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Great Britain Heading for Stagflation

Over two years ago the British government began to counter the overheating of the economy, reflected in inflationary trends and worsening foreign trade difficulties, by radically increasing interest rates. The rise in demand and production has slowed down noticeably but the national product was still on the increase in the first half of 1990 with a current annual rate of 2 to 2½%. Despite a certain decline, the utilization of capacity has remained high. Employment has hardly risen at all recently; the unemployment rate, which had been halved within the space of four years, has kept to nearly 6%. The stabilization targets have not been attained. The price and wages upswell intensified in the first half of this year and the large deficit on current account has declined only little so far, amounting to 3.3% of gross domestic product as compared with 3.8% in 1989.

The policy of high interest rates has curbed the increase in investments in plant and equipment appreciably; they probably hardly rose in the first six months of 1990 above the corresponding figure for the previous year. Business investments thus increased little and investments in residential building dropped markedly with only public sector investment expanding more rapidly. Real disposable income has continued to grow noticeably. The erosion of purchasing power has been exaggerated by the high inflation rate, since this to a large extent reflects rises in interest which do not lead to an immediate corresponding cut in the purchasing power of the consumer – a peculiarity of the British

method of calculating the price index. Private consumption has thus continued to expand tangibly. Demand from abroad has expanded at a lower rate since autumn of last year, reflecting the economic slowdown of major trading partners. Visible exports have, however, still gone up to an appreciable degree; in the first six months they exceeded the level for the corresponding period last year by nearly 12%, whereas the current rate is distinctly lower. Imports have expanded more rapidly again this year. The basic upward trend, though, was less pronounced than that for exports, with the previous year's figure being topped by a mere 5%.

In the last few months the external value of the pound sterling has appreciated after the government announced in May its basic willingness to participate in the European foreign exchange mechanism, contrary to previous declarations. As a result expectations of a depreciation receded and the high rates of interest prompted a resurgence in financial investments in sterling. The appreciation trend was given a boost by the high rise in oil prices in August, Great Britain being a net exporter of oil. At the beginning of September, the pound was 6% higher against the D-Mark than it had been in May. The appreciation of the British currency and the price hike in oil have improved the terms of trade, thus enlarging the scope for domestic income distribution.

This considerable rise in the value of sterling is all the more remarkable as prices and wages are rising far more rapidly than in the other EMS countries. As early

Basic Indicators of Economic Trends

(Changes as compared with the previous year in %)

	1988	1989	1990 1st half year		1988	1989	1990
Real gross national product	4.6	2.2	2¼ ^a	Consumer prices	4.9	7.8	9.8 ^c
Industrial production	3.8	0.5	1.5	Producer prices ³	4.5	5.0	6.1 ^c
Rate of unemployment ¹	8.1	6.3	5.7	Average value of exports	0.3	7.1	5.0 ^d
Volume of exports	1.6	5.5	11.8	Average value of imports	-0.9	6.4	6.0 ^d
Volume of imports	13.4	7.8	4.6	External value of sterling ⁴	6.0	-3.0	4.0 ^e
Trade balance ²	-20.8	-23.1	21.6 ^b	Gross weekly earnings ⁵	8.7	9.1	10.2 ^f
Balance on current account ²	-15.0	-19.1	-17.7 ^b	Unit labour costs ⁵	6.8	9.4	10.1 ^g

^aEstimated in part. ^bSeasonally adjusted, projected for the whole year. ^cJuly. ^dMay. ^eAugust. ^fJune. ^g1st quarter. ¹in % of gainfully employed. ²In billion pounds. ³Domestic industrial products. ⁴Effective rate of exchange. ⁵Overall economy.

Sources: National statistics; OECD: Main Economic Indicators.

ECONOMIC TRENDS

as July, before the increase in oil prices, consumer prices were 9.8% higher than they had been one year before. Even ignoring mortgage rates which are incorporated into the price index as indicators of housing costs and ignoring the impact of taxes, the rate of almost 7% was above average. Evidently there was still some leeway for businesses to pass on increased costs. Since the beginning of the year, the major impulses have been generated internally. While the costs of imports, that had gone up by 10% during 1989, stabilized at the beginning of the present year, labour costs rose even more rapidly. By the middle of the year, average earnings from employment were a good 10% above the previous year's figure, while overall productivity only increased marginally.

The more forceful wage push alone means that the high interest rates are unlikely to diminish in the near future, even more so considering the drastic rise in oil prices that is countervailing the "stability import" via the stronger pound. A certain monetary relaxation will probably not be introduced until some time next year, when the government will be keen to establish low interest rates because of the parliamentary elections due to take place in the first half of 1992. Fiscal policy is generating moderate demand-side impulses this year. In the first four months of the financial year as of April, there was a considerable budget deficit that cast doubt on the feasibility of the planned surplus of almost seven billion pounds (1.3% of gross domestic product). The unexpectedly large deficit is primarily attributable to revenue shortfalls partly as a result of cyclical trends and in part due to poorer earnings than expected from the privatization of public assets. As this is not essentially incompatible with the goal of consolidation, the government is likely to put up with this more adverse development in its finances.

The foreseeable overall climate marked by high interest rates and a strong pound will further dampen the propensity to invest. Earning prospects outside the oil sector will worsen not only as a result of poorer sales expectations but also due to the increasing cost dilemma of businesses, whose scope for passing on cost increases will narrow while increases in wage costs will for the time being hardly slow down, especially since the appreciation of the pound has strengthened the competitiveness of foreign suppliers. The growth of private consumption will also continue to slow down, concomitant with the slackening rate of increase in real disposable income partly due to oil price induced inflationary pressures and partly because of the dwindling rise in employment. Exports will probably rise more slowly due to the worsening situation of the world economy.

In the second half of 1990, the gross national product is likely to grow little. Even the slackening of the economic policy reins which is to be expected in the course of 1991 will only have a stimulating influence in real terms after a delay. Gross domestic product for 1990 as a whole will still grow – also thanks to a stronger increase in oil production – by nearly 2% and in 1991, by 1% to 1 1/2%. With more or less stagnant employment, unemployment will go up appreciably. In the train of the drastic rise in oil prices the price upsurge will gain momentum in the short term; only in the course of next year will there be a gradual slackening off. The rate of inflation may be expected to decline tangibly as a result of the cessation of interest rate and tax effects, averaging a good 9% for 1990 and some 7 1/2% for 1991.

Compiled by the Department of World Business Trends of the Hamburg Institute for Economic Research (HWWA).

HWWA Index of World Market Prices of Raw Materials¹
(1975=100)

Raw Materials and Groups of Materials	1989		1990					
	AA ²	Aug.	May	June	July	Aug.	24.8.	21.9.
Total index	158.0	151.8	155.4	147.5	157.2	204.5	228.2	249
Total, excl. energy raw materials	150.7	146.6	152.9	150.0	151.9	156.1	157.7	155.5
Food, tropical beverages	104.3	96.7	100.7	96.5	93.9	92.4	94.8	91.1
Industrial raw materials	186.0	184.6	192.6	190.8	196.0	204.7	205.6	204.5
Agricultural raw materials	191.3	191.6	209.8	207.9	208.0	216.7	218.5	215.0
Non-ferrous metals	223.5	219.8	206.8	198.7	207.2	219.6	220.4	224.3
Energy raw materials	162.3	154.8	156.9	146.0	160.3	232.7	269.3	303.6

¹ On dollar basis. ² Annual Average.