General assessment

Against the background (before the Iraqi invasion of Kuwait) of continuing growth in the major overseas economies, despite confirmation of sluggish US performance, and (now even) higher oil prices which threaten the decline in inflation, this Assessment considers three themes: the balance of savings and investment in public and private sectors in the West and the needs of Eastern Europe; the financial strains which are particularly acute in the United States but also evident in Japan and the United Kingdom; and exchange rate tensions within the ERM which provide a context for sterling's welcome recent strength. The implications of this last development for UK policy are also considered.

Events in the Gulf trigger an oil price rise while industrial growth, outside the United States, remained steady . . .

By the end of 1989, the major overseas industrial economies had experienced seven successive years of economic expansion, a period of continuous growth unsurpassed in the post-war era: this expansion continued in the first quarter of 1990. In Japan and continental Europe, growth was maintained at or above long-run potential, while in the United States growth continued at a reduced rate—indeed the latest data show it to have been distinctly sluggish. There is some evidence that consumer prices are rising more slowly, but, despite a generally firm policy stance, underlying inflationary pressures are a source of concern in a number of countries. The fall in prices of non-oil commodities was a helpful factor during 1989; their decline faltered in the first half of 1990, and crude oil prices rose ahead of OPEC's July meeting.

Since the bulk of this *Bulletin* and Assessment were prepared Iraq has invaded Kuwait, leading the United Kingdom, the United States and a number of other countries to freeze the assets of, and financial transactions with, both countries. The United Nations Security Council condemned Iraq and has since voted for mandatory economic sanctions including trade in oil. The invasion and associated uncertainty triggered a sharp rise in spot oil prices of about 50% over the average price ruling in the first half of the year. The consequences, if a rise in the oil price of this order were sustained, are complex; responses to major economic shocks are notoriously difficult to predict. The impact (in the United Kingdom as elsewhere) is inevitably to raise price indices on account of their direct (and indirect) oil content. At the same time it directly reduces demand in the oil importing countries. Higher oil prices imply an income transfer from oil importers to oil exporters of up to 1% of OECD GNP on the price increase to date (around $9 per barrel, although the new price has far from settled down). This is proportionately less than on earlier occasions, reflecting in part the substantial reduction in oil input per unit of GNP since 1974 and 1980; and on past form the beneficiaries are likely to spend the money quite quickly. Thus the direct demand deflationary effect, though disruptive, might be quite modest. To this direct effect should be added the consequences of the policy response particularly in industrial countries. At the moment it is very difficult to judge the likely scale or duration of any disruption to oil supply. This makes it hard to judge either the magnitude of the inflationary pressure or the time scale over which it should be countered. Experience of earlier shocks, however, suggests that a firm policy response offers the best medium-term prospect.

Any rise in sterling as a result of the United Kingdom's position as an oil producer would provide some offset to the inflationary impulse in this country. However, the resulting downward effect on import prices might be slower than the upward effect of petrol prices, particularly on the RPI. The UK equivalent of the transfer from consuming to producing countries is, as we are self-sufficient, one from consumers to oil companies (which may remit some of their profit abroad) and the Government, whose North Sea revenue is likely to gain by about £2 billion in a full year (after allowing for companies' additional cost recovery). Thus the direct demand reduction facing the UK non-oil economy is likely to be somewhat smaller than elsewhere, although the non-oil trade balance is likely to be adversely affected by lower world demand. The oil balance, of course, stands to gain from the higher oil price both immediately through the increased value of net exports and in time through fuel economies and the boost to North Sea output.

. . . but financial strains emerge in both the United States and Japan . . .

