General assessment

Activity in the major economies has continued to exceed expectations as the effects of a general tightening of monetary policy last year take time to work through. In the meantime inflationary pressures have intensified, leading to further rises in interest rates in the United States and Europe this year. Oil prices have risen sharply, while other commodities are only a little off their peak. This Assessment considers these developments, proposals for the next steps in handling ldc debt and the United Kingdom's domestic situation. The picture of the UK economy in 1988 is now clearer, with better-identified demand components and a more plausible profile for savings. Labour costs are, however, now rising more rapidly. Together with uncertainty about the precise effects of earlier policy steps, the picture of strengthened demand and higher cost inflation warranted a cautious Budget. Monetary policy also has to remain restrictive.

Policy has been tightened internationally in response to widespread inflationary pressures . . .

In most of the major industrial countries there are only tentative signs of the effects of the tightening of monetary policy during the past year. In general, growth has continued robust, although there are emerging indications of some deceleration in the United States and (more clearly) in the United Kingdom where action began earlier. Much of the tightening has occurred only in the last two quarters, as it became apparent that momentum was even stronger than expected and the inflationary threat greater, and it will take time for the interest rate increases to have their full effect.

Inflationary pressures have intensified recently in the major economies. Measures of capacity utilisation are now at or even above the peaks of the late 1970s. Unemployment has fallen to a fifteen-year low in the United States and to the levels of the early 1980s in Japan and Canada; and even in continental Europe, where unemployment rates remain historically high, labour markets have tightened. Non-oil commodity prices rose again at the end of 1988 and have fallen back only modestly. With relatively low levels of stocks, prices remain vulnerable to supply shocks or continued strong growth of demand. Oil prices have risen quite sharply during the past six months as cutbacks in OPEC output gained credibility, and supply has been subject to a series of disruptions. Moderation of demand, and the additional supply capacity expected to come on stream later in the year, may cause prices to fall back, but some of the recent strength has yet to feed through fully into output prices in the major economies—as is also the case for non-oil commodities. In

response to exceptional demand growth, consumer prices have risen almost 4% in the latest twelve months in the major six overseas economies as a group, compared with an average of 3% in 1988. The short-term prospect is for further edging up, until the pace of demand growth clearly recedes in response to the tighter stance of policy.

The Bank's latest forecasts of world economic prospects are summarised on pages 198–9.

... and needs to remain firm for a time, both in the United States, where there are local debt concerns ...

Governments in the industrial countries are alive to the dangers of inflation and at the recent Washington meetings reaffirmed the importance of its control. Although the tightening of policy that has occurred should be sufficient to slow the growth of demand and output to a more sustainable rate, it remains to be seen whether this will be enough to reverse the rise of inflation quickly. The prevalence of flat, or even downward sloping, yield curves is consistent with expectations that in the longer term policy will succeed in reducing inflation. Firm policy will also give signals to wage bargainers that faster increases will not be accommodated. Some pick-up has occurred in the rate of wage inflation, but to date the increases have been relatively modest despite the tightening in labour markets.

Amid signs that inflationary pressures in the United States had increased, the Federal Reserve tightened monetary policy again at the end of February, emphasising its resolve to counter the threat, despite concerns about domestic and international debt. These concerns have been separately addressed by the US authorities. At the beginning of February a wide-ranging plan was proposed to resolve the problems of the savings and loan industry, including the issue of $50 billion of bonds (through an off-budget vehicle) to finance the liquidation and sale of insolvent thrifts. In addition, procedures have been put in place by bank regulators to increase the monitoring of corporate borrowing. The wider aims of US policy would be more satisfactorily achieved if specific actions which commanded the respect of the markets were undertaken to reduce the fiscal deficit along the lines of the Gramm Rudman Hollings legislation within the framework recently agreed between the Administration and Congress.

