Economic commentary

- *GNP growth in the major overseas economies quickened in the first quarter, but remained below its recent peak.*
- *In the first quarter, external demand made a large positive contribution to growth in the G3 economies, resulting in some trade deficit reduction in the United States but in no overall narrowing of imbalances.*
- *The UK current account is responding to slower demand growth at home relative to that in our major trading partners.*
- *Domestic demand and output growth are now coming more into balance, though the adjustment process has been uneven between industries, regions and demographic groups.*
- *The continuing strength of fixed investment, though not unwelcome, is surprising in the light of the company sector's financial deficit which remains at an unprecedented level.*
- *Non-oil commodity prices remain weak; but oil prices have risen sharply as a result of OPEC cut-backs in production and mounting political tension in the Gulf.*
- *There is broad agreement between various measures that underlying UK inflation is some 6%–6½% per annum, and has been rising, whereas that of our main trading partners is substantially lower and has been falling.*

Real GNP/GDP growth

Percentage changes on previous quarter; *seasonally adjusted*

	United States	Japan	Germany	France	Italy	Canada	Major 6
1989 Q1	0.9	1.8	2.6	1.5	1.0	0.8	1.4
Q2	0.4	-0.8	0.2	0.6	0.7	0.4	0.2
Q3	0.4	2.9	-0.1	0.5	0.7	0.6	0.8
Q4	0.1	0.8	1.0	0.8	0.5	0.5	0.5
1990 Q1	0.4	2.5	3.3	0.7	0.9	0.6	1.2

Substantial amounts of **capital** *will be required in* **Eastern Europe . . .**

The major industrialised countries have now entered their eighth successive year of economic expansion, the longest period of sustained growth since the war. Activity remains strongest in continental Europe and Japan, with North America experiencing the most pronounced slowdown. Inflation performance is less easily differentiated on geographical lines with inflationary pressures still evident in Japan and among some EC countries. There was a marked fall in measured inflation in Japan and North America in the second quarter, but in many countries inflation continues to be underpinned by pressures from the service sector. Some demand pressure is also expected in Germany following GEMU, although its extent will depend on expenditure patterns and restructuring needs in East Germany and the fiscal stance in West Germany.

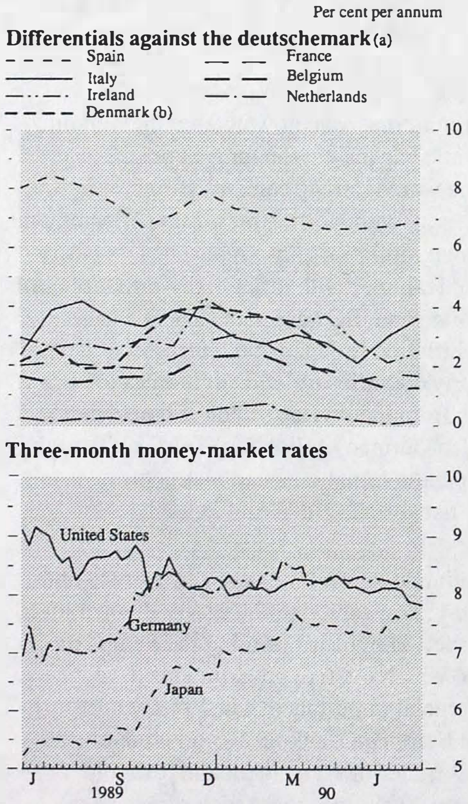
Western banks and potential direct investors are generally adopting a cautious approach in providing capital to the newly-democratised countries of Eastern Europe. The role of priming the pumps for future private investment, which western governments have assumed, is therefore of crucial importance. On 29 May the founding members of the European Bank for Reconstruction and Development signed the Articles of Agreement and it should become operational in early 1991, once the Articles have been ratified by national parliaments. In West Germany, a second supplementary budget worth DM 4.76 billion has been approved, providing initial financing for the East German social security system. A German Unity Fund has also been established, which will channel DM 115 billion to East Germany over the next five years; DM 95 billion of this (equivalent to 14% of general government expenditure in 1989) is to be raised on West German capital markets. In July the Group of 24 OECD countries agreed to extend their programme of assistance to East Germany at least until there is full political union with West Germany, in early December. Assistance was also extended to Bulgaria and Czechoslovakia, both of which are expected to be admitted to the IMF/IBRD by September, as well as to Yugoslavia. The G24 and the G7 Summit in Houston failed to reach a consensus on financial assistance to the Soviet Union; most Western governments believe that without a more solid base of political and economic reform, large-scale direct financial assistance at this stage could inhibit real structural change. An IMF-led study of the Soviet economy has been commissioned to establish criteria under which assistance could effectively support the reform process, and technical assistance is being provided to help moves towards a more market-oriented economy.

. . . *requiring greater* global saving *or higher* interest rates

At this stage there are few firm indications of the likely scale of capital flows that will be required either to finance the reconstruction of Eastern Europe or to aid reform in the Soviet Union. An additional uncertainty is the effect of the imminent switch by the COMECON countries to world prices and hard currencies for their own trade, because the terms of trade losses that Eastern and Central Europe will suffer against the Soviet Union could run to several billion dollars a year. The IBRD has made it clear that the $7.5 billion which it is devoting to the area over the next three years will not be at the expense of lending to other countries but concern has been expressed about the perceived inadequacy of global saving. It is feared that, should saving not rise in line with global demand for capital, then world real interest rates will rise and there will be some crowding out of existing investment plans. However, although long rates rose during the first four months of 1990 because of the expected implications of Eastern European developments, they have subsequently fallen back a little.

The attempts at fiscal consolidation currently under way in North and South America and also within the EC will go some way toward reducing government dissaving. In the United States, the projected federal budget deficit for the current fiscal year has risen, principally because of the cost of the Savings and Loan restructuring. Even excluding these costs, however, it is expected to overshoot the original Gramm-Rudman target for the current year of $100 billion by around $60 billion. The Administration's latest projection for the fiscal year 1991 is for a deficit, excluding Savings and Loan costs, of $170 billion, $100 billion over the Gramm-Rudman target for the year. Negotiations have started with Congress on a package of measures to reduce this deficit.

Interest rate differentials *narrowed against the* **deutschemark**

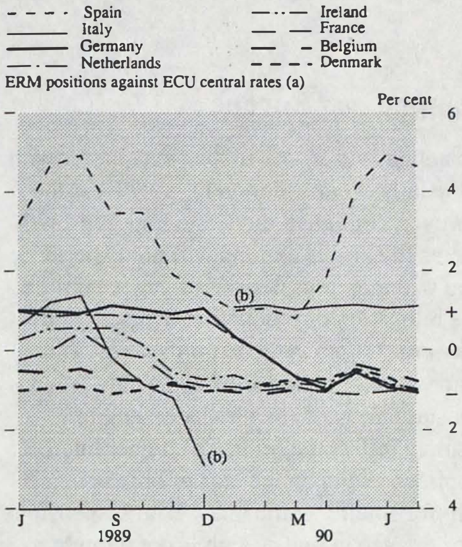


(a) Three-month money-market rates.
(b) Interbank rate.

