General assessment

Rates of economic growth in the three main economies are starting to converge. The move out of recession in North America, and a slowdown in Germany and Japan, have reduced the marked divergence in growth rates that was evident at the beginning of the year. An encouraging feature of these developments is the affirmation that policy is directed to achieving sustainable growth and low inflation. In Germany there are signs of a rise in inflation, but any increase is likely to be modest, as the authorities have reiterated their anti-inflationary commitment. In the United Kingdom inflation has continued to fall, although there is uncertainty about the timing and strength of the early phase of recovery.

In 1991 world trade is unlikely to grow by more than about 3%, although more rapid growth is likely in 1992. Faster growth in the industrial countries will add to the demand for the exports of other countries, especially those newly industrialised. But in the longer run the growth of world trade depends upon both a successful conclusion to the Uruguay Round of trade negotiations—where achievements still lag behind aspirations—and the further integration of the former communist countries of Eastern Europe and the USSR into the world trading system.

The strength of the dollar . . .

The main feature of foreign exchange markets in the past quarter was the continued strength of the dollar against the deutschemark—with the dollar in early July as much as 25% above its February low. The dollar's strength reflected the emerging evidence of recovery in the US economy and the resulting expectation that short-term dollar interest rates were less likely to decline any further; with the partial reversal of these expectations at the end of July the dollar fell back against European currencies. An appreciation of the currency would be expected in any economy where growth prospects had been revised upwards, provided that there were few barriers to movements of capital and—importantly—monetary policy was perceived to be counterinflationary in the long run. This is because increased activity, and the associated rise in investment and probable fall in domestic saving, raise the expected profile of interest rates thus making the currency more attractive, even though the current account may deteriorate in the short run. Uncertainties about the potential inflationary impact of German reunification, and concern over developments in the Soviet Union and Eastern Europe, adversely affected the deutschemark. Against the yen, the dollar has risen by a more modest 5% since its February low. G7 finance ministers and central bank governors, meeting in London on 23 June, indicated that they stood ready to intervene to maintain orderly markets, but made no commitment regarding the level of any currency. Nevertheless, there has been, from time to time, concerted intervention in foreign exchange markets involving sales of dollars.

The pattern of current account imbalances among the three major economies altered in the first quarter of this year. Transfers relating to the Gulf War contributed substantially to the US surplus of

$10 billion, following a deficit in 1990 of $92 billion. In Germany, by contrast, the emergence of a current account deficit (following last year's surplus of $47 billion) is largely the result of the impact of unification. As a result, the German deficit is likely to continue for much of this year, while the United States is likely to return to deficit. In Japan the current balance remained in strong surplus in the first quarter—a feature which is likely to persist.

. . . reflected the prospects of US recovery . . .

Evidence of the long-awaited recovery in the US economy is not yet decisive. Following two quarters of decline, the advance estimate of GNP rose in the second quarter and housing starts, factory orders, automobile sales and non-farm payrolls have all risen since their low points. More recently, however, there have been suggestions that the recovery might be faltering. In response, the Federal Reserve eased policy further in early August. Hence, the outlook is probably still for a mild recovery in the latter half of 1991. Thereafter real GNP could rise by around 3% in 1992. Current inventory levels are low, and a potent force for recovery in the short term is re-stocking as demand increases. The robustness of this prognosis depends upon the extent to which fragility in the US financial system will limit the supply of bank credit as the upturn proceeds. Credit and broad money growth remain weak, though so far this is attributed as much to slack demand for credit as to unavailability.

In contrast to the United States, growth in Germany and Japan, buoyant in the early part of the year, is likely to slow down as the year proceeds. In the western part of Germany, growth in the second half of 1991 may be restrained by pressure on capacity and the effects of increases in indirect taxes. GNP growth is likely to slow—from a twelve-month rate of 5.2% in the first quarter, to perhaps 2%–3% by the end of the year. There are, however, signs that output, if not employment, may start to recover in the eastern part before the year is out. In Japan, rapid growth in the first quarter of the year is unlikely to be sustained. The delayed effects of a tight monetary policy have led to roughly constant real household expenditure and to a fall in housing starts. Orders are falling and inventories rising.

