General assessment

The last three months have been marked by volatility in currency markets. For much of the period the US dollar was unexpectedly strong against both the yen and the deutschemark. In part this may have reflected political factors. A persistently strong dollar would be likely to weaken activity in the United States, where it is already slowing, and stimulate it in Europe and Japan, where monetary policy has been tightened in the face of inflationary pressures. A stronger dollar is also unhelpful to the adjustment of international imbalances in the longer term. Against this background, this Assessment discusses developments in the UK domestic economy and the emerging picture of the responses of domestic demand and output to earlier measures.

Interest differentials narrow as the US dollar strengthens and activity slows in North America . . .

While there are clear signs of an emerging slowdown in North America in response to earlier monetary tightening, growth in Japan and the major continental European economies continues to exceed expectations. If sustained near recent peaks the level of the dollar would tend to reinforce this pattern of growth. Less benignly it might also tend to put some upward pressure on inflation in the major economies as a group. This is because some commodity prices exhibit some short-term stickiness with respect to changes in the dollar, and perhaps also because inflation in the continental European economies may be more responsive to a positive stimulus from import prices than is inflation in the United States to a negative stimulus. Official interest rates have been raised by $\frac{3}{4}$% in Japan and by a further $\frac{1}{2}$% in Germany over the last three months to contain the inflationary threat arising from strong growth and from the rising costs of imports. (Consumer price inflation, which has also been raised in both countries by consumer taxes, has reached 3% in Germany and in Japan.) These interest rate increases, and earlier tightening in Germany, will help to slow domestic demand somewhat and limit the response of wages to prices. They should also tend to support the yen and the deutschemark—which would be an important part of the transmission of tighter monetary policy.

Recently there have been signs that this process is beginning to work, as the narrowing of interest differentials in favour of the dollar, and large scale co-ordinated intervention, have succeeded in bringing the dollar back from its peak levels, although at the end of July it remained 6% higher in effective terms than at the start of the year. Reductions in US interest rates in the last two months have assisted the process; partly reversing a series of tightening moves which began early last year.

The reduction in US interest rates has occurred against a background of slowing and better-balanced demand, slower monetary growth and a firm dollar. Consumer spending and residential investment have weakened considerably, although healthy business investment and good export performance have helped to maintain total demand. Measured inflation in the United States has moved higher this year, despite the strong

dollar, as capacity remains quite tight and oil and commodity price rises have fed through. The recent signs of slowing growth should imply some reduction in inflationary pressures, although, as output growth eases, slower growth in productivity may add to pressures on unit costs even though wage growth has remained encouragingly modest to date.

. . . elsewhere monetary policy remains tight while co-ordinated intervention has influenced exchange rates . . .

Given the critical importance, as the seven major countries re-emphasised at the Paris Summit, of not only stabilising but reducing inflation in the major economies, monetary policy must remain tight. Trends in the main external influences are difficult to interpret but give grounds for some encouragement. Oil prices, which are, of course, themselves influenced by prospects for activity in the industrial countries , fell back from earlier peaks after the June OPEC meeting, while spot non-oil commodity prices, which had shown no trend in the early part of the year in SDR terms, have recently turned down. Greater efficiency in the use of energy and raw materials has reduced the impact on the major economies of oil and commodity prices, while rapid growth of trade between the major economies has increased the importance to each of developments in the others. This increased interdependence raises the risk of spreading inflation and emphasises the need for close economic co-operation. Within Europe, as the process of liberalising capital movements and the internal market programme near completion, such co-operation will assume particular importance. Indeed, in late June the Madrid meeting of the European Council called for a strengthening of economic and monetary policy co-operation as in stage 1 of the programme set out by the Delors Committee.

See the Governor's IEA lecture, 'The future of monetary arrangements in Europe', on pages 368–74.

