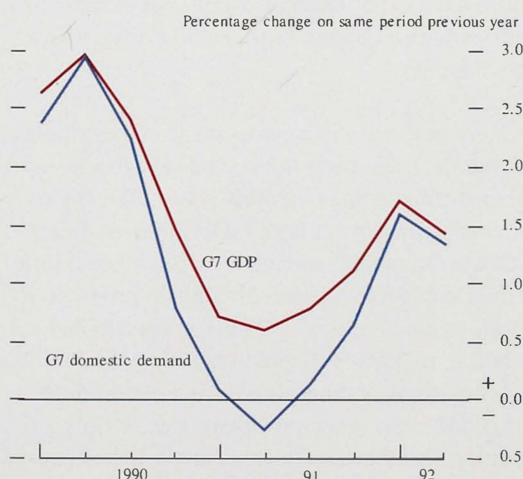
General assessment

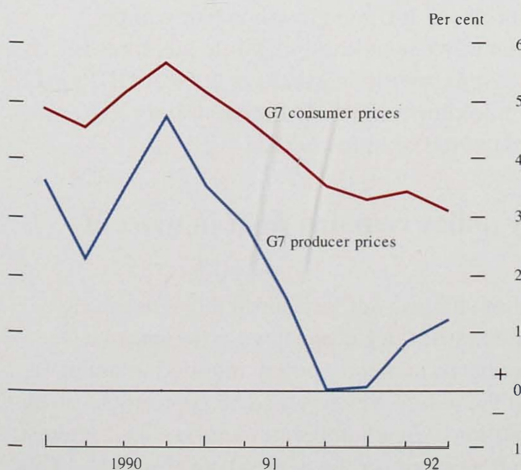
Developments in the past few months have been dominated by exchange market tensions—particularly among the European currencies. Continuing tight German monetary policy was reflected in the monetary policy of other ERM members, even where this was at odds with the requirements of the cyclical position in those countries. The resulting strains in the ERM were exacerbated by doubts about the future of the Maastricht Treaty, and this led to the realignment of the lira, and a slight fall in German interest rates, on 14 September. Despite this, speculation in the exchange markets increased as the French referendum approached, and led to the temporary suspension of ERM membership in the United Kingdom and Italy and a devaluation of the Spanish peseta. In the United States and Japan, subdued growth and inflation resulted in a further loosening of policy: in the United States the federal funds rate was eased by a further 25 basis points in September, while in Japan a substantial fiscal package was announced in late August.

Chart 1
Growth in the G7 economies (a)



(a) Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Chart 2
Inflation in the G7 economies



World trade growth is likely to be slower than previously expected . . .

The prospects for world trade have once again declined since the publication of the last *Bulletin*. Twelve months ago, the volume of world trade was expected to rise by 18% between 1990 and 1993. But successive downward revisions have meant that world trade in 1993 is now expected to be only 12% higher than in 1990—a reduction of six percentage points. Much of this can be traced to the slowdown in growth in the G7 economies (Chart 1). The counterpart has been a further easing of inflationary pressures worldwide. In the G7, the prices of traded goods have grown exceptionally slowly in the past eighteen months. Inflation defined more broadly remains higher, but still on a downward trend (Chart 2).

Despite a marked slowdown in growth in the second quarter, the Bundesbank has remained concerned about inflationary pressures in Germany. Consumer price inflation fell by one percentage point, to 3.3%, in July as the VAT increase dropped out of the twelve-month comparison. But inflation rose to 3.7% in October, and is unlikely to fall much during the remainder of this year, despite the impact of the recent appreciation of the deutschmark. A further increase in measured inflation is expected in January when VAT is raised by one percentage point. The authorities continued to give prominence to the need to contain the growth in M3, which had grown in September by 9% (at an annual rate) over the fourth quarter base, compared with a target range of 3.5%–5.5%. The usefulness of M3 as an indicator this year has been challenged on numerous grounds, partly associated with the effects of reunification, and it is possible that the relationships between monetary growth, activity and inflation may have been distorted. But the Bundesbank emphasises that 'special factors' account for only a small part of the overshoot of M3 and, notwithstanding some easing in money-market rates, has felt constrained to maintain a tight monetary stance.

