General assessment

The world economy has again grown more rapidly than had been expected. This is reflected in a higher level of capacity utilisation in industrial countries and also a higher level of non-oil commodity prices. Both of these developments carry a threat of higher inflation, to which most countries have responded by raising interest rates. The United Kingdom has shared fully in this experience while the growth of domestic demand here has exceeded that both of the major overseas economies in aggregate and of domestic supply. This Assessment discusses these developments and the UK policy response of raising interest rates without provoking an excessive strengthening of sterling. This has produced a combination more compatible with the objectives of policy than was the case three months ago.

The dollar and world activity strengthen . . .

The dollar has risen strongly since mid-June, despite concerted central bank intervention to limit its appreciation against the deutschemark, and at the end of July stood, in effective terms, 5% above the level established in January. This increase has occurred against a background in which the US monthly trade deficit has declined at a faster rate than previously, although this improving trend is less clear for the current account deficit, which widened in the first quarter as the volatile invisibles component deteriorated. The dollar seems also to have benefited from a swing in Japanese sentiment towards US Treasury bonds, whose price was, for a short time, also bid up. Although the recent decline in the US trade deficit has been a helpful development, it may have encouraged over-optimistic expectations of the speed of its continuing fall, and the higher level of the dollar which has resulted may slow the reduction in global imbalances that appears to be under way at the moment.

The upturn in growth in the major overseas economies in the second half of last year gathered momentum in the first quarter of 1988, to an extent not previously envisaged. Once again the strength in activity was widespread and seemed to become more broadly based. There is, however, some tentative evidence that this degree of buoyancy was not fully sustained in Europe and Japan in the second quarter, though in the latter case any slowdown would be from an exceptionally high growth rate. In the United States, growth of personal consumption eased a little in the second quarter, while industrial production accelerated. Activity was sustained by strong growth in the tradables sector, a necessary development if there is to be a lasting reduction in the current account deficit, and by business investment, similarly necessary for sustained growth.

. . . feeding fears of inflation as commodity prices rise . . .

Strong activity will help to reduce unemployment in industrial countries and ease the debt problem in developing countries. Other problems may, however, be intensified. After almost six years of expansion in the OECD area, there is a risk that more rapid growth will stimulate inflation. The incipient pressures associated with tight labour markets and high levels of capacity usage have become more apparent, notably in North America

and the United Kingdom. In Germany and France where growth has been slower and exchange rates strong, at least until January, inflationary pressures generally remain slight.

All countries, however, will have been subject to an inflationary impetus from higher non-oil commodity prices. Following a substantial decline through most of the 1980s, these prices have risen since the beginning of 1987, and accelerated in the first half of this year. Prices of industrial raw materials, notably metals, rose most strongly. Although supply factors have contributed to the increase, the strength of demand in the OECD area, as well as from some developing countries, has become a more powerful influence. More recently, drought conditions in North America have raised food prices, which had previously been more subdued, but their direct effect is not felt by the European consumer as a result of the CAP. As yet, the increase in the prices of commodities has not had a significant impact on inflation rates in the major economies, in part because of the offsetting influence of weaker oil prices this year; but this could change should the new level be sustained.

Recent trends in non-oil commodity prices are discussed further in the note on page 308.

. . . as do interest rates—though indebted LDCs benefit on balance

These developments have been associated with an increase in inflation expectations in many countries, and bond yields have in general risen from their February lows, although for the most part they remain below the levels of the beginning of last October. As the balance of concern has shifted from sustaining growth to restraining inflation, monetary authorities in most major countries have responded by adopting a more cautious stance of policy, reversing to some extent the deliberate easing following the share price fall last October. These moves will contribute to the containment of inflationary pressures, and growth in the major overseas economies may be rather less rapid in the second half of the year.