. . . and uncertainty in the Soviet Union

Progress in Eastern Europe has been overshadowed by the state of the economy in the Soviet Union and the various plans for managing the transition from a discredited central planning system to a market economy. The political situation there is fragile. The economic collapse of the Soviet Union is reflected in the loss of control of the budget—the deficit in the first quarter exceeded the target for the year as a whole—and a fall in GNP in the first quarter of 1991 of roughly 8%. Nevertheless, the Soviet Union is rich in material and human resources. Following the Economic Summit in London in July, there were discussions between the G7 industrialised countries and the Soviet Union. G7 Heads of Government said that they would welcome a 'special association' between the Soviet Union and the International Monetary Fund, in addition to co-operation between the international financial institutions and the Soviet Union, and the provision of western technical assistance. All this will, it is hoped, lead to the irreversible move toward a market economy without which financial assistance would be of little value. The immediate need is for a stabilisation of the public finances and a credible programme of structural reform, including a new union treaty to determine the allocation of economic responsibilities between the Union and the Republics.

The focus of monetary policy in the major economies has been the need to reduce inflation. Following sharp declines during the second half of last year, primary commodity prices have stabilised in the past few months. Despite these earlier declines, however, there has been no fall in the average inflation rate in the G3 countries. It is not surprising, therefore, that monetary authorities have been cautious over the rate at which monetary policy has been eased. In the United States, money supply (M2) growth has been below the mid-point of the target range (2½%–6½%) and underlying consumer price inflation continues to fall. In Japan concern about domestic inflation and the weakening of the yen against the dollar led the Bank of Japan to hold interest rates constant until 1 July when the Official Discount Rate was cut by ½%. In Germany, a weaker exchange rate and historically high rates of increase of earnings led to upward pressure on inflation. An increase in indirect taxes in July meant that the headline rate of inflation over the previous twelve months exceeded 4%, a rate greater than that in France and some other European countries. To date the Bundesbank has resisted an increase in interest rates, although in July the target range for the annual growth rate of M3 during 1991 was lowered by one point to 3%–5%.

The note on page 328 illustrates the degree of convergence achieved so far by members of the EC.

The convergence of growth rates this year has been mirrored by a move toward convergence in other dimensions of economic performance. Within the European Community such convergence is a necessary condition for sustainable economic and monetary union. In that context three indicators have been employed in the discussion of criteria for the achievement of nominal convergence—inflation rates, interest rates and fiscal deficits. Within the membership of the ERM, inflation differentials narrowed during the first half of 1990, especially among the narrow band countries, but there has since been little further progress. The behaviour of short-term interest rates has been broadly similar. But there is much less evidence of convergence in fiscal positions and several countries have uncomfortable debt servicing requirements. Italy has announced its intention to reduce its public sector deficit, and Germany has already raised taxes in order to limit the deficit that resulted from the costs of reunification. Interest rates in Germany, which have appeared, to date, to set a floor for rates in other countries in the ERM, have been maintained at historically high levels. Other member countries (including the United Kingdom) have reduced rates towards German levels. But further interest rate reductions that may seem justified on domestic grounds—in France, for instance, where inflation is now no higher than in Germany—become more difficult if the exchange rate constraint within the ERM is biting.

The domestic recession has been surprisingly deep . . .