This contrasts with fiscal policy, where German reunification is proving to be a continuing burden on German public sector finances. Under pressure from lower than expected revenues and mounting financing demands from the east, the general government deficit is expected to increase from DM 110 billion in 1991 to

DM 120–130 billion (4% of pan-German GNP) in 1992. This excludes the costs of the Treuhandanstalt and other public corporations. The impact of reunification is likely to place a substantial long-term burden on public finances.

... as the impact of the post-reunification boost to German demand diminishes ...

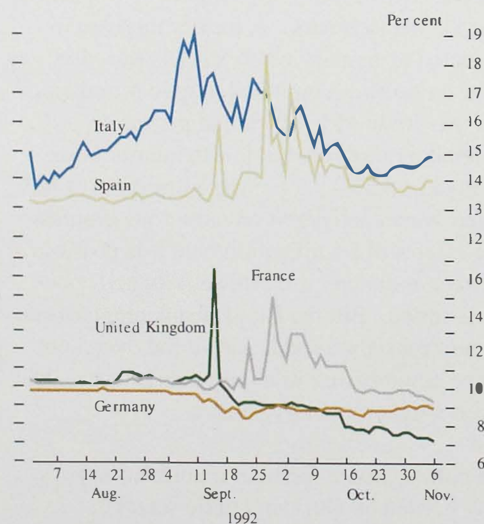
German economic policy since reunification has had two principal effects on the European economy. In 1990 and 1991, there was a boost to activity from additional demand growth in Germany. This has now diminished, and in 1992 the main effect has been tensions in exchange markets, as it has become increasingly apparent in some countries that a monetary policy as restrictive as that in Germany was no longer domestically appropriate.

It is difficult to be sure about the size of the boost to activity in Europe from additional demand growth in Germany. Estimates suggest that it may have added around 1% to total European Community output in 1990 and 1991 taken together. However, some countries were affected more than others by this 'ripple effect'. In particular, Belgium, Holland and Denmark are likely to have experienced more than the average rise in output; France, Italy and the United Kingdom have experienced a rise in output close to the average; and countries such as Spain, Greece and Portugal are likely to have seen less benefit.

The French economy has continued this year to share in the 'ripple' from German demand but the trade performance has also been bolstered by further improvements in competitiveness. The trade surplus accounted for approximately 0.6% of GDP in the first half of the year. Wage increases in manufacturing have averaged a little more than 4% a year over the last two years, but annual productivity growth has at times been as much as 3.5%. This has contributed to a continued fall in inflation, to 2.6% in September. Nevertheless, although France has shown signs of emerging from a period of relatively slow growth, GDP grew at an annualised rate of only 0.4% in the second quarter, and there remains a danger that recovery may falter if European interest rates remain high.

Despite the impact of German demand growth, there remains little sign of a recovery in Italy, where GDP grew at an annualised rate of 0.8% in the second quarter, but where industrial production and confidence remain depressed. Income growth is likely to be reduced by the abolition of wage indexation, while measures to contain the budget deficit (currently in excess of 10% of GDP) may further dampen the outlook for activity. Inflation in Italy remains high (5.3% in the third quarter), but lower than last year.

Chart 3
Short-term interest rates (a)



