General assessment

World activity is expected to recover, although uncertainties continue to surround growth prospects in the United States, and these have led to some easing of policy in recent months. Continuing modest progress on inflation has also permitted policy easing in other major countries. The most notable exception is Germany, where the effects of reunification are still being felt. In the United Kingdom, interest rates have fallen by 4½% since entry into the ERM and by ½% since the publication of the last Bulletin. *Official statistics suggest that output stopped falling in the summer. Recent data suggest that a modest recovery may have already begun.*

World activity is expected to recover

The world economy is beginning to return to more normal rates of growth. In the major six overseas economies growth is likely to exceed 1% this year, and may rise towards 3% in 1992. Cyclical disparities in the performance of industrial countries have been diminishing. This can be seen most clearly in the three largest economies. Growth in the United States resumed in the third quarter. But while manufacturing output has been rising since the spring, other indicators, such as capacity utilisation, suggest that the recovery may have slowed in recent months. Output growth in Japan is slowing to a more sustainable pace following a period of rapid expansion. Similarly, in Germany the growth of output is starting to fall and future prospects will depend to a considerable extent on the speed with which the east can increase productivity, thereby reducing fiscal dependence on the rest of the country.

In the other major overseas economies, Canada is enjoying a more pronounced upturn having suffered a deeper recession. Domestic demand in France is weak, although a strong export performance led to an increase in output. Conditions in Italy are, if anything, a little weaker.

Monetary policy is being eased in some countries . . .

The lack of compelling evidence of recovery in the United States led the Federal Reserve to cut the discount rate twice, in September and November, lowering it to 4½%, its lowest level since 1973. Since changes in interest rates affect demand and then output only with a lag, the full impact of the earlier reductions in interest rates on the level of activity is not yet visible. Moreover, the relatively high level of capacity utilisation, in comparison with past cycles, means that the pace of recovery that is consistent with a further reduction in inflation is likely to be slower than in previous upturns.

In Japan also, policy has been eased. The official discount rate was lowered to 5½% in mid-year and market rates have since come down further. Reserve requirements were cut by some 40% in October, reducing the implicit tax on banks and assisting conditions in the markets. Notwithstanding the slowdown in economic growth and the stronger yen, the stance of monetary policy seems likely to remain cautious, reflecting the authorities' commitment to contain inflationary pressures.

Concerns about inflation led the Bundesbank to raise interest rates in August, and a further tightening cannot be ruled out. Despite uncertainties over the inflationary outlook for the next year or so, Germany continues to attract credibility as a longer-term counterinflationary anchor. This is reflected in German long rates which, after rising in advance of unification, have declined over the past year. At 8.4%, the German long bond rate is the lowest in the ERM, albeit at a diminishing distance from other countries, with the long rate in France at 8.7%, and in the United Kingdom at 9.6%.

In other ERM countries, Belgium and the Netherlands followed Germany in raising interest rates in August. A notable exception was France where official rates were initially left unchanged and subsequently lowered by 25 basis points, taking French three-month interest rates below those in Germany for the first time in ten years. The franc has remained at or near the bottom of the ERM narrow band.

The easier policy stance in the United States has caused the dollar to lose ground against European currencies and, more particularly, against the yen in recent months. The upward movement of the yen (6% since end-June) is a response to the renewed expansion in Japan's current account surplus. Ministers and Governors of the G7 countries, meeting in Bangkok last month, concluded that recent movements in exchange rates were broadly in line with continued adjustment of external imbalances.

. . . but the deterioration in fiscal deficits gives grounds for concern

Budgetary conditions have become more difficult in a number of countries. Following unification, the Federal German deficit has risen sharply, and, despite recent and prospective tax increases, is expected to be 4½% of GDP this year and 4¼% next. It is possible that this year's outturn may be somewhat below earlier expectations, but this is largely the result of delay in disbursements in the east. In the United States the outlook for the Federal fiscal deficit is unclear. The budget agreement reached between Congress and the White House last autumn implied a deficit of just over $200 billion for 1991/92. Since then the projected deficit has risen to well over $300 billion, although this partly reflects expenditure postponed from the previous year. The agreement of last year seems increasingly likely to be reopened to permit reductions in defence spending to be offset against either higher expenditure on other items or a reduction in taxes. It is to be hoped that this is not a sign that the original commitment to cut the deficit is waning.

Certain other EC countries also appear likely to exceed fiscal targets this year. Although the recent budgets in France, Spain and

Italy all plan for a reduction in deficits next year, in France and Spain these reductions will leave the deficit at levels greater than those previously envisaged for 1991, and in Italy could still leave the deficit at 8.5% of GDP. Where, as in France, this overshooting is due to lower than expected growth and the resulting impact of automatic stabilisers, and where the fiscal situation is sound and inflation low, it is not a cause for immediate concern. Indeed, to the extent that ERM constraints preclude the relaxation of monetary policy, the effects of automatic stabilisers can be positively beneficial. But it is important that such increases in deficits are indeed temporary. In some other countries, such as Italy, where budget deficits and inflation remain high, it is essential that the planned reduction in the deficit next year is in fact achieved. More generally, it remains important to set underlying fiscal policy in a medium-term context, on paths which provide for convergence to long-term sustainability in all EC Member States.