Official interest rates *moved downward , as did* inflation, *during the second quarter. . .*

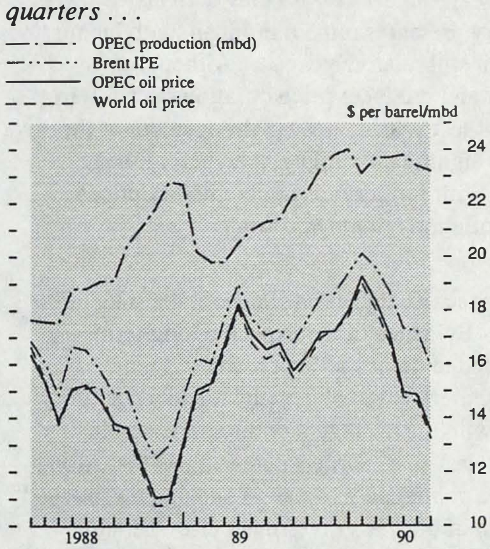
The fiscal expansion in West Germany, coupled with any monetary tightening prompted by inflationary pressures following GEMU,

Currencies *remain polarised within the* **ERM**

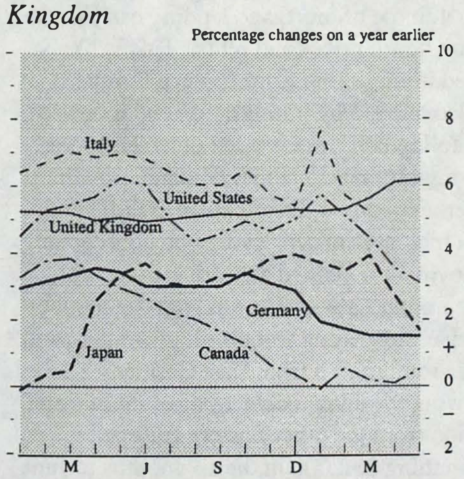


(a) Last working day each month.
(b) The lira entered the narrow band in January with a lower central rate.

Oil prices *fell in the first and second quarters . . .*



. . . facilitating some reduction in **producer price inflation** *- except for the United Kingdom*



may help to strengthen the deutschemark and lift it from near the bottom of the narrow band of the ERM where it remained throughout the second quarter. The lira and the peseta continued to benefit from strong capital inflows and they consequently remained the strongest ERM currencies. The strength of capital inflows to Denmark and Italy enabled the authorities to cut official interest rates by 0.5% and 1% respectively and the Irish also eased twice in June against a background of lower domestic inflation. These followed French moves to cut rates by a total of 0.5% in April. The Belgian authorities have announced plans to narrow the franc's permitted bands of variation against the deutschemark. Following the announcement, the key three-month treasury bill rate was cut by 1.1%, thereby facilitating some public debt service reduction: Belgium has the largest stock of public debt in the EC, amounting to 130% of GDP.

The reduction in twelve-month producer and consumer price inflation in the second quarter reflected a reversal of food and energy price rises in the first quarter. The decline of non-oil commodity prices in the second quarter was attributed to several factors: disruptions to metal supplies were less common, enabling some stock replenishment, and factors influencing food prices were more evenly balanced, with adverse weather conditions and political tension in coffee and tea producing countries offsetting stock rundowns. Overall, non-oil commodity prices in the second quarter remained 12% lower than a year earlier. Oil prices slumped in the second quarter because of continued excess supply but rose sharply in July as OPEC agreed to cut back production, and yet further early in August as political tensions in the Gulf mounted.

Growth in the United States *remains sluggish . . .*

Growth in the United States has picked up from the fourth quarter of last year but still remains sluggish. The service sector remained relatively strong and supported growth in the first half of the year and manufacturing is now showing some recovery. External demand made a significant contribution to growth in the first quarter, largely through an export improvement rather than any major slowdown in imports, and exports of capital goods are expected to continue to grow strongly, benefiting from improved competitiveness and the relative strength of demand in the rest of the world. The trade deficit in the five months to May, at $39 billion, was around $5 billion lower than in the corresponding period last year. Weaker corporate profitability suggests that capital investment may slow and problems in the real estate sector have weakened residential investment. Against this background, the Federal Reserve allowed short-term interest rates to fall in mid-July to offset the tighter conditions which resulted from banks adopting less lax credit standards. Service sector inflation remains around 6%, accounting for much of the inflationary pressure in the economy as a whole, and the core rate of inflation, which excludes volatile food and energy prices, remained around 4.5%–5%, with no significant fall in prospect.

Canada was affected by unseasonably good weather in the first quarter, and inventories were adjusted. As a result, the 2.2% annualised rate of growth was higher than the underlying rate. Slower industrial activity and weakening business investment were offset by exceptionally strong net exports and this was reflected in a strong rise in the trade surplus. Twelve-month consumer price inflation fell in the second quarter to around 5% but the notable spread between this and almost static producer prices remained, reflecting the strength of both service sector inflation and consumer demand. With labour markets still tight and wage settlements and inflationary expectations high, further improvement may prove difficult.

. . . but is stronger in **Japan** *and* **Europe . . .**

Japanese GNP grew by an annualised 10.4% in the first quarter with external demand making the largest contribution to growth for the first time since 1984. However, continued moderate import growth may be expected and it seems likely that exports will not experience the rapid growth associated with previous periods of yen weakness because of the effect of the relocation of production overseas and perhaps because of capacity constraints in the export sector. The strength of external demand was accompanied by some slowdown in the rate of growth of consumption and, to a lesser extent, of business investment. This may reflect the impact of higher interest rates both on consumer confidence and on the cost of borrowing, which is especially relevant for smaller companies. The suspension of the market in new equity finance in mid-March is not thought to have affected larger, cash-rich, companies. There is no evidence of banks restricting lending to the corporate sector as a whole, although lending to the real estate sector is being actively discouraged. Inflationary pressures remain in Japan, with labour markets tight and the yen still relatively weak. Although the twelve-month consumer and producer price inflation rates fell in April, when the effect of last year's sales tax dropped out of the calculation, they remain significantly higher than before the introduction of the tax. With further falls in commodity prices unlikely, the forces on inflation remain upward.

Recent large data revisions raise uncertainties about the state of the West German economy. Evidence of the expected long-term movement from export-led to domestic-led growth did not materialise in the first quarter; external demand made a positive contribution to growth with the average monthly trade surplus considerably higher than last year. Orders data suggest that strong export demand may have continued into the second quarter, buoyed by the continued strength of business investment elsewhere in Europe. Domestic demand was supported by strong commercial and residential construction in the first quarter, facilitated by favourable weather conditions. Demand for housing was strong and this was reflected in a high volume of mortgage lending early in the year and upward pressure on house prices and rents. This is likely to continue, given continued immigration from Eastern Europe. Consumer spending was also buoyed by immigration and increases in real disposable income following January's tax cuts. However, there is some evidence to suggest that consumer demand growth may have steadied, as uncertainty about the effects of GEMU and the possibility of future tax increases raised saving and consequently reduced demand. Unemployment remained at 7.3% in June with immigrants accounting for around 13% of that total but the number of vacancies continued to rise, suggesting some skill mismatch with new immigrants. Although immigration from East Germany slowed in the second quarter following the announcement of economic and monetary union, immigration from the other Eastern European countries remained high, totalling 232,000 in the six months to June and 28,500 in the first two weeks of July alone. Inflationary pressures eased in West Germany ahead of currency union, with weak import prices offsetting the effects of higher wage settlements and some widening of profit margins. Higher construction costs are, however, a cause for concern.

