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ECONOMIC STRATEGY - LATEST DEVELOPMENTS

This note reviews some of the latest economic developments as background to today's meeting with the Prime Minister.

2. Output appears to be falling rapidly and unemployment is rising steeply but this is not markedly out of line with the forecast published in the FSBR. In the first half of the year total output appears to have fallen by 1-2%; this is in line with the forecast in the FSBR. The fall in manufacturing output has possibly been faster than expected. The forward indicators all point to weak demand and output in the second half of the year. Unemployment has risen by 160,000 (wholly unemployed, excluding school-leavers) in the past two months. The August figure on this definition is 1.7 million and compares with an FSBR forecast for the third quarter of 1.62 million; the average for the first quarter of this year when the forecast was made was 1.38 million.

3. The composition of the fall in output during this year has been a little different to the forecast. Net exports have done rather better than forecast while stock-building has shown a larger decline. The balance of payments has been better than forecast.

4. The real income of the personal sector has held up reasonably well with earnings increases keeping ahead of the TPI. The company sector has taken the impact of the fall in real income and is now

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under major pressures which are showing up in attempts to reduce stocks and cut employment. These pressures were not unexpected and reflect: the balance of the effects of high oil prices, a high exchange rate, and rapid wage increases.

5. Money supply has been rising faster than the target of 7-11% growth. Mr. Middleton's note points to a possible underlying increase of 16% per annum in £M3 since February if due allowance is made for the removal of the corset. The whole picture has been confused by re-intermediation and estimates of the underlying monetary growth could still change significantly. In addition there is wide variation in the indications of alternative measures of monetary growth with the M1 measure undershooting the target range. There has also been a very large PSBR in the first half of the financial year.

6. Sterling has remained strong and the trade-weighted exchange rate has continued to drift upwards. The extent of the rise continues to confound the expectation of most people including those of us who pay close attention to relative inflation and monetary developments; but the effect on all measures of competitiveness has been substantial and unprecedented. There is a tendency for many observers to confuse the scale of the problem by making comparisons with the fourth quarter of 1976; but comparison with the pre-devaluation periods of 1967 and 1972 shows the difficulty of the present position. Labour costs are not the whole story but nevertheless this indicates very difficult circumstances for those involved in international trade including companies producing for the domestic market.

7. The slowdown in price increases has been marked in recent months. This shows up in the behaviour of retail prices and wholesale prices; the CBI enquiry into the 'balance' of firms

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expecting to raise prices over the next four months points to a continued downward pressure on price increases. The latest retail price figures for July show that this pressure is affecting the broad categories of prices in very different ways:

Total	15.9
Food	11.5
Housing	29.1
Nationalised Industries	27.4
Other	13.8

It is also instructive to look at the behaviour of 'prices in the shops'; this can be approximated by the implicit price index for retail sales. In the 12 months to July this rose by 11-12%. The CBI have drawn attention to this in their latest Economic Situation Report. The major pressure upon prices over the next few months will come from Nationalised Industry prices; these are expected to continue to rise at a rate close to 25% per annum over the next six months. Price rises are being held back to an important extent as firms try to dispose of unwanted stocks and to boost sales. But so far there are only few signs of wage settlements responding though claims are now lower.

8. Thus inflation is coming down - possibly rapidly - but money supply growth is not; one interpretation of the recent figures is that the underlying monetary growth since end 1977 may have been around 16%. Two questions follow:

(i) If monetary control is not reducing inflation what is?

(ii) What does it imply for the role of monetary policy; if inflation is being reduced does it matter that money supply is above target?

9. Undoubtedly, the sudden appearance of spare capacity in the economy - however achieved - is closely associated with the fall in inflationary pressure. External factors have also had an important

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influence upon the inflation rate; world oil prices and commodity prices played a crucial part in the increase in inflation and are now contributing to the slowdown. In addition it is now clear the extent to which the pressure of anti-inflationary policy is coming from the exchange rate. The very high real exchange rate combined with a very high PSBR since April and a major over-shooting of the monetary target means that the downward pressure upon prices is coming substantially from exchange rate pressure. The extent of the squeeze on those companies trading in international markets is even greater than anticipated whilst non-traded services are protected (eg insurance companies) and nationalised industries and local authorities may be borrowing more than planned.

10. But does an overshooting of the monetary targets matter if the inflation rate is being reduced? I would want to argue that it does matter, particularly from a medium term point of view:

(i) The present combination of the exchange rate, monetary policy and fiscal policy means that the effect of the squeeze upon the economy is very uneven. Real wages have not begun to fall yet and a disproportionate impact is felt by the internationally traded goods sector. To some extent this is inevitable but an excessive imbalance is not in the longer term interests of the economy. A lower exchange rate combined with tighter fiscal policy and lower monetary growth might produce the same overall pressure on the economy but distribute the pressure more evenly across the economy.

(ii) The anti-inflationary policy is exposed in the face of a sharp drop in the exchange rate. At some stage downward pressure on the exchange rate is probably inevitable; and despite lower inflation some fall in the nominal exchange rate seems inevitable if the real exchange rate is to return to a more normal level. It would be unfortunate if policy drifted towards support for the exchange rate in order to maintain the anti-inflationary stance.

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(iii) A considerable part of the benefit of the expectations mechanism is lost. It would be useful to be able to argue that "the growth of money supply has been reduced and inflation has been reduced - we intend to continue to reduce monetary growth and agents should take note"; the impact of the message is lost if the first part of the statement does not stand. Nevertheless the reduction in inflation, whatever the cause, will have helpful implications for inflationary expectations. It is also more difficult to sustain the debate in the face of the argument that this is just like any other deflationary policy. Part of the defence of the monetary policy has been that the loss of output will be minimised providing wages and prices move in line with money supply; the extent to which that generalisation holds probably depends in part on the extent to which the exchange rate moves in line with relative monetary growth. On the other hand the limited fall in real money supply over the past year and the enormous CGBR in the past five months make it equally difficult to argue that the recession is due to deflationary government policy.

(iv) The crucial period during the cycle for monetary policy is probably when world output recovers and demand begins to expand. Typically at this stage monetary and fiscal policy is relaxed and expansionary forces have been excessive. Excessive monetary growth in recession may not damage the anti-inflationary process immediately but it could provide the basis for an excessive growth of demand later; this might either prevent inflation being reduced as low as it otherwise might or accommodate an upturn in inflation when demand and world prices accelerate.

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11. This would point towards reaffirming the monetary commitment and the intention to continue to work within the framework of the MTFS.

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(TERRY BURNS)
3rd September, 1980.