General assessment

The end of hostilities in the Gulf removed a major uncertainty from the world scene. It has been followed by a rise in measures of consumer confidence and a rally in stock markets. This optimism, however, has yet to be reflected in higher levels of activity. In the major economies, growth is more subdued than had been expected at the turn of the year, while the inflation outlook is only a little more promising. In the United Kingdom the recession has been deeper than anticipated, but a recovery in activity may be in prospect. Interest rates have been reduced to their lowest level since November 1988, and the headline rate of inflation has started to fall rapidly.

Demand weakens in the United States . . .

In the United States, the rebound in consumer confidence and low real interest rates will help recovery in the second half of the year. Preliminary data for the first quarter of 1991 show that output has fallen by 1.1% from its pre-recession level in the third quarter of 1990, indicating that the recession has been relatively mild. The stock of corporate debt remains at an all-time high and, together with the recent rise in the dollar, suggests that neither investment nor export demand will lead the economy out of recession. The financial surplus of the business sector is consistent with a low level of demand for credit. There is continuing pressure on the finances of the federal, and also state and local, governments. On balance, therefore, the pace of recovery from recession is likely to be less brisk than normal, but should be sustainable. While core inflation has fallen recently from 5.7% to 5.1%, it remains uncomfortably high.

Following a period during which it exceeded the growth of productive potential, output growth in Japan is falling to more sustainable levels. GNP rose by ½% in the final quarter of 1990, and domestic demand fell for the first time since 1986, with private consumption falling by ¼%. Net external demand remained strong with a rise in export volumes and a fall in imports. Business investment is high, and surveys of intentions indicate only a small decline in manufacturing investment over the next year. The fall in the current account surplus was mirrored by a decline in long-term capital outflows to $44 billion in 1990, the lowest net outflow since 1983. Growth in overseas direct investment has also shown signs of slowing during the past year, and net portfolio investment in foreign securities was down sharply, although there are indications of a modest recovery in recent months. At the same time there is further evidence of retrenchment by Japanese banks in their international operations, including those in the United Kingdom.

. . . and in Europe

A similar picture can be painted in Europe where slower growth—industrial production in the European OECD members has fallen by some 1% from its September peak—has produced a slight rise in unemployment to 8.2% in February from 8.0% in October. Within the ERM the wide band currencies have strengthened relative to the effective mid-point of the narrow band. High interest

rate currencies—the peseta and the lira—have been at the top of the broad and narrow bands respectively. In both Spain and Italy there have been modest reductions in interest rates and evidence of a desire to limit such falls until further progress has been made in bringing down inflation. The ability of the French authorities to lower interest rates has been constrained by the virtual disappearance of the differential between French and German short-term interest rates and the tensions between the franc and the peseta.

Despite the problems of Eastern Europe . . .

Despite a rise in the official Lombard rate to 9% at the end of January, and subsequent falls in interest rates elsewhere, the deutschemark has weakened within the ERM. In large part this development appears to reflect concern over the consequences of the collapse of output in the former GDR for the public finances of the Federal government and the resulting pressure on the counterinflationary stance of monetary policy. Industrial production in the eastern part of the country is now around one half of its level of a year ago and 'effective' unemployment accounts for about one third of the workforce. The opening of the market in the east, and the collapse of trade with the Soviet Union following the ending of the CMEA arrangements, revealed the true extent of the failure of the previous economic system. Although output has declined rapidly, consumption has risen, supported by massive transfers from the western part of the country amounting to around one half of output in the east. The strain on public finances is evident, and, despite recent tax increases, the fiscal deficit has risen to over 5% of GNP, with little prospect of an early decline. The rapid rise in East German wages will reduce the incentive for those in employment to migrate to the west, although it will also increase unemployment. During the period in which new and viable enterprises are being created, there will continue to be pressures on German public finances, and hence on interest rates.

The recent strength of the dollar—which has risen by around 20% against the deutschemark since its trough in early February and by almost 10% against the yen—will stimulate activity in the rest of the world, while the further reduction in US interest rates should help to offset the impact on output of the rise in the exchange rate. The rise in the dollar will, however, also tend to limit the reduction of the external imbalances among the G3 countries, although these have already been reduced substantially since 1987—the US deficit, for example, falling from 3½% of GDP in 1987 to under 2% in 1990.

