General assessment

Growth in overseas economies seems to be moderating, in part in response to firm monetary policies in the face of inflationary threats which are present in all the major economies. The strength of the deutschemark, on a reappraisal triggered by developments in Eastern Europe, has complicated the position of other members of the EMS. France and Italy have proceeded with dismantling their exchange controls and Italy narrowed the band in which the lira can fluctuate. This Assessment reviews these developments, the response of the West to the call by Eastern Europe for assistance, and the continuing adjustment of domestic demand in the British economy. The implications for policy of the risks to the consensus UK forecast are considered.

Growth and inflation abroad respond to monetary tightening, and the deutschemark strengthens . . .

The past three months or so have seen continued broadly favourable progress among the main industrial economies. Growth has slowed to a moderate rate in North America and there are tentative indications of moderation in Japan and continental Europe, although the pace there remains buoyant. A slowing of the tempo is welcome in view of the inflationary pressures in a number of countries where labour markets have tightened and wage settlements have crept up. Were growth overall to continue above potential, the risk of a further intensification of inflationary pressure would remain. Monetary policy can claim some credit for the slowdown in North America, while the more recent rise in interest rates in continental Europe and Japan in the second half of 1989 should help to bring growth more into line with potential in 1990. Falling non-oil commodity prices, too, have been helpful in easing inflationary pressures; and the oil price, which rose towards the end of last year, has since fallen back. Forecasts for the major economies as a group show growth at a rate just below potential in 1990. However, with inflation expected to fall only slightly, monetary authorities will need to remain cautious.

Recent events in Central and Eastern Europe (discussed more fully below) brought about a reappraisal of prospects for the West German economy. This contributed to the strength of the deutschemark, which appreciated by 6% in effective terms between June and December 1989 and in turn helped to dampen inflationary pressures in the Federal Republic. Adverse developments in Central and Eastern Europe would, however, have a negative effect and the potential for further domestically-generated inflation remains significant. This year's wage round will be critical, as the major unions confront employers against a background of strong growth, much improved profitability and skill shortages, without the labour inflows from Eastern Europe yet providing any relief. Given the pivotal role of the deutschemark, it is essential for continued progress against inflation in Europe that German monetary policy should remain firm. This is particularly important given the implementation in January of the third stage of the German tax reform plan for 1986–90 which, while containing a number of welcome structural features aimed at stimulating supply, will have a significant expansionary impact on demand.

The strength of the deutschemark has, however, brought problems for other European currencies. France and several smaller countries have raised interest rates and intervened successfully to support their exchange rates. France has moreover removed its remaining exchange controls, ahead of the Community deadline of 1 July, and Italy is dismantling its controls too. Following a period of downward pressure on the lira within the wide band of the EMS exchange rate mechanism, in early January the Italian authorities fulfilled their intention of joining the narrow band, with the new central rate approximately equal to the rate then prevailing in the market and an unchanged lower limit. A realignment within the ERM would help to lower German inflation and contribute to external adjustment, but it would do so at the cost of raising inflationary pressure elsewhere, and might affect confidence in the system at a particularly sensitive time.

. . . while yen weakness presents problems for Japan and the United States

While external pressures on inflation in Japan, partly arising from the 14% fall (in effective terms) of the yen last year, have become more prominent in recent months, there are also domestic concerns. And although strong economic growth has maintained pressure in the labour market, the growth of earnings appears for the moment to have stabilised and increases in productivity have helped to keep unit labour costs comfortably in check. Nevertheless, the labour market may once again give cause for concern in the coming months, with the approach of the spring wage round. In addition, monetary growth remains persistently high and inflationary symptoms have also been apparent in high domestic equity and land prices. High domestic asset prices may have induced a corrective switch of demand towards higher-yielding overseas assets, tending not only to reduce Japanese asset prices but also to weaken the yen. Given the pattern of imbalances, weakness of the yen is unhelpful, as it will tend to raise the Japanese external trade surplus in the long run and may provoke further protectionist moves against Japanese exports. The Japanese authorities pushed up interest rates again shortly before the year-end in response to these developments.

