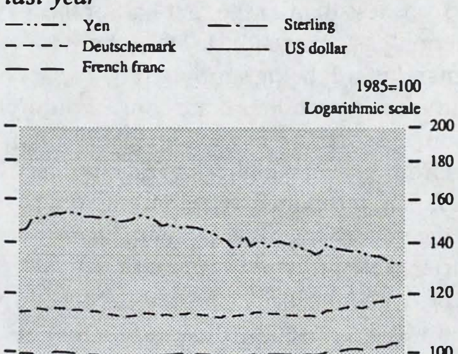
Economic commentary

- *Developments in the foreign exchange markets at the turn of the year were dominated by the strength of the deutschemark.*
- *Growth has slowed modestly in the United States and there are tentative indications of a slowdown in Japan and continental Europe, though growth there remains buoyant. Inflationary pressures remain, even though non-oil commodity prices are exerting a downward influence on input prices.*
- *Developments in Central Europe will have far-reaching economic implications, though in most cases restructuring will take a considerable time.*
- *Growth in the United Kingdom slowed further in the second half of last year and will be modest in 1990. Developments in the coming year depend to a large extent on how the company sector responds to its growing financial deficit.*
- *Inflation remains uncomfortably high and the recent weakness of sterling will have added to inflationary pressures.*
- *There were encouraging signs of an improvement in the trade balance in the fourth quarter.*

The **deutschemark** *strengthened against the major currencies towards the end of last year*



Bank of England index.

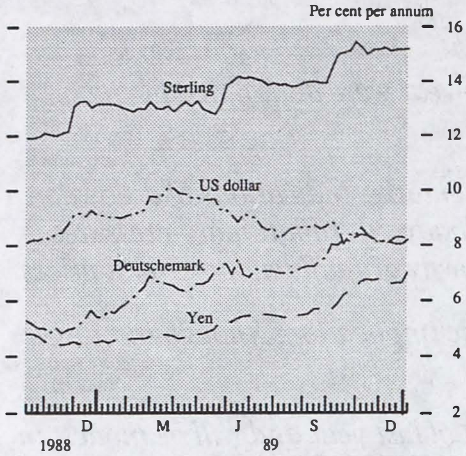
Currency markets *have been dominated by strength of the* **deutschemark**

A feature of the fourth quarter of 1989 was the strength of the deutschemark. A variety of factors have been suggested to explain this, including a reassessment of future growth prospects stemming from developments in Central Europe, tighter German monetary policy and Germany's increasing trade surplus with other EMS countries. The immediate impact of the influx of immigrants from the east will be to increase inflationary pressure as they add to consumption and demand for housing. Unemployment will also increase in the short run, (with implications for the social security budget) without necessarily easing pressures in the labour market, as many of the immigrants require training. In the longer run, immigration should stimulate residential and other fixed investment and increase potential output. The strength of the deutschemark has led to pressure within the ERM, with the Italians resetting the central rate of the lira (3.7% below the old central rate, but at the level of the market rate) in early January at the same time as the lira joined the narrow band. France and Belgium increased their interest rates in late December. The removal of all remaining French exchange controls from 1 January (six months earlier than the deadline set by the Community) did not have any noticeable impact on the franc or on the stability of the ERM.

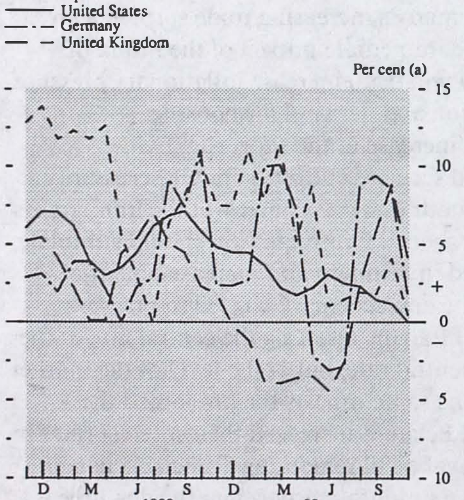
Monetary policy *has been tightened in* **Japan** *and* **Germany** *but has eased in the* **United States** . . .

The Japanese authorities tightened monetary policy at the end of December, raising the official discount rate by 0.5% to 4.25%. Japanese short-term interest rates were on an upward trend throughout 1989 and the latest move by the Bank of Japan was

Money market rates *have fallen in the* **United States** *but risen in* **Germany** *and* **Japan**



Industrial production *in the* **major countries** *is growing more slowly*



(a) Latest three months on previous three at annual rate, seasonally adjusted.

motivated by the weakness of the yen, continued high monetary growth, buoyant domestic demand and a tight labour market ahead of the annual spring wage round. While the German authorities have been moving towards tighter monetary policy and looser fiscal policy (with long-planned tax cuts taking effect in January), the mix has been moving in the opposite direction in the United States. Markets perceived a loosening of US monetary policy in November with a cut in the federal funds rate to 8.5%, followed by a further reduction in December to 8.25%. These actions were partly prompted by concerns about the weakness of the industrial sector, where there were employment losses in the second half of the year. Meanwhile, there have been some signs of a small reduction in the federal deficit, Congress agreeing to a revised fiscal 1990 budget with $14 billion of expenditure cuts (including $4.5 billion of the Gramm-Rudman automatic sequester).

Recent data have presented a picture of slower but still positive growth in the United States and tentative evidence of a slackening in growth in Japan and Germany from high levels earlier in 1989. While the growth rate of the major six overseas economies is below its peak at the beginning of 1988, it is still quite high by historical standards.

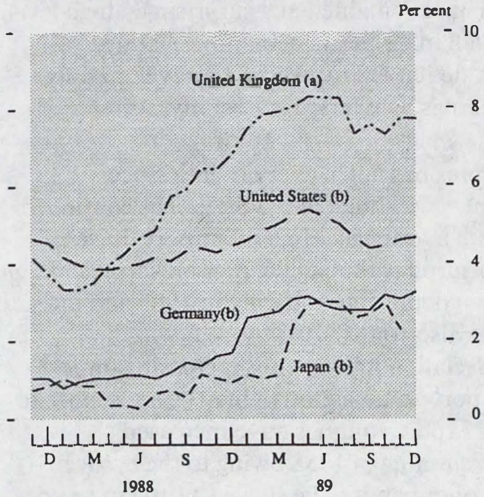
The slowdown in the United States has not been as marked as some commentators expected. GNP growth was higher in the third quarter than in the second, supported by net exports and incentive-induced buoyancy in car sales. Industrial production increased in November and December after falls in the previous two months. Nevertheless, fourth quarter growth was depressed by weak investment and by a falling-back of net exports.

