provide an effective counter-inflationary discipline in an open trading economy like the United Kingdom, which remains more susceptible to inflationary tendencies than many others despite the progress made in reducing rigidities in labour and goods markets in recent years. Nevertheless, the combination of a stronger currency and lower interest rates does not represent an ideal response to current concerns and a different balance would be desirable if it could be achieved. Moreover, exchange rate stability remains desirable in its own right, with benefit to industry, and will continue to be sought so far as is possible without jeopardising the counter-inflationary thrust of policy.