General assessment

Prospects for growth in the world economy have deteriorated sharply over the last quarter. Expectations of the rate of growth of the major six overseas economies in 1992 have been lowered from around 3% to closer to 2%. The weaker outlook is most evident in the United States and Japan where the authorities have responded by cutting interest rates. In Europe, by contrast, interest rates have generally been rising. The Bundesbank raised rates at the end of last year. All other ERM countries, apart from the United Kingdom, followed this move by raising rates by varying amounts. In the United Kingdom, output has yet to recover. But there has been considerable progress in reducing inflationary pressures. Risks remain—primarily those associated with high levels of indebtedness—but leading indicators continue to point towards an upturn this year.

Recovery in the United States appears to have stalled . . .

Following the falls in output seen last winter, the US economy grew modestly during 1991 and, by the fourth quarter, GDP was marginally higher than a year earlier. But, with the exception of exports and the housing sector, all the major indicators of activity have deteriorated since the summer, suggesting that the recovery has stalled. Growth is being restrained by high corporate and personal indebtedness, the resulting difficulties in the real estate market, and a necessary restructuring of industry. Private fixed investment (as a percentage of GDP) has declined to a level not seen since the 1940s. This lower rate of investment is being reflected in per capita real wages, which are lower now than they were in the late-1970s. The US administration has attempted to address both structural and conjunctural problems with its budgetary proposals, which include some temporary tax reductions—mainly intended to stimulate house purchase and investment in equipment—as well as changes to capital gains tax and personal allowances. But the scope for stimulatory fiscal policy initiatives in the United States is constrained by the size of the Federal budget deficit which is expected to rise to 6.7% of GDP in fiscal 1992, from 4.8% in fiscal 1991. This has resulted in an unusually steep yield curve as inflationary expectations have allowed bond yields to fall by only 1.7 percentage points in the past two years, compared with the 6 percentage point reduction in short yields. The long-bond rate is currently almost $3\frac{1}{2}$ percentage points above short-term rates.

The growth of the Japanese economy has also slowed markedly. GNP in the third quarter of 1991 was still 4% higher than a year earlier, though lower rates of growth are expected through the winter until around the middle of this year. The downturn has been led by investment, which is now growing at around 7–8%—a more sustainable rate than in the recent past. Although the Japanese slowdown has not been as acute as that in the United States, business profitability and confidence have suffered, and there have been concerns that associated falls in asset prices—of both equities and, especially, real estate—could lead to difficulties for financial institutions and other companies which could trigger further declines. Equity prices are already 40% below their peak in December 1989 and land prices—which have been very high by international standards—have also fallen sharply. The Bank of Japan has had to balance its determination to keep inflation under control with concerns over the fragility of the economy and, with consumer price inflation around 3%, felt able to cut its discount rate to 4½% at the end of December. The budget announced by the Ministry of Finance for the coming fiscal year should also give a mild stimulus.

. . . while in western Germany, output has fallen again . . .

Weak demand in other countries contributed to a second successive quarterly decline in GNP in western Germany in the third quarter of last year. Tax increases and smaller purchases of western consumer goods in the new eastern Länder also depressed demand. Preliminary estimates suggest GNP remained flat in the fourth quarter. As in the United States and Japan, growth is likely to be slow in the first half of this year, but should pick up later as the income tax surcharge is removed in July. Slow growth, combined with some reluctance to make major cuts in subsidies and other public expenditure in western Germany, is aggravating the budgetary problems arising from unification, although delay in financing investment in the new Länder held the general government deficit down to around DM 130 billion in 1991, less than had been anticipated. A similar figure, equivalent to some 4½% of GNP, is expected this year. In the absence of further budgetary cuts or tax increases, the deficit is unlikely to decline much before 1994. During 1991, consumer prices rose by 4.2%. Excluding indirect tax increases, however, underlying consumer price inflation was around 3½%. Hourly earnings in manufacturing grew by over 6% in the year to the third quarter. The Bundesbank has expressed its concern over both the size of the deficit and the level of settlements that may emerge from the forthcoming pay round, and has reiterated its determination to bring inflation back down.

