General assessment

In addition to the usual review of developments in the major market economies this Assessment also considers some aspects of the economic changes occurring in Central and Eastern Europe, of which migration to West Germany is one dramatic symptom. As in West Germany, growth in Japan has remained buoyant while that of the United States has slowed somewhat, but inflation risks remained pervasive and outside the United States had been aggravated by the strength of the US dollar. The contribution of these developments to the rise in German interest rates at the beginning of October, which was followed by several other countries, including the United Kingdom, is considered. The process of adjustment to the earlier policy tightening here, by which final demand appears to have slowed more than output, with the accumulation of stocks accounting for both business borrowing and the continued large deficit on visible trade, is also examined.

Growth has continued in the major OECD economies, with recession in the United States still seeming unlikely . . .

The buoyant overall performance of the major overseas economies has slowed only moderately in recent months. Inflation overseas has stabilised, at least for the time being, helped by an easing in commodity prices. World trade growth has remained quite strong, while further external adjustment has occurred in the United States and Japan in the course of the year; the position, however, remains finely balanced. Although inflation has for the moment stopped rising, forecasts suggest that at best it is likely to fall only slowly. Labour markets remain tight, with capacity utilisation at high levels. The danger of inflation has not been eliminated.

Although strong investment worldwide in the past two years has added to productive capacity, growth in Germany and Japan continues to outstrip estimates of their productive potential, implying additional pressure on plant and labour utilisation. Nevertheless, the pick-up in consumer price inflation earlier this year in both countries was due primarily to import prices, reflecting the increase in the oil price and the strength of the dollar, and to increases in expenditure taxes. Whether or not the effect of these factors on inflation proves to be temporary depends on the response of wages. So far wage increases have remained modest in both countries, although in Germany particularly this may reflect the effects of multiyear wage settlements, many of which are due for renewal shortly. An easing of growth and indicators of price inflation would help prospects for forthcoming negotiations there.

. . . and events in Eastern and Central Europe add new challenges . . .

The substantial further influx of migrants into West Germany seen this year will give a boost to residential and consumer demand which may be helpful to the adjustment process. It will encourage production for the domestic market rather than for export and reduce the heavy dependence of German industry on external markets. Many of the migrants, particularly those

from East Germany, are young and skilled and are likely to be more mobile and flexible than resident workers. Their arrival will improve the age structure of the population and raise West German productive potential in the longer term.

The counterpart of West Germany's gain is a loss of valuable labour in Eastern Europe, which reinforces the need to improve economic performance and living standards in that region. In those countries which are opening themselves up to western democratic influences, particularly Poland and Hungary, the key requirement is to foster market-based development. At the Washington meetings in September the Chancellor underlined the remarkable and historic events in Eastern Europe. He noted the start Hungary had made on liberalising its economy and the prospect for free elections there, and the commitment by the new Polish government to far-reaching economic and political reforms. He emphasised the importance of developing the role of the private sector in these countries and welcomed the encouragement they are giving to inward private investment. Finance Ministers and central bank Governors of the G7 expressed their readiness to support Poland in implementing a strong and sustainable programme of adjustment to be agreed with the IMF. Part of the support would come in the form of a Paris Club rescheduling of Poland's debt to official creditors.

The immediate task is for the authorities to rectify macroeconomic imbalances (particularly on the fiscal front) which otherwise will stand in the way of successful structural reforms. To that end, a bold stabilisation programme was outlined by the Polish Finance Minister at the end of the Washington meetings. This envisaged a notably more rapid process of change than that achieved elsewhere in Eastern Europe. The Soviet Union is grappling with the problems of perestroika, which may provide increasing scope for Western investment and technical assistance. Elsewhere, Yugoslavia—another socialist country which has espoused more market-based policies—is attempting major changes in the structure of its economy as part of its policy to curb dangerously high inflationary pressures. It will not be easy to manage the reform process in any of these countries. Gradualist policies, whether sector-by-sector or in a sequence of across-the-board steps, are fraught with problems. Liberalising one sector may increase the strains on other still-regulated ones, while phased changes in relative prices are liable to present opportunities for speculation which both distort and discredit the process even if they do not raise the average price level. On the other hand there are risks in attempting to unleash market forces where neither market structures nor market attitudes are in place. In particular, if inflation is not to rise, interest rates will have to be used to restrain the spending of money balances and the expansion of credit, an area in which prudential controls will also become more important as the bankruptcy of enterprises becomes a real possibility.

. . . to existing ones such as 1992 and EMU

The process of economic and monetary integration in the European Community has received fresh impetus. The European Council in Madrid, noting that the report on economic and monetary union prepared by the Delors Committee provided a good basis for further work, asked the competent bodies to adopt

the provisions necessary for the launch of the first stage on 1 July 1990. A major element of the first stage will be the completion of the internal market (including the creation of a single financial area), the legislative framework for which is due to be completed by the end of 1992. Economic and monetary policy co-operation and surveillance mechanisms are also to be strengthened, and all member states' currencies will have joined the narrow band of the exchange rate mechanism of the European Monetary System before Stage 1 is complete.