In the United Kingdom, inflation has continued to fall and commentators have become increasingly eager for clear evidence of an upturn in economic activity. Expectations of the level of output during 1990 and 1991 were revised downwards last autumn and winter, so that by March the average of some 30 forecasts published for the UK economy showed a level of real GDP in 1991 as much as 4% below that predicted only seven months earlier. At that time, most forecasters expected that the decline in output which began in the middle of last year would come to an end this summer. The fall in consumption in the second half of 1990 was out of line with past experience, and was the primary source of error in most economic forecasts. The causes of the decline are still not fully understood, although it may, in part, relate to the rapid rise in unemployment which began towards the end of last year, together with the cumulative impact of falls in real personal sector wealth (as house and share prices fell). Looking ahead, a recovery in output in the remainder of this year is likely to depend primarily on a revival in personal consumption. This will be helped by the cuts in interest rates since last October. Consumption did indeed rise in the first quarter, although in large part this reflected a boost to expenditure on heating from the cold weather in February and to expenditure on durables in March in anticipation of the VAT increase.

It is always particularly difficult to spot turning points, the more so if, as now seems likely, the subsequent recovery is initially relatively slow. The unavoidable lags in compiling the national accounts mean that estimates for GDP are as yet available only up to the first quarter of this year. In those three months, real GDP is estimated to have been more than ½% lower than in the previous quarter, and nearly 3% lower than in the second quarter of 1990. Of the major components of demand, only private consumption showed a rise: fixed investment, public consumption, net external trade and inventory investment all fell in the first quarter. Non-oil output has declined for three successive quarters and the latest batch of economic statistics suggests it may have fallen again, although probably more slowly, in the second quarter.

. . . but the outlook is more encouraging . . .

A number of monthly series provide more recent evidence, though their interpretation is far from straightforward. The trend of retail sales is hard to discern in the aftermath of the VAT increase. Provisional estimates showed that the volume of retail sales in June was 1.3% higher than the previous month. But retail sales are volatile, and a reasonable inference would be that retail sales are no longer falling, halting the downward trend evident since spring 1990. Exports rose sharply in June. Although in part this was the result of an exceptionally large rise in exports of cars, the underlying level of non-oil exports has been rising in recent months. Manufacturing output continued to fall—it was 1% lower in the three months to May than in the previous three—but this was a much less rapid decline than seen late last year.

At present, therefore, there is no clear evidence of an end to the recession, and the economy is probably 'bumping along the bottom'. But, although there can be little certainty over timing, the future level of output is more likely to turn up than turn down. Pointers to the future are provided by a number of leading indicators. The level of business optimism, as measured in surveys, has recovered from its trough at the beginning of the year, although it remains at a relatively low level and there are, as yet, few concrete signs of a further recovery of confidence among industrialists. In the housing market, prices have hardly changed in recent months, while turnover has been at best flat. More positively, the CSO's longer leading indicator, which was flat through the second half of 1990, has shown a strong upward movement this year. The *median* lead of this indicator is twelve months, implying some resumption of growth in the second half of this year with much stronger growth

See the note on page 334 for a discussion of leading indicators.

in 1992; but it must be said that the variation in the length of the lead shown by this indicator in past cycles has been quite wide.

... and inflation is still falling

Meanwhile, convincing progress has been made in reducing inflation. The twelve-month increase in retail prices was down to 5.8% in June from a peak of almost 11% last autumn. Roughly half the decline was attributable to cuts in mortgage interest payments. Reported increases in producer prices have also slowed, bringing the official series more into line with the rate of increase implied by the CBI survey of price changes (see the May *Bulletin*, page 194). Reports from the CBI and other sources now suggest that industrialists are having difficulty in securing wholesale price rises of more than 3%–4%. Indeed, according to the last two CBI monthly surveys, price expectations are at their lowest since February 1967, with as many firms expecting to cut prices as to raise them. Hence, it is likely that there will be some further reduction in the rate of increase of the RPI by the end of the year. Not all price changes, however, enter the RPI. Recent announcements by some leading car manufacturers of intentions to cut prices by up to 10% will have no direct effect on the RPI. The construction of the index is on an 'average household' basis and the price indicator used for the purchase of motor vehicles only includes used (ie second hand) cars. In the latter part of the year there are likely to be oscillations in the headline rate of inflation as various events that occurred in 1990, such as significant changes in petrol prices and mortgage interest rates, no longer enter the twelve-month comparison.