In East Germany, the cost of living in June was 12.1% lower than a year earlier, largely because of distress selling ahead of GEMU. However, prices rose significantly following currency union on 1 July, as did taxes and social security payments. Industrial production slowed substantially, falling 7.3% in the first six months of the year and the result has been a sharp increase in unemployment, particularly following currency union, and a shift towards short-time working. Several unions have negotiated large pay rises and job guarantees, which may endanger their ability to compete with West German producers.

French GDP growth slowed in the first quarter to an annualised 2.8%. The trend in industrial production has been downward and retail sales showed some signs of weakening in the second quarter. The significant improvement in the French trade account in the first quarter was largely a result of non-recurring factors and second quarter figures have been more in line with last year's average. There has not therefore been any change in the underlying trade performance although, like the other oil-importing industrialised countries, France benefited from the weakness of oil prices in the second quarter. Consumer price inflation fell to 3% in May and June but continues to be underpinned by service sector inflation, which remains above 4%.

Italian consumer price inflation benefited from lower import prices, the twelve-month increase falling to 5.7% in May, but the strength of public sector pay settlements may fuel future price rises. Renewed income growth contributed to a deterioration of the trade deficit in the first quarter, reversing the improvement seen in the second half of last year when demand was slowed by indirect tax increases and a slowdown of income growth.

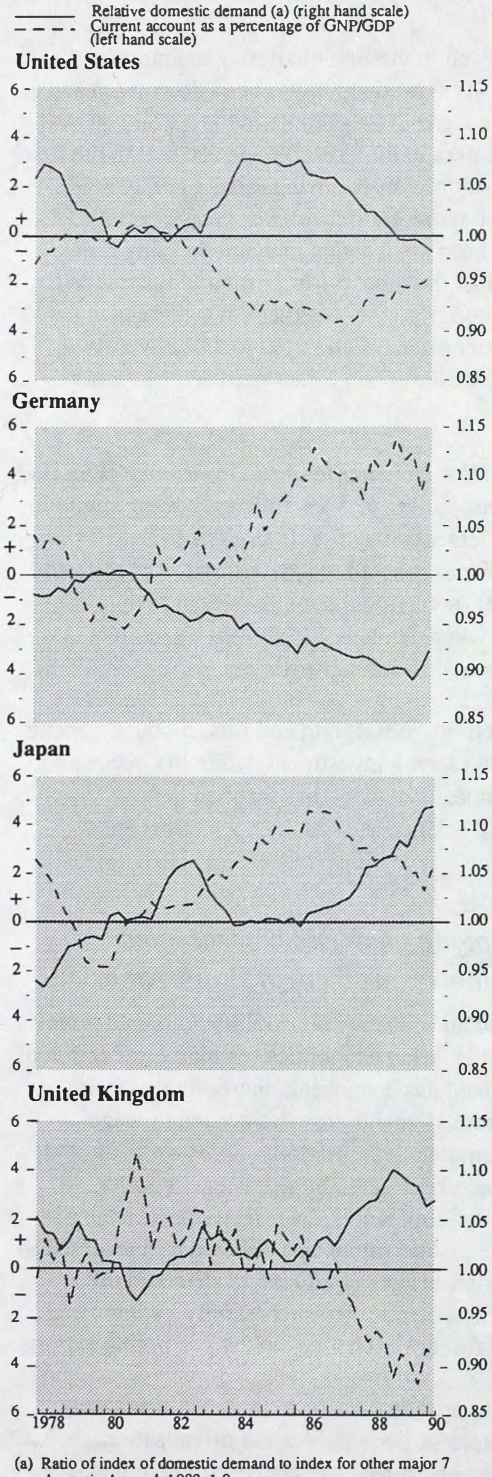
Elsewhere in Europe, activity in Belgium and Luxembourg remains buoyant, led by continued strong investment, while in Greece and Spain the strength of domestic demand has resulted in a deterioration of the trade balance as capacity constraints are encountered.

Stronger growth *among the* **NIEs** *now threatens* **inflation** *which remains a problem in* **Latin America . . .**

Strong domestic demand and capacity constraints prompted policy tightening in several of the Asian economies. With the exception of Hong Kong, where demand has been weak, increasingly severe labour shortages and strong demand growth have led to wage increases which have compounded inflationary pressures. Export volumes have been adversely affected by persistent capacity constraints and, except in South Korea, by effective exchange rate appreciation. Elsewhere in Asia, monetary policy has been eased in China as growth and inflation have continued to slow and the current account deficit has been limited successfully by imposing controls on imports and foreign exchange and by promoting exports.

In Latin America, further progress has been made on structural reform, notably in the areas of trade policy and privatisation. Ambitious adjustment programmes have also been attempted in Brazil and Argentina. In Brazil, a radical counter-inflationary plan

Relative domestic demand *is a key explanation of* **current account imbalances**



(a) Ratio of index of domestic demand to index for other major 7 domestic demand, 1980=1.0.

was introduced in March which entailed a severe liquidity squeeze. Initially, the month-on-month rate of inflation fell dramatically but key fiscal reform measures were delayed, resulting in a rise in inflation. Argentina experienced a severe recession and hyperinflation early in 1990, prompting a further fiscal package which had some success in reducing inflation. Both programmes resulted in a strong trade performance but import liberalisation measures and a recovery of domestic activity held Mexican trade in deficit. Despite this weak trade performance, the Brady debt relief package for Mexico has proved successful thus far. Progress has also been made on arrears in other countries; Argentina made a partial interest payment to the banks in June following IMF endorsement of its programme and Peru has initiated discussions with its creditors.

The liberalisation of international capital flows has been in progress for some years now with recent moves most prominent among EC member states. The resulting increased pool of internationally mobile savings may have made the large payments imbalances which emerged during the 1980s more sustainable. However, the persistence of imbalances has given rise to protectionist pressures, especially in the United States, and it is against this background that the Uruguay round of GATT talks and the Structural Impediments Initiative (SII) between the United States and Japan have been conducted. A major obstacle to agreement in the GATT talks has been agricultural policy and failure to reach agreement in this area may endanger negotiations covering wider areas including trade in services and intellectual property. Negotiations on agriculture covering the reduction of internal support, export subsidies and border protection are to begin in August. The year-long SII talks were completed in June with agreement on specific measures to remove structural barriers to imports and promote domestic demand in Japan, and in the United States to increase private saving and eliminate the federal deficit.

Relative cyclical positions *in the major countries help explain* external imbalances . . .

