General assessment

Following Iraq's invasion of Kuwait in August the oil price doubled. Most industrial economies were then already slowing. The oil price has since fallen back again despite the outbreak of hostilities in the Gulf in mid-January. These events have affected asset prices and exchange rates which were already coming under pressure from differential economic performance and, in the ERM, from the impact of German unification on demand there which contributed to the pressures leading to a rise in German interest rates at the end of January. US rates were again reduced at the beginning of February. This Assessment considers these developments as the context of the recession now evident in the United Kingdom and the policies appropriate to the reduction of underlying inflation as the twelve-month increase in the retail price index falls sharply.

Hostilities in the Gulf add further uncertainties to the strains . . .

The Iraqi invasion of Kuwait in August led to the cessation of the flow of both countries' oil into the world market, but this was rapidly replaced by other producers. Nevertheless it also raised uncertainty about future supplies and thus increased the precautionary demand for stocks. This demand was sufficiently impatient and insistent in the face of refining bottlenecks to cause a temporary doubling of the price to $40 in early October. The price has gradually fallen back to half that level, a fall only very briefly interrupted at the start of hostilities. Saudi Arabia, in particular, has sustained an increased level of production and the price has also been depressed by some slackness of demand. Uncertainty had undermined investors' confidence, leading to weakening share prices everywhere, and had effects on relative demands for different currencies, arresting the weakening of the US dollar against the yen and the mark.

Stability in the world economy would be supported by a continuing steady flow of oil from the Middle East. The course of hostilities will determine the extent and duration of any further reduction in production or refining capacity there. A short conflict could see some depletion of strategic stockpiles as oil is released under the auspices of the International Energy Agency. Such action could help to stabilise the oil market. Ministers and central bank Governors of the major industrial countries meeting in New York after the outbreak of hostilities agreed to co-operate, as necessary, to maintain stability in international financial markets.

. . . of a world economy already slowing

These effects impinge upon a world economy which, following several years of rapid growth, has already slowed, though with

varying intensity in different countries. Output is now declining in North America and the United Kingdom while most of Europe is experiencing significantly slower growth. In Japan, prospects are also for growth at a pace somewhat reduced from the very rapid rate recently achieved. The slowdown in most countries reflects weakening consumer confidence, with cuts in investment tending to follow. The only major exception so far to the general slowdown is in Germany, where increased demand following unification has not only given a boost to activity there but is spilling over into demand for the output of other industrial countries; but here too some slowing seems likely.

The high oil price in the third quarter of 1990 contributed to a further decline in Japan's current account surplus to less than $40 billion in 1990 from almost $60 billion in 1989 and $90 billion in 1987. Spending abroad, notably on tourism and business travel, has also grown in volume while exports have slowed. There are signs that the trade surplus may now be stabilising as industry benefits from some recovery in export growth following the weakness of the yen in 1990.

Exchange rates come under pressure both within the major economies . . .

As the current account surplus has fallen, the pattern of Japan's capital flows has also changed, and there is evidence that banks' retrenchment in international business is resulting in wider margins. Exports and imports of long-term capital were broadly in balance towards the end of 1990, even though significant outflows of overseas direct investment continued. Japanese residents were net sellers of foreign securities as yield differentials moved in favour of the yen at the start of the fourth quarter. There have probably been offsetting increases in short-term outflows. Despite expectations to the contrary, any shift in Japanese portfolio preferences has not so far had much effect on the structure of global asset returns, although the fall in the Japanese surplus and its ability to finance the American deficit may have affected the yen/dollar exchange rate.

As inflows from Japan diminished, slowing economic activity in the United States was already reducing Government revenue there when agreement on a budget was finally reached in October. The five-year deficit reduction package, with cumulative cuts of almost $500 billion, has relatively little impact in the current fiscal year when the deficit seems likely to be higher than had been projected, on account of the costs of the conflict in the Gulf and lower revenues if activity slows. For the longer term, however, the associated reform of the budgetary control system provides grounds for hoping that the United States has begun to address its fiscal problems seriously.