... and in the other major countries, including those in external surplus

In the major surplus countries the macroeconomic policy stance appears broadly satisfactory. In present circumstances firmer monetary conditions in Germany (where interest rates were raised by half a point in mid-April) and Japan (where short-term market rates have tended to edge up recently) simultaneously bear down on domestic inflation and can help to sustain an appropriate pattern of exchange rates (to which the Group of Seven countries have restated their commitment) between the dollar and other major currencies. Structural policies also have an important contribution to make. Although, as in deficit countries, the primary aim of the continuing process of structural reform is to enhance efficiency and flexibility and to increase the rate of sustainable non-inflationary growth, some structural measures may also help to promote external adjustment. As

reaffirmed in Washington, the full benefits of international competition will only accrue if the trading system is liberalised further. The recent resolution of the difficulties that arose in the mid-term review of the Uruguay GATT round is a very welcome sign, though difficult negotiations still lie ahead. Welcome too is the European Commission's clarification last month of the proposed reciprocity provisions in its Second Banking Directive, which should go some way to allay fears that the Community's market in financial services will be other than liberal and outward-looking after 1992.

New initiatives are being considered to lighten the burden of debt repayment by less developed countries

In the short run the policy tightening by industrial countries will aggravate the problems facing debtor countries in Latin America and elsewhere, but new initiatives to lighten the burden of servicing their debt are being considered. The proposals by the US Treasury Secretary (see also pages 186–7) build on the approach emerging from last September's IMF-IBRD Annual Meetings in Berlin. An increasing role for voluntary, market-based debt reduction (such as debt buybacks, debt-for-bonds exchanges at a discount, and debt/equity swaps) was then acknowledged, with the proviso that there should be no transfer of risk from the banks to official creditors. A central part of Secretary Brady's proposals is the suggestion that money from the international financial institutions (IFIs) might be linked more explicitly than hitherto with debt reduction where there were fundamental and convincing economic reform programmes. The institutions might also provide some limited support for debtors' interest payments in cases of concessionary debt restructuring; commercial banks would contribute by forgiving a portion of their claims in exchange for such support, or by withdrawing at a discount. The compatibility of these proposals with the spirit of the Berlin communiqué depends on the precise terms offered: it can be argued, for example, that the greater the reduction in commercial bank claims, the better are the chances that remaining debt, including obligations to official creditors, will be fully serviced. It was subsequently agreed at the Washington meetings in April to set aside a portion of existing funds available from the IFIs to facilitate debt reduction for countries undertaking sound economic reforms, and to examine closely proposals for interest support. It was stressed, however, that official creditors should not substitute for private lenders.

The balance of advantage to banks in forgiving their claims depends very much on the particular circumstances. To the extent that debt reduction stimulated higher rates of investment, it could increase debtors' capacity to pay, possibly to such an extent that the banks were better off in the long run. The emphasis in the new proposals on strong economic programmes and attracting non-debt sources of capital, such as direct investment and a reversal of capital flight, should also help towards this end. Were, however, additional resources to be spent on consumption, debt relief might be seen as encouraging the profligate, with detrimental effects on the incentives for countries which hitherto have faithfully serviced their debts. The proposals have already aroused considerable, and probably unrealistic, expectations among debtors regarding the scale of relief on offer. It will be important to establish firm ground rules quickly so that

substantive negotiations between individual countries and the banks can begin.

At home, the extent of the exceptionally rapid growth of domestic demand last year is now clearer . . .

National accounts statistics released around the time of the Budget present a rather more coherent picture of last year's developments in the economy and reinforce the impression of exceptionally strong growth of demand and output for much of the year—particularly in the third quarter—as also in the preceding year. The expenditure figures show rapid (7%) growth of domestic demand in the year to the fourth quarter, rather closer to the path implied jointly by the output measure of GDP and the trade figures. The upward revisions to demand earlier in the year were concentrated in fixed investment, now estimated to have increased by nearly 12% in the year as a whole. This more buoyant profile for investment is more consistent not only with survey evidence but also with the perception of high corporate profitability, high utilisation of existing capacity, and rapid growth of imports of capital and intermediate goods. Moreover, as pointed out in the CSO's investigation into balancing the United Kingdom's national and financial accounts, the unidentified element in the corporate sector's accounts suggests that fixed investment has been consistently underrecorded.

