General assessment

Sterling entered the ERM on 8 October. This Assessment discusses the context and implications of that decision and the related decision to reduce base rate to 14%. These actions occurred against the unsettled international background of events in the Gulf which have pervasive implications for the world economy through their immediate and prospective effects on the price of oil. They also impinge on the domestic economy; despite its self-sufficiency in oil, adjustment is required. Moreover, domestic demand had already slowed substantially in response to the earlier tightening of policy. For these reasons unemployment has already starting rising and is liable to do so further unless wage behaviour adapts to the disciplines implied by ERM membership.

Sterling entered the ERM on 8 October . . .

Sterling's entry into the exchange rate mechanism of the European monetary system on 8 October reinforced the Government's counterinflationary policies. By then the effects of the tighter policies pursued over the previous two years were becoming evident. Responding to higher interest rates, the twelve-month growth of retail sales had slowed from over 7% in the first half of 1988 to less than ½%. The pressures on companies' profit margins and cash flow had been intensified since the spring by a firming of the exchange rate, partly in anticipation of sterling's likely entry into the ERM. Sterling had risen about 6% against the deutschemark and 16% against the US dollar in the six months preceding entry and some industrialists had begun to express concern that the economy might be tilting into recession.

The dilemma for the authorities was that whereas high interest rates—banks' base rates had been at 15% for a whole year—had clearly been biting on real demand and output, and were also reflected in slower growth of the monetary aggregates, the resulting slowdown in inflation had yet to work its way through. Indeed, despite the pressure on companies' profit margins and financial positions, wage settlements had continued to increase even though productivity had scarcely been growing. By September, average earnings were as much as 10% higher than a year earlier. These inflationary pressures were aggravated by rises in oil prices stemming from the Gulf crisis.

. . . and base rates were cut by 1%

The Bank's adoption of a Minimum Lending Rate of 14% on 8 October reflected this background in conjunction with the earlier strengthening of the exchange rate and the clear commitment to keep sterling within its new ERM limits. The Governor has emphasised that henceforth companies can have no grounds for expecting a lower exchange rate to validate any failure to control costs. The greater stability which ERM membership offers sterling against other European currencies should in itself be welcome to business as it will enable firms to plan and invest with greater certainty. If companies recognise that they are now operating under a changed regime the benefits of lower inflation will accrue sooner, and at lower cost in terms of lost output, than could otherwise be expected. But if they fail to recognise the constraints under which they now operate the outcome will prove painful for them.

It is over eighteen years since sterling was last pegged against other currencies. When a floating rate was adopted in 1972 there had been hopes that it would free this country from the balance of payments constraint which was held to have limited growth since the war, but it quickly became apparent that this perception was misplaced. Where excess demand had previously led to reserve losses, under a floating rate it led to depreciation and fast inflation. Floating rates have also proved less stable than had been expected and a return to fixed rates within the Community is thus consistent with the lessons of experience. With sterling in the wider band, the United Kingdom can still maintain interest rates higher than in the narrow band countries, as may be required by domestic considerations.

The higher oil price caused by the Gulf crisis tends to raise inflation and reduce growth in most economies . . .

The sharp rise in the price of oil since the Iraqi invasion of Kuwait has changed the international outlook for the worse. Since the increased oil price transfers real income from importers to exporters, the prospect for economic growth in the industrial economies as a group has deteriorated. Their inflation rate will be higher in the short term than had previously been expected. This rise in inflation will occur even if, as the communiqué from the Finance Ministers and Central Bank Governors of the Group of Seven suggested, policy is directed towards preventing the price rise affecting the underlying rate of inflation. Such a non-accommodating policy stance implies higher nominal interest rates than would have been seen in the absence of the price rise.

The transfer of real income from oil importers to oil exporters will stimulate some flows in the reverse direction as the increased income is spent on goods from the industrial economies, partially offsetting the slowdown in economic activity. The impact on the measured trade balances of the industrial economies will depend on the precise pattern of this increased spending and also on the statistical treatment of financial contributions to the cost of the military build-up in the Gulf. The US current account in particular may benefit from increased military expenditure by oil exporters and this would tend to offset the impact on US output of possible cuts in defence spending at home. The timing of any increased spending by oil exporters will also be important in determining the prospects for activity in the industrial economies: the political uncertainty in the Gulf suggests that any increase in expenditure on local investment projects by oil producers is unlikely to be very rapid.

. . . in several of which growth was already falling and signs of financial fragility appearing . . .