Output growth in the United States has slowed to an underlying rate of perhaps 1½%–2%, although it may temporarily fall short of that as the car industry adjusts to weaker demand. This prompted a succession of small moves by the Federal Reserve to ease policy in an understandably cautious way given the signs of the persistence of inflation in the US economy and dollar depreciation. The relative weakness of industrial production and falling profits suggest that the tight monetary stance has had more effect there than on services, where growth has been resilient. The recent fall in the dollar—more against ERM than Asian currencies—should, now that capacity constraints have lessened, encourage US manufacturers to continue switching to export markets, where demand is strong. A fall against the yen would accelerate this process. The December fiscal package made some welcome expenditure cuts and the Administration's budget announced on 29 January proposed further cuts, as well as measures to increase revenue, in order to meet the Gramm-Rudman targets for fiscal 1991. The Budget will not, however, be finalised for some time to come. While savings on

US defence spending, following the reduction in East/West tension, are not prominent in the Administration's present proposals, the so-called 'peace dividend' should help to lower the US budget deficit in the medium term, depending on the course of developments in Eastern Europe.

Economic and political reform continues apace in the East while the West offers assistance

The new governments emerging from the political upheavals in Eastern Europe face an extraordinary economic challenge. Lacking both experience and the basic institutional framework of a market economy, they will be hard pressed to provide the improved living standards now expected by their peoples, although the scope for raising productivity (and hence real incomes) eventually is immense. Western governments have committed themselves to support the reform movement, linking the prospect of assistance to concrete steps towards full democracy and the development of market-based economies. Commercial investors will have to be assured that, as a first step, countries quickly adopt fiscal and monetary measures which re-establish a balance of aggregate demand and supply consistent with a sharp reduction in inflation, whether actual or suppressed, and with the availability of foreign sources of finance. The difficulties in achieving such a balance should not be underestimated. Against the background not only of consumer aspirations but also in several cases of a liquidity overhang, the impact of trade liberalisation on the payments position, and of price liberalisation on the price level, could generate a political backlash and a policy reaction. The nettles of reform and restraint must, however, be grasped.

It is too early to judge the scale and composition of Western capital flows needed to sustain Central European reforms. Western governments are being asked for substantial sums to help finance the difficult initial period of adjustment. Considerable amounts are already beginning to benefit Poland, for example, partly through the Stabilisation Fund (to which the United Kingdom was an early contributor) and part is to be channelled through the IMF. A role is also seen for new institutions such as the proposed European Bank for Reconstruction and Development. It is hoped that public funds may pave the way for inflows of private capital with the accompanying know-how and technology. Relatively low labour costs and potentially large markets should help to attract direct investment, but much will depend on how successful the new governments are in establishing an underlying economic environment conducive to enterprise and initiative. While Western financial institutions can also be expected to respond to opportunities to finance trade and investment, often in association with their Western corporate clients, the scope for general, medium-term sovereign lending is likely to be strictly limited, given the already high levels of indebtedness in a number of countries and the experience of such lending elsewhere.

East Germany is a special case. Because of its relationship with the Federal Republic, and its relative industrial competence, major corporate investment might be expected to follow fairly quickly after the necessary legislative changes leading to a significant degree of economic re-integration. The management of the process, particularly of its monetary aspects, will however call for considerable care if the transition is to be smooth. The Federal Republic is also expecting a major boost to its own economy as a result of the extra demand, and in due course supply, that will be generated by immigration, not only from the East Germans but of ethnic Germans from other parts of Central and Eastern Europe.

If the process of radical economic reform were to be successful and to extend to the Soviet Union, the existing trading arrangements of the Comecon countries would be replaced by the multilateral trading system. This could, in time, make a significant contribution to global welfare as the potential gains from trade were realised. The initial value of trade with these countries is, however, very small, accounting for only just over 3% of OECD exports. Thus, even under the most favourable circumstances it is likely to be some time before they are fully integrated into the world economy.

The downward trend of UK domestic demand growth is confirmed . . .

It is now evident, despite occasional erratic monthly figures in particular series, that a downward trend in growth of demand and output is firmly established. The rate of growth of consumers' expenditure has fallen sharply, with housing-related expenditure particularly weak. Continued rapid growth in personal incomes, together with subdued consumer demand, led to a rise in the saving ratio to 5½% in the third quarter—the highest level recorded for two years. This series exhibits considerable volatility in the short term but a rise was to have been expected given a weakening of consumers' confidence, the slowdown in the housing market and (in the third quarter) the large part of the growth in personal incomes accounted for by dividend payments. Non-oil GDP in the fourth quarter of last year is likely to have been less than 2% higher than a year earlier. The pick-up reported in consumers' expenditure before Christmas was probably in response to widespread price discounting which may have brought sales forward from January.