. . . but interest rates have risen further

On 19 December, the Bundesbank raised both the Lombard and discount rates by 50 basis points to 9.75% and 8% respectively—the highest level since the Second World War. To the extent that the inflationary pressures arising from unification are peculiar to Germany, it might seem reasonable for rises in interest rates to be limited to that country. But the fixing of exchange rates between Germany and its neighbours restricts the extent to which interest rates can diverge. The 2¼% range of exchange rate flexibility provided by the narrow band of the ERM might have been expected to permit some countries to hold their short-term interest rates a little below German rates at a time when their economies were experiencing lower inflation and more unemployment. But attempts to do this—notably by France—have not yet succeeded, perhaps because the credibility of the Bundesbank's commitment to long-term price stability remains undiminished by current inflationary and budgetary pressures. But there is no reason to suppose that, as the process of disinflation outside Germany proceeds, deutschemark interest rates must continue to represent the floor to the system. It is encouraging in this regard that the convergence criteria agreed at the EC summit at Maastricht to assess member states' readiness to proceed to Stage 3 of EMU focussed on convergence of long-term bond rates rather than of short-term rates. Long-term rates give a better indication of expectations of inflation over the long term. Bond rates suggest some convergence has already been achieved in this regard between the original narrow band members and Britain. Rates on peseta, lira, escudo and drachma bonds, however, remain notably higher. ERM members with a sufficiently strong fiscal position could compensate for any undesired increases in interest rates by some temporary easing of fiscal policy, for example allowing the 'automatic stabilisers' to operate. But other member states may have great difficulty meeting the Maastricht criteria for fiscal convergence and their scope for action in this area will be more constrained.

The sharp widening of interest rate differentials between Germany and other ERM countries on the one hand, and the United States on the other, led to major movements in exchange rates in the three months to the end of January. The US dollar depreciated against the deutschemark by 5%. The dollar effective exchange rate index fell by 3%, taking it back to its level at the beginning of 1991, some 10% below the peak reached in July. The deutschemark index has been much more stable.

The problems facing the former Soviet republics . . .

The damage that a breakdown of trading relationships can cause is illustrated by the threats facing the former Soviet republics. The replacement of the command economy which had operated over this huge territory was bound to be difficult, especially in view of the artificial, monolithic specialisation of production which had been imposed on the republics. But the difficulties will be severely compounded if the republics, each anxious to conserve for its own citizens the goods it produces, deny themselves the benefits of trade with their neighbours. The impoverishment of the people—already severe—will be far more acute, if, for instance, one republic refuses to export grain while another refuses to export vital machine tools. The key to establishing efficient trading patterns is the provision of a monetary standard in which the public have sufficient confidence for it to act as both a store of value and a medium of exchange. Monetary values can then provide the price signals which are the essence of a market economy. The rouble has not been meeting these needs for some time.

Sustaining trade between the states of the new Commonwealth would have been easier if it had been possible to keep a single, stable currency. But all currencies require a measure of trust, in particular trust in the issuers not to indulge in inflationary financing through excessive monetary creation. Against a history in which the printing of banknotes provided the main means of budgetary financing, and where the combined Union and republican budget deficit had risen to around 20% of GNP, not all the newly independent states can agree on ways to regulate the issue of a common currency. It is vital that the stability of any new currencies is ensured by restraining their issuance, which will require budget deficits to be cut and other means of financing to be created. At the same time, the states will need to co-ordinate their economic and monetary policies, and in particular to establish efficient arrangements for exchanging the various currencies, if inter-state trade is not to be further hampered. There is an increasingly urgent need for the West to play a major role in helping to make possible a successful transition to a market economy and democratic society.

. . . require urgent Western assistance

With the former centrally planned economies now embracing liberalisation of markets, it is more important than ever that those industrial countries which benefited most from the expansion of world trade in manufactures in the 1950s and 1960s ensure a successful conclusion to the Uruguay round. Bilateral and regional agreements—provided they do not conflict with the multilateral approach—are helpful. But a better package for the world economy would be one in which the GATT was extended to new areas—such as services and intellectual property rights—and further progress was made in eliminating trade restrictions.

In the United Kingdom, activity has yet to recover . . .