The slower growth in US activity was especially marked in certain sectors, such as automobile production and those industries most affected by cuts in defence procurement, and areas with particular concentrations of these industries have experienced some degree of recession. Slower growth has added to existing difficulties in the real estate sector. In the North East, which was overbuilt during the boom years, commercial and residential property prices have slumped, and elsewhere there are signs of increasing weakness. Bank regulators have intensified their scrutiny of real estate lending, as have the banks themselves. Fears have been expressed that reactions to a succession of essentially microeconomic problems in the US financial sector, such as difficulties with real estate lending and the collapse of the junk bond market, could combine to produce a macroeconomic effect as the supply of credit is cut back by lenders anxious to avoid areas of apparent risk. So far the statistical evidence is that any such response is of only modest proportions, though anecdotal evidence is accumulating, and the Federal Reserve has offset the effect on credit conditions overall by a slight easing of short-term interest rates. The deterioration of the rating of banks relative to many industrial corporations is inducing the latter to borrow directly from the markets rather than through banks.

The yen has made only a limited recovery from its earlier weakness and equity prices are well below the peaks seen at the end of last year. There were some indications of a decline in consumer confidence in the first quarter, possibly as a result of the equity price fall, but indicators of consumer spending suggest that the fall in wealth has not yet had any significant impact on consumer behaviour. Survey evidence indicates that some cutback in business spending growth may occur (albeit from high rates) toward the end of this year. In the longer term, additional stimulus to domestic demand may follow the Structural Impediments Initiative on which the United States and Japan have now reached agreement. A commitment to increased public sector investment in the 1990s was one of a number of measures aimed at reducing some of the rigidities in the Japanese economy in the hope that trade, particularly with the United States, would become more balanced.

. . . and global savings will need to rise to match higher investment demands . . .

Investment has recently made a major contribution to demand growth in Japan and Western Europe, and this seems likely to continue, albeit at a reduced pace. This is only one of a number of calls on world savings which will be made in the coming years, with others being the requirement for capital for reconstruction in East Germany and elsewhere in Central and Eastern Europe and the continuing need for funds to finance development in the Third World. To bring world savings and the calls upon them into balance might require higher real interest rates. If private sector investment is not to be inappropriately constrained, the social rate of return required on public sector spending might also need to be raised. A reduction in public sector dissaving in those countries with large public sector deficits is called for, together with the maintenance of fiscal discipline in those countries which have achieved reductions or reversals of their deficits. The process of fiscal consolidation remains important in the United States, despite the evidence of slowing activity. The widespread consensus there on the need to produce a further budgetary package is therefore encouraging.

. . . not least for reconstruction of previously centrally planned economies

The scale of financial requirements for reconstruction in East Germany is now becoming more clear. The West German government has announced a 'Unity Fund' of DM 115 billion (some 4½% of GNP), financed for the most part by borrowing spread over the next four and a half years, while other plans include borrowing by the West German telecommunications and postal authorities. The European Commission is to bring forward proposals for assistance to East Germany, Central Europe and the USSR and the issue was also considered at the Houston Summit. While supporting in principle President Gorbachev's reform efforts, the G7 called for a thorough study (to be co-ordinated by the IMF) prior to any decision on collective financial assistance, but it did leave the way open for individual governments to make their own bilateral initiatives with the USSR. West German banks were already putting together a DM 5 billion loan, 90% guaranteed by the Bonn government.

There has been much discussion of how far citizens of the former GDR would spend or save Ostmark balances newly converted into deutschemarks. But other than in the short term what matters is the level of consumption out of income after conversion, and in particular the proportion which is spent on newly available western goods. This will in turn determine the extent to which the labour force in the East suffers redundancy before the longer-term benefits of restructuring are felt. The authorities in the Federal Republic will want to avoid renewed migration, which would become more likely if the population were to become disillusioned by too slow a pace of economic transition. Incentives will be needed to retain the workforce in the East, but the charge on industry cannot run ahead of the growth of productivity if sufficient investment is to be forthcoming; in the meantime some subsidies to the labour force in Eastern Germany may be inevitable.

Within the ERM exchange rates have been polarised . . .

