General assessment

In general, the international economy continues to perform more strongly than expected, as it has since the end of 1987, but worries about inflationary pressures have led to policy tightening in several countries and this, along with other factors, points to a slowdown in growth this year. However, recent forecasts have proved fallible and, if growth does not recede, inflation could pick up. Partly because of these inflationary concerns, expansion outside the United States is not seen as a source of relief to the US balance of payments, and further progress in reducing the major international payments balances will depend on prudent US policies. At home it is now apparent, despite defects in the statistics, that demand was stronger last summer and autumn than was thought at the time. This contributed to the pick-up in inflation seen last year, despite excellent productivity performance. This Assessment reviews these issues as they contributed to the decision to raise interest rates further in November. The tightening of policy last summer led, after a lag, to a slowing in the growth of money and credit, and there are now welcome signs that the effects are spreading to the wider economy. The full effects both of the earlier and the more recent tightening are bound to take time to come through; meanwhile policy has to remain cautious.

Growth abroad has continued to exceed expectations . . .

Recent developments in the major foreign economies tend to confirm the generally more favourable picture of the international economy that emerged last year. Output rose sharply in the third quarter following a pause in the second, and later data suggest continued relatively robust growth. Consumer price inflation rose slightly in a number of countries through last year, but on average has remained moderate. The inflationary tensions apparent in the first half of the year associated with the sharp rise in non-oil commodity prices eased somewhat in the second half, and falling oil prices reinforced this tendency. Inflation may also have been restrained in some countries by the strong growth in productivity over the past year, probably reflecting buoyancy in activity. Towards the end of the year, however, some external pressures re-emerged as non-oil commodity prices rebounded, in part reflecting the continued strength of demand, and as oil prices rose, reflecting somewhat greater OPEC cohesion.

The strength of output is to be welcomed, but only if it remains consistent with the maintenance of low rates of inflation. The duration of the current period of growth is not in itself a reason for expecting its imminent demise, but capacity pressures are becoming more apparent in the major economies, if to differing degrees. Judgements as to the precise extent of spare capacity, and more generally the rates of output growth likely to be consistent with the absence of inflationary pressures, are notoriously difficult to make, particularly in view of the effect on capacity of the recessions of the 1970s and early 1980s and the subsequent restructuring. In nearly all countries the trend growth of capacity output seemed to fall sharply between the 1960s and 1970s. Few countries have seen a subsequent recovery in performance as good as that in the United Kingdom.

. . . but some slowing is now in prospect . . .

Despite uncertainties about underlying trends, the authorities in a number of countries have tightened monetary policy in response to a perception, supported by a number of indications, that output growth since 1987 had exceeded that of capacity, and that the threat of inflation was therefore increasing. A slowing of growth in the major overseas economies this year has been a central feature of a number of recent forecasts, including those by the OECD, the IMF and the Bank, all of which allow for some policy tightening; they also agree that a substantial upturn in inflation is unlikely. These forecasts present in many respects quite a comfortable picture.

The Bank's most recent forecasts of world economic prospects are summarised in the November 1988 Bulletin, *pages 482–3.*

If, despite the monetary tightening that has occurred, growth does not weaken, inflationary pressures might become more significant in some countries, not least the North American economies, and further action would then be necessary to combat and indeed reverse its upward creep. Policy-makers need to err on the side of caution until there is firm evidence that growth has slowed to a more sustainable rate. Judging whether or not to tighten the monetary stance in a particular case is inevitably difficult, as responses are uncertain in timing and magnitude and indicators often conflict. Raising interest rates by too much would add to fragilities caused by high levels of domestic and international debt.

. . . as demand patterns have failed to curb imbalances

Although the pattern of domestic demand growth among the major economies probably made some contribution to the adjustment of payments imbalances between the United States, Germany and Japan last year, its magnitude is likely to have been only limited, and weakened towards the end of the year as external adjustment slowed. Even in Japan, where the strength of domestic demand expansion was particularly opportune, exports were surprisingly strong and the surplus fell by little in dollar terms, although by more as a proportion of GNP. The pattern of demand growth in Europe was less helpful. The rise in domestic demand in Germany was much the same as, or less than, in its major European trading partners, and may slow further this year (on account of the tax increases implemented by the German authorities), with implications for the current balance. With the favourable competitiveness effects of the substantial decline of the dollar in the three years after the start of 1985 now wearing off, and US domestic demand still fairly strong, the US trade deficit has ceased to improve in recent months. Although in 1988 the growth in domestic demand of its competitors probably exceeded that of US domestic demand more strongly than for some years, this gap was not large and needs to widen further if the US current account deficit is to fall to more sustainable levels, not least because of the large existing gap between imports and exports.

Sustained strong non-inflationary demand growth in competitor countries is helpful in providing opportunities for US exporters to expand sales further. Nevertheless, given existing trade patterns, most of any additional stimulus to domestic demand in these countries (taken together) would increase pressure on their own production, with only a small proportion being supplied from the United States. Thus expansion on the scale needed to offer significant relief to the United States would involve unacceptable inflation risks. In fact, forecasts suggest that growth in US export markets is more likely to slow. Higher US saving and slower growth in US domestic demand, together with continued moderation in costs to improve competitiveness, are therefore the key to more substantial reductions in the US deficit. The prospect of a tighter US fiscal stance is important in achieving this aim and would provide welcome support to monetary policy.