In Germany, the pace of expansion is still strong but below the exceptional levels reached earlier last year. Growth for the whole of 1989 is estimated at 4.0%, the highest for ten years. GNP growth in the third quarter was less than in the first half of the year and industrial production has changed little since the beginning of the year. Demand is still being supported by the buoyancy of exports and investment while private consumption has remained weak. Consumer demand may pick up in 1990 as a result of real income gains from tax cuts, higher wages and the effects of immigration. In Japan, the evidence from industrial production figures is that the underlying rate of growth has slowed slightly. Third quarter GNP growth was unexpectedly strong but this partly reflected a bounceback from a weak second quarter when consumption was depressed by the introduction of the sales tax. Despite rapid import growth, net external demand made a positive contribution to GNP in the third quarter.

. . . and weak **commodity prices** *have helped to restrain* **inflation** *in the major economies*

Recent data suggest that inflationary pressures persist in the major three overseas economies. Upward pressure has come from a variety of factors including rising food prices in Japan and Germany and oil price increases. However, in each of the major three economies, producer price inflation was moderated by the steep downward movement in non-oil commodity prices during 1989. Metals prices were depressed by lower demand in the motor and construction industries and by easing of supply

The downward trend in **inflation** *stalled in the fourth quarter of last year*



(a) All-items RPI.
(b) Consumer price index.

disruptions. Developments in food prices were mixed, as coffee and cocoa were depressed by a surplus of production, while sugar prices were boosted by supply problems (but have fallen recently). Agricultural non-food prices have weakened only moderately. Oil prices increased from August as a result of strong demand, with particularly large increases in December attributable mainly to exceptionally cold weather in the United States. Prices subsequently fell back from their end-year levels as demand slackened and output increased (OPEC production in December was the highest for ten years).

Consumer price inflation in the United States averaged around 4.6% (at an annual rate) in the fourth quarter. Producer price inflation reached a low in August of 4.2%, but at the end of the year had increased to 4.9%. Oil prices accounted for a large part of the increase in both measures of inflation; underlying rates (excluding food and oil) have been steady. There is as yet no evidence of consumer price increases affecting wage growth; earnings growth slowed in the final quarter of the year.

In Japan, the twelve-month rate of consumer price inflation increased in September and October with food prices increasing strongly owing to bad weather but these rises were partially reversed in November. Wholesale prices fell in both October and November but the recent weakness of the yen and higher oil prices will tend to increase import prices. Despite tightness in the labour market, earnings growth in September and October was well down on that at mid-year though there is some concern about the prospects for the forthcoming wage round.

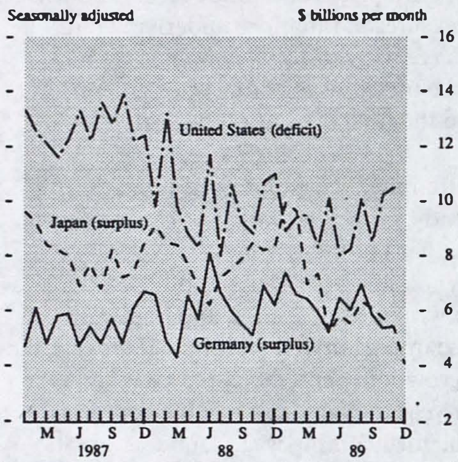
The labour market is also tight in Germany, although in the longer term the pressure will be eased by immigration from the east. In recent months the increased immigration has halted last year's sharp decline in unemployment as a large number of the immigrants are not skilled in the use of modern technology and many require language tuition before they can be employed. Earnings accelerated sharply in September and wage negotiations are causing some concern, while consumer and producer price inflation in the last three months of 1989 were running at about twice the level of a year earlier. Inflationary pressures of largely domestic origin have more than offset a sharp decline in import prices associated with the deutschemark's recent strength. However, the effects of currency appreciation and of the dropping-out of indirect tax rises last January from the twelve-month rate of inflation should lead to lower inflation figures in the early months of 1990.

Exchange rate movements *are obscuring underlying developments in* **trade**

While recent trade figures have been particularly volatile in the United States, Japan and Germany, there has been some tendency towards reduction in the trade imbalances among these countries. The adjustment has been led by Japan but the German trade surplus has also declined recently. Much of the reduction reflects the impact of terms of trade changes.

The US trade figures have been particularly volatile and difficult to interpret as they have been affected by the Boeing strike, Hurricane Hugo and the San Francisco earthquake. The recent

German *and* **Japanese trade surpluses** *fell in the second half of last year*



fall in the dollar has also hindered interpretation of recent movements. The trade deficit narrowed in September but increased again in October and November, partly as a result of higher imports of industrial materials and supplies but also owing to a fall in exports of aircraft as a result of the Boeing strike. Import volumes have remained at a surprisingly high level given the extent of the fall in domestic demand. The third quarter current account deficit fell markedly, however, mainly reflecting increased earnings on overseas direct investment.

The Japanese trade surplus has fallen every month since September and the surplus with the United States has continued to decline compared with a year ago. High oil imports have helped reduce the trade surplus, though the non-oil surplus has also been falling. The yen depreciated sharply in 1989 and the initial impact of this has also contributed to the fall in the surplus; the recent depreciation of the yen is increasing import values, while strong import volume growth may be a response to its earlier appreciation. Export volumes have increased significantly since the beginning of 1988 owing to the cyclical strength of the world economy but have slowed a little in recent months. The current account surplus increased in November (with a marked improvement in the invisibles deficit), but was still below the August level and considerably down on its level at the same time in 1988.

The German trade surplus reached a peak in August reflecting the strength of European export markets and has declined subsequently. Exports nevertheless remain high, reflecting continued strong demand among Germany's trading partners, with capital goods exports still especially buoyant. There have, however, been signs of strong import growth in the most recent figures, possibly reflecting immigrants' expenditure and the stronger currency. Recent data also indicate a somewhat reduced rate of growth in foreign orders which may foreshadow a further fall in the surplus, though the deutschemark's appreciation may tend to increase it in the short term through terms of trade effects. The strong trade performance caused the current account surplus to increase slightly in the third quarter with the surplus on service transactions little changed from the second quarter.