Inflation among the original members of the narrow band of the Exchange Rate Mechanism is in the range 2½% to 3½%, but significantly higher in Italy, which joined the narrow band in January, and in Spain, in its wider band. The spread of nominal interest rates broadly reflects inflation differentials, and with the markets not expecting a realignment, the lira has been close to its upper limit and the peseta has been strong, while the other currencies have been clustered towards the bottom of their permitted margins. Given the strength of the lira, the Italian authorities recently joined those of the Netherlands, France, Belgium, Denmark and Ireland in easing short-term interest rates, although they might have preferred a higher rate to induce convergence, and interest rate differentials between these countries and Germany have narrowed significantly since the beginning of the year. The Bundesbank has made it clear that it is aware of the inflationary threat arising from unification and that it would not hesitate to raise interest rates were it to feel it necessary. The current configuration of exchange rates within the ERM suggests that some non-deutschemark currencies would be free to choose whether or not to follow any such move by the Bundesbank, depending on how they view their own domestic monetary conditions.

. . . while sterling's recent recovery is a welcome reinforcement of tight policies . . .

For the time being inflationary pressures remain strong in the United Kingdom (and they will be augmented by the recent jump in the oil price, if it is sustained). Although, at nearly 10%, the twelve-month increase in the RPI is currently affected by special factors which are unlikely to recur, underlying inflation at 6%–6½% on a range of indices has also risen. The recent strengthening of sterling is therefore particularly welcome, and should help to bring underlying inflation here more into line with Community levels. Provided the stronger exchange rate is maintained, there will be disinflationary influences through import prices and downward pressure on profit margins, which in turn should bear down on both wage demands and offers. Through these channels the 8% recovery in sterling's effective exchange rate index since April will reduce RPI inflation below what it would otherwise have been. Indeed it should reduce the price level by the full 8% over four or five years. With the rise in interest rates in the interim this restores monetary conditions to those ruling prior to sterling's fall last year; similarly the associated temporary gain in competitiveness will have been reversed, narrowing the difference in pressure on the domestic sectors exposed to higher interest rates and the trading sectors which benefited in the short run from sterling's weakness.

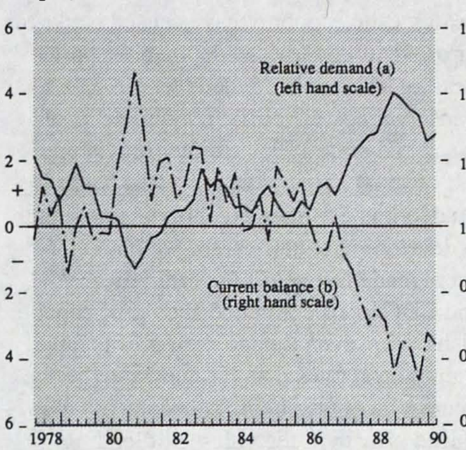
See pages 324–5.

The effects of a higher exchange rate on activity and the current account are likely to be small. In the shorter term, competitiveness will be worse than otherwise, but the consequences of this are mitigated by the modest elasticities of trade flows with respect to competitiveness and the time it takes for the full impact on exports and imports to come through. A further factor is that the response of domestic prices is more immediate than that of wages. Thus real household incomes initially rise and this tends to sustain domestic demand and employment. While this is not helpful to the current account, the latter benefits from the greater initial fall in sterling import prices than in export prices. Over the longer term the

This argument is developed in greater detail in a note on page 316.

evidence suggests that wage increases would follow price increases downwards so that the initial loss of competitiveness would be recouped, leaving activity and the current balance little changed. It would indeed be expected that a sustained change in a nominal magnitude would not have permanent effects on the 'real' economy. While this rather encouraging theoretical view is supported by estimates drawing on recent experience, it does require that, as in the past, negotiated wages be consistent with a steady improvement of competitiveness after the initial loss associated with a rise in the exchange rate.

Relative domestic demand and the balance of payments



(a) Ratio of index of domestic demand to index for other major 7 domestic demand, 1980 = 1.0.
(b) Current balance as a percentage of GDP.