. . . world savings should prove adequate in the short run

Doubts have been expressed in some quarters about the ability of world financial markets to meet the demand for capital, arising from the development of Eastern Europe and the damage in the Gulf region during the Iraqi occupation of Kuwait, without further upward pressure on real interest rates. But large though these investments may be relative to the existing capital stock in the regions concerned, their timing is unlikely to result in a substantial increase in world investment in the short term. Investment in Eastern Europe is likely to be constrained by uncertainty about both the economic outlook and ownership of existing enterprises, rather than the level of real interest rates. Moreover, greater integration of

capital markets means that increases in capital formation in particular regions can be financed by drawing on savings from other countries. Given this, and the fall in investment resulting from the slowdown in the industrialised economies, there is little evidence that would justify immediate concern over a 'shortage of savings'. Were such a shortage to emerge, the appropriate policy response would be to raise public sector saving by reducing fiscal deficits and to augment incentives for household saving. Lower real interest rates could follow, but not precede, a rise in the supply of saving.

As the recession has deepened in the United Kingdom . . .

In the United Kingdom the recession has been deeper than almost all forecasters envisaged. In the autumn of last year most forecasters were predicting a rise in GDP in 1991 over 1990. But it is now clear that GDP declined throughout the second half of last year—falling by over 2% between the second and fourth quarters—and there are, as yet, few signs of a recovery in activity. Real total domestic demand fell even more sharply—by some 3%—with a reduction in the trade deficit helping to offset the impact on domestic output.

Within domestic demand, the weakness of personal consumption in the second half of last year was the most unexpected development. Consumer spending fell by 1.7% between the first and second halves of last year, the largest half-yearly fall since the mid-seventies. It is possible that the figures will be subsequently revised—there is a sizable discrepancy in the national accounts in the fourth quarter, with measured expenditure significantly lower than the level that would be implied by the other estimates of GDP—and the fall is puzzling given the continued growth in real disposable incomes over the same period (1.4%). But it is consistent with the reduction in the real value of housing and financial wealth of the household sector since the beginning of 1989. It is probably also related to a more general decline in confidence, influenced by factors such as rising unemployment and lower expected growth in real incomes. The recovery in consumer confidence, the increase in share prices (25% since the trough in November 1990) and reductions in mortgage rates point to a rather less subdued outlook in the coming months.

. . . the external balance has improved . . .

The slowdown in the growth of demand over the course of 1990 led to a sharp improvement in the United Kingdom's trade deficit. The current account deficit for the six months to March averaged around £400 million a month, compared with £1,200 million a month in the previous six months. Most of this change was the result of an underlying improvement in the visible balance. Some exporters have successfully switched from the US market—where the earlier weakness of the dollar coupled with the economic downturn made exporting difficult—into the European market. The difficulties facing exporters now centre on the uncertain prospect for the world economy in general and the European economy in particular. Retaining overall market share will be increasingly difficult if wage costs continue to rise more rapidly than those of our competitors.

Monetary growth has slackened further so far this year, suggesting that the private sector continues to adjust. M0 grew by 2.7% in the year to March, which is consistent with the falls that have been seen

in the volume of retail sales and a reduction in the rate at which shop prices are rising. Mortgage lending rose by only just over £6 billion in the first quarter of this year—less than in the final quarter of last year. Lending for consumption was virtually flat. This, together with the steady rise in personal sector deposits, may indicate that the consolidation of personal finances, which has now been in train for over two years, has not yet ended.

. . . and growth in the monetary aggregates has fallen

Consolidation of corporate finances is at a much earlier stage. The corporate sector's financial deficit reached £27 billion in 1990, £56 billion in the last three years. This has pushed gearing to unprecedented levels, and, together with the weaker prospects for output, contributed to the reduction in corporate expenditures in the fourth quarter of last year. In turn, this adjustment has been reflected in slower growth of broad money as companies reduced both their bank deposits and liabilities. The twelve-month growth rate of M4 fell below 10% in the first quarter, compared with 18% a year earlier, and bank lending to companies rose by only £1.7 billion in the first quarter, compared with an average quarterly rise of £4.3 billion last year.