As overseas, the performance of the domestic economy has been disappointing. Output appeared to have stopped falling in the first half of 1991, but no recovery in the level of activity has yet occurred. The increasing fragility of the world economy has undoubtedly been a factor inhibiting the resumption of growth, but the delay in the upturn is also associated with the weakness of domestic expenditures, reflecting consumers' and firms' reluctance to add to existing debt burdens. Although survey measures of confidence have faltered in the last quarter, it nevertheless remains true that the leading indicator measures point firmly to an upturn in output in the course of 1992.

The weakness in the world economy has led to difficult trading conditions for British exporters. Despite this, UK exports remained relatively stable in mid-year (aside from some month-to-month volatility owing to car exports), and non-oil export volumes (excluding erratics) rose by over 2% in the fourth quarter to stand 4% up on a year earlier. Imports also rose in the fourth quarter, but by just over 1%.

The rise in domestic demand in the third quarter was more than accounted for by an apparent end to destocking. Consumption was flat and there was a further fall in fixed investment. A clearer picture of the recession emerges from comparing changes in the various components of demand between the third quarters of 1990 and 1991. In that year, domestic demand fell by over 3%: three fifths of the fall was attributable to cuts in investment, and the bulk of the remainder to lower consumers' expenditure. The improvement in the trade balance over this period mitigated the impact on GDP, which fell by 2¼%.

The recession has been accompanied by substantial progress in reducing the underlying rate of inflation. Although 'headline' RPI inflation turned back up in November, as the effect of cuts in mortgage interest rates twelve months earlier dropped out of the calculation, underlying inflationary pressures have diminished. There have been further falls in the rates of increase of output prices and wage settlements. Over the twelve months to December, output prices excluding food, drink and tobacco rose by 3.9%, and at an annualised rate of only 2.3% over the past three months—the lowest rate in almost twenty years. Wage settlements are also rising more slowly. In the three months to December, wage settlements in the economy as a whole rose by only just over 5%.

... but underlying inflation has fallen significantly

Such aggregate figures conceal a difference between the rates of inflation of goods, on the one hand, and services, on the other. In the twelve months to December, prices of goods other than alcohol and tobacco (each subject to significant increases in excise duty in last year's budget) rose on average by only 5¼%, despite the 2½ percentage point increase in VAT in April on most goods other than food. But retail prices of services (other than housing and utilities) rose by 10½%. Counter-inflationary policies—and in particular the ERM commitment—appear to be biting first, as might be expected, in traded goods sectors where the threat of overseas competition is greatest. In the longer term, as relative price movements affect the composition of demand, the more sheltered sectors will suffer if they fail to restrain price increases.

The reduction in domestic inflation, and inflation in the industrial world more generally, has been assisted by continuing falls in commodity prices. Metal prices, for example, have halved in SDR terms since January 1989, and the Economist all-items index of commodity prices fell by almost 8% in the year to January. During the fourth quarter of the year, dollar oil prices fell by over 15%. These developments have been translated into continuing falls of domestic manufacturing input prices—down by more than 1%—during 1991.

Service industries have so far suffered less than some other sectors from the recession, but to a greater extent than in previous downturns. Between its peak in the second quarter of 1990, and its level in the third quarter of 1991, service sector output fell by 1.8%. This compares with a fall of 1.7% in the 1979–81 recession, and a *rise* of 0.6% in 1974–5. Manufacturing output, however, has fallen by 6½% from its peak, compared with falls of 11% in 1974–5 and 17½% in 1979–81. The regional pattern, too, is rather different than in the earlier recession: the south-east and south-west together accounted for 27% of the rise in unemployment in 1979–81, but 54% in 1990–91. Scotland and the North, by contrast, contributed almost 16% in 1979–81, but only 5½% in the present recession.

The private sector has eliminated its financial deficit, ...