The narrowing of external imbalances among the major economies has reflected mainly changes in their relative domestic demand positions, and perhaps to a lesser extent movements in their exchange rates. In the United States, domestic demand rose sharply relative to other major economies in 1983 and 1984, at a time when the exchange rate rose by more than 10% in effective terms, and this was mirrored in the very large deterioration in the US current account deficit that became such a feature of the 1980s. Since 1986, relative domestic demand growth has fallen and, with a lag, the current account has improved somewhat, though it has apparently responded much less to the fall in the dollar's effective exchange rate of over 30% between 1985 and 1987.

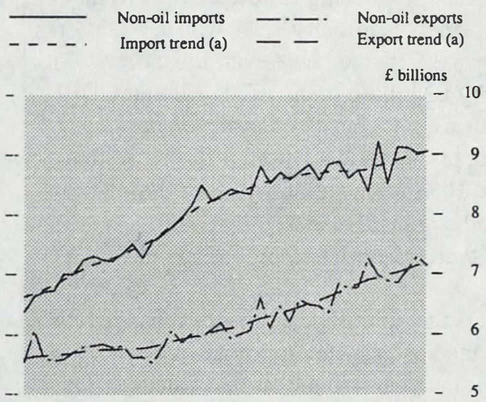
A similar relationship between relative domestic demand and the current balance can be observed in other major countries. In Germany, growth throughout the 1980s has been export led and domestic demand has fallen steadily relative to that in other major countries. This has been accompanied by a general strengthening of the deutschemark. But from the second half of 1989 there has been a sharp reversal of the trend in relative domestic demand that looks like continuing this year and may indeed accelerate with the impact of unification. Although it is too soon to expect to see clear evidence of a reversal in the trend of the current account in response to relative domestic demand, a flattening of this trend in relation to GNP does seem to have occurred since about 1987, a period over which the trend increase in the deutschemark effective exchange rate has also flattened. In Japan, domestic demand has risen consistently relative to other major countries since 1986 and has been accompanied over virtually the same period by a falling Japanese current surplus; reversal of the trend rise in the yen's effective rate has been a much more recent occurrence.

. . . as in the **United Kingdom** *. . .*

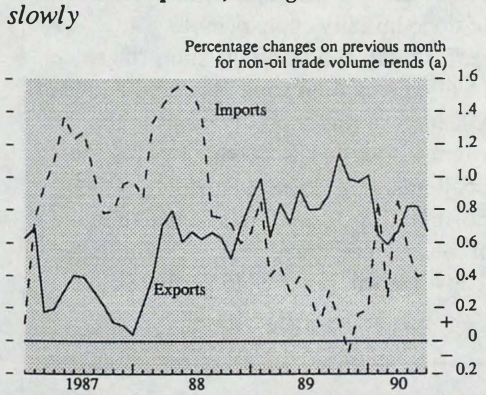
A similar story can be told of the United Kingdom where domestic demand rose sharply between mid-1986 and mid-1988 but has been reined back with the progressive tightening of policy since then. As relative domestic demand grew, so the non-oil trade balance deteriorated.

The UK current account deterioration in 1987 and 1988 reflected both an acceleration in non-oil import volumes as domestic demand grew faster than the capacity of the domestic economy to meet it, and falling non-oil export growth as UK manufactures were absorbed more by domestic demand and as capacity constraints became binding. During 1987 and 1988 UK competitiveness, as measured by relative unit labour costs, deteriorated by over 15% and in part this reflected a similar rise in sterling's effective exchange rate over these two years (which was reversed in 1989 though it has been largely restored this year). But effective competitiveness measures tell a somewhat different story (see the article on page 352) and competitiveness now appears in any case less powerful than demand in explaining medium-term movements in the current balance (see the note on page 316).

UK non-oil imports *remain much higher than* **exports . . .**



. . . but the trend in **exports** *is improving relative to* **imports,** *though now more slowly*



(a) Trends are maximum likelihood smoothed Kalman filter estimates.

. . . where improvement in the **current account** *is set to continue*

As domestic demand stopped growing last year, and relative to other major countries fell sharply, so capacity constraints ceased to bind and manufacturers looked to export markets as the main means whereby they could maintain output levels. At the same time domestic demand growth was no longer drawing in imports at the previously excessive rate. Thus the adjustment in demand has created a better prospect for a sustained improvement in the current account balance.

Interpretation of recent trade figures is made more difficult by erratic movements but changes in the composition of trade bear out the story of cyclical adjustment as the main driving force. The improvement arises mainly from increased exports, of both capital and consumer goods. Slow growth of demand within the United Kingdom has affected imports of capital goods, and the trade balance for commercial vehicles has improved by £200 million between the first four months of 1989 and 1990 reflecting the particular weakness of domestic trading conditions of this sector.

The balance of trade in cars has improved since the third quarter of last year, with import volumes falling and exports rising. Somewhat in contrast, there has been a less substantial improvement in the balance on other consumer goods, where import volumes dropped at the end of last year but have since picked up again, particularly in the second quarter, although individual monthly figures for both

The effects of the exchange rate on inflation, output and the current balance

An article in the May 1990 *Bulletin*[1] analysed in some detail the effects of changes in interest rates on the UK economy. Two main channels were suggested through which an increase in interest rates could reduce inflation: first, by decreasing domestic demand; second, by strengthening the exchange rate, where it reduces the rate of growth of import prices and therefore inflation directly. Here, some aspects of the transmission mechanism involving the exchange rate are explored.

Although the effect of interest rates on the exchange rate is at times difficult to predict, the exchange rate is a very important influence on monetary conditions. Because imports comprise about 30% of total UK expenditure, the price of imports is a major determinant of UK prices in general. Import prices influence directly prices paid by UK consumers and producers but also, through the discipline of competition, the prices that UK producers can charge in their home market. Traded goods, and the exchange rate, have such an important role in the UK economy that convergence of its inflation rate on that of its more successful trading partners can, in practice, only be achieved with a firm exchange rate.

Nonetheless, maintaining a firm exchange rate at a time when UK inflation is higher than that of its trading partners is clearly not costless, since it implies a loss of competitiveness. This reduces UK exports and encourages imports and therefore entails a worsening current account and/or lower growth than would be the case if the exchange rate were weaker. However, the extent of these costs depends crucially on the extent to which trade volumes are affected by competitiveness and how quickly UK prices and costs (particularly wage costs) react to the loss of competitiveness. If earnings continue to rise strongly following a fall in import prices, UK producers will not be able to compete as effectively either in the United Kingdom or abroad, leading to lower output and employment in the United Kingdom. If, on the other hand, UK prices and costs respond rapidly to lower import prices, and some relaxation of demand for domestic resources, low inflation can be achieved more quickly and at less cost.

Recent econometric research suggests that, in general, UK prices nowadays adjust relatively quickly to changes in import prices and that trade volumes are not particularly sensitive to changes in competitiveness. This suggests that a firm exchange rate policy can help to reduce inflation without undue costs in terms of output and the balance of payments. Such research inevitably embodies past experience of, for example, labour market behaviour where relationships are not necessarily immutable.