Developments in Central Europe *will have profound implications for the world economy, though* **economic progress** *may be slow*

Western governments have been hard pressed to respond to the pace of developments in Central Europe and, in particular, to calls for Western assistance in promoting the reforms now under way. In Poland and Hungary, the European Community and the wider group of twenty-four industrialised nations (G24) have put in place a number of mechanisms to assist with restructuring, some of which could eventually be applicable to other new regimes in Central Europe. The European Investment Bank is to lend up to ECU 1 billion to Poland and Hungary over three years and the Community is to provide up to ECU 300 million from its own budget. A European Bank for Reconstruction and Development is to be set up; its membership and capitalisation have yet to be agreed, but it could eventually lend up to ECU 2 billion a year. In addition, substantial amounts of emergency food aid have been made available to Poland and several countries have set up technical assistance schemes; the United Kingdom know-how fund is to provide £50 million to Poland and £25 million to Hungary over five years and is to be extended to other countries in the region introducing reforms.

Future financial assistance to Poland and Hungary is to be linked directly to agreement on, and performance under, IMF programmes. The Polish authorities have embarked on a radical market-oriented stabilisation programme which will form the basis of a Fund Standby Arrangement (SBA). This will allow repayment of a $500 million bridging loan provided through the Bank for International Settlements and will be backed up by a $1 billion 'stabilisation fund' established by the G24 to support the new exchange rate, facilitate World Bank finance and allow negotiations on the rescheduling of some $4¾ billion of debt service obligations to be taken forward. Hungary, which of all the countries in Central Europe has most experience in moving towards a market economy, is shortly expected to receive IMF approval for a new Standby Arrangement following the adoption of a restrictive budget for 1990.

All of the countries in Central Europe will benefit from new arrangements on trade and co-operation from the EC. Existing agreements with Czechoslovakia, Poland, Hungary and Romania are to be re-opened to provide for an accelerated lifting of tariffs and quotas on a wider range of exports to the EC and more economic co-operation, while new agreements along similar lines are being negotiated with Bulgaria and the GDR, as well as the Soviet Union.

The financial needs of countries other than Poland and Hungary differ considerably and a central issue will be their relationship with international financial institutions. Czechoslovakia, which had been a member of the IMF up until 1954, is seeking re-admission as soon as possible, while Bulgaria is considering applying to join. The GDR has also expressed an interest but will almost certainly look to the Federal Republic for its immediate needs. Romania, which is a member, broke off contacts with the Fund in mid-1987 and the new government has sought to re-establish relations. As in all countries in the area, structural adjustment and rehabilitation of the infrastructure will require considerable external financing. Western governments, commercial banks and other private sector institutions will all have a part to play in this.

Non-oil developing countries *faced a harsher climate last year*

Preliminary estimates point to a slower rate of growth of export volumes in non-OPEC developing countries during 1989, following unusually rapid growth in 1988. Looking ahead, developing countries' trade may suffer further as a result of slower growth in the major economies. The slowdown in export volume growth has been a feature common to all the non-OPEC developing countries. In the newly industrialised economies of Asia (NIEs) it has reflected growing capacity constraints and wage cost pressures which have contributed to rising inflation, an appreciation of real exchange rates in all the NIEs except Hong Kong and the effects of a slowdown in import growth in China. At the same time, import growth in the NIEs is likely to have strengthened in response to exchange rate appreciation and the impact of higher wages on domestic demand. The aggregate current account surplus of the NIEs is therefore thought to have declined, possibly more markedly than in 1988.

Elsewhere among non-oil developing countries, the deterioration in the external environment during 1989 reflected a weakening in the terms of trade for producers of primary commodities and adverse domestic developments in some of the largest less developed economies. In Argentina, the renewal of commitment to reform early in the year now looks less likely and there is no evidence of progress in regaining control over inflation. Brazil has experienced a deterioration in its trade balance, reflecting an appreciating real exchange rate, higher domestic demand and the effects of earlier trade liberalisation on imports. This has been compounded by a deteriorating fiscal position, high and rising inflation and mounting arrears on payments to external bank creditors. In China, success in controlling the overheating apparent in the economy since early 1988 has been achieved at the expense of an increasing risk of recession and an interruption to the process of reform. Controls on access to foreign currency and new foreign borrowing are turning the trade and current account deficits around, although the position remains delicately balanced in the absence of significant official or private foreign financing.

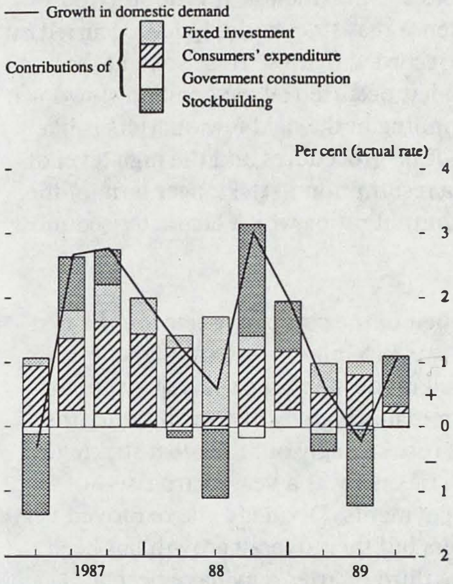
The proposals launched by US Treasury Secretary Brady in March of last year, for a broader array of financing techniques to be incorporated into the restructuring of debt owed by middle-income LDCs to commercial banks, have taken firmer shape with the announcement of commitments by banks to debt relief packages for Mexico and the Philippines. In both cases new money contributions by banks were less than hoped for, underlining the growing evidence of reluctance among commercial banks to take on increased exposure to heavily indebted LDCs. Elsewhere, Morocco and Venezuela are still negotiating with creditor banks, and proposals for debt reduction have been a feature of discussions. Costa Rica has reached agreement on a package which includes a buyback and a restructuring of existing debt into bonds carrying a fixed rate of interest below market rates.

Output growth in the United Kingdom *has slowed markedly, despite a recovery in oil production . . .*

Output in the United Kingdom continues to grow more slowly. GDP rose by ½% in the third quarter to a level just under 2% above that of a year earlier. Overall growth was boosted to some extent by the beginning of a recovery in North Sea oil production, following the series of disruptions which had beset that sector since the middle of the previous year. Output of the energy and water supply sector rose by over 5%, while manufacturing output grew by ½% and that of services rose by only ¼%.