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

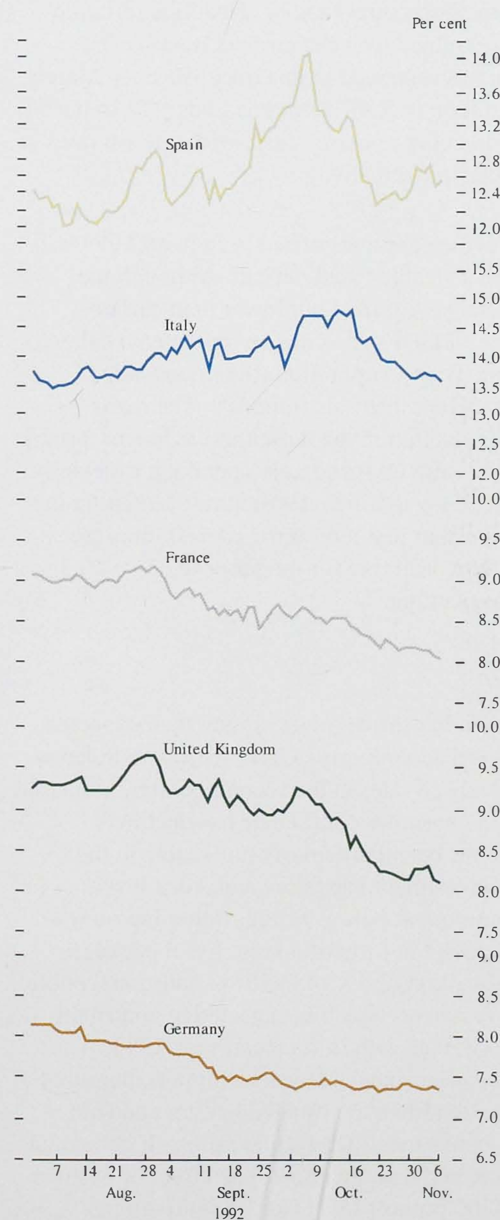
... and monetary policy remains tight in most of Europe ...

Against a background of sluggish activity and stable—or falling—inflation, a number of countries in Europe have experienced a growing conflict between the monetary policy required to maintain the exchange rate, and the policy which would be appropriate given domestic cyclical conditions. In a number of cases nominal interest rates might have been lower, but for the demands of the ERM. This was particularly the case for those countries that had benefited little from increased German demand, and which were—partly as a

consequence—in a different cyclical position. The tensions which thus arose in the foreign exchange markets were exacerbated by uncertainty over the ratification of the Maastricht Treaty following the Danish referendum result in June and the impending French referendum in September. Pressure on the exchange rate was initially felt most keenly in Italy, where the discount rate was raised to 15% in early September, and short-term official money-market rates exceeded 20%. Outside the ERM, too, speculative pressures intensified, resulting in Finland's decision to abandon its Ecu peg on 8 September, and heightening the pressure on the Swedish krona. Overnight interest rates in Sweden rose to 500%.

The increase in Italian interest rates was insufficient to limit speculation against the lira and the authorities devalued its effective central rate by 7% on 14 September. At the same time, monetary policy was eased slightly in Germany, and the Lombard and discount rates were reduced to 9.5% and 8.25%. Nevertheless, speculation intensified and, on 16 September, it became clear that existing parities were unsustainable. In the United Kingdom, interest rates were raised to 12%, and a further rise to 15%, to take effect on the following morning, was announced. At the end of the day the authorities announced the temporary suspension of ERM membership, and interest rates reverted the next day to 10%. Italy also announced a temporary suspension of the lira from the ERM, and the peseta was devalued by 5%. Exchange controls were re-imposed, or existing controls strengthened, in Ireland, Spain and Portugal. Outside the ERM, the Swedish krona continued to be supported by a variety of measures.

Chart 4
Ten-year government bond yields (a)



(a) End-day observations.

. . . although interest rates have recently fallen in some countries

Following the 'petit oui' result of the French referendum, speculative pressures gradually eased in most countries. But in France interest rates were forced sharply upwards after repeated bouts of speculative exchange market pressure and substantial intervention. The five–ten day repo rate was raised from 10½% to 13% on 23 September. It remained there until 29 October, when it was reduced to 10½% once more. Two further small cuts took French rates below the levels prior to the exchange market upheavals in September. Among the other major European economies, interest rates remain highest in Italy and Spain (see Chart 3). Interest rates are lowest in Germany and also in the United Kingdom, where, following suspension of ERM membership, the authorities have reduced interest rates three times, to 7%.

From the beginning of September, long-term bond yields fell in most European countries (Chart 4). In the United Kingdom, France, Belgium and Denmark benchmark yields had eased by around 100 basis points by early November, with smaller reductions in the Netherlands, Spain and Germany. Yields in Spain and Italy rose briefly in late September but have since been largely reversed, whereas in Ireland and Sweden rates have yet to return to their former levels.

Policy has been eased in the United States . . .