The table shows the effect of a 10% appreciation of the effective exchange rate according to the Bank of England model of the UK economy.[2] It shows deviations of each series from their base value, given a 10% appreciation. For the current balance, figures represent annual totals; elsewhere they show their quarterly path.

The effects[a] of an exchange rate appreciation of 10%

Quarter	1	2	4	8	12
Response of:					
Current balance (£ billions)			0.7	-1.6	-2.0
Consumer prices (per cent)	-0.4	-1.0	-2.2	-4.6	-6.6
Relative unit labour costs (per cent)(b)	9.9	9.8	9.2	6.8	3.8
Export volumes (per cent)	-0.4	-1.2	-2.1	-2.2	-1.6
Import volumes (per cent)	0.3	0.4	0.3	—	-0.3
Export prices (per cent)	-2.0	-3.0	-4.6	-6.8	-8.3
Import prices (per cent)	-4.3	-6.3	-7.5	-8.7	-9.5
GDP (per cent)	-0.2	-0.4	-1.0	-1.3	-1.3
Unemployment ('000s)	4	15	48	129	180

(a) This simulation was conducted on the assumption that policy is not altered in response to the change in the exchange rate. All estimates relate to differences in levels from the base case.

(b) Defined in a common currency.

The table shows that after only three years consumer prices are 6.6% lower (and inflation 2% lower) than if the appreciation had not taken place. Competitiveness, measured here in terms of relative unit labour costs (where a positive sign implies a worsening of competitiveness), is rapidly being restored to its original levels. Competitiveness is initially 9.9% worse, but after three years is only 3.8% worse. However, the current balance is worse by £2 billion in the third year and GDP is 1.3% lower than would otherwise have been the case. In the longer term, prices are likely to fall further so that virtually all of the 10% appreciation will feed through to the price level, and competitiveness, output and employment will tend to return to their base levels.

One point to note is that in the short run an exchange rate appreciation will tend to cause an improvement—£0.7 billion in the first year—in the current balance. This is because an exchange rate appreciation increases the *value* of UK exports relative to the value of imports so that the balance of trade initially appears more favourable. This effect only applies in the short run since consumers in the United Kingdom soon react to the lower sterling price of UK imports and those overseas to the higher foreign currency price of UK exports by changing their expenditure patterns. This change in volumes then causes the trade position to worsen. Thus a change in the exchange rate can cause a temporary improvement in the current balance, known as the J-curve effect, that is subsequently reversed.

(1) 'The interest rate transmission mechanism in the United Kingdom and overseas' in the May 1990 *Bulletin*, pages 198–214.
(2) See 'The Bank of England model 1989: recent developments and simulation properties', by F J Breedon, A J Murfin and S H Wright; Bank of England *Technical paper* No 29, May 1990.

Contribution to change in visible balance[a]

£ billions

	1990 H1 compared with 1989 H1	1990 H1 compared with 1989 H2	1990 Q2 compared with 1990 Q1
Total change	**2.0**	**0.4**	**0.6**
of which:			
Oil	0.6	—	0.2
Non-manufactures	-0.5	-0.4	—
Manufactures	2.0	0.8	0.5
of which:			
Erratics	*-0.6*	*-1.1*	*0.3*
Semi-manufactures	*1.2*	*0.6*	*-0.3*
Cars	—	*0.3*	*0.1*
Other consumer goods	*0.1*	*0.2*	*-0.1*
Intermediate goods	*0.1*	—	*0.2*
Capital goods	*1.2*	0.6	*0.2*

(a) Individual components may not sum due to rounding. Within manufactures there may be a discrepancy due to converting imports from OTS to BOP basis.

Current account summary

£ billions

	1986	1987	1988	1989 H1	1989 H2	1990 H1
Visible balance	-9.4	-10.9	-20.8	-12.4	-10.7	-10.4
of which:						
Non-oil balance	*-13.4*	*-15.1*	*-23.6*	*-12.8*	*-11.8*	*-11.4*
Oil balance	*4.1*	*4.2*	*2.8*	*0.5*	*1.0*	*1.0*
Invisibles(net)	9.3	6.6	5.9	3.5	0.6	1.3 (a)
Current balance	—	**-4.4**	**-15.0**	**-8.9**	**-10.2**	**-9.0**

(a) Involves CSO projection for the second quarter 1990.

imports and exports have been distorted by erratic trade in antiques. Clothing and footwear imports have been particularly strong recently and this bears out anecdotal reports of very difficult competitive conditions facing UK producers of these goods. Also, food, drink and tobacco imports have continued growing in volume terms, reflecting the relative strength of this element of consumers' expenditure.

Besides their medium-term effect (through competitiveness) on real trade flows, exchange rate movements also affect the current account, measured in sterling terms, more immediately through changes in the sterling value of imports and exports priced originally in foreign currencies. These so-called J-curve effects tend to offset competitiveness effects in the short term. Depreciation of the exchange rate last year, therefore, will have reduced the improvement in the current balance that would otherwise have resulted from trade volume trends, and the reversal of much of that depreciation this year, if maintained, will help to restore that improvement.

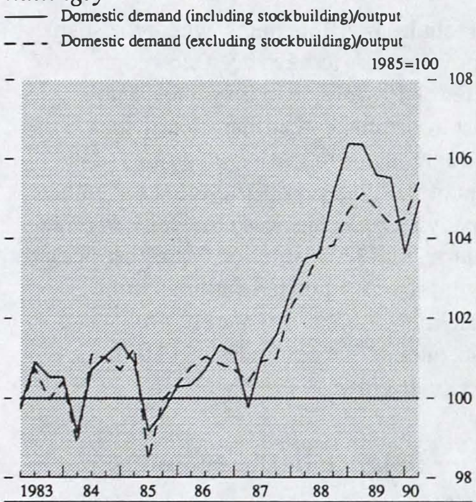
The current balance also includes invisible items, where the sharp deterioration since 1986 now appears to have been slowed, if not halted. In the fourth quarter of 1989, trade in invisibles is now estimated to have been just in surplus, rather than clearly in deficit as had previously been thought, and a rather larger surplus of over £700 million in the first quarter of this year is projected to continue in the short term. This steadying reflects a less erratically adverse transfers balance (particularly with EC institutions) together perhaps with a modest continuing improvement on net earnings from services, but offset by a declining surplus on interest, profits and dividends as the current account deficit continues and UK net monetary liabilities in particular grow.

Progress towards better **balance in the economy** *paused in the first quarter*

The trade statistics lend support to the picture of demand and output emerging from the national accounts and other indicators. Domestic demand is estimated to have grown quite strongly in the first quarter of this year, having fallen in the fourth, though this erratic path appears largely to result from stock movements and other temporary factors. Final domestic demand (public and private consumption plus fixed investment) shows a smoother path, growing by 1% in the fourth quarter and 1¼% in the first quarter of this year, having been flat in the second and third quarters of 1989, but even within this there are erratic elements.