The main risks to the prospect and pace of recovery are associated with the private sector's indebtedness to the banks and building societies which has grown rapidly in recent years. In the personal sector, capital-gearing (gross debt as a proportion of gross financial and tangible wealth) is estimated to have reached an historic peak of over 15% in the third quarter of last year; for companies the peak (at the end of 1989) was considerably higher, at around 33%. It is unlikely, however, that these ratios will rise much further, as companies and consumers seek to restructure balance sheets. The personal sector moved from financial deficit to a surplus of around £8 billion in 1990, and may have increased its surplus to £18 billion in 1991. At the same time, companies' financial deficit has shrunk from a record £26 billion in 1990 to just over £9 billion in the first three quarters of 1991. Income-gearing ratios are already much reduced from their earlier peaks, reflecting the decline in interest rates. The personal sector's gross income-gearing is estimated at 11½% in the third quarter of 1991, down 2 percentage points from the first quarter; for companies the decline was even more marked—from 39% to 31%.

One factor which reflects future expectations and the wish to take on debt is the state of the housing market. House prices have fallen by almost 5% since mid-1989. Turnover as a percentage of the stock of owner-occupied dwellings is lower than at any time since at least 1977. The fall in house prices may be seen as an unwinding of the rapid rise in prices in the mid to late-1980s. Even now, house prices are not, on average, historically low in relation to incomes, although disparities have narrowed substantially in most regions over the last 18 months. If there were to be further falls in house prices and continuing low turnover, consumers' expenditure might remain depressed—partly owing to the direct impact of housing turnover on durables expenditure, but also through the reduced scope for equity extraction and the general impact on consumer confidence.

. . . action has been taken to stimulate the housing market . . .

Overhanging the housing market is a substantial stock of unsold houses, many of them houses possessed by lenders from mortgagors defaulting on loans. A significant minority of borrowers, confronted by high interest rates and slower growth of nominal incomes, have found themselves to be overburdened with debt. Possessions by mortgagees have risen to unprecedented levels, from averages of over 3,000 a year in the 1970s and 12,000 in the 1980s to 44,000 in 1990 and around 75,000 last year—representing less than 1% of outstanding mortgages. The actions taken in December by the Chancellor, temporarily suspending Stamp Duty on conveyances of up to £250,000, and by various mortgage lenders to slow down the rate of possessions and sales of these dwellings, should help stimulate turnover in the market and prevent further depression of house prices from this source. The cuts in mortgage rates announced in January by some of the major lenders should also have a beneficial impact.

. . . and credit growth should be adequate to fund the recovery

Other concerns have been expressed that financial factors might impede recovery—notably that there will be insufficient credit available to borrowers to finance higher activity. But some commentators have suggested a potentially more serious problem, with banks having insufficient capital to be able, given supervisory requirements, to support the expansion of lending required by the private sector. There are a number of uncertainties, including the ease and cost at which banks could raise any new debt or equity capital required; but analysis of the positions of the major British banks suggests that they should be able to meet the financing requirements of British residents this year while maintaining a margin of capital above the minimum 8% ratio set by the Basle international convergence standards.

Bank lending to the private sector has slowed noticeably. The level of new bank lending (net of repayments), as a proportion of the stock of loans, declined from 20% in the year to the beginning of 1990 to less than 6% during 1991. This has been mirrored by growth of only $6^1/_4$% in broad money, M4, during 1991. This was unusually slow by the standards of recent years but is in line with the developments in the economy already described: in particular, a growth of nominal GDP of only around $4^1/_2$%, the lowest figure since the early 1960s. But the widening of margins by lenders and the tightening of their lending criteria are also likely to have contributed to the slower growth of intermediation by banks and building societies. In view of the access of large companies at least to other sources of credit, it is difficult to judge the extent to which the slower rates of growth of money and bank credit are simply part of the disinflationary process or whether they suggest, other things being equal, a tightening in the terms on which credit is available.

The process of reducing debt burdens to new and lower desired levels takes time. This, and the slowdown of the world economy, has meant that the weakness of non-oil output, though less pronounced than in earlier recessions, has persisted for longer. The reduction in interest rates that took place during 1991 will help to accelerate the adjustment to lower levels of indebtedness. But the US experience suggests that such reductions do not have an immediate impact. In any event, the recent tensions in the ERM have made further easing of monetary policy difficult. Fiscal policy is playing a role through the automatic stabilisers and the temporary suspension of Stamp Duty on house purchase. But the basis for sustainable growth remains a credible commitment to the ultimate goal of price stability. This is bolstered by membership of the ERM and a medium-term target for public spending and borrowing.