Although monetary policy remained tight in Europe, the US authorities eased policy further with a cut of 25 basis points in the fed funds rate on 4 September. This was the twenty-fourth easing

of monetary policy since 1989, and one which took real short-term interest rates close to zero. The move was prompted by low economic growth, and in particular by weak labour market conditions, against a background of subdued inflation. Output in the United States has continued to grow in the past few months: GDP rose at an annualised rate of 2.7% in the third quarter, compared with 1.5% in the second quarter and 2.9% in the first quarter. But signs of recovery have been mixed and confidence remains weak. Consumption grew at an annualised rate of over 3.4% in the third quarter, but there remains some weakness in the labour market, where non-farm payrolls fell by 14,000 in the three months to September. Industrial production was flat over the summer months. Monetary growth has also been weak, although the slowdown in the growth of M2 may partly be accounted for by disintermediation and other structural factors. Headline inflation has remained broadly unchanged over the past six months: consumer price inflation has remained at just over 3% since March, while core inflation has fallen to 3.3% from just under 4% in the second quarter. The yield curve remains steep, with interest rates at the long end close to those in Germany.

The US Administration which assumes office in January 1993 will continue to be faced with a sizable fiscal deficit. Although the deficit for the last financial year turned out lower than earlier projections—at about 5% of GDP—this mainly reflected a delay to funding of the Resolution Trust Corporation (the organisation established to resolve insolvent thrift institutions). The main obstacle to a significant reduction in the deficit in the longer term is the continuing upward pressure on mandatory spending, especially on health care, which creates a significant structural element in the deficit. This in turn means that real long-term interest rates are likely to remain higher than desirable for the purpose of encouraging investment spending.

. . . Japan . . .

Economic activity in Japan has grown more slowly than expected, and policy has been relaxed accordingly. GNP, for example, grew by only 1.1% (at an annualised rate) in the second quarter, industrial production has fallen and consumer confidence has declined sharply. The slowdown has been particularly noticeable in the corporate sector, where investment has fallen and stock levels continue to rise. The consequent policy easing, following on from earlier interest rate cuts, took the form of a large fiscal package, with proposals for ¥10.7 trillion (2.3% of GNP) of additional public spending and private investment, which is expected to contribute one percentage point to GDP growth in financial year 1993. The package also confirmed earlier financial system support measures which were designed to strengthen the financial system and aid confidence, and to help banks meet BIS capital ratios. It generated an increase in confidence, and had the immediate effect of pushing the Nikkei up by over 4000 points (25%) from its mid-August trough, although it has since fallen back. The major banks' capital ratios now mostly lie in the 8.5%–9.0% range, rather higher than in the spring.

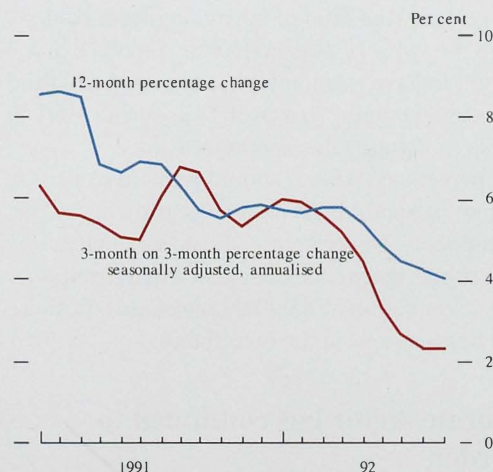
The difficult world economic situation underlines the importance and urgency of bringing the Uruguay Round of world trade negotiations to a successful conclusion. The rapid growth of world trade in manufactured goods since the Second World War has owed

much to the GATT system, under which tariffs have been reduced progressively in a multilateral framework. In addition to lowering tariffs further, the Uruguay Round aims to limit the scope for using non-tariff barriers and trade-distorting subsidies, to widen the scope of the GATT to include 'new' areas of services, investment and intellectual property, and to bring agriculture and textiles fully within GATT disciplines. The trade liberalisation of a successful Uruguay Round would result in a healthy reallocation of resources as production patterns in each country adjust to reflect comparative advantage. Not only would it give a much needed non-inflationary stimulus to the world economy, it would also give a boost to confidence and a greater degree of predictability in the business environment. But failure to conclude the Round successfully would mean the loss of these benefits and would lead to a strengthening of protectionist tendencies which, if allowed to gather pace, would have potentially very serious implications for trade and growth alike.

