General assessment

Growth abroad is now moderating but for the year as a whole is likely to exceed expectations substantially. Although the US trade deficit has fallen, the improvement may be slowing and less of the counterpart lies in reduced German and Japanese surpluses than had been hoped. Weaker commodity prices mean that the external inflationary pressures on industrial countries have lessened, though the difficulties of indebted commodity producers remain severe. Against this background the supply performance of the domestic economy has been remarkable. Output continues to grow rapidly, although less so than domestic demand, and shows little sign of faltering. Earnings have accelerated but much of this has been offset by strong productivity growth. This Assessment considers the recent tightening of policy designed to rein back domestic demand and reverse the worsening of inflation, and examines the signs that it is working, not least through the housing market.

Growth has moderated, despite strong investment, and policy has tightened slightly . . .

Activity in the major overseas economies appears to have slowed in the middle of the year from the very rapid rates of late 1987 and early 1988 towards a more sustainable pace. This process has been supported by a tightening of monetary policy in most countries amid some signs of emerging inflationary worries. Nevertheless, output in the major economies may be 4% higher in 1988 than in 1987, well over one percentage point more than expected by most forecasters at the turn of the year.

The main element in the much stronger performance has been a surge in business investment, which may increase by some 12% in the major economies this year. Better profitability, pressures on capacity in some countries, and greater confidence among businessmen, arising from a more stable planning background of low inflation and reduced exchange rate volatility, have all played their part. This strong investment is welcome, as it adds to productive potential and improves prospects for non-inflationary growth; but, in the short run, capital goods producing sectors may themselves face capacity problems.

Excluding the effects of the drought, the US economy grew in the first half year at a rate slightly above that widely believed to be sustainable in the medium term, but it slowed in the third quarter. While the balance of demand has been favourable, with exports and investment the main engines, consumer spending has remained relatively robust. The trade account has improved, although the invisibles balance has deteriorated as net external debt has grown. Despite a setback in August, the current account deficit is likely to be some $20 billion or so better this year than last. Consumer prices remain subdued but there are signs of growing labour and cost pressures, and the widest measure of domestic inflation, the GNP deflator, rose markedly in the second quarter. The tightening by the Federal Reserve has helped to contain these inflationary threats, but fiscal action to promote higher national savings must be a high priority for the next Administration.

. . . as payments imbalances of the major countries change little . . .

Despite the slowdown recorded in the second quarter, the Japanese economy continues to make good progress. The labour market is very tight but wage inflation, although rising, remains relatively moderate. With import prices still below the levels of a year ago, a significant pick-up in inflation does not seem imminent. Although market interest rates have followed the international trend to some extent, the Bank of Japan has not altered the discount rate. Strong domestic demand continues to suck in imports rapidly, but exports remain fairly resilient and there are early indications in the third quarter that the current account surplus may be about to stop falling.

In Germany, the current account surplus widened significantly in the second quarter to a new high. Although growth has been much more robust than earlier feared, the positive external contribution in the second quarter is unhelpful. Much of the counterpart to the widening German surplus lies in other European countries. This may in part reflect the comparative advantage of German industry in supplying capital goods at a time of strong investment growth.

Against this more favourable world economic background their commitment to stability of exchange rates was reaffirmed by the G7 in Berlin. The counterpart to the reduced US deficit in the first half year was not, however, as hoped, a significant reduction either of the Japanese surplus, or of the German surplus (which was, if anything, growing). If these surpluses persist, world growth might slow as countries with rising deficits, the United Kingdom among others, take action to restrain demand.

. . . while lower commodity prices should help to reduce inflation worries

Partly as a result of slower world growth, external inflationary pressure from commodity prices has eased; spot prices, which rose strongly in the second quarter, fell back by some 11% in SDR terms through the third quarter. The external inflation picture has also been altered by the weakening oil market, with a breakdown of production discipline causing an excess supply of oil. A period of significantly lower oil prices would give further terms of trade gains to industrial and commercial sectors in most of the major economies which would boost growth prospects. The experience from 1986, however, suggests that the initial impact might be contractionary, as finance-constrained oil exporters reined back on imports more quickly than those who benefited expanded their spending. These influences, though generally benign for the developed world, are less auspicious for indebted developing countries—particularly those exporting oil.

The recent agreement concluded by Brazil with the commercial banks illustrates the contribution new financing options can make to the rescheduling process. One of these, the conversion of some of the existing exposure into lower-interest 'exit bonds' (which are intended to absolve the lender from participation in future restructurings), leads to a reduction of debt service obligations. With its enhanced opportunities for creditor banks to engage in local business, and other features, the agreement accommodates a wide range of differences in creditors' expectations and objectives.

At the IMF/IBRD Annual Meetings in Berlin, G7 governments acknowledged the potential contribution of market-based debt reduction to alleviating debt problems, and continued to reject any transfer of risk from the commercial banks to the official sector. Nevertheless, official multilateral and bilateral creditors have been making an increasing contribution to the overall financing requirement of many debtor countries. Agreement has been reached by the Paris Club on a package of concessional terms for the rescheduling of the debt of the poorest sub-Saharan African countries. The size of the benefits from this package depend on the choice of option by creditors. Most of the major creditors have indicated that they are prepared to reschedule on terms that reduce debt service obligations and the first reschedulings under this agreement have recently been concluded.

At home, domestic demand outpaced supply in the first half of the year . . .