The unexpected strength of activity in industrial countries, and the accompanying recovery of non-oil commodity prices, has improved the balance of payments prospects and debt servicing capability of many heavily indebted developing countries. Encouraging progress has also been made in Brazil's negotiations with its bank Advisory Committee, the Paris Club and the IMF; and a complex package of rescheduling and new money, reflecting the further evolution of the 'menu approach', has been put to the banks. Nevertheless, some countries, for example Argentina and Nigeria, continue to face acute financing difficulties. As regards the poorest countries, agreement was reached at the Toronto summit to provide debt relief, along lines proposed by the United Kingdom and others; and progress has been made, within the Paris Club, on devising the details of a menu of comparable burden-sharing options from which creditors may choose.

Domestic demand in the United Kingdom is growing faster than abroad—and than output . . .

Recent economic indicators in the United Kingdom point towards continued buoyancy of domestic demand and an associated gradual acceleration of costs and prices. Following an overall increase of 4% last year, and 5% in the year to the fourth

quarter, domestic demand is estimated to have risen by nearly 7% in the year to the first quarter of 1988. Although the extent of any imbalance between domestic demand and output is obscured by the large residual in the national accounts, domestic demand is clearly growing faster than the economy's supply potential. Moreover, these growth rates are consistently higher than those recorded, on average, in the major overseas industrial countries. Indeed, despite some recent acceleration abroad, the gap between domestic demand growth in the United Kingdom and in her major competitors has widened. It is, of course, true that UK supply performance has also improved, with manufacturing productivity rising faster than most of our competitors'; nevertheless, domestic demand has been growing faster than potential supply, thereby contributing to a deterioration in the current account position.

The recent faster growth of demand in the United Kingdom reflects increased spending by both the personal and the corporate sectors. Private consumption growth had been growing even faster than the very rapid growth in real personal disposable incomes (thus depressing the personal saving ratio) for some years. Possible factors underlying the steady fall in the saving ratio, from around 14% in 1980 to only 4½% in the second half of last year, have been discussed in earlier *Bulletins*: lower inflation and the rapid expansion of personal sector borrowing have been contributory influences. Much of the increase in personal borrowing in recent years has been on mortgage, and has been accompanied by rapidly rising house prices—particularly in the last year. This rise in borrowing has been faster since March, perhaps in part a reaction to the Budget announcement of the ending of interest relief on multiple mortgages. Higher mortgage interest rates will in due course raise the already high cost of servicing these large debts and may thus contribute to a recovery, over time, in the personal saving ratio.

. . . as savings recover a little while investment grows apace . . .

The recorded personal sector saving ratio rose to 5¼% in the first quarter although there continues to be a large unexplained residual in the sector's accounts. This recovery largely reflects the exceptional buoyancy of non-wage incomes, especially company dividend payments. Most dividend payments to the personal sector go to life assurance and pension funds rather than households and, although figures are not yet available, on past behaviour it is likely that the rise in the personal sector saving ratio was concentrated in these institutions, with much less of a rise in the household sector saving ratio. The latter ratio has declined fairly steadily through the 1980s and turned negative at the beginning of 1986. While it is not yet established that the downward trend has come to an end, some recovery may have occurred in the second quarter of this year as the effects of the Budget tax cuts will have boosted household sector disposable income, whereas the rise in expenditure is provisionally put at only just over ½% (although subject to revision). Further testimony to the strength of consumer spending comes from the monetary aggregates—notably M0, which rose by over 7% in the year to June, well in excess of the target range. The sensitivity of demand for M0 to interest rates means that, given their higher level, its growth should moderate in due course.

The strength of the public sector's financial position is, however, a rather more encouraging development, as is the recent recovery of investment spending. In part this reflects a construction boom, particularly in housing, but business investment also rose 10% last year, and was very buoyant towards the end of the year, especially in financial services. Manufacturing investment is also showing signs of recovery and is estimated to have increased by 3% in the first quarter of 1988. Surveys have suggested that this is likely to continue, and will include some expansion of capacity as well as the substitution of capital for labour. Despite recent increases in interest rates, real rates of return on physical assets still exceed those on financial assets, and buoyant expectations on the part of businessmen, high levels of company profitability, and rising levels of capacity utilisation all point towards increased investment spending.