. . . and the United Kingdom

The United Kingdom was, by this summer, among those countries experiencing a conflict between the monetary policy required to maintain the exchange rate, and that which seemed appropriate for domestic conditions. Its position in the economic cycle was quite different from that of Germany, despite having benefited from the 'ripple' generated by increased German demand. Although still above the EC average, underlying inflation (the retail price index excluding mortgage interest payments) had fallen significantly—to 4% in September from 5.7% a year previously. On a shorter comparison (the seasonally adjusted change in the index in the latest three months over the previous three at an annualised rate), the deceleration was even more marked—down towards 2% from over 5% six months ago, and over 6% twelve months ago (see Chart 5). At the same time, notwithstanding a 0.1% increase in non-oil output in the second quarter, activity remained weak, with little sign of any significant pick-up in the third quarter. As a result, the United Kingdom had an increasingly distorted mix of monetary and fiscal policy—the former remained very tight and the fiscal deficit was expected to increase. But since the temporary withdrawal from the ERM on 16 September monetary policy has been eased significantly: at 7%, interest rates are now at their lowest for nearly 15 years. The measures announced in the Autumn Statement amount to a further slight easing of fiscal policy in the short run, but are consistent with a reduction in the deficit in the medium term.

Chart 5
Underlying inflation (a)



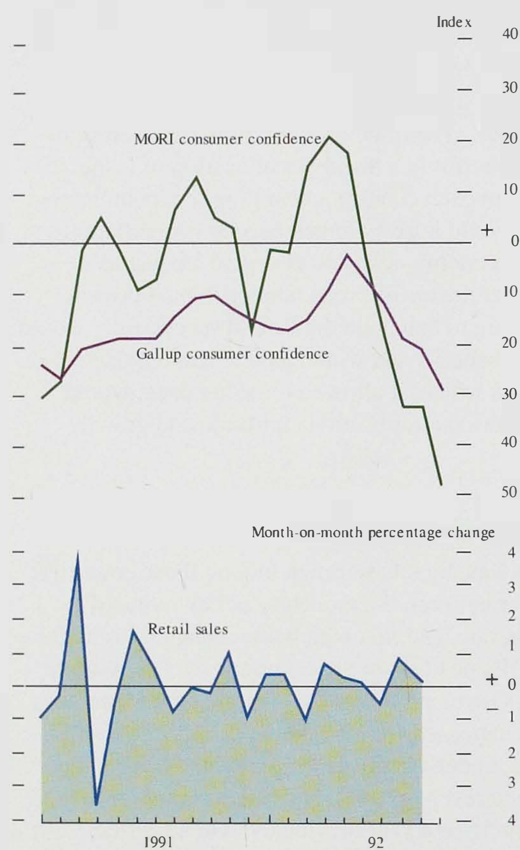
(a) Growth in retail prices excluding mortgage interest payments.

Recent economic data and surveys have suggested a subdued picture for activity in the second half of the year. Having risen by 0.4% in the second quarter, manufacturing output was unchanged in July and fell by 0.3% in August, as car production declined by 18%. The October Quarterly CBI Survey suggests that manufacturing output fell in the third quarter as a whole.

Despite falling confidence, consumers' expenditure has been maintained . . .

Consumption in the third quarter is likely to be broadly unchanged from its second quarter level. Retail sales showed a bounce-back in August from the depressed July level, although this may have been associated with both the temporary recovery in housing market turnover (before the suspension of Stamp Duty came to an end) and