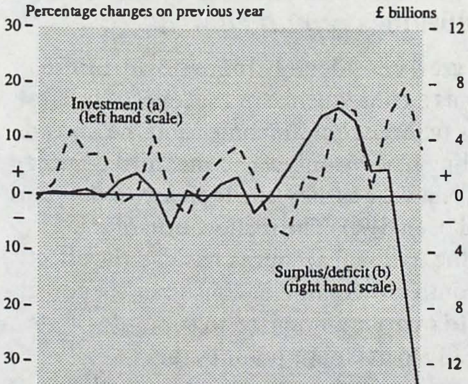
The slowdown in manufacturing output can be gauged from the fact that its growth in the year to the third quarter—at 3½%—was its lowest for three years and less than half that recorded a year earlier. Within manufacturing, sectors furthest removed from distribution—upon which the recent slowing in household spending has borne most heavily—have generally shown the greatest resilience. Output of capital goods, for example, grew by over 3% in the third quarter, while production of consumer goods fell. Manufacturing output remained broadly flat in October and November and, while there is little prospect of a significant upturn in output over coming months, there are equally, as yet, few signs of a recession; the balance of respondents to the CBI monthly trends survey expecting to raise output remains just positive, though it has shrunk markedly compared with balances seen in the first half of last year.

Stockbuilding *has been an important influence on the composition of* **domestic demand growth**



As usual, a number of revisions to earlier figures accompanied the release of data on the third quarter. These do not fundamentally alter the view of the economy as experiencing a marked slowdown but in some respects present a more plausible view of recent developments. The figures for output, for example, have been revised up modestly to show marginally higher growth in the first half of 1989; a small rise is now recorded in the second quarter rather than a small fall. In addition, the statistical adjustments made to the expenditure measure of GDP in order to reconcile it to the output measure, which previously had been added predominantly to recorded stockbuilding, have now been retrospectively spread more evenly across all major components of demand. This has had little effect on the recent quarterly path for recorded consumer spending but gives, if anything, a more plausible picture of investment, which, on the new figures, looks to have been stronger over the past year than had appeared to be the case earlier. The corollary of this reallocation of statistical adjustments is that recorded stockbuilding, though still extremely substantial at £6 billion in the year to the second quarter, is now more than £1 billion lower than previously estimated, with a further £1.5 billion recorded in the third quarter. The allocation of the statistical adjustment is inevitably judgemental and there can be no guarantee that the composition of demand implied by the recorded figures is accurate. The possibility remains that some elements of final demand remain underrecorded and that the adjustment to stockbuilding is excessive. The most likely candidate for underrecording still seems to be company investment.

Investment *held up last year despite the rapid growth of the* **company sector's financial deficit**



(a) Private sector non-residential fixed investment at 1985 prices.
(b) Company sector financial surplus/deficit at current prices.
(c) Partly estimated (data available up to Q3).

. . . *and lower* **investment** *growth is expected this year*

Industrial investment was reported as flat in the third quarter, at a level about 8% higher than a year earlier. This continues the slowdown from the fourth quarter of 1988 when the figure was over 15% on the same basis, with the slowdown in manufacturing and 'other' investment having been equally marked. The principal factor behind the slowdown seems to be the moderation in output growth, though the higher level of real interest rates may be playing some part. The company sector's financial deficit, which widened further—to £6½ billion—in the third quarter, may also be exerting some additional dampening influence and the response of companies as a whole to their growing deficit will clearly be an important influence on investment in the coming year.

Although capital expenditure is unlikely to grow strongly this year, cutbacks on the scale of those seen in 1980 (when the company sector was last in financial deficit) are unlikely. Continuing expenditure on a number of large projects, most notably the Channel Tunnel and various property developments, together with a projected considerable expansion of activity on the part of the water and electricity industries, is likely to underpin total spending. Recent survey evidence nevertheless suggests that manufacturing firms may, on balance, invest less this year than last.

Recent trends in stockbuilding remain far from clear. Despite the reallocation of part of the large statistical adjustments mentioned earlier, these still accounted for 60% of total recorded stockbuilding in the first nine months of 1989. Evidence from CBI surveys suggests that at least part of the allocation of unrecorded expenditure to stockbuilding is warranted; an increasing number of respondents are reporting more than adequate levels of inventories. Nevertheless, it is not obvious from survey or other evidence that stockbuilding has occurred on the scale suggested by the recorded figures. To the extent that involuntary accumulation has occurred as the demand slowdown has proceeded, some unwinding in the next few quarters is likely. The availability of just-in-time procedures and the high level of real interest rates suggest a resumption in the longer term of the downward trend in stock-output ratios which characterised most of the 1980s.

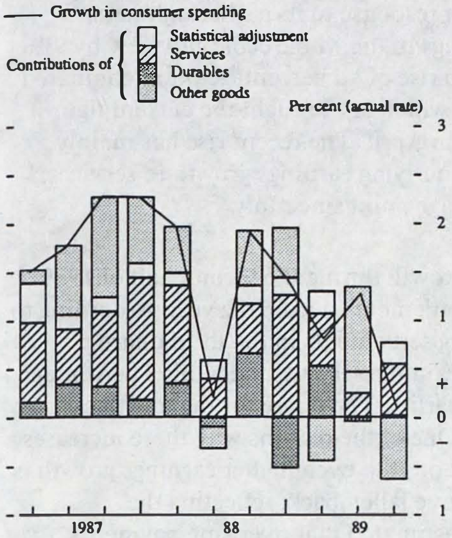
The recorded financial deficit of the company sector in the first three quarters of last year was £15 billion—two and a half times the total in 1988. Profits fell modestly in the third quarter but profitability nevertheless remains high by historical standards. Interest and tax payments rose strongly but the most striking feature of the allocation of income was a very sharp rise—of nearly 30%—in dividend payments. Dividends have moved very erratically in recent quarters but their overall growth has been very strong. The rise in the third quarter may have been a reflection of underlying profitability but may also have been partly defensive in a quarter in which takeover activity was exceptionally high. Domestic takeovers reached a record level of £12½ billion, of which over four fifths were cash financed, and this seems to have been the main reason for extremely high bank borrowing by companies, amounting to some £14 billion. Takeover activity in the fourth quarter seems, by contrast, to have been much more subdued.