. . . but pressure on capacity increases and labour costs accelerate . . .

Higher investment is, of course, an essential development if the improved supply performance is to be sustained. Pressures on capacity have recently intensified in many industries and this might lead to slower output growth, and higher inflation, especially should the investment recovery not continue; but the most recent monthly industrial and manufacturing production figures, and the evidence of the latest CBI survey, suggest that capacity constraints, on the whole, are not yet acute. Although there are skill shortages, and employment is rising steadily, there is scope for fuller utilisation of labour. The failure of output to keep pace fully with demand probably owes more to the rapidity of the latter's growth.

According to the Halifax Building Society, house prices, having risen 20% last year, are now rising above that rate and the ratio of house prices to average earnings is approaching the peak reached in 1973. CBI figures for the first quarter of 1988 indicate that wage settlements are continuing rather higher than last year, both in manufacturing and in other parts of the economy. Earnings figures published by the Department of Employment show that earnings growth is also higher than last year, although when the effects on earnings of increased overtime are taken into account fears may be somewhat allayed. It is important, however, that, if productivity slows as growth reverts to a more sustainable rate, settlements should moderate to contain the increase of unit labour costs. Higher unit labour costs, admittedly, might not feed through fully to higher prices if profit margins, which have expanded quite rapidly in recent years, were now to be trimmed somewhat. It seems unlikely, though, that margins will absorb all the pressure of generally rising unit labour costs, especially if the latter are accompanied (as suggested by the recent monthly figures) by faster rises in material input prices associated with higher non-oil commodity prices. Taking these indicators together, it seems that the evidence is pointing towards some further rise in inflation over the period ahead.

. . . underlining the appropriateness of a firm counter-inflationary stance

The appreciation of sterling earlier in the year represented a tightening of monetary conditions, but one which was largely offset by lower interest rates. The combination of a stronger currency and lower interest rates did not represent an ideal

response to concerns about excessive growth of domestic demand, but, at the time, market sentiment was such that higher interest rates would have led to undue upward pressure on sterling. Since May, however, the pressure on sterling has been less acute, latterly because of the strength of the dollar, but also in response to the trade figures for May. These changed market conditions allowed a tighter policy stance through higher interest rates. At the end of July interest rates were 3% above their low point in May, with the effective exchange rate at 76½, close to the level at the start of the year when the US dollar was at its low. This tightening of policy was necessary in the light of the emerging inflationary pressures discussed above.

See the article 'Trends in real rates of return' on pages 376–81.

There has been an improvement in the rate of return on capital in the United Kingdom which will have tended to attract an inflow of long-term capital and may have been a factor in upward pressure on sterling earlier this year. The pound weakened, however, on publication of the May trade figures, which took the cumulative deficit for the year to £4.7 billion, three times that for the whole of 1987, but was resilient in the face of a further billion pound deficit in June. As explained in the Commentary (see pages 321–2), the trade figures almost certainly exaggerated the deterioration but the underlying movement into substantial current account deficit has largely reflected rapid growth in UK domestic demand, accentuated by a strengthening of sterling.

The tightening of monetary policy in recent weeks will exert downward pressure on inflation and on the growth of domestic demand. This will in turn tend to make for a reduction in the current account deficit. Faster growth of demand abroad would help to limit any further widening of the deficit, but if this were accompanied by a build-up in inflationary pressures in other countries, as well as in the United Kingdom, it would be of little comfort. An improvement in competitiveness could no doubt also make a contribution to lowering the deficit, but if this were to be achieved by a lower exchange rate or higher inflation abroad, as opposed to a reduction in the growth of UK unit labour costs, the upward pressure on inflation would be further aggravated. In order to achieve a simultaneous reduction in the current account deficit and the rate of inflation, it will be necessary for the rate of growth of domestic demand to slow to less than that of productive potential. It is unlikely that this would occur sufficiently rapidly had policy not been tightened.