Renewed confidence in some LDCs . . .

Outside the industrial countries there has been a continued revival of confidence in several Latin American countries as evidenced by a recovery in the market price of their debt, repatriation of flight capital and renewed access to international capital markets. Mexico and Chile have made particular progress; Venezuela has embarked upon structural reform in the context of a renewal of support from the IMF; Argentina has begun to implement fiscal and exchange rate reforms; and Peru is taking steps to restore relations with its creditors after a seven-year moratorium.

For some countries their adoption of firm macroeconomic policies, combined with market-based structural reform and better governance, is thus beginning to pay dividends in terms of access to foreign sources of savings. While banks, especially those facing capital constraints, are naturally more reluctant to provide new medium-term balance of payments financing, other inflows—predominantly bond and equity investment—are being supplemented by new short-term trade and other bank credit facilities.

Such encouraging signs of a more sustainable pattern of external financing for some ldcs are, however, tempered by the serious difficulties that continue to be faced by the most heavily indebted and poorest countries, especially in Africa. Although industrial countries have acknowledged that there is a pressing need for further debt relief for countries willing to undertake economic reform, progress in the Paris Club to develop ideas such as the UK-sponsored Trinidad Terms initiative has been slow—in contrast to the relative speed with which much larger debt write-offs for Poland and Egypt were negotiated. The UK authorities announced last month that they would take the lead in implementing additional relief. These problems, and the need for a successful conclusion to the Uruguay Round, merit greater attention.

. . . contrasts with the continuing uncertainty in the former Soviet Union

Meanwhile, international economic policy attention has been focused on the problems of the former Soviet Union, which is now in considerable disarray. The true extent of economic dislocation

is hard to assess. Inflation is rising rapidly, as is the consolidated budget deficit. Without a clear and credible economic constitution that defines the allocation of responsibility among the republics, a stabilisation programme will be difficult to implement. In the short run it is vital to restore monetary stability and to avoid the break-down of inter-republican trade. The west is committed to help in this process, but it is hard to provide even training and technical assistance while the political structure remains uncertain. In the longer term, trade is the best form of aid, especially to a region well-endowed with natural resources. Both Eastern Europe and the former Soviet Union, on the one hand, and Western Europe, on the other, are partners in the process of transition—the former must adapt to the disciplines of a market economy, and the latter must allow access to its markets if trade is to flourish.

In the United Kingdom, interest rates have fallen . . .

In the United Kingdom, the stance of policy has remained firmly counterinflationary. Success in bringing down inflation has been accompanied by further cuts in interest rates—now 4½ percentage points lower than at the time of joining the ERM. There has been a broadly similar reduction in the short-term sterling-deutschemark interest rate differential which, by the end of October, had fallen to around 100 basis points. At the same time, sterling has remained relatively stable within the ERM. The variability of the sterling-deutschemark exchange rate has fallen substantially in the year following ERM entry compared with the preceding twelve months. These developments bear testimony to the credibility which the markets now attach to the commitment to sterling's parity in the ERM.

Output in the second quarter recorded its fourth consecutive decline; but the 0.6% fall in gross domestic product included a sharp, but temporary, loss of North Sea oil production which masked a much reduced rate of decline in non-oil activity—down by only 0.3%. This underlying improvement has continued. The recovery in oil production following the completion of maintenance and safety work in the North Sea earlier in the summer has already given an impetus to total activity. Recent data suggest that the non-oil sector may have stopped falling during the summer, and there are growing signs that a modest but sustainable upturn may now have begun. Housing starts in the three months to September were over 11% up on the previous three months; on the same comparison, import volumes were up by 1½%, with capital goods imports up by 3%. And the decline in the rate of increase of unemployment also points to an improvement in conditions.

. . . and a modest recovery may now have begun

The initially encouraging signs in some areas are amplified by the growing optimism apparent in recent surveys. Consumer confidence, for example, has increased since its trough last year, back to levels last seen in 1988. Among industrialists, too, confidence has recovered sharply: the October CBI survey, for example, shows a marked improvement in confidence and in expectations regarding output, orders and employment growth in the coming months. Optimism among industrialists is also at its highest level since 1988.

The recovery in consumer confidence which has occurred through the summer suggests that consumption may now have passed its

trough. But it is difficult as yet to be confident about the pace at which recovery will proceed, as developments in the housing market have introduced additional considerations for which there is little historical precedent. Some of the 40% of families with mortgages under annual review schemes, for example, may not quickly see the effect of interest rate changes in their monthly outgoings. This may have contributed to the sluggishness of consumption in the second (and perhaps third) quarters. But, as interest rates have fallen further, many building societies have permitted adjustment in the interim. Indeed, the Halifax building society (which accounts for 16% of the mortgage market) changed rates for all borrowers in August. This, together with the sharp fall in interest rates, will now have reduced debt service burdens for the majority of borrowers.