Household spending *picked up at the end of last year, though* **spending on durables** *remained weak*

Consumers' expenditure grew considerably more slowly in 1989 than in the previous year as a consequence of the level of interest rates and the effect of this on household incomes and the housing market. Consumer spending rose by only ¼% in the third quarter to a level 3¾% above that of a year earlier (the increase in the year to the second quarter had been 5½%). The reallocation of the statistical adjustment in the national accounts has had the effect of boosting the twelve-month growth rate of consumer spending; the adjustment in the third quarter amounted to some 2% of the total and added around ¾ of a percentage point to the twelve-month growth rate. The effect on the quarterly path has been modest, however, and the pattern is still one of a marked slowing.

The impact of high interest rates continues to be seen most clearly in spending on durables which was flat overall in the year to the third quarter. A fall in expenditure on furniture and floor

Spending on consumer durables *was weak last year*



coverings was offset by a modest rise in that on vehicles. The main area of growth among non-durables was, once again, services, on which expenditure is recorded as having risen by 1¼% in the third quarter even though recorded output growth was less than half this. Preliminary estimates indicate some pick-up in consumer spending in the fourth quarter with a rise of 1¼%. A large increase in retail sales was recorded in December, which may have reflected widespread pre-Christmas discounting by retailers. This, together with the difficulty of seasonal adjustment around the Christmas period, means that the December figure and hence consumption in the fourth quarter may have been erratically high.

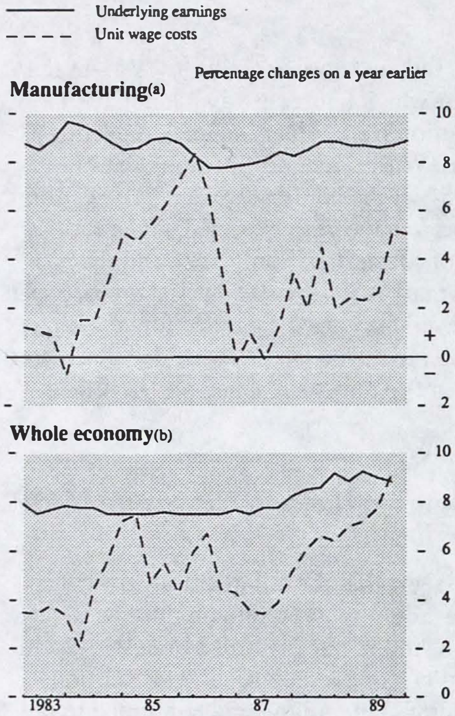
Total personal disposable incomes rose sharply—by 3%—in the third quarter (the latest for which figures are available), with a particularly large contribution from 'other income', reflecting a rise in dividend payments. With consumer spending flat, the saving ratio increased to 5½%—the highest level since 1987. Some rise in the saving ratio was to have been expected, given the evidence of a weakening of consumers' confidence and the slowdown in the housing market. The particularly sharp rise seen in the third quarter, however, may also be a reflection of the fact that large rises in dividend payments tend to be added to savings rather than spent, and the ratio may have fallen back a little at the end of the year.

Conditions in the **labour market** *may be easing slightly but remain tight . . .*

There are now increasing signs that the fall in output growth is having some effect on the labour market, though this has so far taken the form of a slowing in the rates at which unemployment is falling and employment is rising. Labour market conditions therefore remain tight overall. Unemployment continued to fall in the fourth quarter of last year, reaching 1.6 million, or 5.8% of the workforce, by the end of the year. Since peaking in July 1986, recorded unemployment has now fallen by about 1.5 million to reach its lowest level for nine years. There has been a perceptible moderation in the rate of decline, however; over the last six months the monthly fall in unemployment has averaged 29,000, which compares with 48,000 in the corresponding period a year earlier.

Recent figures also suggest that there has been some fall in the rate at which employment is rising, though the trend remains strongly upwards. The workforce in employment increased sharply—by 130,000—in the third quarter, though the rise in the first three quarters as a whole was over 100,000 less than in the corresponding period of 1988. The slowdown has largely reflected a slower rise in employment in services, where the increase in the second quarter was the lowest recorded for more than two years (excluding the fourth quarter of 1988 which was distorted by the rundown of the Community Programme). It also seems that manufacturing employment, which had risen in 1987 and 1988, has resumed its long-term trend decline with a fall of nearly 35,000 in the second quarter. The most recent figures show manufacturing employment apparently stable in the third quarter but only because of a surprising (and presumably erratic) sharp rise in August and it seems likely that manufacturing employment fell in the second half of the year as a whole.

Unit wage costs *increased sharply last year*



(a) 1989 Q4 data are an average of October and November.
(b) Unit wage costs adjusted for interruptions to oil production.

... and there is no sign of any reduction in settlements *or* earnings growth

Although the labour market may be easing, the rate of earnings growth continues to rise in response to its earlier tightness. Underlying average earnings in the whole economy grew by 9¼% in the year to November, a rise of ½ a percentage point compared with three months earlier, which has brought the current figure back to that last recorded in April. The recent rise has mainly reflected an increase in underlying earnings growth in services; this has risen by 1 percentage point since July.

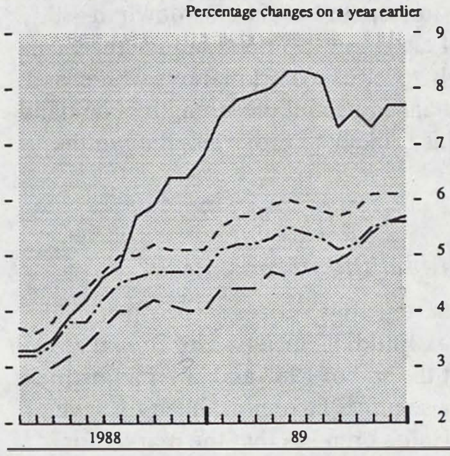
The increase in earnings growth during the second half of 1989 follows the edging up of settlements during the year. According to CBI figures, manufacturing settlements in the third quarter averaged 8¼%, up from 7½% in the second, and a full 2 percentage points higher than a year earlier. The figure for the fourth quarter is likely to be higher still. One of the reasons why these increases have not been fully passed on into even higher earnings growth is that overtime payments have fallen back, reflecting the slowdown in output. It is estimated that overtime payments made no contribution to manufacturing earnings growth during the third quarter of 1989 compared with half a percentage point a year earlier, and their contribution may have been negative in the fourth. It is likely that other cyclical elements of earnings drift, such as productivity bonuses, have also fallen back with the slowdown in the economy, though it is hard to measure these with any precision.

