General assessment

The short-term outlook for the world economy has altered little over the past three months. Growth in the major six overseas economies for calendar 1992 is unlikely to exceed 2%, which, although low by past standards, is above the 1.1% achieved in 1991. But the overall picture conceals significant changes among the main economies, with the revival in the United States not matched elsewhere. There have been differences too in policy responses. Over the past three months, interest rates have been reduced in the United States and Japan, and in the latter there has also been a degree of fiscal expansion. In Germany interest rates remain high. In the United Kingdom, the recession is thought to have continued into the first quarter of this year. But confidence has begun to recover again and will be helped by the cut in interest rates on 5 May. Inflationary pressures have continued to ease.

The volume of world trade grew by only 3% last year, compared with 5% in the preceding year and an annual average growth rate of $5\frac{1}{2}$% during the 1980s. In part, last year's performance was boosted by a rapid growth of both imports and exports by the Asian newly industrialising countries whose trade grew by $13\frac{1}{2}$%. In 1992 the prospect is for a modest increase in the rate of growth of world trade. For the longer term, sustained growth in trade depends upon a successful conclusion to the Uruguay round of the GATT, and a recognition of the importance of multilateral agreements. Lack of progress in the areas of agriculture and services threaten these negotiations.

As recovery begins in the United States . . .

In the United States, there are signs of a modest recovery. GDP grew by 2% at an annualised rate in the first quarter of this year, the highest rate since the first quarter of 1989. Retail sales rose by $2\frac{1}{4}$% in real terms in the first three months of this year over the previous quarter, and housing starts increased by 17% over the same period. Short-term interest rates have fallen by $2\frac{1}{4}$ percentage points over the last twelve months, and there were reductions last December of $\frac{3}{4}$ percentage point and a further small reduction of $\frac{1}{4}$ percentage point in April. As yet the impact has not fed through to industrial production or to employment. Inflation has fallen further to an annual rate of 3.2%. The reduction in interest rates has helped the process of reducing high income gearing ratios of households, corporations and financial institutions, but the commercial real estate market remains a source of weakness. Although there are signs of a pick-up in turnover in this market, office vacancy rates are still high and rising, and it is not yet clear that prices have stopped falling.

. . . activity slows further in Japan . . .

Output in Japan fell in the fourth quarter and the year-on-year growth rate was only a fraction above 3%. Falling profits and high levels of gearing led to a decline in corporate investment. Since then the economic situation has further deteriorated. Industrial production fell by around 3% in the first quarter of 1992. The February Tankan survey showed business confidence at its lowest level since 1987. Even more striking was the fall in the stock market with the Nikkei index falling below 17,000 in April, its lowest level since 1986. At this level, share prices were almost 60% below the peak at the end of 1989. Evidence of economic slowdown is widespread. A fall in consumer confidence was accompanied by a reduction in the growth rate of retail sales in the fourth quarter of last year, and investment in housing continued to fall. There have been further declines in monetary growth. The authorities introduced both fiscal and monetary measures to stimulate the economy. An emergency fiscal package was introduced for the first time since 1987, and at the beginning of April the Bank of Japan cut its discount rate by 75 basis points to $3^3/_4$%.

The fall in Japanese share prices was especially significant for financial institutions, reviving concerns about the capital adequacy of banks because of the contribution which revaluation reserves on holdings of securities make towards meeting target capital ratios. Since the beginning of the year, the share prices of major banks (City, long-term credit and trust banks) have fallen by an average of around 40%. The share prices of the big four securities houses have also fallen by about 30%. It is estimated that when the Nikkei index is below 18,000 many large Japanese banks have capital adequacy ratios below the 8% Basle minimum which they are required to reach by March 1993. Banks are also experiencing pressures resulting from property-related lending, including lending made indirectly via non-bank financial institutions. The main fall in banks' profits is not expected to be reflected in their accounts until the 1992/93 financial year results are published. Despite the difficulties facing the banks, there is, as yet, no evidence of a general lack of funds for domestic lending, although Japanese banks have reduced the volume of their overseas lending.

. . . and remains subdued in western Germany

In the western part of Germany, GDP was unchanged in the fourth quarter from its level in the third. Indeed, because of offsetting movements in the second and third quarters, it was at the same level as in the first quarter. The weaker picture painted by GNP, which fell by 1% between the first and fourth quarters of 1991, is misleading in that it excludes that part of output attributed to the labour input of workers from the new Länder who remit their earnings back to the east. Some slowdown in activity in western Germany was both inevitable and desirable; business investment and consumption, which contributed to the earlier expansion in demand, both weakened considerably during the course of last year. Although the level of capacity utilisation has fallen from a peak of 90% in December 1990 to 87% in December of last year, it still remains well above the level of 75% seen in the trough of the 1982 recession. Thus activity in the western part of Germany is not especially weak, and most forecasters expect growth to resume in the second half of this year. In the new eastern Länder, output, after a rapid fall, showed some signs of revival towards the end of 1991.

