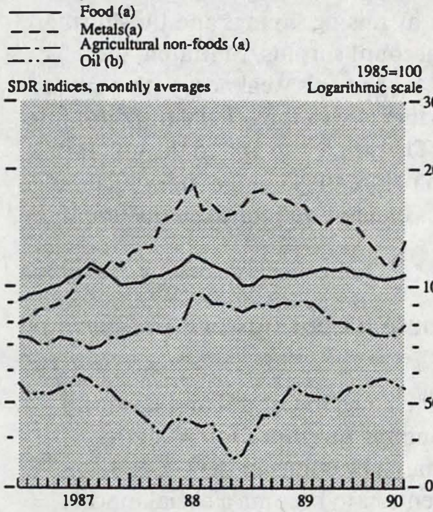
General assessment

The major overseas economies have continued to grow relatively buoyantly. This has helped UK exports while increasing the inflation risks in the industrial world. Developments in Japanese financial markets and in Germany's unification have also increased uncertainty. This Assessment considers the progress of policy adjustment in the United Kingdom against this background.

Continued growth abroad sustains inflation risks . . .

External developments in recent months have mixed implications for the UK economy. The persistence of buoyant activity in the major overseas economies taken as a whole is favourable to UK exports and to an underlying improvement in the trade balance. Nevertheless there are signs that output growth in the major economies is continuing to press against capacity, with possible inflationary consequences, despite an easing of the pace last year, particularly in North America. The sharp fall in the prices of many commodities last year provided a helpful offset to domestic cost pressures in a number of industrial countries, including the United Kingdom. However, with activity holding up in the major economies, it is unlikely that this benefit will be repeated this year, and indeed prices have strengthened in recent weeks. Crude oil prices have followed an independent course, but some reversal of the sharp reductions seen this spring is to be expected if, as on past occasions, OPEC manages to restrain over-production.

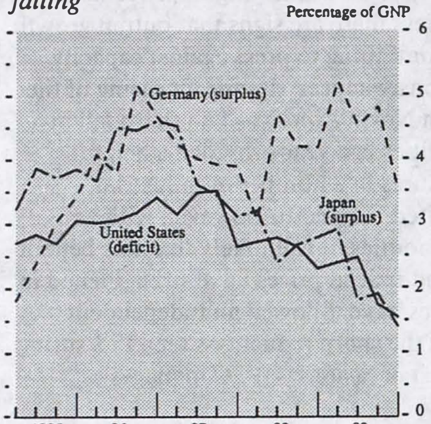
Commodity prices *are starting to recover though oil prices have fallen recently*



(a) 'Economist' indices of spot commodity prices.
(b) North Sea Brent price.

Many industrial countries remain susceptible to inflationary tendencies. A number of European economies have experienced strong growth of domestic demand in recent years, in part reflecting recovery of consumer and business confidence after earlier success in reducing inflation. In several, domestic pressures have re-emerged, or at least earlier progress in reducing inflation has been halted. Overall, concerns about potential inflation have intensified this year, with earlier perceptions of a general cooling in activity receding as indicators, in the main continental countries in particular, have suggested continued buoyancy. There are signs, albeit ambiguous, that after a period of slow growth the United States may be reverting to trend. Tight labour markets in North America and Japan and skill shortages in Europe have highlighted the possibility of rising wage pressure, but so far moderation has tended to prevail, perhaps as wage bargainers in each country recognise potential competitive pressure from others. The risk nevertheless remains that unduly buoyant demand could, in due course, overstretch supply and push up labour and goods prices everywhere. As in the United Kingdom, so also in the other major economies there are difficulties in assessing the extent to which supply constraints may have been shifted by fundamental productivity improvements, and policy-makers in those countries face a far from easy task in keeping growth on a steady, non-inflationary, course. It will be greatly in this country's interest that they succeed.

The **current account**[(a)] *imbalances of the United States and Japan have been falling*



(a) Seasonally adjusted.

. . . as the yen and Tokyo share prices weaken . . .

The yen has been under further downward pressure in the recent period, despite the narrowing of interest rate differentials. The source of the pressure appears in part to be a reassessment of relative asset prices in Japan, principally on the Tokyo Stock Market. Western analysts had been predicting a fall in the Tokyo market for some time, since equities there had seemed increasingly overvalued, but the timing of any correction was impossible to predict. In the event, the trigger seems to have been a combination of political uncertainties and interest rate fears associated with inflation worries. The losses that have occurred represent a significant reduction in Japanese financial wealth (not offset significantly by gains on foreign assets) compared with the December peak, although as stock prices have come back only to the levels seen in late 1988 the impact may be limited.