Settlements in the service sector have also been rising. The CBI estimates that private service settlements averaged 8.6% in the first half of 1989 (compared with 7.3% in the second half of 1988) and seem certain to have risen above 9% in the second half of the year. The fall in underlying earnings growth in services as a whole, and the implied decline in wage drift, during the middle of 1989 was due partly to a fall in bonus payments in retailing, where the economic downturn has so far been most pronounced. The rise since then in underlying earnings growth in the service sector partly reflects the relatively high settlements won by local government workers during the summer.

The strongest upward pressure on wage settlements during last year came from the rise in the rate of inflation. According to the CBI, over half of all firms in the private sector cited the cost of living as a very important upward influence on settlements during the 1988/89 pay round. The need to recruit and retain labour in tight labour market conditions also had a major influence. About one third of manufacturing firms and just under a half of private service sector firms reported this factor as an important upward pressure on settlements. This reinforces the message from the CBI industrial trends survey which indicates that, while shortages of skilled labour declined in importance as a constraint on output in 1989, they remained significant throughout the year. Profitability was a much less significant influence on settlements and had little effect, on balance, in manufacturing.

With a fall in the rate of productivity growth in manufacturing to an annual rate of around 3% at the end of last year, unit wage costs in manufacturing accelerated and by November were almost 6% higher than a year earlier. In the economy as a whole, the increase in unit wage costs in the year to the third quarter was over 9% even after allowance is made for the effects of lost oil output. Given the strains already evident in company finances, these developments are unlikely to prove sustainable. Unless earnings growth moderates, the implications of the slowdown in the economy for employment may become increasingly serious as employers seek to contain labour costs by shedding labour.

Inflation *in the* **United Kingdom** *remains uncomfortably high*



Inflation *has risen slightly in underlying terms . . .*

Inflation, as measured by the twelve-month rise in the all-items RPI, stood at 7.7% in December, and on this measure was therefore 7.6% in the fourth quarter as a whole—significantly lower than in the second quarter when a peak of 8.2% was recorded but only a little lower than in the third. Considerable volatility in the index from month to month has resulted from the inclusion of mortgage interest payments; a fall in the twelve-month increase to 7.3% in October was more than accounted for by a rise in mortgage rates a year earlier, while the rise in November reflected the latest round of increases. The less volatile measure excluding mortgage interest payments was 6.1% throughout the fourth quarter—the highest rate since 1983.

In the early part of 1989, the rate at which 'retailed' prices (the prices of goods sold in shops) were rising was persistently below that of the RPI, even excluding all housing costs. One explanation is that the more conventional measures of inflation were being boosted by services (excluded from 'retailed' prices), the prices of which reflected accelerating labour costs. In the second half of last year, however, the rate at which retailed prices were rising picked up markedly and converged on that of the RPI excluding housing. Higher prices of food, alcohol and tobacco seem to have been responsible and the depreciation of the exchange rate will have played some part, though it is impossible to measure the effect of this very precisely.

Over the coming months the inflation rate is likely to remain fairly volatile. The dropping out of higher mortgage interest rates at the beginning of 1989 will have the effect of putting some downward pressure on the all-items inflation rate while the switch from rates to the community charge may increase it. Inflation may also be boosted by increases in a number of administered prices in the spring, though the size of these is not yet known. More fundamentally, continued pressure from unit labour costs and reduced competitive pressures on manufacturers of tradable goods, together with higher import prices, resulting from the lower exchange rate in 1989 may have contributed further to inflationary pressure.

Contributions to twelve-month rise in manufacturers' input prices
Not seasonally adjusted

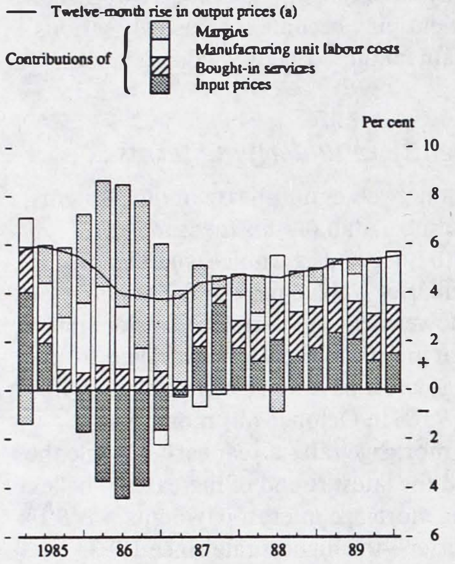
	1989 Q1	Q2	Q3	Q4
Domestic:				
Petroleum products	—	0.2	—	0.5
Electricity	0.6	0.5	0.5	0.7
Food manufacturing materials	1.0	2.1	1.7	2.1
Other materials and fuel	0.2	0.2	—	0.1
Imported:				
Food manufacturing materials	0.1	0.2	0.2	0.4
Metals	2.2	1.0	—	-0.6
Other imported materials	1.4	2.1	1.9	2.4
Revisions (a)	0.6	0.4	0.1	—
Total	**6.1**	**6.7**	**4.4**	**5.6**

(a) The published CSO contributions table is not updated when revisions to input prices are made.

. . . and there has been only a modest narrowing of manufacturers' margins . . .

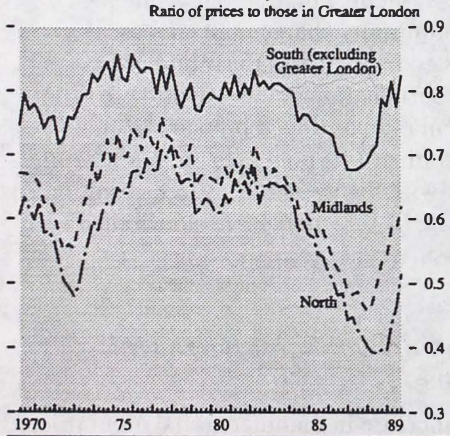
The twelve-month rate of increase in manufacturers' input prices fell to 4¾% in December, having risen over much of the period since the summer. Despite December's fall, the rise in input price inflation between the third and fourth quarters was 1½ percentage points—largely a reflection of accelerating prices of domestically produced inputs. Although the exchange rate depreciated by 4%

The contribution of **margins** *to the rise in* **output prices** *has fallen*



(a) Excluding food, drink and tobacco.

Regional house price relativities *have been distorted in recent years*



in effective terms over the last quarter, import prices have made no contribution to the growth in manufacturers' input prices, the effect having been largely offset by lower commodity prices and, in particular, falling metal prices.