A widening of bank margins also appears to have contributed to the slower growth of broad money and credit. A recent informal Bank of England survey of around 100 companies (varying in size and sector) carried out in mid-April suggests that while many companies have seen their borrowing rates decline in line with base rates, there has been a general rise in bank margins. A number of firms experienced changes in the terms on which they could borrow because in current conditions their creditworthiness had deteriorated. These findings do not, however, constitute evidence of a 'credit crunch', and reduced corporate borrowing is a symptom rather than a cause of recession. The increase in bank margins, and the rise in share prices, may have encouraged some companies to switch from bank lending to other forms of finance. Announcements of sterling capital issues by industrial and commercial companies totalled £3.5 billion in the first quarter of 1991, well up on the average quarterly rate of £2 billion in 1990.

Despite the apparent similarity with the earlier recession . . .

The fall in both GDP and manufacturing output over the last year is comparable with the fall in the early stages of the previous recession. The profiles of consumer and corporate expenditures are also in line with their previous paths. But there are differences, as well as similarities, between the current situation and that of the early 1980s. In particular, the earlier recession was associated with an exceptionally large deterioration in external competitiveness and consequently fell more heavily on the tradable goods sector, especially manufacturing. Unemployment rose sharply in those areas most dependent on manufacturing (rising from 6½% to over 11% in the North for example, but from only 4% to 6½% in the South-West). The present recession is rather different in character, with a greater impact on the service sector, and the south.

Nevertheless, the slowdown in the pace of economic activity appears so far to have had only a limited effect on the level of wage settlements. In certain areas where competitive pressures are especially strong, there are signs that settlements are now being

agreed at levels lower than the prevailing headline rate of inflation, and some 'pay pauses' or 'freezes' are being announced. It was at this stage of the cycle in 1980–81 when a sharp fall in the rate of increase of settlements started to take place. But in some of the more sheltered sectors it is clear that settlements are not yet fully responding to either the increasing slackness in the labour market or the moderation in the rate of inflation. If this lack of adjustment persists, the rise in unemployment is likely to continue for some time.

. . . an upturn in activity is in prospect . . .

The differences between the two recessions are sufficiently marked to suggest that the present recession will be neither as deep nor as prolonged as in 1980–81. Although the backward-looking economic data imply that there has been a substantial fall in output, forward-looking series are more favourable. The most recent CBI survey, for example, suggested that although the economy remained in recession in the first quarter, a rather better performance was likely to be recorded in the second. The CSO's longer-leading indicators are also pointing more convincingly towards an upturn than they have for some time.

The recovery in confidence is linked to the four cuts in UK interest rates—each of half a percentage point—since the turn of the year. Short-term sterling interest rates now exceed deutschemark rates by less than 3 percentage points, a reduction in the premium of two points over the last three months. Base rates are now 3 percentage points below their level prior to sterling's entry into the ERM. Despite this, sterling has strengthened within the broad band, and, by mid-April, had risen above its central rate against the deutschemark (DM 2.95). This strength of sterling in the ERM coincided with the sharp rise in the dollar against the deutschemark, and the sterling-dollar exchange rate fell by 13% between 6 February and 27 March. The sterling effective index weakened at the end of the first quarter, but it remains well above its level of a year ago.

. . . but inflation should fall further

Recession at home and the prospect of a reduction in inflation have made it possible to reduce interest rates to their lowest level since November 1988 and this did not prejudice sterling's position in the ERM. The 'headline' rate of inflation—as measured by the increase in the RPI over the previous twelve months—has started to fall rapidly. Since October it has fallen from a peak of 10.9% to a little over 8%, and a further sharp fall is in immediate prospect. The 'underlying' rate of inflation is less easy to measure. The change in prices over a twelve-month period depends as much on events a year earlier as it does on current news about prices. The twelve-month change in the RPI (excluding mortgage interest payments and the community charge) fell from a peak of 8.4% in October 1990 to 7.3% in March, whereas moving averages of changes over shorter periods peaked somewhat earlier and have since fallen a little further. Following the Budget it is also no longer appropriate to use the change in the RPI excluding not only mortgage interest payments but also the community charge as a measure of the underlying inflation rate; excluding only the former provides a more useful indicator.

The strength of sterling within the ERM has been maintained despite reduced interest rate differentials against ERM partners. The effects of the four ½% cuts in interest rates this year have yet to be seen. This, and the need to maintain downward pressure on inflation, means that there is a need for considerable caution over the pace of any further decline in interest rates, when approaching what may be a turning point in the cycle.