Chart 6
Confidence and retail sales

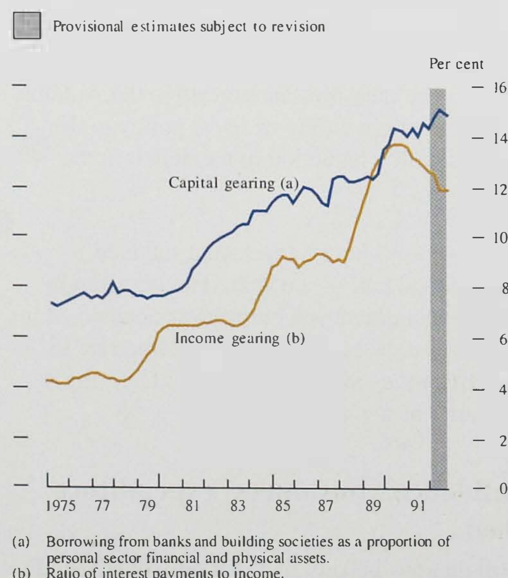


exceptional discounting by retailers. The further slight rise in September was also encouraging, although apparently in conflict with the message from consumer confidence surveys. Both the Gallup and Mori surveys have fallen sharply from their peaks earlier in the year: indeed, following sterling's exit from the ERM they fell to their lowest levels since the end of 1990. Although it is unwise to set too much store by the confidence surveys—their performance in predicting consumption has been poor in the past eighteen months, see Chart 6—the decline in confidence suggests that a marked rise in consumption is not imminent.

A further factor acting against any significant revival in consumption is the housing market. While turnover increased steadily during the summer—particulars delivered rose by over 50% from May to September, to a level almost 26% higher than in September 1991—prices continued to fall. The 2.7% fall in the Halifax house price index in September was the largest monthly fall ever recorded, and it was followed by a further 0.8% fall in October. While interpretation of these figures is obscured by the reintroduction of Stamp Duty, the 2.7% fall in the latest three months over the previous three months (to a level more than 7% below the same period last year) suggests a further weakening of the market. The recent price falls also marked a change in the regional pattern, with significant variations across the country, and sharp falls in areas which had previously displayed some resilience.

Falling house prices both discourage first-time buyers from entering the market and damage the balance sheets of existing homeowners. Personal sector capital gearing (the ratio of borrowing from banks and building societies to the value of personal sector financial and physical assets) is thought to have risen in both the second and third quarters (to near 15%) after averaging just over 14% during 1991 (see Chart 7). The fall in mortgage rates announced since September (around 2¼ percentage points) should provide some stimulus in the longer run, particularly as income gearing constraints are further reduced. Nevertheless, the unanticipated deterioration in balance sheets during the course of this year may further discourage the accumulation of debt by households, further depressing activity and house prices in the near future.

Chart 7
Personal sector income and capital gearing



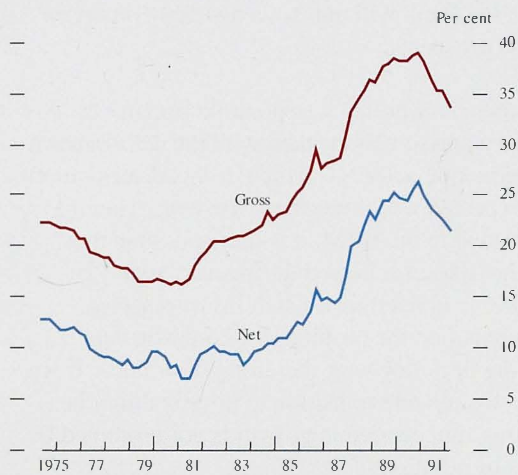
(a) Borrowing from banks and building societies as a proportion of personal sector financial and physical assets.
(b) Ratio of interest payments to income.

... while the corporate sector has continued to reduce its debt burden

Meanwhile the corporate sector continues to restructure its balance sheet. After signs of a recovery in M4 borrowing in the second quarter (after a total repayment of £2.2 billion in the previous four quarters), in the third quarter industrial and commercial companies (ICCs) made a substantial net repayment to the banks. Companies have also reduced their capital issuance, suggesting a renewed attempt at restructuring—perhaps in response to the continued poor outlook for orders. The net result will have been a further decline in corporate capital gearing, which had already fallen significantly from its earlier peak (see Chart 8).