The twelve-month rate of increase of manufacturers' output prices remained remarkably stable throughout last year at around 5%. A relatively low (though increasing) rate of growth in unit labour costs in manufacturing means that the fall in domestic profit margins will have been, at best, modest. However, with importers showing some propensity to cut their margins (in response to the lower exchange rate) and the latest CBI trends enquiry indicating the balance of firms expecting to increase prices below that of the previous year, some moderate fall in domestic margins is likely in response to the slowdown in demand at home. The CBI also indicates that manufacturers may now be looking increasingly towards export markets where, as a result of the fall in the exchange rate and the strength of demand abroad, pressure on margins is likely to prove less than in the home market.

. . . but **house prices** *are falling in most areas*

In the year to the fourth quarter, house prices rose by just over 5%, according to the Halifax Building Society. The annual growth rate has fallen from 34% at the end of 1988 and, after adjustment for seasonal influences, house prices have now fallen for seven consecutive months. The Halifax reports that the market for first-time buyers has remained firmer than for other buyers, partly because of a variety of mortgage schemes which have been introduced to ease payments in the first few months. Builders have also been offering discounted prices and other tangible incentives. Nevertheless, the ability to buy of first-time buyers (based on such variables as income and mortgage repayments) has fallen considerably since the middle of 1988.

The ratio of house prices to earnings turned down towards the end of last year and is now firmly established on a downward trend. The extent and duration of further falls in the ratio depend on a number of factors which are difficult to predict. In the absence of significant further falls in nominal house prices, it would take several years for the ratio to fall back to its level of the first half of the 1980s. There is no necessary reason to suppose, however, that it will fall back to this level; fundamental forces such as the availability of credit may have resulted in the equilibrium ratio having risen over time.

As well as altering the relationship between house prices and earnings, developments in the housing market in recent years have disturbed regional differentials. During the early part of the boom in 1987 and 1988, house prices in Greater London rose more rapidly than in other regions, so the ratio of regional prices to those in Greater London fell. Some return towards the average ratios of the past may be expected, although regional relationships may also have altered for more fundamental reasons. Part of the correction has already occurred, as house prices have fallen in Greater London, while continuing to rise in Northern regions. A 'normal' ratio of prices in the North to those in Greater London in the past has been around 0.6; in the fourth

Recent trends in trade in manufactures

The development of a substantial current account deficit in the past three years has largely reflected movements in trade in manufactured goods. This note examines developments in the manufactures balance in terms of both categories of goods and the main determinants of trade.

Table A shows contributions to the change in the visible balance made by trade in various categories of goods over several periods in the past. The deficit last year was larger than in 1988, owing to a somewhat smaller oil surplus, and a manufactures deficit larger by £1.1 billion. The deterioration in the manufactures balance was due mainly to trade in consumer and intermediate goods, offset partly by an improvement of £1.4 billion in trade in erratic items (mainly ships and aircraft). A comparison between the third and fourth quarters of 1989 shows the oil surplus increasing as North Sea production difficulties were overcome, but by far the largest improvement was in trade in manufactures, with all categories (except erratics) showing some improvement. Imports of consumer goods fell substantially, probably in response to weak actual and expected retail sales and earlier unplanned stockbuilding. By contrast, exports of consumer goods, and especially cars, rose strongly. Trade in capital goods also made a positive contribution to the visible balance. Because of the unusually large movement between the third and fourth quarters of last year, however, a comparison between trade in the second half of 1989 with trade in the same period of 1988 may be more useful. This is illustrated in the last column of the table which shows that over this period the visible deficit narrowed by £1 billion, owing mainly to improved trade in manufactures. This was more than accounted for by erratic items, though the balances on semi-manufactured and capital goods also improved markedly.

Table A

Contributions to changes in the visible balance[a]

£ billions

	1989 compared with 1988	1989Q4 compared with 1989Q3	1989H2 compared with 1988H2
Total change	**-2.2**	**+2.1**	**+1.0**
of which:			
Oil	-1.4	+0.2	-0.2
Non-manufactures	+0.3	+0.3	+0.3
Manufactures	-1.1	+1.6	+0.9
of which:			
Erratics	*+1.4*	*+0.1*	*+1.0*
Semi-manufactures	*-0.6*	*+0.5*	*+0.2*
Cars	*-0.3*	*+0.3*	*-0.2*
Other consumer goods	*-0.8*	*+0.1*	*-0.2*
Intermediate goods	*-0.9*	*+0.1*	*-0.1*
Capital goods	*+0.1*	*+0.5*	*+0.2*

(a) Individual components may not sum to the total change because of rounding.

Table B looks at trade in manufactures, and presents an explanation (based on the Bank's econometric model) of recent annual changes in the balance, which is first decomposed into two parts: that due to changes in export and import prices, and that due to volumes. In each of the years in the table, the rise in the deficit has been principally due to adverse changes in trade volumes, rather than prices. The table then uses the Bank export and import equations to analyse how much of the deterioration due to volume changes has resulted from changes in a number of explanatory factors: domestic demand relative to that overseas, domestic capacity utilisation, trend increase in import penetration (due to international specialisation) and effective competitiveness. The latter is further decomposed into the effects of changes in the effective exchange rate and changes in relative unit labour costs measured in local currency. Finally, changes in trade volumes which are unexplained by the Bank equations are noted.

Table B

Decomposition of changes in the manufactures balance

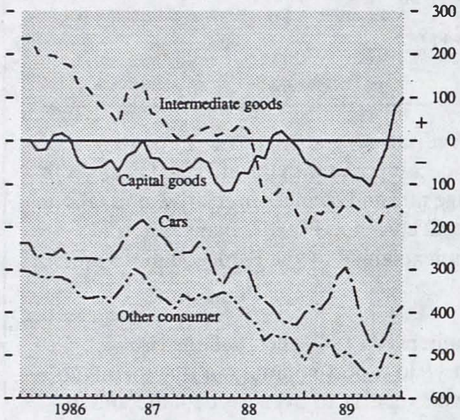
£ billions

	1986	1987	1988	1989
Total change	**-2.4**	**-1.8**	**-7.1**	**-1.1**
of which, due to movements in:				
Trade prices	-0.4	0.1	1.2	0.7
Trade volumes	-2.0	-1.9	-8.2	-1.8
of which, due to movements in:				
Demand	0.6	-2.5	-5.4	-1.0
Pressure on capacity	0.4	-0.2	-0.8	-0.4
Trend rise in import penetration	-1.2	-1.2	-1.3	-1.4
Competitiveness	0.5	2.9	—	-1.8
of which, due to movements in:				
Exchange rate	1.1	3.0	0.3	-1.0
Relative unit labour costs in local currency	-0.8	-0.1	-0.4	-1.0
Unexplained volume change	-2.3	-0.9	-0.8	2.8