Falling house prices have reduced personal wealth, and hence consumption, in the United States as well as making residential construction a particular source of weakness in activity. At the same time, problems in commercial real estate have led to heavy losses at some US banks. In the face of worries about asset quality, banks have tightened their lending policies and bank share prices have fallen by nearly a quarter over the year (while other shares fell only slightly), making it difficult to raise new money to bolster capital and conform to internationally agreed ratios. While the difficult credit conditions are of concern to the US monetary authorities, the continuing retrenchment and restructuring in the

banking industry, not just in the United States, can also be seen as a delayed response to over-capacity. Against the background of a rapidly weakening economy and abating inflationary pressure, the Federal Reserve has continued to ease policy. Higher oil prices do not seem to have become embedded in wage settlements and only a limited impact is expected from the recent decline in the dollar. Weakness of the dollar may, however, be a cause for concern to countries in trade deficit, though surplus countries facing inflation pressures might be less disturbed.

. . . and in the ERM . . .

In the summer the ERM narrow-band currencies moved to within about 0.5% of their bilateral central rates, but since the beginning of November the band has widened in several phases, reaching 1.9% in mid-December. The widening appears to have been triggered by the ½ percentage point increase in the German Lombard rate on 1 November, and the immediately succeeding increases in the Dutch and Belgian official rates (¼ percentage point), the day after the Bank of France had reduced the French official intervention rate. Contrasting interest rate expectations in the United States and Germany (after the election there in early December) were also a factor behind the deutschemark's overall strength, but internal European developments were more important in the ERM. On 31 January the Bundesbank raised both the Lombard rate and the discount rate in response to continued concern over domestic inflationary pressures associated with unification. With most other narrow-band members already experiencing marked slow-downs in growth, only the Netherlands immediately followed this rise.

The extent of the tension in monetary policy between Germany and its ERM partners depends in part on the mix of policies it pursues. It seems widely accepted, not least by the German authorities, that the costs of unification will be reflected in a fiscal deficit which is likely to rise above 5% of GDP this year. This amount will be supportable—indeed, overestimates of expenditure last year mean that a part of the deficit has already been funded—but inflationary pressures are likely to persist until there are signs of an increase in output in eastern Germany. The Bundesbank in particular remains determined to resist an increase in inflation which could still break through, at least temporarily, the widely perceived critical level of 3% in 1991 (after averaging 2.7% in 1990). Before the most recent rate increase the Bundesbank had repeatedly warned about trends in money supply, wage demands and the fiscal deficit. Regarding the last, it is especially important that the recently formed government achieves its announced DM 35 billion of expenditure cuts and keeps the deficit within acceptable bounds. Otherwise the growing deficit would imply that a further part of the burden of containing inflation be borne by monetary policy.

. . . presenting Germany's partners with a dilemma

Developments in Germany and the dollar exchange rate could therefore pose an awkward dilemma for other members of the ERM. The inflation outlook for most other narrow-band currencies is little worse than in Germany, with France, Benelux, Denmark and Ireland all having rates of 4% or less. Growth in all these countries slowed in 1990, and may fall further; and unemployment in many is high or rising. Against that, these countries should gain more than others from increased German demand for imports, which mitigates the effects of tighter German monetary policies. If this stimulus is

inadequate, fiscal relaxation is not an option: Belgium, the Netherlands and Italy all have substantial fiscal deficits and high debt/GDP ratios. An easing of fiscal policy across the Community would in any case be a perverse response to the jump in German demand.

With floating exchange rates, a country-specific demand shock, such as that associated with German unification, might have led to a nominal appreciation of the deutschemark as a mechanism for switching demand from Germany to its partners, while reducing its import prices and hence inflationary pressures. Within the ERM, however, members value the exchange rate stability that the system has delivered in recent years, which is seen as a powerful influence for the downward convergence of inflation, and there is consequently a determination to avoid realignment. The necessary real adjustment would then call for lower inflation in Germany's partners than it experiences itself. The need for such an adjustment would be reduced, however, if demand in Germany were curtailed either by fiscal tightening or in response to the increased uncertainty arising from events in the Baltic Republics of the USSR, which might particularly affect Germany.

At home, recession becomes evident . . .

Data for the third quarter of 1990 confirmed the continuing slowdown in domestic activity in this country. Excluding the energy sector, where activity was low even by normal seasonal standards, domestic output fell by 0.4% in the quarter, with manufacturing output down rather more sharply (2%). More up-to-date indicators suggest that the recession deepened in the fourth quarter, with continuing falls in retail sales and manufacturing production. Unemployment, which has been accelerating since last March, rose by an average of nearly 60,000 per month in the three months to December—comparable with the average monthly rise during the recession of 1980–81. The weakness in demand has also been evident in the trade figures, reducing the monthly visible deficit from £1.8 billion in the first half of the year to less than £1 billion in the fourth quarter.