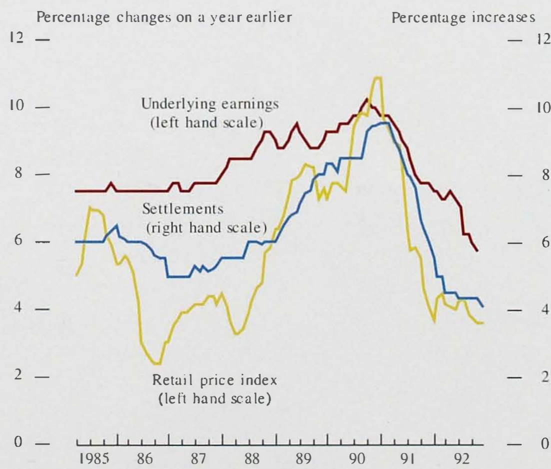
The easing of monetary policy has allowed real interest rates to fall and thus reduced concerns over financial fragility. Nevertheless, the quarterly rate of company liquidations and personal bankruptcies remains high, and commercial property prices continue to decline, so putting pressure on property companies and their banks. The latter are also affected by the consequent declining value of

Chart 8
ICCs' capital gearing (a)



(a) Ratio of outstanding borrowing (debt at nominal value) to capital stock at replacement value.

Chart 9
Pay settlements and the RPI



collateral on loans across a number of sectors, although the position would have to deteriorate further for the banking system as a whole to hit capital constraints.

Inflation has fallen further . . .

Indicators of inflation have continued to show progress. The slowdown in retail price inflation has been broadly based, with declines in the growth of all the major sub-components of the index. The most marked progress has been in the 'goods' elements of the index: using the shorter-run comparison (the seasonally adjusted change in the latest three months over the previous three months expressed at an annual rate), goods price inflation has fallen to 1.6% from 6% a year ago. But service sector price increases have also slowed sharply, from over 9% to under 6%. At the same time, earnings growth in the whole economy, having responded to both lower settlements and a decline in bonus payments, fell to 5½% in September, from 7½% six months ago (see Chart 9). The Industrial Relations Service provisionally estimates that whole economy settlements averaged only 3.9% in the three months to October, down from 4.3% in the three months to June. Unit labour costs are growing even more slowly for, despite the weakness of output, productivity in the economy as a whole is growing at a twelve-month rate of around 2%. In the manufacturing sector, twelve-month productivity growth has averaged more than 4% in the year so far.

The corollary of the increase in productivity has been further increases in unemployment, which rose by almost 120,000 in the third quarter, to 2.85 million. The increase in unemployment does suggest, however, that inflationary pressures are likely to remain subdued in the coming months. A similar conclusion may be drawn from measures of capacity utilisation or of demand pressure. Of course, the fall in the exchange rate between 16 September and early November—over 12% against the deutschmark and more than 13% in effective terms—is likely to raise inflation relative to the level that would have obtained in the ERM. But, given the degree of underutilisation and the depressed state of the labour market, it seems likely that the pass-through of the depreciation will be delayed, relative to past experience, and may even be smaller than in the past. Within the ERM, it was probable that inflation would have declined rapidly over the next 12–18 months. Depreciation is likely to slow the rate of decline.

. . . and price stability remains the principal objective of the new framework for monetary policy

Following the suspension of sterling's membership of the ERM the Chancellor announced that the achievement of price stability remained the ultimate objective of monetary policy. Price stability, for this purpose, is defined as an underlying inflation rate (based on the retail prices index excluding mortgage interest payments) of 2% or less. Monetary policy will be conducted by reference to a wide range of indicators of potential inflationary pressure, including narrow and broad money, house prices and the exchange rate—recent developments in which have been described above. The significance attached to these indicators depends on the extent to which they help predict future inflation. The final aspect of the policy framework, and one of its most important elements, is transparency and accountability: the requirement to explain fully the factual background against which policy decisions have been

made. In their Mansion House speeches, the Chancellor and the Governor announced initiatives to achieve this goal. Starting with the February *Bulletin*, the Bank will publish a quarterly report on inflationary trends and prospects.

The recent easing of monetary policy was possible because of a reduction in inflationary pressure associated with the deterioration in the prospects for economic activity. Much of this deterioration is due to lower than expected world economic growth. Had the United Kingdom remained in the ERM, it is quite possible that price stability would have been achieved during next year. Although clearly desirable in itself, price stability attained so quickly might have intensified the problems of domestic debt deflation. Some easing of policy was, therefore, desirable. It is vital that a steady and sustainable transition to price stability be maintained. In the long run, economic growth is not promoted by tolerating higher rates of inflation.