The effects of the recession and the rise in unemployment can also be seen in slower growth of average earnings. The underlying rate of increase in earnings in the economy as a whole fell in May, for the fifth consecutive month, to 8½%. Earlier in the year this could be ascribed to reductions in the more cyclical elements of pay, such as overtime and bonus payments, but in the last three months the impact of lower wage settlements has become more important. The reduction in the headline RPI inflation rate will itself have had some influence on wage bargainers, but it seems that more companies are looking forward to levels of pay that can be afforded rather than looking backward and basing settlements on past inflation. This trend is most evident in manufacturing industry where the CBI report settlements to have averaged 6.5% in the second quarter compared with nearly 9% at the end of last year. No doubt the continuing growth of unemployment, even if less fast than earlier in the year, has also curbed employees' willingness to pursue higher claims.

Interest rates have been cut ...

Monetary conditions have eased considerably in recent months. The succession of interest rate cuts since last October lowered banks' base rates from 15% to 11%, the latest half percentage point reduction occurring on 12 July, and mortgage rates also have fallen. Over this period sterling has moved relatively little against the deutschemark and other ERM currencies, but the substantial strengthening of the dollar since February has brought sterling's effective exchange rate 3½% below its level in the fourth quarter of last year. The fall in the exchange rate will amplify the effects on the economy of the interest rate cuts.

Despite this easing in monetary conditions, monetary growth and the growth in lending by banks and building societies remain modest. This reflects the time it takes for changes in monetary conditions to have their full impact on the economy. The easing of policy in 1986 and 1987 had its largest effect on the growth of nominal GDP only at the end of 1988. Up to that point the private sector was continuing to move rapidly into deficit. By the same token, the sharp rise in interest rates that started in June 1988 did not have its full impact on the economy until this year. Since 1989 the private sector has been reducing its financial deficit, by moderating its expenditure. The combination of continuing improvement in the current balance, and the re-emergence of a public sector borrowing requirement, suggest that the private sector was continuing to adjust in the second quarter of this year. This is one reason for the exceptionally weak growth of only 1% in lending in the second quarter. Companies, in particular, have borrowed far less from the banks, not only because of lower fixed investment and cut-backs in stocks, but also because many larger companies have taken advantage of stronger equity prices to increase their capital issues. Personal sector income gearing has remained high, despite the cuts in mortgage rates. Growth in M4, though modest in the second quarter (under 2%) was not as low as the growth in lending to the private sector. This was partly because the banks and building societies together financed some of the temporarily inflated PSBR. M0 slowed somewhat in the second quarter and its twelve-month growth of 2% remains within the target range of 0% to 4%. It is consistent with slow growth in nominal spending over this period.

. . . but sterling's position in the ERM has been maintained

The lags between changes in monetary conditions and their impact on the economy observed in the past have varied, but the effects of the easing of policy since last autumn—which should ultimately be substantial—can be expected to continue to accumulate throughout next year and into 1993. That the 4 percentage point cut in short-term interest rates has been achieved without threat to sterling's position in the ERM is a measure of the credibility financial markets now attach to the authorities' commitment to maintain sterling's parity. Since sterling joined the ERM, the differential between sterling and deutschemark twelve-month eurocurrency rates has fallen from 6% to under 2%, a position not reached by the French franc until 1989 after ten years' membership of the ERM. Such differentials can widen and narrow—reflecting in part relative cyclical positions—but currently sterling's differential against deutschemark rates is a little narrower than the lira's. Differentials between the original narrow band countries have now fallen to no more than ½%. It is impossible to be sure of the size of the differential between sterling and deutschemark interest rates that will, in future, be consistent with maintaining sterling's position in the ERM. But the scale of the reduction that has taken place so far is striking.