Co-ordinated exchange market intervention has helped to give signals about the appropriateness of exchange rates. The difference between the initial and longer-term effects of exchange rate changes makes it difficult to interpret recent trends in the payments positions of the three major economies. Although the relative slowdown of US domestic demand has helped to reduce the US trade deficit so far this year below last year's average, the smaller deficit may in part be related to the initial J-curve effects arising from the strength of the dollar and may to this extent be more than reversed later. Although in a world of deregulated capital markets external surpluses and deficits may simply reflect adjustment to desired savings and investment positions and be quite smoothly financed, they give rise to some vulnerability which continues to be aggravated by fiscal pressures in the United States. Not the least of these may be political pressures to limit inward direct investment or to seek greater management of trade. The negotiating stance of the United States, though designed to open other countries' markets, is based on the threat of reducing imports and therefore runs the risk of restricting trade rather than freeing it.

. . . and the first negotiated debt reduction package is agreed for Mexico

The combination of a higher dollar and lower US interest rates has left the external financing position of the heavily indebted middle-income countries as a group little changed on balance.

Within the group, moreover, net oil exporters such as Mexico and Venezuela have continued to benefit from oil prices which, for the moment, remain significantly higher than in the second half of last year. Other commodity prices have weakened, however. With little prospect of an improvement in global economic conditions faced by debtors, and continuing uncertainty whether effective adjustment policies will be sustained, UK banks have raised the general level of their provisions, which had changed little since the introduction of the matrix in August 1987.

Considerable progress has been made in developing the debt reduction proposals announced by the US Treasury Secretary in March, including the terms of IMF and IBRD financing of voluntary debt or debt service reduction negotiated between a debtor and its bank creditors. The techniques embodied in the package recently agreed between Mexico and its bank Advisory Committee seem likely to become a model for other qualifying heavily indebted countries seeking debt relief, although it remains to be seen whether the precise arithmetic will prove acceptable to a sufficient majority of the creditor banks. The Advisory Committee has accepted the principle that debt or debt service reduction backed by principal and interest collateral is to be regarded as an equivalent contribution to that of new lending without collateral, and this mix of financing options should encourage acceptance of the package by individual banks.

Monetary tightening at home is having continuing effects . . .

It is now well over a year since monetary policy in the United Kingdom began to be tightened. It was expected that the effect on the economy would take time to emerge in full, with some asset prices and forms of expenditure affected before others, while the prices of most goods and services would react only to a slackening of demand. Developments so far have been consistent with those expectations. However, the economy is now seen to have been expanding more rapidly, and with greater inflationary implications, when policy was first tightened than appeared at the time; only in this sense has progress been disappointing. While the balance of evidence is strongly that adjustment to last year's tightening is by no means yet complete, the mechanism is working as expected.

Monetary conditions have also been influenced by some sharp changes of mood in financial markets in recent months. The steadiness of the exchange rate into the early part of this year had been an important factor contributing to tight monetary conditions. The subsequent weakening reflected in part the resurgence of the US dollar and the effect of political events elsewhere. Nevertheless, the speed and scale of the fall in sterling in late May were such as to threaten the prospective reduction in inflation, both directly through import prices and by reducing pressure on UK price setters. Interest rates were raised by a further 1% in late May to counter that threat. Subsequent downward pressure in the exchange market, which was indeed to prove transient, was resisted by the authorities.

The housing market was the first to react to policy tightening, most noticeably in the South-East, where high house prices and heavy mortgage borrowing had made borrowers most exposed to

interest rate increases; and where prices have begun to fall. Prices in the North continue to rise but at a more subdued rate and by June, taking account of normal seasonal movements, prices in the country as a whole had stopped rising. Mortgage lending has remained subdued, although the building societies have gained market share, as they had been able, until April, to attract relatively cheap retail funds and the balance of activity has shifted towards lower-priced property.

. . . particularly on demand for consumer durables

Having slowed sharply in the first quarter, consumer spending maintained its more moderate growth in the second. So far this year spending on household durables—most likely to be affected by the slowdown in the housing market—has been at a quarterly level almost 5% below the peak reached in the third quarter of last year. Private sales of motor vehicles have, on the whole, proved relatively resilient. Spending on non-durables has been erratic, with the only source of persistent strength coming from 'other services', which includes international travel. While a number of related indicators (retail sales, M0, consumer credit) suggested a pick-up in May, provisional figures for retail sales in June were consistent with a moderation of its growth. Stockbuilding has responded to the slowing in consumer demand. In the first quarter, distributors reduced, in part at the expense of manufacturers who saw their stocks rise, stocks which they had involuntarily built up in the previous three months. Distributors and manufacturers alike have reported their stocks as too high, and further adjustments have probably been in train.

