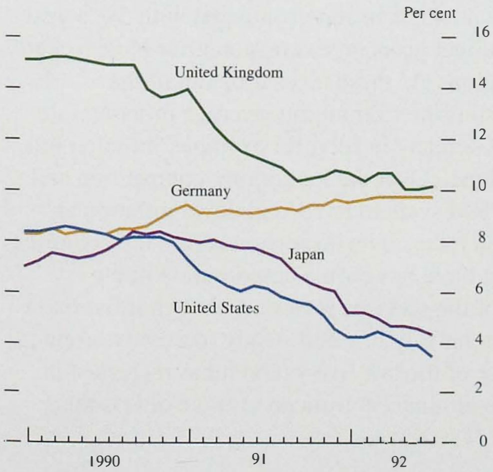
General assessment

The slow pace of recovery of the world economy continues to cause concern. Growth in 1992 will, for the third year in succession, be less than the trend rate of growth of productive potential. For the G7, output in 1992 is likely to be only 1¾% higher than in 1991. The faltering recovery in the United States led the Federal Reserve to cut its discount rate by 50 basis points at the beginning of July and in Japan the Official Discount Rate was lowered again at the end of July. In Germany, continuing rapid monetary growth led the Bundesbank to raise its discount rate by 75 basis points in mid-July. The Danish rejection of the Maastricht Treaty on 2 June introduced further uncertainties into the European economic outlook. The gap between short-term interest rates in Europe, on the one hand, and the United States and Japan, on the other, continues to widen (see Chart 1). Differences in long rates are, however, much smaller. In the United Kingdom, survey data and indicators of economic activity have offered mixed signals on the prospect for recovery, but there has been further progress in reducing inflation.

Chart 1
Short-term interest rates (a)



(a) Rates used are 3-month euromarket rates, monthly average of end-day observations.

Activity remains subdued in the United States . . .

In the United States, growth slowed in the second quarter and inflation remained low. At the beginning of July, in response to slow growth of the economy and of money and credit, the Federal Reserve eased monetary policy by cutting its discount rate by 50 basis points to 3%, allowing the federal funds rate to fall by a similar amount. Short-term market interest rates have now been cut by two thirds in just over three years, in a series of twenty-three 'easing steps'. But expenditure has not increased as rapidly as might have been expected, reflecting the pressure of continuing high debt levels. Although industrial production grew by 1.9% between January and May, employers responded to increased demand more by extending hours worked than by expanding payrolls, and quickly cut back both in June when industrial output fell back by 0.3%. Changes in the pattern of financial flows have meant that M2 growth has remained below its target range. Results from US banks for the first half of 1992 showed a broad-based improvement compared with last year, increasing their capacity to lend when demand for credit revives.

The Japanese economy is still experiencing a slowdown. Industrial production fell again in May and is now 8¾% below its July 1991 peak. Stock levels have continued to rise and business confidence is at a six-year low. Corporate sector gearing remains high, with net financial liabilities amounting to around two thirds of nominal GDP. The volume of retail sales fell 0.3% in the second quarter. But there are some signs of a recovery in the housing market with housing starts up 2% in the three months to May over the previous three months. The banks' results for the year to end-March showed a fall in profits, reflecting both the economic slowdown and weakness in financial and property markets. Further falls in the Nikkei index have intensified pressures on the banking and financial sectors. The Official Discount Rate was cut by 50 basis points on 27 July. The ruling LDP has put forward proposals for a supplementary fiscal stimulus of up to ¥6–7 trillion (1.3% of GNP) and an economic package is now expected in late August with a supplementary budget in October. Japan has scope to alter its policy mix, since the fiscal consolidation programme of the last decade has left the general government sector in surplus.

. . . and in Europe . . .

Activity in Western Europe remains sluggish. Output in the major economies of the European Community was around 2% higher in the first quarter than a year earlier, although even this figure—boosted by unusually rapid first quarter growth in Germany—may exaggerate underlying growth over the period. Private sector expenditure throughout Europe has been constrained by high real interest rates and slow growth in real disposable incomes. The Community's unemployment rate in May stood at around 9.5% compared with 8.7% a year earlier.