A clear pattern in corporate spending is harder to discern, but fixed investment seems to have slowed while companies still seem to be accumulating stocks at a rapid rate. Interpretation of companies' behaviour is affected by the allocation of statistical adjustments introduced to make the national accounts more coherent. Within the company sector, the bulk of these adjustments are still being made to stockbuilding but even excluding this element there still seems to have been a substantial accumulation of stocks since the middle of 1988, part of which may be run down over the coming year. By contrast, it seems quite possible that fixed investment, despite slowing, has been underrecorded to some extent. In any case it is likely to grow at best moderately this year, given weaker demand and the pressures on company finances. The weakness of domestic final demand and the associated fall in non-oil imports (albeit from an erratically high level) contributed to the fall in the visible trade deficit in the fourth quarter. Export growth, partly reflecting the relative strength of demand abroad, also made a substantial contribution.

The continuing slowdown in the economy is also reflected in the financial figures, although the picture there is more obscure. Banks' and building societies' lending to households was much more subdued last year than in 1988, but lending to business was erratic, subsiding towards the end of the year after a remarkable peak (associated with takeovers rather than any revival in capital spending) in the autumn. Twelve-month growth of M0, after falling until July, has stabilised slightly above its target range, despite the somewhat slower trend in current-price retail sales, while growth of M4 has slowed only a little, to 18% at the end of the year.

. . . but sterling's fall and high wage settlements threaten inflation . . .

The evidence of the slowing of economic activity contributed to a modest revival of confidence in sterling, which stabilised in December after having continued to depreciate in the late autumn despite October's interest rate rise. Sterling's comparative weakness reflected both domestic political uncertainties and conflicting external influences, principally the buoyancy of the deutschemark since October, mitigated subsequently by the weakness of the dollar. Sterling's 11½% depreciation in effective terms through last year took it close to its level of three years ago.

Concerns about sterling also doubtless reflect the modest progress so far achieved in bringing inflation back down to the levels of our major competitors. The clearest sign that the tightening of policy over the past eighteen months is working to restrain nominal wealth and thus inflation can be seen in house prices, where the previous rapid rise gave way in the second half of the year to falls in several regions outweighing the effect on the national average of rises elsewhere. In contrast, wage settlements are creeping up further, roughly offsetting the fall in wage drift as overtime and incentive payments reflect weaker activity. In consequence, average earnings are continuing their rise at or slightly above 9% over a year earlier, and with productivity also feeling the effects of the activity slowdown, the rise in manufacturers' labour costs has been pushed up to 5¾% on the same basis. The stability of the twelve-month rise in manufacturers' output prices, at around 5% for the last eighteen months, in the face of these cost pressures, reflects in part weaker materials prices (more than offsetting the effects of the lower pound) and, recently, a narrowing of profit margins. In this latter respect weaker demand conditions are starting to have the desired effect. The difference between the stability of inflation in manufacturers' output prices and the rise in the rate of growth of the mortgage-exclusive retail price index over the past two years is accounted for largely by public utilities and private services, where the rise in labour costs has been relatively fast.

With policy continuing to bear down on the growth of expenditure, and costs responding only slowly, it seems inevitable that the economy will slow markedly this year, with the growth of output falling below that of capacity. According to the official forecast with the *Autumn Statement*, domestic demand will be unchanged this year compared with last, with only slow growth in consumers' expenditure and fixed investment, and substantial destocking (mainly in the first part of the year). With net exports also benefiting from strong growth of world trade, output growth falls much less (from 2% to 1¼%) and there is a marked improvement in the external current account. The twelve-month rate of retail price inflation, excluding housing, falls by less than one percentage point through the year, but the GDP deflator, which is affected less by administered components of the index, rises by 5% in 1990/91 as against 7% in 1989/90.

. . . re-emphasising the need for firm policy

This prospect is, as usual, subject to a number of uncertainties and risks, specifically of lower activity and higher inflation. Levels of gearing in the economy, notably in the company sector, have risen rapidly in the past twelve months, as companies have been running an unprecedentedly heavy financial deficit for at least the past year. With interest rates remaining comparatively high in real terms, and debt servicing costs biting hard into disposable income, it cannot be ruled out that both personal and particularly company expenditure will be cut back more sharply than projected in the forecasts. On the other hand, sterling weakness, perhaps in response to a further tightening of monetary policy overseas, or wage settlements in this country responding less than expected to falling activity, would push up costs and prices more rapidly (as well as shifting the pattern of demand adversely). These inflation risks underline the continuing need to maintain a firm fiscal stance and to prevent any relaxation in monetary conditions.