The direct and indirect effects of unification have to a large extent been responsible for the rise in inflation in the old Länder to a peak of 4.8% in March. Wage settlements have reflected this inflation and earlier demand conditions; a wage award worth around 5.4% in the public sector indicates continuing wage pressure. In the wake of unification the monetary aggregates are difficult to interpret, but growth in M3 of 9.7% in the target period so far, accompanied by strong bank lending, is continuing to cause concern. Short-term market interest rates have remained high, close to the Lombard rate of 9.75%.

Short-term interest rates in Europe are high by world standards . . .

High interest rates in Germany have obliged other countries in the ERM, especially those in the narrow band, to maintain higher interest rates than domestic considerations would, for the most part, have dictated. Throughout the EC, output growth has remained sluggish. In the year to the fourth quarter of 1991, GDP in the EC grew by about 1%. Improvement in inflation has, however, been modest. Consumer price inflation in the EC fell from $5^1/_4\%$ in March 1991 to $4^3/_4\%$ in March 1992, but this improvement was fully accounted for by the reduction in retail price inflation in the United Kingdom.

In the ERM itself no serious tensions have arisen in recent months. Within the narrow band, the French franc has risen, leaving the Danish krone at the bottom. An interesting development has been the increased fine-tuning of interest rate differentials, with changes as little as ten basis points in official rates, as countries such as Belgium and the Netherlands have sought to keep their currencies very closely aligned with the deutschmark. Denmark, too, has refined its monetary policy instruments so as to facilitate fine tuning. The wide band was close to its limits for most of the period. For a while it was fully stretched, from which some relief was obtained by a Spanish interest rate cut. The band narrowed further following the general election in the United Kingdom, when sterling rose from its average during the campaign of under DM 2.86, to a peak of over DM 2.94, the highest rate since September of last year. A credible commitment to the ERM bands has meant that markets have tended to stabilise rates when limits have been reached. On 6 April the Portuguese escudo joined the ERM, appreciating to the upper reaches of the wide band and replacing the Spanish peseta as the strongest currency in the system.

Turning to the East, fourteen of the former Soviet republics were admitted to the IMF at the end of April. Russia has made a bold start on reform and now needs to adopt an economic reform programme drawn up in consultation with the IMF. Its success will depend on the commitment and ability of the Russian government, and especially the central bank, to implement firm budgetary and monetary policies. Performance in the early months of this year was mixed. Prices were liberalised, but output continued to fall and the target for the budget deficit in the first quarter proved too ambitious. Following the lead taken by the United Kingdom earlier in the year, the G7 announced in April a support package for Russia. This comprised $18 billion of finance through the multilateral agencies (especially the IMF), debt deferral, and assistance from individual industrial countries. This is estimated to meet Russia's financing needs for 1992. The IMF has also approved in principle the establishment of a $6 billion rouble stabilisation fund.

. . . but differences in long-term rates are smaller

The effective demands on world savings likely to be made in the coming year by Eastern Europe and the former Soviet Union will be less than many had anticipated. Likewise the costs of post-Gulf

War reconstruction in the Middle East have proved lower than expected as have demands for funds to invest in the industrial economies. This should serve to relieve upward pressure on real interest rates arising from changes in the balance between the demand and supply of world savings. But the rise in public sector deficits in a number of countries—especially Germany, the United States, France and the United Kingdom—will tend to act in the opposite direction. At present, short-term real interest rates are high in Europe, reflecting the determination of ERM participants to maintain their exchange rates against the deutschmark. In the United States, as in Japan, short-term real rates are considerably lower, reflecting a more accommodative monetary stance. These apparent differences in real rates can be reconciled with a high degree of capital mobility by the expectation of a rise in the dollar and yen against ERM currencies. At longer maturities differences in interest rates are smaller, with a downward sloping yield curve in Europe, and a steeply upward sloping curve in the United States.