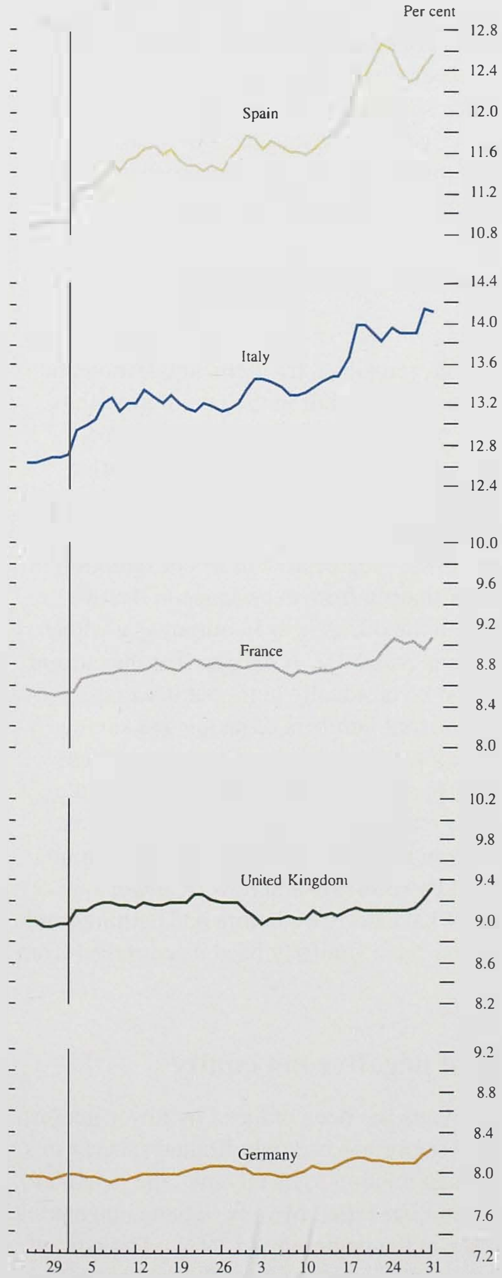
The outlook for the rest of this year is still fairly bleak. In the western part of Germany, output growth in 1992 as a whole may be around 1%. In the eastern Länder, however, the trough of activity may now have been passed and growth in this region could add ½ percentage point to the pan-German growth rate. In France and Italy GDP showed an upturn in the first quarter. France should sustain a moderate recovery this year but prospects in Italy for the remainder of the year are uncertain. Activity in Spain remains subdued.

. . . where inflation has fallen a little . . .

There has been only a modest reduction in inflation in the European Community. Consumer price inflation, averaged over the Community, fell to around 4½% in June compared with 5% a year earlier. Increases in indirect taxes in several countries have recently boosted measured inflation. As these taxes drop out of the twelve-month comparisons the Community average inflation rate should fall further. In Germany in July, for example, inflation fell to 3.3% from 4.3% in June. Over the longer run, competition and the framework of the ERM seem to have held down inflation in traded goods sectors and reduced its dispersion across the countries of the Community. But there has been a deterioration in the inflation performance of the services sector. Although inflation in traded goods has been relatively low and steady (currently around 3%, close to the average of the last five years) it has increased in the non-traded sector to around 7% from an average of less than 6%.

Monetary policy in Germany remains tight. At its mid-year review, the Bundesbank Council raised the discount rate to 8¾%, narrowing the 'corridor' between the discount rate and Lombard rate to 1%. The wages round produced settlements of around 5½%–6%, rather less than expected. But monetary growth in Germany has been very high. In June M3 was 8.7% above its level of the last quarter of 1991 (measured at a seasonally adjusted annual rate), compared with its target range of 3½%–5½%. Most of the overshoot is associated with an acceleration in bank lending (to an annual growth rate of around 12% in the early part of the year) which, in so far as it reflects subsidised lending to eastern Germany, could prove to be relatively unresponsive to high market interest rates which are currently just below the Lombard rate of 9¾%. There seems little chance that the monetary target for M3 will be met this year, even though inflation and growth are now slowing down.

Chart 2
10-year government bond yields (a)(b)



(a) End-day observations.
(b) Vertical line shows the date of the Danish referendum.