. . . and it is apparent that personal incomes rose more rapidly than thought earlier

Incomes in the personal sector are now estimated to have risen by over 10% last year and real disposable incomes by nearly 5%. As with expenditure, these new income figures seem more plausible than the previous, lower, estimates in several important respects. Upward revisions to income from employment are consistent with the preliminary results of the 1988 Labour Force Survey, which found that employment had grown considerably faster through 1987 and 1988 than previously thought. In conjunction with lesser revisions to consumption, they also imply a rather higher personal saving ratio than previously estimated: the downward trend over the past five years is still apparent, but the new figures suggest much less of a fall in the personal saving ratio to the middle of last year; and the latest figures show a small rise between the third quarter and the fourth. This profile may reflect the effects of rising inflation and the tightening of monetary policy in the second half of 1988. Despite the sustained fall in the personal saving ratio, personal sector wealth has roughly doubled in real terms since the start of the decade. This reflects rising asset prices, and makes the fall in measured savings less surprising; indeed it may partly explain it, although the evidence is not clear cut.

Company profits, though revised down, were also generally strong last year; while underlying profitability remained high compared with preceding years, non North Sea industrial and commercial companies' trading profits actually fell a little in the fourth quarter, as output growth decelerated and margins came under pressure. Such was the momentum of their fixed investment and stockbuilding that these companies moved quite heavily into financial deficit in the quarter, for the first time on any scale since the early 1980s. This could augur less well for a

continuation of the marked and prolonged investment upswing, though reported intentions are holding up. The expenditure measure of GDP still shows a distinctly smaller increase in the year as a whole (2½%) than the income and output measures (4¼%–4½%). It is therefore possible that certain components of expenditure could be revised up yet again at some stage.

The extent of the slowing of demand this year is not yet clear . . .

Data for the first months of 1989 support the view that domestic demand has been slowing, although to an extent that is not entirely clear. Having dipped in January, retail sales bounced back in February and were flat in March but trend growth seems virtually to have ceased since last October. Borrowing by the personal sector, particularly borrowing on mortgage, fell away after last August but recovered somewhat in March. While the trend in import volumes has continued to be strongly upwards, growth in the first quarter was faster in capital and intermediate goods than consumer goods. Manufactured exports have also performed well, which suggests that the problem continues to be one of excess demand rather than competitiveness, despite the fact that the revised labour cost figures are higher than had been thought.

There is, for the time being, little good news on inflation; wage settlements continue to creep upwards and earnings growth, at 9¼%, is uncomfortably high. The results from the 1988 Labour Force Survey mean that productivity growth has been rather less good than previously thought: for the year to the second quarter of 1988 productivity growth in the non-oil economy was revised down from 3.4% to 1.6% with a corresponding increase in unit wage costs; the rise in labour costs was further boosted by a fall in estimated productivity between the third and fourth quarters. Cost performance in manufacturing has been markedly better than in the rest of the economy, but the twelve-month increase has edged upwards to around 3%. Profit margins in manufacturing probably widened further in 1988, but less strongly than in 1986 and 1987.

The current account deficit for the first quarter is estimated to be significantly smaller than in the fourth quarter of last year. The March figures are particularly encouraging and, though they owe something to erratic elements in non-oil exports, a decline in the monthly deficit through the year (reflecting the slowing of domestic demand and recovery in North Sea oil output) could lead to a figure for the year similar to that for 1988. Sterling, whose earlier strength has tended to restrain inflation, and which rose in effective terms towards the end of last year, has since slipped back a little.

. . . and this uncertainty called for caution in the Budget

Against this background, the Budget was appropriately cautious, implying net tax cuts of just under £2 billion (½% of GDP) compared with an indexed base this fiscal year, although somewhat more in a full year. At £14 billion, the PSDR projected for 1989/90 remains at about last year's level, maintaining the considerably tighter fiscal stance that emerged then. The cut in

employees' national insurance contributions will have conveniently-timed effects on demand and should boost the supply of labour by improving incentives among the lower paid, and so may among other things have a useful moderating effect on pay increases. Apart from that, the Budget implies only minor modifications in the immediate economic outlook. According to the forecasts, output growth should slow perceptibly in the next twelve months but not by as much as domestic demand. The twelve-month rate of retail price inflation should begin to fall more rapidly in the autumn, reflecting the timing of mortgage rate increases last year.