For some, however, arrears have already accumulated to a point where lenders have felt obliged to repossess property. Repossessions have risen exceptionally rapidly this year and may now be one of the most significant factors depressing house prices—and hence the ability or willingness of households to increase their indebtedness further for the purposes of consumer spending. The scale of repossessions—newly repossessed properties accounted for around 5½% of housing turnover in the first half of this year, compared with 3% in 1990—has also had the effect of raising the price of 'top-slice' mortgage insurance, which will have a detrimental effect on the disposable income of first-time buyers.

The performance of UK companies in overseas markets has been both encouraging and, to some degree, unexpected. Total export volumes rose by 1% in the third quarter while, in the second quarter, net trade contributed some ¾% to GDP—substantially offsetting the negative contribution of 1¼% from domestic demand. Manufacturing companies in particular have taken advantage of stronger overseas markets to offset the worst effects of the domestic recession. For example, in the first nine months of the year, production of passenger cars for export stood almost 90% higher than a year earlier and, although special factors make this example somewhat exceptional, it is clear that many companies have been seeking and finding increased opportunities to sell in overseas markets.

Financial pressures on the corporate sector ...

The direct evidence on the behaviour of companies confirms our earlier view of a major retrenchment occurring through the second quarter. This seems to have been effective in all aspects of companies' operations and has included labour shedding and cost cutting, reduced capital expenditure, substantial destocking and a sharp reduction in dividend payments. The net result was a moderate recovery in trading profits and a further sharp fall in expenditure which, together, reduced the sector's financial deficit to less than £2 billion in the second quarter, from around £5½ billion in the first quarter and an average of £6½ billion throughout last year. Stock reductions were particularly sharp in the second quarter. After falling by 1.1% and 1.5% of GDP in the previous two quarters, stocks are currently estimated to have fallen by more than 2% of GDP in the second quarter. More recent evidence, however, is consistent with a slowdown in the rate of destocking, which should act as a positive stimulus to the rate of

growth. Fixed investment expenditure has fallen sharply (though less than first thought) and is likely to remain subdued for some while. But for many companies the late 1980s were a period of very heavy investment expenditure, and new capacity brought on-stream during 1989/90 is still to be fully exploited. The fall in the financial deficit, coupled with the ability to raise funds on the capital markets, permitted companies to repay bank borrowing and to build up deposits. This improvement in their liquidity is probably a necessary precursor to resumed real expenditure.

The past two years have witnessed a marked slowdown in the rates of growth of the money and credit aggregates. In the third quarter of 1989 the twelve-month growth of M4 stood at 17.0%, with growth of bank and building society lending at 22.2%. Since then, the twelve-month growth rates have fallen to 6.4% and 7.2% respectively. To some extent the slowdown was not surprising. Falls in real asset prices in 1988 and 1989 had signalled a likely slowdown in the rate of real monetary growth. Although the growth rates of both money and credit have recently been exceptionally low in nominal terms, in real terms they are higher than in previous recessions. Such nominal growth rates, which are in line with those of incomes, may not be inconsistent with recovery.

. . . are reflected in lower rates of growth of pay . . .

Companies have made considerable strides in containing the growth of their unit costs. Pay settlements in the economy as a whole have fallen from a peak of almost 10% in the fourth quarter of 1990 to 6½% in the third quarter of this year, and in manufacturing from 9% to 5¼%. At the same time, progress on productivity has been encouraging. The extent of this progress is apparent from the ability of the company sector as a whole to raise its trading profits during a period when output has been flat or falling and price increases have fallen to low levels. In other words, the squeeze on company margins may have eased a little in recent months. Companies may thus be less inclined to raise margins sharply in the early phase of the upturn, which would augur well for inflation.

. . . and prices

Headline inflation has fallen steadily over the past few months, from 5.8% in June to 4.1% in September. Excluding mortgage interest payments, retail price inflation has fallen from 6.9% to 5.7%. Producer price inflation in manufacturing (excluding food, drink and tobacco) has fallen from 5.2% to 4.7%; and the October CBI survey found that a balance of 10% of manufacturers reported that they had *reduced* domestic prices in the previous four months. World commodity prices continue to fall. In October, the Economist nominal index—in SDRs—stood some 12% lower than a year earlier. This has contributed to a decline in manufacturers' input prices, which are now 3% lower than a year ago, having fallen by over 2% in the past three months.

While past and prospective progress is encouraging, underlying inflation in the United Kingdom (as measured by the increase in the RPI excluding mortgage interest payments) is still higher than in the core ERM countries. It also remains above the 3% annual average rate of inflation in the United Kingdom between the end of

the Korean war in the early 1950s and the beginning of the Vietnam war in the late 1960s. There is no reason to suppose that the UK economy is incapable of returning to those inflation rates nor, eventually, of attaining price stability. To achieve this will require flexibility in both product and factor markets, and the consistent application of counterinflationary policies.