. . . and monetary policy is tight

The commitment to maintaining exchange rate parities in the ERM means that tight monetary policy in Germany has led to restrictive monetary conditions across the Community. This has led to strains within the ERM, but the gains in terms of credibility from maintaining parities have been judged collectively by the member countries to outweigh the gains from altering parities in response to differential shocks. Boosted by a weak dollar, the deutschmark has risen in recent weeks. Interest rates, especially at the longer maturities, have risen more in those member countries of the Community which are adversely affected by greater uncertainty about monetary union. The negative vote in the Danish referendum on ratification of the Maastricht Treaty raised long-term bond yields more in those countries for which the prospect of monetary union was a crucial ingredient in the credibility of monetary policy than in countries in which credibility was based on domestic factors. Long bond yields rose more in Spain, Italy and France than in either Germany or the United Kingdom (see Chart 2). Exchange rate pressure was felt most markedly in the case of Italy despite a rise at one point of over five percentage points in repo rates. The advances rate was raised to 15¼% as a consequence of continual pressure on the lira.

The economic situation in the former Soviet Union (FSU) remains very difficult. In Russia, for which the IMF approved a First Credit Tranche drawing of $1 billion in August, further important reforms remain necessary for agreement to be reached on a Stand-By Arrangement. Stabilisation programmes in the other CIS republics are generally not far advanced. Of considerable importance is the establishment and maintenance of arrangements for the co-ordination of monetary policy within the rouble zone, and for the orderly withdrawal of those countries which wish to leave it. In the countries of Central and Eastern Europe economic conditions remain depressed, although some encouragement can be derived from the growth of new private sector activity. A growing concern is the increasing pressure on government revenues in Hungary and Poland. Progress continues towards structural reform, but it is slow and will be delayed further unless the problems of banks' existing bad loans and the rapid growth of trade credit to firms in difficulty are dealt with more decisively.

In the United Kingdom, recovery remains elusive . . .

The recession in the United Kingdom continued into the first quarter of this year, when real GDP contracted by a further ½%. In its early stages the recession could be attributed to a sharp fall in domestic demand of 4.7% between the second quarters of 1990 and 1991. Because the balance of trade improved over this period, the fall in GDP was somewhat smaller at 3.5%. But since last spring the decline in GDP has been much slower. And domestic demand actually rose by about ½% between the summer of 1991 and the spring of this year. The weakness of GDP over this period reflected a deterioration in the real balance of trade, due in part to changes in the rates of growth of demand in the United Kingdom and its trading partners.

The general improvement in business and consumer confidence in May has not been sustained. Indicators of consumer confidence fell back in June and July, and business confidence surveys offer

Chart 3
Non North Sea output: comparison of recent recessions

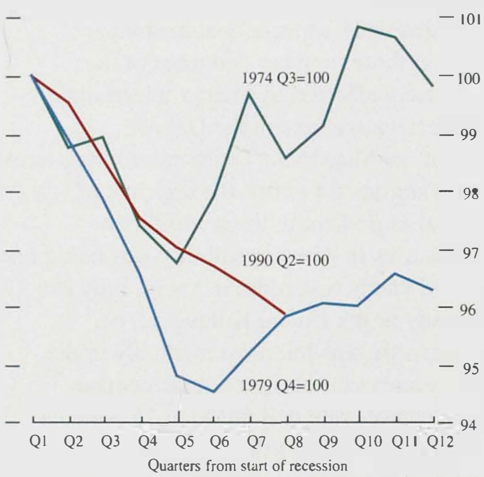
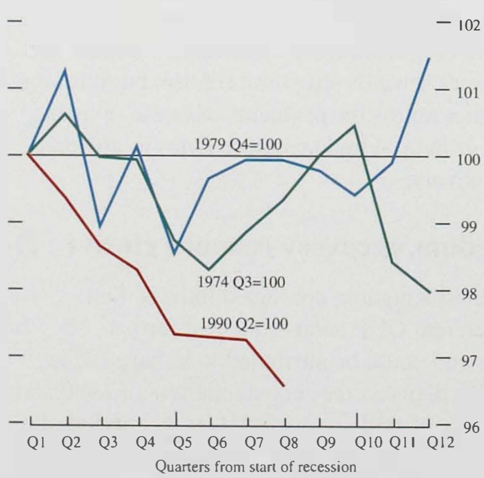


Chart 4
Consumption: comparison of recent recessions



conflicting signals. After increasing in February and March, manufacturing production has fallen again. The growth rate of exports has been somewhat erratic and imports continue to grow fairly rapidly. The outlook thus remains very uncertain but slow growth in the economy should be evident during the remainder of this year.