On the other hand, output growth, which slowed during last year, appears now to be reviving. In the first quarter output was 1¾% higher than a year earlier and manufacturing output grew by a similar amount in the three months to May compared with the previous three months, though perhaps a third of the latter rise may reflect recovery from disputes in the motor vehicles and engineering industries. Within manufacturing, output of investment goods has shown strong growth while a fall in output of clothing and textiles contributed to relatively slow growth (under ½%) in output of consumer goods in the latest three months compared with the previous three. It is not easy to reconcile this firming of output with evidence from the CBI trends survey, where the balance of manufacturing firms expecting to increase output has been negative this year; and the new orders balance was sharply negative in

Domestic demand *is still stronger than* **output,** *but adjustment is occurring - if haltingly*



July—at 19%, it was lower than at any time since the end of 1982. Even export orders, according to CBI respondents, are no longer expected to grow in the next four months. Output of the energy and water supply industries has been more uneven and affected by setbacks and recovery in North Sea oil activity; in the first quarter it was little changed from a year earlier but erratic movements may continue to distort the annual growth rate for this sector as they have in the past. The services sector continued to show clear growth of output which rose 1% in the first quarter and was 2½% higher than a year earlier. Overall this produced a ¾% (seasonally adjusted) rise in the output measure of GDP in the first quarter.

The balance between the growth of domestic supply and demand, which has shown such a marked improvement over the past year, weakened somewhat in the first quarter, leading to a pause in the improving trend of the external trade account. The much improved balance achieved in the fourth quarter of 1989 resulted mainly from a very sharp (£2 billion) turnaround in stockbuilding behaviour. Although destocking continued in a more modest way in the first quarter, and stock levels may still overall be higher than desired, indicating further destocking to come, the most aggressive phase of stock adjustment appears to be over and this has been reflected in some firming of imports, orders and production. Indeed, it is notable that while distributors' stocks and manufacturers' stocks of inputs and finished goods all fell in the first quarter, manufacturers' work in progress rose quite strongly. Intermediate goods imports have also been strong in recent month.

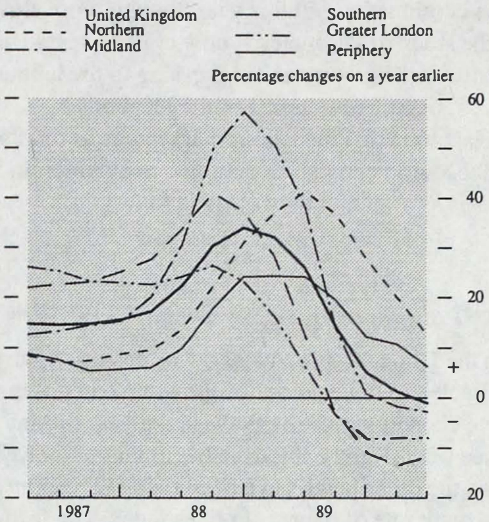
The **impact of adjustment** *has been uneven . . .*

Aggregate measures of economic activity do not reveal the variety of the experience of adjustment, which varies in timing and intensity for different groups. There are important differences in the experience of different industries, regions of the country and socio-demographic categories.

When monetary policy was progressively tightened to restore a better balance between domestic supply and demand, starting in mid-1988, the impact was initially felt most strongly in the residential housing market. This was not unwelcome because the previous rapid rises in house prices and consequent increases in housing wealth had played an important part in the strong growth of demand. As house prices ceased to rise—and in some areas like the South East began to fall—the effects were felt more widely. Demand for durable consumer goods such as carpets, furniture and white goods, associated with house purchase, softened, as did demand for housing-related services such as those of estate agents. Vehicle sales—both cars and commercial vehicles—have fallen as replacement decisions have been deferred; so have more discretionary items of expenditure such as foreign holidays.

On the company side the impact has also varied. Property companies and those associated with the residential housing market probably experienced the earliest and most direct consequences. On the other hand, those companies with a strong export orientation, and this includes many of the newer multinational companies that have set up operations in the United Kingdom in the last decade, have done relatively well, particularly in areas such as chemicals and capital goods.

Regional *differences in the timing and scale of* **house price inflation** *have been marked*



Northern=North, Yorkshire and Humberside and North West.
Midlands=East and West Midlands.
Southern=South West, South East (excluding Greater London) and East Anglia.
Periphery=Wales, Scotland and Northern Ireland.

Many of these less affected industries are mainly located outside the South East. Furthermore, personal indebtedness is probably higher in the South East, where property price rises were more sustained, and rose to higher levels, in the mid-1980s than in the northern part of the country. Thus the regional impact of economic adjustment has been very uneven and concentrated to a large extent where the inflationary pressure was greatest.

Demographic factors may also be important. Over the past decade increasing numbers of people have retired from a generation that for much or all of their working lives have been members of occupational pension schemes, and who in increasing numbers both own their own homes and have arranged their affairs so that their mortgages have been paid off by the time of their retirement. Others, older but still working, may find that housing costs make a declining claim on income as mortgages are repaid. Thus an increasingly affluent generation of older and retired people is emerging for whom high interest rates, far from restraining consumption, may actually allow increased spending. On the other hand, historically higher house prices and mortgage commitments in relation to income mean that high interest rates impinge much more sharply on younger generations and the replacement of domestic rates by the community charge may tend to reinforce this intergenerational shift in spending power.

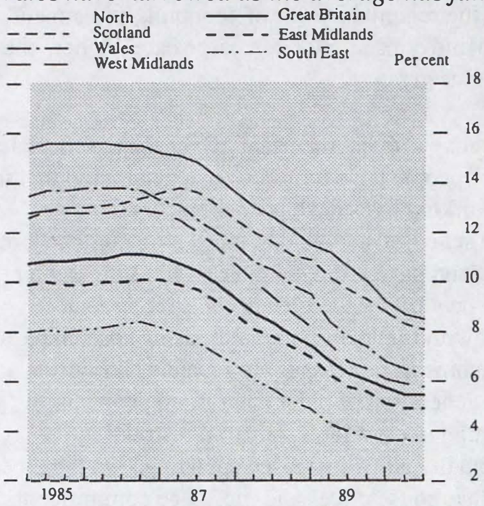
Although high interest rates (and the community charge) will shift disposable income from young to old, the effect of this on aggregate saving and consumption will depend on relative marginal propensities to consume. The old, with shorter time horizons, might be expected to have a higher propensity to consume, but their relatively higher uncommitted income may tend to reduce that propensity. For the young, on the other hand, increased mortgage and community charge payments are likely to be met from a lower amount of discretionary income, and capital market imperfections may shorten their effective planning horizon, also tending to raise their marginal propensity to consume. The evidence strongly suggests that on balance this intergenerational shift in spending power will lower consumption as well as changing its composition.

. . . though in the **labour market** *disparities are diminishing . . .*

Another aspect of demographic change that may have some effect on spending patterns has been the more rapid growth of female employment. In just over three years from 1987 the female workforce in employment rose by 1½ million (14¼%), 0.6 million more than male employment (which rose only 6½%). The largest rise has been in the service industry which has accounted for the bulk of the 1.7 million rise in employees in employment and probably accounts also for most of the 0.6 million rise in self-employment over these three years. One quarter of the total rise in employment has been in part-time employment—probably substantially female.