The *Financial Statement and Budget Report* reaffirmed the medium-term financial strategy as the framework for monetary policy dedicated to restoring the steady downward trend in the growth of money income and expenditure, with price stability as the ultimate objective. The target range for M0 is unchanged at 1%–5%. The objective for fiscal policy continues to be the achievement of approximate fiscal balance in the medium term which is seen as a necessary support for monetary policy as well as furthering structural aims. The large fall projected for the PSDR through the next few years reflects some reduction in the planned receipts of privatisation, further net tax reductions, and a decline in the effective tax rate as incomes grow more slowly.

Monetary policy seems to be bearing down on the household sector . . .

As with the real economy, monetary developments have been mixed, but tend to support the view that demand growth has slowed, so far mainly in the household sector. Last year's rise in interest rates would be expected to have a bigger effect on narrow and non-interest-bearing money (M0) than on broader definitions; M0 growth has indeed slowed down considerably since last summer. Although to some extent reflecting responses to higher interest rates, the deceleration in M0 also reflects the slower growth in the value of transactions, seen in the statistics for retail trade. For both M0 and retail sales there is, however, some evidence of a changing seasonal pattern not fully reflected in the seasonal adjustments used. Neither the pace of expansion last summer nor the extent of the slowdown since may have been quite as great as the statistics suggest.

Broad measures of credit and liquidity were still expanding at a high rate in the first quarter of this year. Reduced growth in demand from the household sector for both mortgages and consumer credit has been offset by a more rapid growth of lending to business, perhaps reflecting in part the deterioration in companies' financial position mentioned earlier. The fall in mortgage lending has been particularly sharp, and has been reflected in both lower turnover in the housing market and lower house price increases. Admittedly the mortgage and housing markets had been exceptionally buoyant and the slowdown has been largely concentrated in the South East; in the country as a whole, house prices were still rising at an annualised rate of over 15% in the first quarter, and the ratio of house prices to earnings was thus still rising. Nevertheless, the regional impact of policy appears to be helpful, with a relative slowing of activity in the South East, where unemployment is comparatively low, and the momentum being maintained elsewhere.

. . . but less so on the company sector

It is good news that lending to businesses should have been less affected by the present level of interest rates than that to households, not least since this seems to reflect the carrying out of previously planned investment, despite the actual or prospective slowing in consumer demand. However, the scale of lending to business in the first quarter was very large: total lending to the private sector growing by more than 5% in the quarter must be a cause for concern, however commendable its composition. That broad money grew less rapidly owed a lot to the continuing inflow of funds to the banking system from overseas, a reflection of the external deficit.

Recent experience underlines the inevitable uncertainties in economic forecasts and the need for care in the interpretation of economic data, as well as for flexibility and caution in the conduct of policy. The uncertainties about the current outlook may now seem less extreme than they were twelve months ago, for there have been no disturbances in the recent past comparable to the stock market crash of October 1987, but there are still fragilities in the world's financial markets and questions about domestic economic performance yet to be resolved. There remain uncertainties, too, about the precise impact of the policy tightening that has occurred.

So far the financial markets, despite occasional doubts, seem to accept that an appropriate degree of restraint has been placed on demand and activity and that improvement in the inflation rate and balance of payments should come through in due course. It would be widely agreed that the principal need now, both here and overseas, is resolute control of inflation as a pre-condition for sustainable growth. The tightening of monetary policy in the second half of last year and the maintenance of a tight fiscal stance in the Budget together amount to a firm demonstration of resolve. The balance of evidence so far is consistent with its having the desired effect. On this evidence the thrust of policy seems broadly right, and much better news on inflation and the balance of supply and demand in the economy would be needed before any loosening of policy could be contemplated.