The prospects for growth in the short run depend critically on consumer spending, which accounts for half of total final expenditure. But the small rise in domestic demand in the first quarter masked an unexpected shift in its composition, with business spending rising and consumer spending continuing to fall. Companies' willingness to spend may have been helped by success in restructuring their balance sheets over the last two years—large companies' liquidity has recovered almost to its 1987 peak. But companies will continue to invest only if there is a prospect of sustained growth of consumption and export demand.

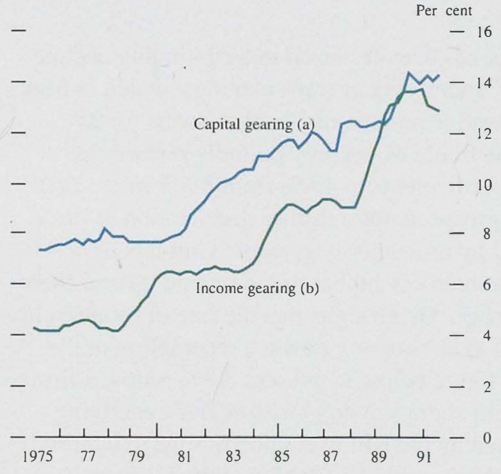
. . . owing to the impact of indebtedness on consumption . . .

Consumer spending, however, remains flat. Falls in inflation and nominal interest rates, together with a fall in the rate of growth of unemployment, might have been expected to encourage some reduction in the rate of personal saving. But in the first quarter consumers cut their spending by 0.7%, despite a rise of 1% in their real disposable income, taking the personal savings ratio up to 11.5%— the highest since 1982. The behaviour of consumption in the present recession differs sharply from experience in the two previous recessions, although the differences in output as a whole have been less marked (Charts 3 and 4). It may be that the current level of savings will prove to be erratically high, but it seems increasingly likely that significant numbers of people are saving more as they attempt to repay some of the large amounts of debt accumulated in the late 1980s. Much of this debt was incurred against expectations that the real burden of servicing it would be reduced by fairly rapid rises in nominal incomes—an expectation that has been frustrated first by recession and now by lower inflation. Others who might have borrowed more had earnings and house prices continued to rise have similarly been discouraged from doing so.

. . . and the problem of negative net equity

The burden of interest payments has been reduced by lower interest rates but so far the personal sector has had only limited success in cutting the scale of its debts in relation to its income: the personal sector gross debt-income ratio has fallen by only $^3/_4$ percentage point from its peak of almost 91% at the beginning of 1991. The ratio of the personal sector's debts to its wealth was broadly unchanged between mid-1990 and the end of 1991 but continuing falls in house prices—now on average 5% lower than a year ago—are likely to have raised the gearing ratio since then (see Chart 5). There was an increase in housing turnover in June, possibly associated with the end of the stamp duty holiday in August. Turnover remains well down on the levels of 1991—18% lower in the second quarter compared with the same period last year. Attention has focused on those home-owners whose properties are now worth less than their mortgage loans. The number of such households is estimated at $^3/_4$ million–1 million (see note on page 266). If households with

Chart 5
Personal sector income and capital gearing



(a) Borrowing from banks and building societies as a proportion of personal sector financial and physical assets.
(b) Ratio of income payments to income.

negative net equity, and others anxious to reduce their debt burdens, are attempting to save more, the pattern of high personal saving and slow growth of consumer spending could persist for some time.

The commercial property market is similarly depressed, with capital values in the second quarter over 9% lower than a year ago. But British banks are less exposed to the property sector than they were in the 1970s. Much of the financing of recent City and Docklands developments has been undertaken by overseas banks. Nationally, the major British banks are responsible for 43% of direct lending to the property sector which, together with construction advances, accounts for about 12% of their total sterling lending, a smaller proportion than in 1973. Although there is little prospect of an early end to the difficulties of this sector, banks have already anticipated problems by making large provisions against loans to property developers.

The price of intermediation has risen . . .