The increase in oil prices comes at a time when the outlook for activity in the industrialised economies shows significant divergence, most notably between the United States and Japan. In the United States the outlook is for weakening activity in the short term, with consumers' expenditure affected by a fall in growth in real income, associated job losses, and the widely publicised problems of the real estate sector. Investment has also been slowing. In the face of this weak economic outlook there have been concerns that bank credit might have tightened further (some banks have themselves been under pressure, especially from real estate problems, and several have announced restructuring plans). At the same time domestic inflation, particularly in the services sector, shows little sign of declining. The difficulty of running a counterinflationary policy in a period of evident weakness, exacerbated by oil price pressures, has also been increased by the delays experienced in securing agreement on a satisfactory programme of federal budget deficit reductions.

The Japanese economy is still benefiting from recent strong investment growth, and is likely to continue to grow, while inflation remains under control despite events in the Gulf. There are, however, some problems in the banking sector: the collapse of prices on the Tokyo Stock Exchange since the beginning of the year has had the effect of reducing the value of banks' hidden assets, so making it more difficult for them to meet BIS capital adequacy standards. The state of the stock market has also made equity issues more difficult, so the Ministry of Finance has allowed banks to raise subordinated debt. A significant downward adjustment of real estate prices would aggravate the problem facing Japanese banks, possibly by weakening equity prices anew.

That part of Germany which was formerly the GDR is in principle exposed to the same difficulties as the rest of central Europe, but is also suffering rapid contraction of its industrial base. The downturn has been more severe than expected, with unemployment and short-time working increasing dramatically. As a result, estimates of the budgetary cost of unification continue to rise, and have necessitated the introduction of a supplementary budget, and the withdrawal of the original Federal budget for 1991 soon after it had been adopted. A budget covering the united Germany will be introduced after the elections in December. So far the costs of unification have been met from borrowing, though cuts in other expenditure are also planned, and the possibility of tax increases has been admitted.

. . . the economies of central Europe being particularly hard hit

For the economies of central and eastern Europe, the increase in the oil price is the latest in a series of problems to hit their energy supplies, creating further problems for the reform process. In the face of falling production, the Soviet Union (the main source of supply to the region) has found it necessary to divert supplies to domestic use and to hard currency sales. In response, many central and eastern European countries had arranged bilateral contracts with suppliers in the Middle East, including Iraq, often in return for part settlement of debts incurred in earlier years. Events in the Gulf have forced these countries onto the world market, adding several hundred million dollars to their import bills. The Soviet Union should, however, benefit from an increase in its hard currency oil revenues.

The proposed changes to the CMEA trading arrangements from the beginning of 1991, in particular the need to pay for raw materials in hard currency and at world prices, will further add to the problems of adjustment: in practice, much will depend on whether the changes are phased in. Diversification of exports, which is necessary to boost hard currency earnings to meet the higher cost of raw materials (including oil), will take time. Furthermore, several of these countries have substantial debt burdens, which also place heavy calls on scarce hard currency resources. These additional pressures are unwelcome at a time when the process of transition to market economies is still very vulnerable. Although the Soviet Union is less adversely affected by these changes, its reform process, of which President Gorbachev has taken control, is at the moment much less clearly articulated.

In the European monetary system the narrow band of the ERM had been fully stretched for some time before the Gulf crisis, with the lira, which joined the narrow band in January, at the top and the remaining narrow band currencies at the bottom. Market perceptions of countries' differing abilities to adjust to the higher oil price have reduced the tension, and the currencies are now close to their central rates, most of which have been unchanged since 1987. The peseta, which since its entry in June last year has tended to be near the upper limit of its 6% band, has, though to a lesser extent than the lira, moved towards its central rate, and sterling, which rose on entry on 8 October, is also near its DM 2.95 parity.

Domestic retrenchment paused temporarily at the beginning of the year but the oil price rise is less damaging here

As long as a year ago, it was expected that the tightening of policy that was already then a year old would make 1990 a year of little growth in the United Kingdom, but that there would subsequently be a resumption of output growth at a rate not very far from that of capacity. It now appears likely that the slowdown will be both steeper and more prolonged into 1991 than had previously been thought. A number of factors point towards this conclusion. First, activity in the first half of the year was considerably more resilient than expected. Second, the increasing fragility of the world economy after the oil price rise is likely to result in a reduction in the growth of world export markets, and hence slow the recovery in UK trade performance, with consequent adverse effects on output growth. Third, the recovery in sterling, welcome as it is in terms of its counterinflationary effects, will tend to restrain UK trade performance—although experience suggests that relative domestic demand growth is the more important determinant of the trade balance.