In the United Kingdom the recession may be coming to an end

In the United Kingdom, real GDP is estimated to have fallen by 2.4% in 1991, and the recession in non-oil output is now the longest since the 1940s—although the peak to trough fall in output has been less than in the previous recession. Output started to fall sharply in the middle of 1990 and by the second quarter of last year was already 3½% lower than a year earlier. There was little further overall deterioration during the second half of 1991, partly as a result of a resumption of higher rates of oil and gas production in the North Sea. On the demand side, consumers' expenditure actually rose during the second half of the year—by 0.3% between the second and fourth quarters. And while stocks continued to fall, stockbuilding nevertheless made a positive contribution to GDP growth of 0.8 percentage points. Fixed investment also fell, but at a slower rate than before. Although the investment-output ratio has now returned to its mid-1987 level, at over 20% it remains historically high.

In the first quarter of 1992 it seems likely that the level of output was either unchanged or slightly lower than at the end of last year. But business and consumer confidence has recently begun to recover. In the latest CBI Industrial Trends Survey the balance of firms reporting that they were more, rather than less, optimistic about the general business situation than four months earlier increased sharply, to the highest level since the second quarter of 1988. And following the general election, financial markets also indicated an improvement in sentiment—with a rise in equity prices, a decline in bond yields, and a rise in the level of sterling. In addition interest rates were cut by ½ percentage point on 5 May. Taken together, these developments are encouraging and herald the prospect of an end to recession.

The pace of recovery depends upon both international and domestic factors. Compared with 1990, the trade performance in 1991 was better than expected, with non-oil export volumes growing by 2¾%—despite slowing growth in world markets—and import volumes falling by 2½%. The growth in imports may have been depressed by the recession, but the improvement in United Kingdom competitiveness also helped. The UK real effective exchange rate (against other major industrialised countries) fell by

$4\frac{1}{2}$% between August 1990 (its recent peak) and March 1992. Against ERM countries competitiveness is broadly unchanged since the date of ERM entry. More recently, trade performance appears to have deteriorated slightly, with export volumes rising by $\frac{1}{4}$%, but import volumes picking up by 3% in the first quarter. The rise in imports may reflect a recovery in home demand, and while this is likely to lead to a widening of the balance of payments deficit, the scale of the deficit, in relation to GDP, is sufficiently small to suggest that its financing will not be a problem.

The pace of recovery will depend on progress in easing the debt burden . . .

The weakness of consumer spending has reflected uncertainty about the future growth of incomes and employment prospects, and attempts by the personal sector to reduce the growth of its debt. The small reduction in the personal saving ratio in the fourth quarter may suggest that the constraints of the debt burden had begun to ease. The fall in interest rates during the course of last year helped reduce the personal sector's income gearing to $12\frac{3}{4}$% in the fourth quarter, down $\frac{3}{4}$ percentage point from its peak at the start of the year. Personal sector capital gearing remained broadly unchanged during the year. The improvements in the corporate sector were more marked, gross income gearing falling by $4\frac{1}{2}$ percentage points (to $31\frac{1}{2}$%) and capital gearing by 2 percentage points (to $30\frac{1}{2}$%). Despite these reductions both personal and corporate gearing ratios remain at historically high levels, but the cut in interest rates in early May will further ease the burden of debt.

. . . and developments in the property market . . .

In the housing market the decline in prices has accelerated in recent months. Prices in the south-east have continued to fall and by the end of the first quarter were some 25% below their end-1988 peak. House prices fell throughout the country in the first quarter. The likely future course of house prices remains unclear. There has been some anecdotal evidence from estate agents, builders and mortgage lenders of greater interest in house purchase, but this has yet to be translated into completed sales which, in the first quarter, were 24% lower than a year previously and 38% below the average for the 1980s. Any significant recovery in house prices will be restrained by the rise last year in possessions of properties (see article on page 173 for a fuller discussion). Although the number of possessions last year was only 0.75% of the number of mortgaged dwellings, lenders have still been left with a relatively large stock of unsold properties. At the end of 1991 lenders had approximately 67,000 unsold properties still in possession. Measures announced in December, including the payment of the mortgage interest component of Income Support directly to lenders, are likely to have helped reduce the flow of new possessions this year. This, together with anticipation of the expiry of the temporary suspension of Stamp Duty in August, is likely to foster some recovery in the housing market in the coming months.

The commercial property market has also been in difficulties, following the earlier boom in construction, especially in London. Rental values on all forms of commercial property are lower than a year ago, but the decline in office rents has been the most marked, down more than 20%. In central London the decline has been even greater. Capital values are also down by some 20% in the office sector—but have been broadly flat in the retail sector and slightly higher for industrial property.