See also the Governor's lecture to the Institute of Economic Affairs, 'The future of monetary arrangements in Europe', reprinted in the August Bulletin, *pages 368–74.*

What should follow Stage 1 is the subject of active debate. The UK Government lays particular emphasis on market forces and competitive pressures, rather than the administrative imposition of institutional changes, as the spur to economic and monetary convergence. This evolutionary approach would build on the foundations laid during Stage 1. An important principle lying behind the single market programme has been to restrict action at the Community level to those areas where it is essential, thus avoiding needless harmonisation and maximising the scope for market forces to exert their influence. Successful progress in the economic and monetary policy sphere should build on the same principles. Greater integration will mean greater competition and the challenge will be to remain competitive, to adopt an outward-looking approach and to be ready to adapt to changing circumstances. In the monetary area this reinforces the priority to be attached to the control of inflation if the opportunities presented by the single market are to be fully realised.

Growth and inflation stabilise in the United States but the dollar's strength has caused problems and contributed to a rise in German interest rates

US output growth seems to have slowed to a sustainable rate; recent indicators have been mixed, with those for manufacturing in particular showing some signs of weakness, but a recession still seems unlikely. The pattern of demand growth has become less favourable than earlier in the year, with consumer spending rather stronger, at least temporarily, and exports rather less buoyant. The rise in inflation in the early months of the year, and its easing more recently, largely reflect movements in food and energy prices; excluding these items the 'core' rate has been much more stable.

The Bank's latest forecasts of world economic prospects are summarised on pages 490–91.

The strength of the dollar this year may contribute to a slowdown in the external adjustment process and, although it has helped to combat inflationary pressures in the United States in a difficult period, it has added to inflationary pressures elsewhere. The dollar's rise has been unwelcome: at their Washington meeting G7 Finance Ministers and central bank Governors considered that the increase in recent months was inconsistent with longer-run economic fundamentals but also cautioned against an excessive decline. Concerted intervention following the issue of the communiqué helped to push the dollar down, but market sentiment proved resilient and, even after weakening on the narrowing of interest differentials and the stock market fall in mid-October, the dollar remains some 5% above the levels of a year ago in effective terms.

The dollar's strength has revived familiar concerns about adjustment of payments imbalances between the largest economies. Forecasts of current account positions are subject to

wide margins of error, but nevertheless there is a broad consensus that on current policies and at current exchange rates the US external deficit is likely to stabilise only temporarily and may begin to widen again next year. To maintain progress and avoid renewed risks of rising trade protection and discrimination against foreign investment, US domestic demand must continue to grow more slowly than that of its major trading partners. Tighter US fiscal policy is essential for this reason and to improve national savings and reduce financial market vulnerability, but may not be the whole answer. The surplus economies must continue, in their own interest, to facilitate imports by tackling relevant structural rigidities. In response both to the strength of the US dollar, with its implications for inflation elsewhere, and to the buoyancy of its own economy, the Bundesbank raised interest rates by 1% early in October. This was followed immediately by several other European countries including the United Kingdom, and later by Japan (where the official discount rate was raised by $\frac{1}{2}$%).

Output and final demand in the United Kingdom have slowed . . .

Output in the United Kingdom was only $\frac{3}{4}$% higher in the first half of this year than in the second half of last. Partly this reflected the sharp drop in energy production associated with accidents and strikes in the oil industry but even non-oil output has been subdued with little growth recorded in the second quarter in manufacturing, construction or services. A recovery in energy production is to be expected in the second half of the year, but on the evidence of surveys little growth is expected in the non-oil sectors where production, nevertheless, remains high by historical standards. The indicators continue to point, meanwhile, to a marked slowdown in the rate of growth of final demand. Consumers' expenditure on durable goods in the third quarter is estimated to have been little changed from the level of a year earlier, with housing-related expenditure the weakest area—as might have been expected given the subdued state of the housing market. Consumption of services was recorded as having been fairly buoyant in the first half of the year (though not in the third quarter) but it remains hard to reconcile this with the relative weakness of output of services. Investment also shows some signs of having weakened, although the profile revealed by the official figures may be misleading because of uncertainties concerning seasonal adjustment.

While it is clear that domestic demand has slowed markedly so far this year, some uncertainty still attaches to the composition of demand as between final expenditure and stockbuilding. In an attempt to increase the coherence of the various measures of GDP, large adjustments have been made to the figures for stockbuilding—from mid-1988 onwards. Taken at face value, such stockbuilding would appear to represent a largely involuntary response by the company sector to the slowdown in final demand, which could have quite serious implications for future output growth as stock positions were unwound. Stockbuilding would also have bolstered the current account deficit in the face of weakening final demand and here too the effect would be reversed as stocks were run down. Some—possibly substantial—amount of involuntary stockbuilding is a quite likely consequence of a rapid, policy-induced, slowdown in final demand. The suspicion

remains, however, that official estimates of the components of expenditure may be giving too much weight to this, in which case final expenditure may be being understated somewhat. The most likely alternative candidate for revision would seem to be investment (possibly including stocks of unsold new houses), given the uncertainty attaching to the estimates of the company sector's finances and the persistence in some sectors of capacity constraints. Even if investment were currently being underestimated, a downturn would be in prospect given the slowdown in consumer spending and the financial pressures on the company sector. The implications of this for output and trade would be broadly similar to those arising from the running down of stock positions, though perhaps smaller.