Also of relevance to inflation, as well as to the current account, is the outlook for domestic demand. While the tightening of policy in the last two years has clearly brought about a major downward adjustment in growth of home demand, there was evidence of a partial revival around the turn of the year; final domestic demand (excluding stocks) is estimated to have grown by about 1% (not annualised) in both the last quarter of last year and the first quarter of 1990. The pattern of stockbuilding remains clouded, but appears to have reduced demand less in the first quarter of 1990 (when manufacturers increased work in progress after very sharp destocking) than in the previous quarter. Figures for trade and retail sales suggest that demand growth has eased back in the second quarter. This is in line with the expectation of fairly weak domestic demand overall this year, as consumers react to declines in perceived real wealth associated with subdued house prices, continued high nominal and real interest rates and pressure on disposable incomes arising from community charge payments. Companies, too, are expected to retrench in the face of the adverse financial position which, as a group, they face (although there is clearly considerable disparity between the experience of different firms, with those highly geared or much affected by housing and consumption having been under particular pressure, whereas those producing investment goods or oriented to export markets have fared relatively well). The buoyancy of world activity, which is expected to persist, is contributing to continued current account adjustment (see the chart) and this net external demand tends to sustain output in the face of relatively slower growing domestic demand.

See the summary of the Bank's forecast of the world economy in the May Bulletin, *pages 178-80.*

Broad money growth continues to decline gradually, tending to confirm the picture of gradual adjustment in the economy at large. The lending counterpart to money is also growing less fast, with the deceleration recently particularly marked in lending to the company sector. This seems to reflect both a reduction in the rate of corporate spending (particularly on acquisitions and mergers) and caution on the part of lenders. Faster growth of M0 in the earlier part of the year added to concern about the faster pace of consumers' expenditure and consumer prices. The recent deceleration in M0 has brought its growth rate back towards its target range, offering some reassurance.

. . . the painful effects of which in the private sector are now emerging

It was not to be expected that a sustained period of high interest rates required to correct earlier laxity would leave no casualties or that the banks should be immune from its consequences. The number of corporate failures has already risen over the last 18 months and has reached levels last seen in 1982–83, following a period of output contraction. A significant proportion of the recent insolvencies has occurred in retailing, property, and construction. Unfortunately data on failures by value are not readily available. Given the high rate of start-ups in recent years (which seems to be continuing) many of the failures are likely to be among small companies. With slower growth in house prices nearly everywhere, and falling prices in the South East (where the boom had been strongest), the number of households in difficulty with their mortgages rose significantly in 1989, and is expected to rise further this year. Households in difficulties remain a small proportion of mortgage borrowers and though building societies, like banks, have responded by increasing their provisions they are on a much smaller scale.

These developments in the domestic economy have caused banks to increase significantly their provisioning for bad debts in the past year, with the Big Four clearing banks raising the level of provisions on domestic loans to almost £2 billion, or about 1% of their domestic loan book as at end-June 1990. Further provisions are likely in the second half of 1990. This year, however, banks in this country are not expected to make further exceptional provisions in respect of their loans to developing countries, for which major provisions (£4.8 billion) were made last year. Accordingly, provisions for domestic and LDC loans combined should be capable of being absorbed by British banks, even though their profits have been less buoyed up by high interest rates than has tended to be the case in the past, and net interest income is being squeezed by declining margins and reduced growth in the volume of lending. The much more competitive environment in deposit markets since the ending of credit controls affecting banks and the abandonment of the building societies' cartel some ten years ago means that the proportion of deposits which are interest-bearing has increased, a trend which has been accentuated by the introduction of current accounts which pay interest.

Growing confidence in the market about the determination of the UK authorities to enter the ERM and expectations that this could happen sooner rather than later have provided additional support for the pound. Recent developments in the Gulf may well underpin that support. The rise in the exchange rate over the past three months has had the effect of tightening monetary conditions and spreading the pressure on company profits, which should increase employers' resistance to excessive pay awards. Membership of the Exchange Rate Mechanism, as the Governor made clear in his Durham lecture, would underpin this monetary discipline, but would not be a new departure or provide a means by which other aspects of the counter-inflationary strategy could be relaxed. A strong exchange rate is an important part of monetary discipline and wage bargainers should be clear that—whether or not sterling is in the Exchange Rate Mechanism—any increase in unit labour costs relative to those abroad will result in a loss of competitiveness. And, again in either case, an appropriate interest rate policy is essential if the progress already made in bringing down domestic demand pressures is not to be dissipated.