... but banks should be able to provide the necessary finance

Corporate defaults have necessitated sharp increases in provisioning against bad debts by banks. This in turn has had a major impact on banks' profitability. Nevertheless, banks' risk asset ratios remain well above the Basle standards, reflecting slow asset growth together with some widening of margins, and positive effects on profitability arising from measures to control costs. On this basis, there is little evidence of constraints on lending from the supply side. The current slow growth in lending is a demand-side phenomenon, as borrowers seek to restructure their balance sheets. Moreover, although further increases in provisioning cannot be ruled out, the level of banks' capital combined with improved profitability and partial recovery of provisions should be sufficient to support lending as the economy recovers.

The twelve-month growth of M4 almost halved during the course of 1991—from 12¼% at the end of 1990, to 6¼% at the end of 1991. Lending by banks and building societies to the private sector slowed even more sharply—from almost 14% to 5¾%—only slightly above the 5¼% rise in GDP at market prices in the year to the fourth quarter. On a sectoral basis, industrial and commercial companies made net repayments to banks last year: their borrowing actually declined in the second and third quarters, and their deposits rose substantially—especially in the fourth quarter. As a result, large companies' liquidity rose back to the levels last seen at the beginning of 1988. In part this may reflect the increased amount of money they have been raising from the capital market. Since the second quarter of last year, sterling equity issues alone have averaged almost £1 billion a month. This switch in the sources of finance has also enabled many companies to reduce their gearing ratios since the beginning of last year. In the first three months of this year the growth of M4 and of private sector borrowing from banks and building societies fell again.

Inflation has continued to fall ...

Although the reductions last year in the numbers of employees in the manufacturing and services sectors were broadly similar, the cutback in manufacturing was proportionately far greater, with a 7% reduction in jobs as against only 1¾% in services. Despite the recession, manufacturers still managed to increase output per head by over 2½% during 1991. Productivity improved further in February, when output per head in manufacturing stood over 4% higher than a year earlier. As a result, the growth in manufacturing unit wage costs fell to just under 3½%—down from a peak of over 12% in April of last year. The rise of 2.8% in manufacturing output prices (other than in food, drink and tobacco) in the year to April was the lowest such figure for almost twenty years. The increase over the last six months has been at a slightly lower annual rate and, with recent pay settlements in the economy as a whole and in manufacturing down to 4½%, there is scope for further reductions in the rate of increase of goods prices. Export prices have also been contained. But prices in more sheltered sectors of the economy have continued to increase more quickly and the RPI (excluding mortgage interest payments) rose by 5.7% in the year to March, still about $2\frac{1}{2}$ percentage points above the average inflation rate in the three lowest inflation ERM countries. It is more encouraging that average earnings growth in the United Kingdom has now come more into line with that in our ERM partners, though given the continuing reductions elsewhere in Europe, there is no room for complacency.

The financial year 1991/92 produced the first public sector borrowing requirement for five years, and at $2\frac{1}{4}$% of GDP (or £13.9 billion) it was the highest since 1984/85. In his March Budget, the Chancellor of the Exchequer forecast a further marked increase in the PSBR in the current financial year, to $4\frac{1}{2}$% of GDP. Even with a recovery in activity in 1992, the recession will continue to affect the public finances as social security expenditure and corporation tax receipts both lag behind the output cycle. There is no doubt that a good part of the increase in general government expenditure (excluding privatisation proceeds) from $39\frac{3}{4}$% of GDP in 1990/91 to 42% in 1991/92 is a direct result of the recession, as is the fall in receipts from 39% of GDP to 38%.

. . . but further progress will require the continuation of counterinflationary monetary and fiscal policy

The prospects for recovery now appear better than for some time. Inflation is low and demand and output show signs of picking up. Confidence has increased—whether judged by consumer and business surveys, or by developments in asset prices. But these prospects are by no means uniform throughout the economy, and the pace of recovery is likely to be slow, depending on the course of the world economy and the impact of domestic and international financial fragility. As the recovery progresses, attention is likely to turn to the longer run question of convergence of economic performance in the European Community. A set of convergence criteria—relating to inflation, interest rates and debt, as well as to membership of the narrow band—were agreed at Maastricht. They provide a benchmark against which potential members of EMU will be judged. It is important that the United Kingdom satisfy these criteria by the time that admission to Stage 3 is discussed by the EC, probably in 1996, and the Government is fully committed to this. A continuation of the present counterinflationary stance of policy will ensure that the criteria relating to inflation and interest rates are met. But the ratio of government debt to national income is likely to rise until 1995/96—the first such rise for about 40 years—although this would not be unexpected during and following a recession. The level of the debt ratio itself is low by both international and historic standards. But to bring the ratio of the general government deficit to GDP below the Maastricht criterion of 3% by the fiscal year 1995/96 will require firm control of public expenditure. A credible medium-term target for public spending and borrowing is an essential part of a strategy for price stability.