Regional differences in unemployment rates have narrowed as the overall level has fallen since 1986. Excluding Northern Ireland, where special factors apply, there was a 7½ percentage point difference early in 1986 between unemployment in the region with the highest rate (Northern England) and that with the lowest (the South East) ; the overall rate has now been halved from 11% to

Disparities between **regional unemployment**[a] *rates have narrowed as the average has fallen*



(a) Rates for the North West, Yorkshire and Humberside, South West and East Anglian regions have been excluded to preserve clarity but show a similiar pattern. In Northern Ireland, where special factors apply the rate is higher and has fallen less.

5½% and the regional disparity reduced to under 5 percentage points.

The continuous downward trend in unemployment which began in July 1986 has slowed since the beginning of the year, and since April there have been small rises in the total. These rises (and the earlier slowdown) started to appear in the South East, East Anglia and the South West but have now spread to most other regions, although unemployment is still falling in Scotland. Vacancies at Jobcentres have also continued to fall this year, though more slowly than last year, and the stock of vacancies is now at its lowest level for four years, supporting the picture of some easing in the labour market. Nevertheless, measured in terms of the level of unemployment, the last time that the labour market was as tight as now was a decade ago. And companies continue to cite recruitment and retention problems as affecting their attitude to wage negotiations.

. . . *and* **wage drift** *slackening* . . .

While conditions in the labour market may now be easing slightly, this has yet to be reflected in lower earnings growth. Underlying earnings in the whole economy grew by 9¼% in the year to May, a rate that has increased only slightly since the beginning of the year. Wage settlements, on the other hand, have been rising in response to rises in the annual growth rate of the retail prices index, and further acceleration of earnings has been prevented only because overtime payments, productivity bonuses and other elements of wage drift have been depressed by the general slowdown in economic activity. Lower overtime payments, for example, are estimated to have reduced earnings growth by a quarter of a percentage point in the first quarter .

As with other aspects of the adjustment process, there are significant sectoral differences. Since the beginning of the year, service sector earnings growth has risen by between ½ and ¾ of a percentage point (to 9¾% per annum) while in manufacturing, earnings growth dropped slightly in May (to 9¼% per annum). This may reflect the greater importance of overtime payments in the manufacturing sector. It is also in line with evidence on the trend in private sector wage settlements collected by the CBI.

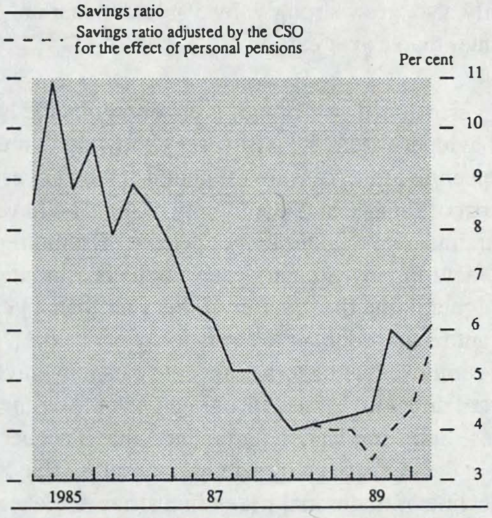
. . . *as* **real earnings growth** *is again reined back*

The conventional measure of real personal disposable income (RPDI) grew by 5% in the year to the first quarter, compared with 4% in the year to the fourth quarter of 1989. The higher growth rate is mainly due to buoyant receipts of self-employment income, dividends and net interest. Higher National Insurance rebates and incentive payments have also raised RPDI through reduced social security contributions. However, given the wide disparities in experience and behaviour of different economic groups, and in particular the fact that high interest and dividend receipts are flowing predominantly to life and pension funds rather than directly to households, it is not clear that changes in RPDI necessarily provide the best short-term explanation of changes in saving and consumption behaviour. Nor do they necessarily reflect short-term budget constraints that may result from sharp interest rate rises or changes in taxation like the community charge. Perhaps no single measure can capture well the distributional effects mentioned above, but an alternative proxy that tracks the growth pattern of consumers' expenditure reasonably closely over the last two years is the difference between the growth rates of average earnings and the retail prices index. Such a measure gives more weight to the effects of rising mortgage rates which thus appear to have depressed spending, and to indirect tax changes and the community charge which will do so. This difference fell from 4 percentage points in mid-1988 to half a percentage point in mid-1989, rose to 1½ percentage points at the end of 1989, and fell back to zero in April this year (and has been slightly negative since).

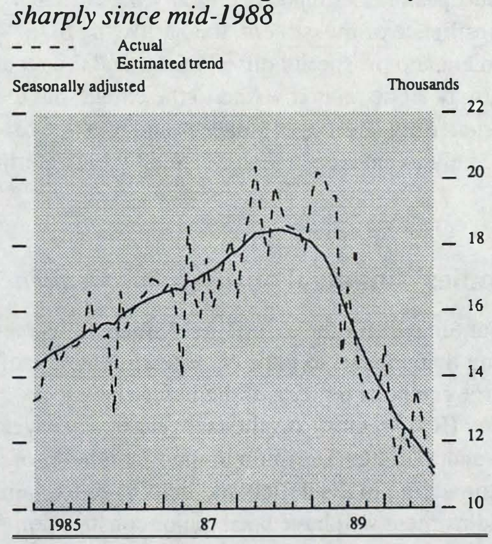
The 1½% growth in consumers' expenditure between the fourth and first quarter may in part reflect this temporary re-opening of the gap between earnings growth and price inflation around the turn of the year but other explanations are also important. In particular, an important contributor to spending in the first quarter, perhaps accounting for as much as half the rise, was expenditure to make good storm damage, paid for largely from insurance claims rather than current income. Such expenditure was particularly concentrated in the services category but may help to explain also the modest recovery of spending on furniture and floor coverings. These special factors apart, the pattern of spending since mid-1989 appears to have shifted away from high priced durable goods (including cars) and towards items such as food and other miscellaneous, generally lower priced, goods and services. Thus more spending on, for example, maintaining vehicles may have substituted for spending on new ones. Given this shift in spending patterns it is perhaps not surprising that growth in consumer credit has slowed since the first half of last year, though individual monthly figures can be erratic as was seen in May. This is also true of retail sales where the sharp fall in June should also be treated with caution; they continue to reflect the strong impact of higher interest rates, and the underlying growth rate may have picked up slightly since the beginning of the year but this has been modest compared with the very sharp slowdown between 1988 and 1989. Also, net equity withdrawal from the housing market fell sharply last year with the sharp downturn in house sales.

The pick-up in the saving ratio, which rose from under 4½% in the first half of 1989 to nearly 6% in the second, continued into the first quarter of this year. This pick-up is rather more pronounced if adjustment is made for the effect of personal pension plans, though it is perhaps rather early to judge how permanent it might be.