As the United Kingdom is still a net oil exporter, the effects of the oil price rise on this country differ in several respects from those in the other major economies. The most obvious difference is that the United Kingdom's current balance of payments is unlikely to deteriorate significantly. The improvement in the visible oil balance should largely offset the impact on export markets of non-accommodating policy overseas. However, the improvement comes almost entirely through the terms of trade. The loss of non-oil output in this country as a result of the oil price rise is unlikely to differ much from the loss of output elsewhere, and will depend on both the policy and wage responses and the disposition of oil exporters' spending.

Monetary growth has fallen significantly but fiscal developments have been less reassuring

Monetary conditions in this country had tightened considerably in the months before the Iraqi invasion of Kuwait. With base rates unchanged at 15%, sterling's effective exchange rate rose 7.3%

from 87.1 in April to 93.5 in July. There was no net change from then until ERM entry, although sterling had been volatile in August and September, with day-to-day movements in the rate sometimes significantly affected by events in the Middle East, as reflected in the oil price. Meanwhile the signs had continued to accumulate that the restrictive monetary policy stance over the previous two years was having its expected effect, not only on demand and output but also on monetary growth. The twelve-month growth of M0 has fallen in each month since April. It is now comfortably back within its target range.

Broad money growth has also slowed this year, with M4 growing in the third quarters of 1988, 1989 and 1990 at annual rates of 24½%, 19½% and 10¼% respectively. Here, too, further deceleration can be expected, as the private sector continues to adjust its money holdings following the slower growth, and recently an absolute fall, in the value of its wealth (notably housing and equities). The slowdown in credit growth has been equally marked. Sterling lending by banks and building societies to private sector borrowers in this country grew at annual rates of 26¼%, 24¾% and 12¾% in successive third quarters. This year it has been lending to the business sector which has slowed most, with the latest data suggesting that manufacturing in particular has curbed its demand for credit since the spring, as it has adjusted to the more stringent conditions brought about by the higher exchange rate.

The public sector continues to repay debt but on a smaller scale than in the recent past. The reduction in the PSDR has been broadly matched by smaller rundowns in holdings of gilt-edged stocks by the UK private sector and abroad. Having peaked at £14½ billion in the financial year 1988/89, the public sector debt repayment had shrunk to £2¼ billion in the twelve months to September, partly on account of temporary special factors relating to the community charge and the changed payment pattern for business rates. Since then accruals of revenue will have benefited from the higher price of oil; an increase of $15 per barrel would raise North Sea tax revenue by about £4 billion in a full year. The Autumn Statement forecasts a £3 billion PSDR for 1990/91.

A modest rise in unemployment has not eliminated pressures in the labour market but a different approach is required in the ERM

The slowdown in output and demand growth has not yet eased significantly the tightness in the labour market that had arisen from a growth rate which exceeded the growth of productive potential. Concern that demographic trends might create chronic shortages may be adding to wage pressures and the reluctance of employers to shed labour. Unemployment has been rising since March and was then still nearly half as high again as at the previous trough, but companies still widely quote difficulties in recruiting and retaining necessary skills and quality of workers as reasons for not resisting inflation-matching wage settlements. It is not surprising that the general rate of price inflation is taken into account by wage negotiators, but employers matching past rather than prospective price rises at a time when the rate of inflation is likely to fall rapidly (to 5½% by the end of 1991 in the Industry Act forecast) could find their profit margins seriously squeezed. In the recent past, indeed, resisting such settlements appears still to have been only the last resort of companies facing financial pressures, and in too many cases a lower priority than cutting investment or training on which the future prosperity of the business depends.

The path of inflation in the early 1980s suggests, however, that wages respond more to changes in unemployment than to its level and so far the change has been very modest. Although unemployment has risen in each of the last six months and the upward trend may be accelerating, the average monthly rise since March is only 10,000 compared with average monthly falls of 34,000 through 1989; in 1980, the average monthly rise was over 60,000. If inflationary pressures are to be removed from the labour market, as well as the market for goods, without undue rises in unemployment, it is very important that negotiators recognise not only that the new exchange rate regime severely restricts the scope for depreciation of the currency but also that temporary shocks to recorded inflation, such as the oil price increase, should not become embedded in underlying growth of labour costs. Attempts by employees to maintain, through higher nominal pay, the real value of private consumption in the face of what may prove to be temporarily higher oil prices would be self-defeating.