Reported industrial investment in the first quarter was surprisingly flat. So strong was its growth through last year that even if there were to be no further growth this year the year-on-year increase would be about 5%. While the latest CBI survey of intentions implies a weaker outlook than earlier CBI and DTI surveys, the prospect is still for some growth through the year in addition. Beyond that, the outlook for further growth of investment seems less promising. Industrial companies can no longer rely on widening profit margins to finance investment as in recent years. Collectively they have recently moved into financial deficit and borrowed heavily from the banks. Capital expenditure has been trimmed in previous periods when economic growth generally has slowed.

Although, overall, evidence continues to accumulate that domestic demand has slowed from the excessive growth of last year, the picture of the balance between demand and output is less clear cut. The recorded growth of each is called in question by the differences between alternative measures of GDP. The external trade statistics suggest that domestic demand is growing more slowly than output, particularly after the effects of North Sea disruptions on output are taken into account. The non-oil trade balance improved slightly between the first and second quarters despite possible anticipatory effects of the dock strike.

The labour market remains tight . . .

So far, as would be expected, slower growth in the economy has not had very marked effects in the labour market. Manufacturing employment, however, has resumed its decline in recent months, and the rate of fall of unemployment is not as great as it was.

Underlying earnings growth has not advanced further and the earlier acceleration was less than might have been expected on the basis of similar periods of high demand pressure in the past. Settlements, however, continue to rise, notably in services, where they have been running recently at about the rate of retail price inflation. The rash of industrial disputes reflects both pressure for, and resistance to, higher settlements, following the acceleration of prices.

Earnings have grown at broadly similar rates in different sectors and have not reflected differences in growth of productivity. In manufacturing, where productivity has continued to grow rapidly, unit wage costs are rising at around 3% per annum. For services the statistics are not so up to date, but, with output apparently slowing, productivity is likely to grow very slowly, and unit wage costs in services may be rising by as much as 8½% per annum. In the longer term there may be scope for faster growth of productivity outside manufacturing, but the differential is unlikely to be eroded; on the other hand there are likely to be limits to the extent to which earnings growth in different sectors can diverge. Inflation of 2½%, as envisaged for the medium term in the *Financial Statement and Budget Report*, would necessitate very low or even negative growth of unit labour costs (and prices) in the sectors, such as manufacturing, where productivity grows relatively fast. This is the experience of our most successful competitors, on whose rate of inflation we wish ours to converge.

... as price inflation peaks

Prices, unlike earnings, have been reflecting productivity differences, so that manufacturers' output prices are now rising at less than 5% per annum, which probably also indicates at least some lessening of the rate at which margins have widened, if not an actual reduction. But faster increases in the price of services appear to be responsible for much of the acceleration in retail prices overall (excluding mortgages) from 4½% to 6% over the past year. Inflation, as measured by the RPI including mortgages, is likely now to have peaked. Much of the earlier acceleration and of the prospective deceleration reflects the mortgage element. Excluding that, the rise in inflation has been slower, and so too may be the reduction. Nevertheless, with a period of slower economic growth in prospect, for a time below the potential growth of the economy, underlying inflation should fall, with reduced profit margins providing the earlier contribution, followed in the next pay round by the further consequences of an easing in labour market pressures. Slower domestic demand will also help to reduce the current account deficit, but again slowly.

There are risks to this prospect. Slow adjustment of the current balance, accompanied by continued tight fiscal policy, implies a continued private sector financial deficit of unprecedented scale. So far private sector confidence seems remarkably robust but expenditures might be adjusted more rapidly, bringing about a faster reduction in inflation (and the current account deficit), at a greater immediate cost in terms of output and employment. On the other hand, a significant fall in the exchange rate could again imperil the prospective reduction in inflation. In this case, although short-term interest rates in this country are already high in real terms, they might have to stay high longer than had earlier been hoped.