While the behaviour of the yen may be explicable in terms of Japanese asset prices and changing preferences of investors, it will be unhelpful in relation to Japan's continuing current account surplus (which remains large, although it has been falling in relation to GDP for about three years). A lower yen improves competitiveness while the private sector may respond, even if modestly, to its lower wealth by raising savings and thus further tending to raise the current account surplus. In March, the Japanese authorities reacted to the yen's weakness with bouts of heavy intervention and a further rise in the official discount rate in the wake of market rates. The yen fell to 160 to the dollar in early April but steadied even before the G7 meeting, which noted the undesirable consequences of a low yen for the adjustment process.

. . . and German developments put upward pressure on output, prices . . .

The continued rapid political change in Central and Eastern Europe raises significant economic questions for Western European economies. The March elections in the GDR confirmed that country's intention to become a social market economy and unite with the Federal Republic. All European countries have a stake in the orderly integration of the two economies. This will require substantial progress on a number of key objectives, principally: bringing the economic performance and financial structure of East German industry closer to its West German counterpart; improving the living standards of East German workers sufficiently to induce them to work and invest locally; and achieving the right conditions to attract private capital to East Germany. Additional public spending has a role to play, and the balance between spending cuts elsewhere, additional borrowing and possible tax increases has to be carefully judged. Reconciliation of these different objectives under the pressure for rapid monetary union will be far from easy.

Prospects for the West German economy have inevitably become more uncertain. The momentum of growth there was already strong, with GNP growth last year the highest for ten years, and the implementation of the third stage of the tax reform in January gave an additional boost to demand. Capacity utilisation has risen to the highest level for at least 20 years and, despite the favourable impact from the strengthening of the deutschemark in the second half of last year, inflation has settled at near 3% per annum in recent months. Forecasts of short-term growth in the Federal Republic have been revised upwards and doubts have emerged about the ability of even an economy with such good credentials to survive the pressures of integration without some, at least temporary, increase in inflation. The slippage of the deutschemark within the ERM band and the rise in deutschemark long bond yields in recent months may in part be attributed to these uncertainties, although the latter phenomenon may also reflect spontaneous rises in real yields as the demand for capital has increased.

. . . and yields

Given the large external payments surplus in West Germany, some of the extra investment demands arising in East Germany may be achieved by switching resources away from other export markets. That development is likely to call for some real appreciation of the deutschemark relative to other major currencies, and possibly some further increase in German yields. The latter will depend on, among other factors, the mix of German fiscal and monetary policies as integration proceeds. How far yields in other countries would need to rise in response to any increase in German rates is less clear. Assuming that much of the re-equipment of the previously planned economies of Eastern Europe will be financed in some way by the industrial countries, some rise in real interest rates to induce the matching savings is in order and may already have occurred. Higher levels of global saving, encouraged in part by additional fiscal consolidation in some countries, including the United States, where deficits remain high, would limit the risks of crowding out investment elsewhere in both industrial and developing countries.

GEMU comes at a time when EC member states are themselves about to embark on the first stage of a process that could lead eventually to economic and monetary union, but there are few parallels. The two Germanys are much more alike in respect of language, history and culture than are the members of the EC. Only artificial barriers, now collapsing, have prevented integration of their capital and labour markets; thus the process of their integration will offer few lessons for EMU. GEMU represents the formation of a single economy ultimately under a single government which is not in prospect for the EC as a whole. Even though the parallels between the two developments are not close, the imminence of GEMU has undoubtedly increased the political urgency with which some Community members seek to move towards EMU.

Growth abroad boosted UK exports last year . . .

Growth of demand abroad relative to that of UK domestic demand, which slowed very considerably in the twelve months to March, has contributed to the recent growth of UK exports. Notwithstanding the setback in March, the scale of prospective destocking should lead to a substantial improvement in the trade balance. While the immediate improvement in the current balance is likely to be limited by the deterioration in the invisibles account, the medium-term prospects for invisibles, as domestic demand growth here reverts to trend and, in due course, nominal interest rates come down, are better.

See the Economic commentary, page 170.

. . . as domestic demand slowed . . .

Doubts about the path of consumers' expenditure resurfaced earlier in the year, when it appeared from M4 lending for consumption, growth of M0 and retail sales in the three months to February that some revival was taking place. The underlying trend in retail sales, which had slowed sharply during 1989, appeared to be picking up again. The fall in March, however, which leaves retail sales less than 1% higher than a year earlier, suggests other explanations for the temporary buoyancy, such as strong and persistent promotional activity by retailers, anxious to cut the excessive stocks they are thought to have accumulated during 1989. Private consumption should continue to be restrained as the higher mortgage rate announced in February and the community charge payments come into effect.

There is evidence that companies are now moving more decisively to adjust to weaker trading conditions and increased financial pressure. Between mid-1988, when interest rates started to rise and output growth to slow, and the third quarter of last year, stocks rose by between £3 billion and £7 billion (depending on how much of the statistical adjustment allocated to stockbuilding belongs there rather than, for example, in fixed investment). Much of this stockbuilding is likely to have been involuntary and past experience suggests that it will be run off this year and next, helping to improve the balance between domestic supply and demand.