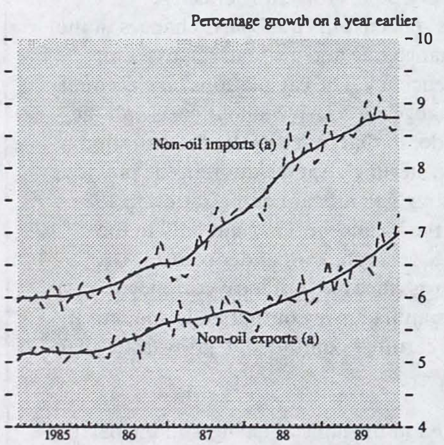
The table shows that between 1987 and 1988 the rise in import volume relative to export volume was due mainly to an increase in domestic relative to overseas demand and to the high levels of domestic capacity utilisation to which this gave rise. In 1989, the deficit continued to rise, though only slightly, owing partly to continued adverse movements in relative demand and the effects of high (but falling) rates of capacity utilisation, but also to worsening effective competitiveness. This reflected in equal parts changes in the sterling effective exchange rate and a rise in relative unit labour costs in local currency. The calculations take account of the lags between changes in relative labour costs and the exchange rate and trade, so that much of the deterioration in 1989 actually reflected sterling's appreciation in the previous year. By contrast, sterling's significant depreciation in 1989 may prove helpful to the balance in 1990 but only to the extent that relative UK costs are kept under control. UK relative unit labour costs (measured in local currency terms) worsened in 1989 as manufacturing output and productivity growth fell, while UK earnings continued to grow faster than our competitors'.

The explanation offered in the table of changes in the balance must be qualified by the fact that the component left unexplained is, in some years, very large. In 1988 the manufactures balance was £0.8 billion worse than the Bank trade volume equations would have predicted, while in 1989 it was £2.8 billion better. The unexplained elements in the manufactures balance may have common roots in a number of developments which the Bank (and other) trade equations fail to capture. In particular, the Bank export equation does not include a variable measuring the incentive for producers to switch between domestic and overseas markets, where this is feasible. In circumstances in which domestic demand is rapidly becoming less buoyant relative to demand overseas, exporters might be expected to concentrate increasingly on overseas sales, with the effect that exports grow more rapidly than a consideration of overseas demand alone would suggest. An alternative explanation of unexpectedly strong exports in 1989 might be that overseas demand was underestimated.

Trade *in most categories of* **manufactures** *deteriorated in the third quarter...*



...but underlying **trends** *in* **visible trade** *improved towards the end of the year*



(a) Including erratics.

quarter the ratio was 0.5, compared with 0.4 throughout 1988, and further rises are to be expected in 1990.

The **current account deficit** *narrowed in the fourth quarter and seems to have been erratically large in the third*

The current account deficit in the third quarter was £6.5 billion, substantially higher than both the CSO provisional estimate (£5.8 billion) and the second quarter deficit (£5.1 billion). The surplus on invisibles turned out smaller than expected, while the deterioration between the second and third quarters also reflects adverse movements in visible trade. The third quarter invisibles surplus was only £0.2 billion, compared with £0.8 billion in the second quarter. This fall was due mainly to unusually low transfer receipts from EC funds (principally the social and regional funds) and a modest fall in the recorded services surplus, which together more than offset a small rise in IPD net receipts. The visible trade deficit worsened considerably between the second and third quarters, from £5.9 billion to £6.7 billion, owing to a deterioration in non-oil trade; the oil surplus remained unchanged at £0.3 billion.

The sharp increase in the non-oil deficit in the third quarter was largely due to a strong surge in manufactured imports. Other indicators—particularly those relating to consumer demand and distributors' and retailers' sales expectations—suggest that third quarter imports, particularly of consumer goods, were abnormally high in relation to actual and expected sales. This is consistent with distributors and retailers subsequently reporting unplanned stockbuilding. In the particular case of passenger cars, imports of which accounted for around half of the deterioration in the visible balance in the third quarter, survey evidence and subsequent estimates of consumer expenditure show that demand was weak in the third quarter, with the result that many new cars were registered by dealers.

The fourth quarter visible trade deficit narrowed considerably, to £4.5 billion, partly reflecting an improvement in the oil surplus to £0.5 billion as North Sea production continued to recover, but mainly owing to a substantial fall in the manufactures deficit to £3.1 billion. The chart opposite shows the annual rate of change in the three-month average of non-oil exports and imports, and demonstrates that underlying export growth became increasingly favourable compared with that of imports towards the end of last year. While import growth fell through most of 1989 (except in the third quarter) export growth has recently been increasing and since October has exceeded that of imports. This is consistent with the latest CBI survey, which reports growing optimism by companies concerning prospects for exports.

The public sector's surplus *for this year may be smaller than had been expected*

The public sector is estimated to have been in surplus in December by £0.4 billion, bringing the cumulative PSDR for the first nine months of 1989/90 to £3.7 billion—less than half that in the same period of the previous financial year. Privatisation proceeds were £2.5 billion less and therefore do not fully account for the difference. The expected outturn for the PSDR in the financial year as a whole was put at £12.6 billion in the Autumn Statement but it now seems likely that the outturn will be somewhat below this.

In the first nine months of 1989/90 Inland Revenue receipts were 15% higher than a year earlier, compared with an increase of 6% in the corresponding period of 1988/89. This reflects the faster growth of wages and salaries and hence of income tax receipts so far this year which has been only partly offset by slower growth of Customs and Excise receipts reflecting the slowdown in retail sales growth, and consumption more generally. The forecast of total receipts for 1989/90 as a whole was revised up in the Autumn Statement by £0.5 billion. This represents an upward revision of £1.5 billion to income tax receipts, partly offset by a downward revision of national insurance contributions, associated with a much greater than expected take-up of personal pensions.

The public expenditure planning total for 1989/90 is expected to be £162 billion. The planning total is projected to increase between the current financial year and next by just over £17 billion. This is a real increase of 5½% if adjusted by the expected change in the GDP deflator. The price deflator for public consumption, however, tends to grow more rapidly than the GDP deflator so that the increase in real terms may be smaller than this. Expenditure on investment is projected to increase by 10% in real terms, which implies an increase in the proportion of expenditure directed towards investment.