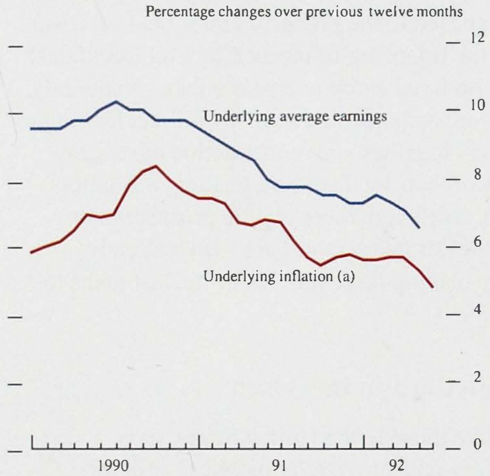
Banks in this country, like those in the United States, have generally been quicker to make provisions and write-offs for domestic bad debts in the present recession than on previous occasions. This has taken provisions to a historically high level but the earlier recognition of potential problems improves the prospect that the rate of new provisions may now begin to decline. Given their current bad debt experience, banks are tending to impose tighter credit standards. Interest spreads are also higher than they were three or four years ago as banks have attempted to restore adequate returns. These responses by the banking sector reflect an assessment of the creditworthiness of borrowers rather than a constraint on the supply of new lending.

Caution on the part of both lenders and borrowers is resulting in slow growth in the total lending of banks and building societies, which continues to rise at around 5% per annum. This is in line with the 5.2% increase in GDP at market prices in the year to the first quarter of 1991, and contrasts with earlier years when lending had consistently outpaced GDP. Lending to the personal sector amounted to only £6.2 billion in the second quarter, almost entirely accounted for by loans for house purchase as consumer credit and loans to unincorporated businesses remained subdued. The prospect for an upturn in personal lending remains weak, with the number of new commitments by building societies in the three months to June the lowest since the series began in 1976. Bank lending to industrial and commercial companies did expand by £1.4 billion in the second quarter following four successive quarters of net repayments, but alongside this companies have been raising less new finance in the capital markets than they did last year as investors seem to have become more selective in their willingness to buy new equity at current yields.

. . . and monetary growth has slowed further

The weakness of the private sector's net demand for finance has no doubt made it easier to fund the Government's increased borrowing requirement without any appreciable impact on bond yields. Nor has there been any significant acceleration in monetary growth. Despite the pick-up in bank lending in the second quarter, M4 growth at 1.1% was slower than in the previous quarter and, if annualised, than the 5.2% growth over the last year. Meanwhile

Chart 6
Inflation and earnings



(a) Excluding mortgage interest payments and introduction of the Community Charge in 1990.

M0 growth, at 1.3% in the year to June, is now in the lower half of its 0%–4% target range, reflecting slow growth in nominal retail sales.

The weakness of activity has been reflected in a continuing decline in the rate of increase of underlying average earnings, which in May were $6^1/_2$% higher than twelve months earlier, the lowest for 25 years (see Chart 6). This figure as yet only partially reflects the decline in median wage settlements to $4^1/_4$% from $8^3/_4$% in the first quarter of last year and prospects for a further deceleration of price inflation are being aided by productivity growth. Unit labour costs in manufacturing were around 3% higher in the second quarter than they had been a year earlier. Given signs that the rate of inflation in the service sector is also at last coming down, a resumption in the fall of the headline RPI figure below its present 3.9% is now a firm prospect. But there is still some way to go before our underlying inflation rate, as measured by the RPI excluding mortgage interest payments, is brought into line with the ERM countries with the lowest inflation rates, where Denmark, Belgium and France currently average 2.6%.

The control of public expenditure should reinforce anti-inflationary credibility

Uncertainty about the degree of slack in the economy makes it difficult to judge the underlying fiscal position. To meet the Maastricht criteria for general government borrowing and debt, and the other criteria relating to inflation and bond yields, is within our grasp. But it will require strict control of public expenditure. The new procedures for controlling the total of public expenditure announced at the end of July are a welcome step forward.

The reconciliation of sustainable growth with price stability depends upon the consistent pursuit of a medium-term framework for macroeconomic policy. The credibility of policy derives from the confidence of private sector agents in the resolve of the authorities to achieve price stability. That resolve is embodied in the explicit commitment to our present ERM parities. But the uncertainties surrounding the prospects for monetary union following the result of the Danish referendum have also demonstrated the importance of maintaining the clarity of the domestic objectives of policy. The small reaction of long-term government bond yields to the Danish referendum result demonstrates the considerable credibility which attaches to present policies. That credibility should not be put in jeopardy.