Trade negotiations have made little progress

Further progress towards orderly adjustment of the still large imbalances between the largest economies will be necessary to keep at bay the rising protectionist pressures which, although not reflected in general tariffs, have been a notable feature of the past decade. Nations which are members of the GATT are meanwhile engaged in multilateral negotiations to liberalise trade further, strengthen the rules against protection and extend them into new areas, including agriculture and services. It is important to all countries with an interest in free trade that these negotiations make steady progress towards the goals set in Uruguay in 1986. Even in the relatively favourable international economic environment of the past year it has, regrettably, proved difficult for the leading protagonists—the United States and the EC—to overcome their starting differences, and an impasse was reached over agriculture at the Montreal meeting in December.

Progress seems to be held up at the moment because each side expects the other to lead with concessions. This may be a misguided approach, not merely tactically. It is possible to point to cases where even unilateral lowering of trade barriers brings advantages in the face of restrictions elsewhere. For example, the freedom of access which this country has for many years offered to foreign firms to supply banking and other financial services here has benefited consumers of these services in the United Kingdom and elsewhere and boosted the development of the UK financial sector. Other countries with emerging financial skills and resources have seen the wisdom of this approach and are following suit. Although the parallels with other kinds of trade may not be close, there is perhaps a moral here for trade negotiators in the United States and the EC who, under pressure from producers, are reluctant to be the first to move; and also for the poorer participants in the process.

UK interest rates rose to curb domestic demand . . .

The deficiencies in the UK official statistics intensified in the third quarter. While the sum of the recorded components of domestic demand implied growth of over 3% on a year earlier, the CSO felt that the implied fall in GDP was sufficiently implausible to be excluded from the calculation of the average measure. According to the more reliable output measure, third quarter non North Sea GDP was 6¼% higher than a year earlier, and if—to go to the other extreme—the whole of the residual error in the accounts were attributed to domestic demand, that would be up by more than 8% in the same period.

The strength of demand contributed to the pick-up of inflation. Excluding mortgage costs, the twelve-month increase in the RPI rose from 3.7% in January 1988 to 5.1% in October (as also in

December). Manufacturers' output price increases also drifted up through the year, but more gently. Until the end of the year the increase nevertheless exceeded that of either material inputs or unit labour costs which had been restrained by continuing productivity growth of about 7% per annum. Despite this productivity growth, UK manufacturers have had more rapidly rising unit labour costs (in local currencies) than most major competitors, reflecting the rapid growth in average earnings of employees in UK manufacturing, which rose in underlying terms by almost 9% in the year to October (and only slightly less to November). The rise in profit margins through the year reflects producers' response to buoyant demand. In services the role of earnings growth (at around 9%) in driving up costs and prices in the private sector has been greater—though the measurement of productivity in these sectors is more difficult.

In the fourth quarter of last year it became apparent that domestic demand had been growing even more rapidly than had been recognised when interest rates were raised in the summer. The opportunity was therefore taken to raise rates by a further 1% when October's disappointing trade figures were announced on 25 November. At 13%, base rates were then 4½ percentage points higher than at the beginning of the year. Sterling was initially marked up and proved resilient against European currencies despite ½% increases in some continental interest rates in mid-December and mid-January. It ended 1988 4% higher in effective terms (on the new index) than it opened. The rise in interest rates last summer contributed, after a lag, to a deceleration of narrow money and the slowing of lending—particularly for house purchase, but also for consumption—towards the end of the year. Broad money also slowed slightly.

. . . with effects spreading into the real economy

With a longer lag, the tightening of policy last summer does also seem to be having an effect that is spreading beyond the housing market. Just as house prices flattened out first in the South East, retail sales also seem to have slowed there first, and to have been subdued nationally over the Christmas period. Smoothing the current balance between September and October (between which the allocation had been distorted by the postal dispute) produces a deficit in the fourth quarter very similar to that in the third, which suggests that it may have stabilised. Only if the improvement through this year were even more rapid than the deterioration through last year, however, would 1989's deficit be lower than 1988's £14 billion.

The main effects of the sharp rise in interest rates through the second half of last year and the mortgage rate increases announced in January (and the earlier increases, which have still to be reflected fully in some borrowers' payments) should become apparent within the next 3–6 months. A slowdown in consumers' expenditure, possibly quite marked, is likely. The uncertainties reflect among other things the unprecedented extent of the personal sector's move into deficit over the past few years, which has been much larger than most observers predicted. It is reasonable to expect that the effect on expenditure of a given change in interest rates will be larger now than in previous years, because households are on average more heavily geared, and because the proportion of floating to fixed-rate debt has risen considerably in recent years. Recent research done in the Bank supports this conclusion and, like similar research elsewhere, points to a heightened response to short-term interest rates. Companies are more likely to be influenced by longer-term borrowing costs (which have risen little), and, given their much improved profitability and current utilisation of capacity, investment demand should hold up. As growth slows, profit margins should narrow, however, and the consequent restraint on prices should in turn reduce pressure for higher pay and help to contain costs.

See 'The interest elasticity of consumers' expenditure'. Bank of England Technical paper, no 20.

The medium-term orientation appropriate to fiscal policy puts the onus of shorter-term adjustment to unanticipated developments on monetary instruments. The use of monetary policy was particularly appropriate in 1988 when the unexpected element was the strength of domestic demand financed by reduced saving and, especially, enlarged borrowing—which higher interest rates should remedy. Moreover, it was areas in which heavy mortgage borrowing had fed demand for housing, pushing up its price, that were likely to prove most sensitive to interest rates—and so it has proved. Fiscal policy, in terms of the scale of debt repayment, in the event proved to have been tighter than expected. This is owing to both lower public expenditure and higher revenue as a proportion of national income.

The evidence to date does not suggest that policy has been tightened too much given the priority of securing the predicted downturn in inflation. This consideration also suggests that the authorities should remain cautious until the indicators provide stronger evidence that the slowdown is under way.