It is now apparent that supply performance in this country has remained remarkably strong this year. Earlier indications that output growth was slowing proved unfounded; the output measure of GDP grew by 2½% (not annualised) in the first half of the year, and productivity—particularly in manufacturing—has continued to rise exceptionally strongly. Industrial production, for which more up-to-date information is available, continued to rise fast in the third quarter despite some signs that the even faster growth of domestic demand was peaking. The unsustainability of demand growth was reflected in greater inflationary pressures and, despite strong export performance, a rapid deterioration in the trade balance.

The rapid growth of domestic demand in the first half of the year was not fully reflected in the expenditure measure of GDP, which fell short of the more reliable output measure and was almost certainly understated. Consumers' expenditure is recorded as having grown only modestly in the second quarter, but more strongly in the third, and the evidence from retail sales, earnings growth and consumer borrowing, not to mention imports of consumer goods, all suggests that consumer demand was actually strong in the first half of the year. It probably received a temporary fillip from the buoyant activity in the housing market in the period immediately prior to the abolition of multiple tax relief on mortgages (which will have contributed to the subsequent slowing of retail sales). The associated borrowing will have depressed the personal saving ratio yet further. But the growth of domestic demand does not reflect consumption alone. Companies too have contributed to its strength and it is clear that the United Kingdom is experiencing an investment boom which may well result in a growth rate in industrial investment in double figures for the year as a whole—in line with the results of surveys conducted earlier in the year.

. . . increasing inflationary pressures . . .

The excessive pace of domestic demand, if allowed to persist, would have serious inflationary consequences. This danger is perhaps most visible in the labour market, where the growth of whole-economy average earnings has edged up further to 9¼%. Most of the increased growth has been due to settlements, which seem to have picked up since the spring. Wage drift remains at

about 2% per annum, and is unlikely to fall by much, even if output growth slows from its recent exceptional pace. Productivity has risen so strongly that, despite the growth of earnings, whole-economy unit wage and labour costs have not accelerated significantly, and in manufacturing they remain particularly subdued.

As raw material prices have also receded, the continued rise in manufacturers' output prices of about 5% per annum is probably a reflection of a further widening of profit margins in the face of buoyant demand. The prospects for inflation, which was pushed up to 5.9% by the mortgage element in the retail price index in September, but has risen above 5% even in underlying terms, thus depend crucially on the extent to which productivity growth can be sustained, or earnings growth slowed, or profit margins narrowed, as domestic demand slows. While there is some scope for a squeeze on profits, it is hard to imagine that process going far without damaging consequences for investment.

. . . and worsening the current account . . .

The most visible sign of the imbalance between demand and output has been the rapid deterioration in the current account, which has continued in the third quarter. The overall deficit for the third quarter, over 3% of GDP, was dominated by July's record deficit, and the monthly estimates since then have shown some improvement. The sharp fall in September's deficit was largely matched by a favourable movement in the balance on erratic items, which had been depressed in August. The deterioration recorded in the trade balance this year has occurred even though manufactured exports have performed well. The deficit is clearly the counterpart of a gap between private sector saving and investment, which should narrow in response to the higher interest rates now ruling.

. . . leading to tighter policy

The 2¼% rise in interest rates over the average of last year, coupled with a 5% rise in the ERI on the same comparison, gives a clear indication of the tightening of policy; moreover, the fiscal position has been much stronger than expected, by at least 1% of GDP. Recent mortgage rate increases will raise the outgoings of mortgage borrowers and leave them less to spend on other things, and perhaps make them less willing to incur more debt in this or other forms. Some borrowers will be protected for a while, because their mortgage payments are fixed for a year at a time; but most will pay the increases in the next few months. Even though building society and bank depositors will benefit from higher interest rates, the net impact on personal disposable income will be negative. In the meantime the number of new mortgages being agreed and (in September) lending itself have slackened by more than the ending of the surge in borrowing to beat the August deadline for multiple mortgage tax relief alone would have suggested. While there is little comfort to be had from the national figures of house prices for the third quarter (which accelerated to a twelve-month increase above 30%), there is evidence of fewer houses changing hands and of those taking much longer to sell. If fewer people move house, that should mean lower demand for associated goods—furniture, carpets, white goods and so on. And if house prices rise more slowly, there will be less net cash withdrawal—particularly by last-time sellers.

The monetary statistics show as yet no sign of deceleration; bank lending as a whole, despite the falling off of mortgages, remains strong, which is consistent with other evidence of buoyant business expenditure. The acceleration in M0 in September reflected the effects of the postal strike, but fast underlying growth suggests continued strong growth in nominal demand through the third quarter.

The rise in short-term interest rates is not expected to have a significant direct effect on investment spending. Long-term interest rates have risen much less; the rate of return on real assets remains high; and so far business confidence seems remarkably robust. It cannot, however, be excluded that investment may become a little less buoyant than had been foreseen, if consumption demand shows clearer signs of weakening.

It is still too early to be sure that the policy tightening that has occurred will prove sufficient to restore the economy to a sustainable path. Successive mortgage rate increases may eventually have a big effect on the housing market and on consumption. A reminder that house prices may fall as well as rise would be salutary, but too sharp a slowing of consumption, if it led to a contraction in investment, would be more serious. The behaviour of inflation will be crucial to the evolution of the stance of policy. Some narrowing of profit margins, smaller pay rises, and exchange rate stability would all be features of the most favourable case. Containment of unit costs requires that output growth fall much less than the slowing required of domestic demand—in which case the trade balance would also improve. The most recent movements of industrial production and retail sales are encouraging in this respect, but inflation is likely to rise further before it peaks and policy will need to remain restrictive until there are clear signs that inflationary pressures are abating.