Notwithstanding the problems of identifying accurately the components of demand, the broad similarity in the growth of output and total domestic demand has been reflected in the external balance—which seems to have stabilised. Given that domestic demand for goods was flat in the second quarter, some have attributed the continuing rise in import penetration to a loss of competitiveness of UK firms. Export growth has, however, continued, admittedly buoyed in part by growing demand abroad, despite the fact that, as output prices have grown at much the same rate as input prices and unit wage costs, manufacturers' profit margins have not been squeezed.

. . . while external influences on inflation have been broadly favourable, domestic cost pressures show signs of intensifying and monetary growth remains high . . .

Inflation, as measured by retail prices, rose slightly in September and is likely to follow a variable path through the fourth quarter, given the interaction of the effect of last year's mortgage rate rises and the increase in mortgage rates this November. External influences on inflation have been broadly favourable in recent months, with the weakening of world commodity prices feeding through into lower input costs for UK producers despite the lower level of sterling this year. Producers' initial responses to the slackening of demand have also been favourable, with profit margins outside manufacturing falling in the second quarter (after a strong rise over the previous year).

There are, however, few signs of an easing of conditions in the labour market as the fall in unemployment has hardly slowed. Manufacturing wage settlements continued to rise, from 5½% in the second quarter of 1987 to 6% in the second quarter last year and just over 7½% in the equivalent period this year, giving an average over the year to June of 7%, as against 6% a year earlier. These figures can be compared with underlying earnings growth of 8½%–8¾% in manufacturing throughout this year. Owing to substantial amendments to the figures, comparison with earlier periods is difficult but implies a narrowing of earnings drift of well over 1 percentage point—much of which seems to be accounted for by a fall in the contribution from changes in overtime working. In the economy as a whole, the underlying increase in earnings has not exhibited any clear trend over the last year, largely because higher settlements in the private sector have been offset by lower settlements in some areas of the public sector and reduced overtime and drift more generally. Unit costs, which have already risen substantially in response to the

slowdown in productivity growth, remain vulnerable to any further slowing of output growth unless either settlements fall back quite markedly or labour is shed.

Monetary growth has slowed, along with that of nominal demand, most clearly in aggregates related to households. Growth of M0 (closely related to that of retail sales) has moved back towards its target range, discounting the effects of last year's postal strike. Borrowing by households fell back sharply after the tightening of policy last year, and remained subdued in the third quarter of this year. Within the smaller total, building society lending has taken a larger share, and grew particularly rapidly in August and September. However, the further rise in mortgage rates effective from this month will mean that the cost of servicing mortgage debt will continue to take a growing share of personal incomes. Credit growth as a whole has slowed much less, because borrowing by business has continued to expand rapidly, especially in the third quarter. This will reflect in great part the company sector's financial deficit, and would be consistent with a further build-up of stocks (or fixed capital) in the most recent period. But a significant amount of lending has been connected with financial transactions, notably takeovers. The proceeds of this type of borrowing will have ended up in the hands of those who sold shares for cash in the course of takeovers. In many cases these will have been non-bank financial institutions, whose holdings of wholesale money expanded rapidly while the returns on short-term instruments exceeded those on less liquid investments. While there may be few immediate implications of such a build-up for expenditure on goods and services, these transactions nevertheless added to the liquidity of the economy.

. . . so that interest rates were raised when sterling came under pressure

So far the slowdown in the economy has had only a limited impact on inflation, which remains unacceptably high. Financial pressures on companies and the desire to restrict stock levels are likely to restrain their prices, but pay settlements are raising costs across the economy as a whole. If these trends continue, firms will look for offsetting economies through shedding labour. If slower growth is not to risk turning into recession it is essential that settlements begin to fall.

Against this background there could be no question but that interest rates here had to rise when they did on the Continent, especially as by mid-October sterling's effective index was 6% below its level at the start of the year—though less than 2% down on two years ago. The rise in interest rates was thus necessary to keep monetary conditions tight. It is likely that mortgage rates would have gone up by the end of the year—though probably by rather less than 1%—even if there had been no rise in bank base rates in the autumn. The base rate rise can therefore be seen as a modest additional restraint of consumer demand and with relatively little additional effect on the retail price index. The effects on non-mortgage borrowing, on companies, and on the exchange rate are, however, less muted and this may be appropriate given the pattern of borrowing and the fall in sterling. As, over time, business adjusts its stock position the correction should extend to the external account: in the meantime we must persevere with non-accommodating policy.