The falling trend in retail sales was paralleled in slower growth of M0 and mirrored by a continued rise in the personal saving ratio. At 8.8% in the third quarter, this was double the figure of two years earlier and almost in line with its average value over the last thirty years. A sustained shift to higher rates of saving and investment would be welcome, but the present rise probably reflects consumers' reaction to the surge in inflation and to the reduced level of transactions in the housing market—factors which can be expected to moderate as and when confidence recovers. In the meantime weak consumer demand—partly in response to falls in wealth, which are also reducing the growth of M4—contributes to recession.

The consensus of recent forecasts, the risks of which are admitted to be on the down-side, indicates that the recessionary conditions which emerged last year are likely to persist into 1991, largely reflecting the weakness of corporate spending. Until last spring, there was little sign of an adjustment by the corporate sector, apart from the reduction in merger activity. The figures for the third quarter indicate that there has been some adjustment in the form of both a sizable destocking (put at £1 billion in the third quarter) and a fall in corporate fixed investment of nearly 5% from the previous quarter. The figures also indicate, however, that dividends have yet

to turn down and that the unprecedented financial deficit of the corporate sector (largely bank financed) continues; the cumulative financial deficit in the first three quarters of 1990 exceeds the total for 1989, itself the largest ever recorded. Consequently, further adjustment is expected, as recent survey evidence also suggests.

. . . but is unlikely to be on the scale of the early 1980s . . .

As the evidence of recession mounts, comparisons are inevitably drawn with the situation in the early 1980s. Although there are some similarities, the major factors contributing to recession then are not present in the same degree now. Other factors, however, notably companies' financial positions, are less favourable. The recession of 1980–81 was quite prolonged, and non-oil output fell by around 2% in each of two successive years. That recession was also associated with a loss of labour cost competitiveness of around 50% over 1978–81; static world demand following the second oil shock; and a violent swing in the stock cycle, in part due to changes in the tax treatment of stockholding. In 1991, the outlook is for a recession that is both shorter and less severe. Despite its strength against the dollar, sterling's real appreciation overall—and particularly against the deutschemark—has been much less than in the early 1980s; the world economy, though slowing, seems unlikely to do so as much as in the early 1980s; and the stock cycle should be a less significant factor. Nevertheless, considerable risks to output remain on account of two new factors not present ten years ago. There is the new situation in the Gulf and the poor financial position of the UK company sector, either of which could prompt a sharper cutback in corporate expenditures than forecasts currently suggest.

While lower corporate expenditure on stocks and investment tends to reduce activity, thus limiting the relief to profits and retentions in the aggregate, a reduction in nominal pay increases would improve companies' financial position without the same negative side effects. Both cost and price competitiveness would improve, boosting net trade as inflation fell. For both reasons the exchange rate might tend to strengthen which, in the ERM, would translate into a lower interest rate premium to the benefit both of corporate cash flow and eventually of domestic demand. While it would be unrealistic to rely on this benign form of adjustment predominating, the argument illustrates the scope, in the present context, for pay restraint to mitigate the prospective recession.

. . . and inflation pressures continue to present a problem for policy

Despite the move into recession, however, there is, as yet, little sign that either earnings growth or underlying inflation has declined. In the year before ERM entry, underlying nominal earnings and unit labour costs in manufacturing both rose by about 10% as productivity was unchanged. Domestic unit labour costs therefore grew some 6% faster, in local currency terms, than in the other major ERM countries. The headline rate of inflation has turned down sharply and, on the basis of plausible assumptions, will continue to do so, but a significant adjustment in settlements is required if further competitiveness losses and consequent unemployment are to be avoided.

It is to be hoped that perception of the constraints implied by ERM membership will make this response more likely. The credibility of these constraints as a discipline on policy makers has been evident at times in the period since October. It is important, however, to recognise that a strong exchange rate, and the interest rates needed to support it, flow in any case from the pursuit of the ultimate objective of price stability. That the ERM constraint is contributing to the credibility of the eventual success is suggested by the downward trend of sterling bond yields since October, which reflects the market's assessment of the improved prospect of sustainable reductions in short-term rates.