Fixed investment also started to fall in the fourth quarter and is likely to continue to do so, although its response tends to be more muted and protracted than that of stocks. CBI surveys of investment intentions point to cutbacks in investment, most notably in building work, and suggest cost of finance and uncertainty of demand as the main limiting factors. Pressure on companies to reduce spending has been indicated for some time by the unprecedented £23 billion corporate financial deficit last year—and this does not include borrowing for acquisitions which was heavy in the third quarter—but, like the downturn in activity, that deficit may not be uniformly distributed. Unlike in the early 1980s, companies oriented towards export markets or staple non-durable consumer goods, particularly food, have so far fared relatively well and may be less inclined to cut investment: those involved in construction, suppliers of housing-related consumer durables, heavily geared retailers, and latterly commercial vehicle suppliers have been more severely affected. If exporters' confidence is maintained there is little reason to expect a repeat of the 10%–15% fall in investment experienced in 1981–82. Even such an extreme fall from current levels would still leave UK non-residential fixed investment a similar proportion of GDP as in Germany and significantly higher than in the United States, as well as remaining above the average achieved over the last 30 years.

. . . but underlying inflation rose

The twelve-month change in the all-items RPI, which peaked last summer at 8.3%, has fallen back less than expected because of further mortgage rate rises, sharp increases in prices of both seasonal and non-seasonal foods, and the effect of a more than 10% depreciation in sterling in the course of last year. The RPI continues to be affected by a number of one-off factors including

February's mortgage rate rise and the Community Charge; the rate could be close to 10% for a period, but should decline before the end of the year. A better representation of underlying inflation is given by the index of manufacturers' output prices, which has been rising at a steady 5%–5½% per annum for around eighteen months, having edged up only slightly since the mid-1980s. This index is now beginning to show the effects of increased wage settlements, slower productivity growth (partly offset by reduced overtime payments) and last year's sterling depreciation, which will have both raised input prices and mitigated the squeeze on margins resulting from weaker demand conditions.

These upward pressures on underlying inflation may not subside as quickly as the effects of the special factors affecting the RPI. Unit labour costs should decelerate when in due course the economy reverts to a more normal rate of output growth, but if in the meantime wage-bargainers sought to match increases in the temporarily misleading RPI, the outcome would be an increase in costs well in excess of that in competitor countries, which would mean that many risked pricing themselves out of jobs. The slowing of activity in the past year has lately brought about a virtual end to the fall in unemployment which has been very pronounced over the last four years; and in the Southern regions, though not in Greater London, seasonally adjusted unemployment is already rising. Wage moderation will be crucial if a reversal in the downward trend of unemployment is to be avoided.

The Budget was neutral, with incentives to save . . .

The recent Budget re-emphasised the authorities' determination to keep the stance of fiscal policy tight, thereby supporting monetary policy. Once the markets had digested the details they appeared to reach the same conclusion. The thrust of the tax measures is broadly neutral, leaving the forecast PSDR for 1990/91 at little lower than the outturn now recorded for 1989/90. Within the overall constraints of prudence, the Budget included some welcome individual measures. TESSAs are a valuable supplement to PEPs, extending their advantages to the risk-averse saver of modest amounts in liquid form, while the abolition of composite rate tax, linked to the introduction of separate taxation of husbands and wives, also increases access to gross returns. The abolition of stamp duty on share transactions is in the same vein; the main reason for welcoming it, however, is that, with other centres progressively dismantling similar taxes, the duty was becoming an increasing threat to London's competitiveness and early announcement was necessary to enable those concerned to plan new procedures for transferring stock on an appropriate basis.

. . . and a reaffirmation of monetary policy . . .

An article on page 198 discusses the effects of interest rates on the economy in more detail.

Monetary policy will continue to be to bear down on inflation, with the authorities maintaining an appropriately tight stance via the instrument of short-term interest rates. As explained in some detail in the recent *Finance Statement and Budget Report*, policy is currently judged with reference to a broad range of financial indicators including share and house prices; weakness in these, reflecting the tightening of policy, has reduced wealth without as yet any corresponding decline in M4. The growth of the target variable M0 is, however, expected to decline. The effective exchange rate has fluctuated within a band of about 5% over the past six months having shown itself on occasions to be vulnerable, notably to political factors. Partly as a consequence of this and partly for the reasons already given, although policy is succeeding in reducing growth of domestic demand, inflation is proving more recalcitrant.

. . . which will have to remain tight

Although the slowing of consumer demand that started nearly two years ago has sometimes been called in question by later data, and adjustment by companies was, as expected, slow to materialise, the evidence is that final domestic demand has not only slowed very considerably but has done so more than output. In this respect the economy is on course and domestic policy would seem to be tight enough. Sterling has not recovered from its unhelpful fall last year—itself attributable only in small part to domestic economic developments. Partly because of this fall and partly on account of labour cost pressures, prospects for inflation are mixed. These prospects mean that there is little chance of any significant reduction in interest rates for some time to come.