The savings ratio *has continued to recover*



Private housebuilding starts *have fallen sharply since mid-1988*

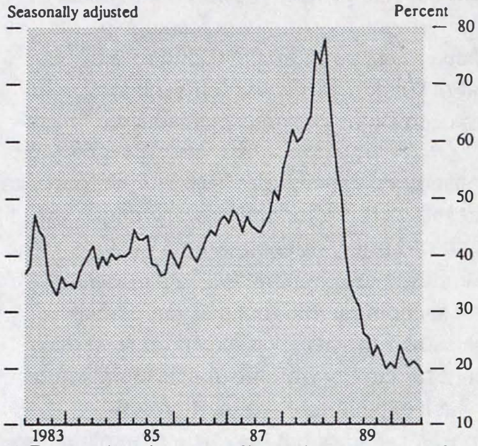


Housebuilding *continues to slow . . .*

Housebuilding activity has fallen considerably since mid-1988. In 1989 as a whole the number of starts was 21% lower than in the previous year, while completions fell by 9%. With a greater decline in starts than completions, there has been a reduction in the uncompleted stock. This is not surprising as high interest rates have put pressure on housebuilders to reduce the amount of work in progress. At the beginning of this year there appeared to be a levelling off in activity, particularly in starts, but this probably reflected the unusually mild winter, and the decline in activity has now resumed.

This fall in activity roughly parallels the decline in the annual rate of increase in house prices, which peaked at the end of 1988 at 34% but has now become negative. In real terms (deflated by consumer prices), house prices in the first quarter of 1990 were about 1½% lower than at the end of 1988. A housing market survey by the

House sales[(a)] *have fallen sharply*



(a) Three-month moving average of house sales as a percentage of properties placed with estate agents in the same period (RICS survey).

Royal Institution of Chartered Surveyors shows a very sharp fall since mid-1988 in the flow of property sales expressed as a percentage of properties placed with estate agents. The suggested slowing of sales may be exaggerated by an increase in the average number of estate agents with whom a particular property is placed but the message is clear.

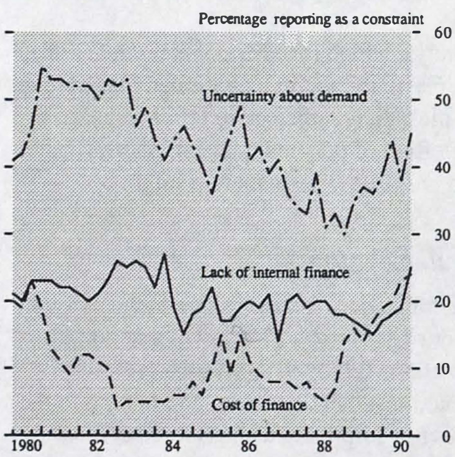
Regional disparities in the timing and scale of house price inflation have continued as the market has slowed. Thus price falls have been greatest in southern regions where earlier rises occurred first and were sustained longer. In Northern England and in Scotland house prices have continued to rise, though at declining rates; in Northern England for example they were 16% higher in the second quarter than a year earlier.

. . . but other **fixed investment** *remains surprisingly firm . . .*

Other new building work rose by 8% in the first quarter. To some extent this reflects the substantial expenditure programmes of newly-privatised industries such as the water boards, and of British Steel PLC, together with large construction projects such as the Channel Tunnel and Canary Wharf, and has gone a long way to offset the fall in investment in dwellings. Investment in plant and machinery apparently also grew strongly, by 5% in the quarter, when it was 8% higher than a year earlier.

This resilience in investment (if confirmed) is encouraging and has occurred in spite of evidence from the CBI survey showing that the balance of firms expecting to increase investment has fallen over the past year and that cost of finance and uncertainty of demand have been growing constraints over a rather longer period. Excluding leased assets, manufacturing investment, for example, is estimated to have been 10% higher in the first quarter of this year than a year earlier. An important factor reducing the sensitivity of fixed investment to short-term cyclical factors in recent years may have been the major inward direct investment programmes of foreign companies—Japanese and American in particular—that have been important catalysts in the industrial regeneration of regions that had suffered from the decline of traditional heavy industries in the early 1980s. These companies came to take advantage of available labour, greenfield sites and low taxes and are very often geared to producing for the European rather than specifically the British market. Thus the resilience of investment, the narrowing of regional unemployment and prosperity differentials, and the recent strength of exports, may all be related. And to the extent that these companies have non-sterling sources of finance (and revenue to service it) they are likely to have been less affected by high sterling interest rates.

The CBI survey[(a)]*shows* **factors likely to curtail investment** *have risen*

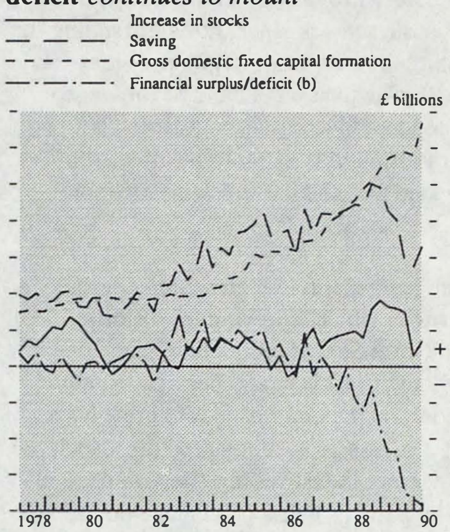


(a) The CBI quarterly trends survey, July 1990.

. . . while **companies' financial position** *has weakened*

This may also account in part for the surprisingly small adjustment in company spending that appears to have occurred in the face of unprecedentedly large financial deficits of the industrial and commercial company (ICC) sector over the last year or so—over £23 billion in 1989 and a further £7 billion in the first quarter of this year. Another factor adding to the deficit and helping to explain the surprising lack of adjustment will have been major construction projects. Undoubtedly also there is some distress borrowing (and

With little adjustment of spending to reduced saving, **companies**[(a)] **financial deficit** *continues to mount*



(a) All industrial and commercial companies.

(b) Equals saving *less* value of physical increase in stocks, gross domestic fixed capital formation and capital taxes and transfers.

adjustment) taking place in those industries and companies that have been less insulated from the impact of economic slowdown.

Profits of non North Sea ICCs picked up somewhat in the first quarter but were 6% down on a year earlier. Nevertheless, by historical standards they remain good overall. North Sea companies' profits continued to recover in response to stronger oil prices and recovery from earlier production setbacks. Non-trading income has also grown, reflecting higher interest rates. In the allocation of income (for all ICCs), interest payments, which were nearly 70% higher in 1989 than 1988, remained high in the first quarter, and dividend payments rose further, though UK taxes and profits due abroad fell. A sizable adjustment to expenditure has come from the turnaround in stockbuilding, which was very sharp in the fourth quarter with more muted destocking in the first (though the significance of this is unclear given that it arises almost entirely from the national accounts statistical adjustment). It should be noted, however, that profits would look weaker if privatised water companies, which have been included in the sector since December, could be excluded (see the article on page 352).

Nevertheless, there remains a puzzle as to what meaning should be attached to the unprecedented financial deficit of the company sector, and why it does not seem to be provoking adjustment in expenditure on the scale that past experience would lead one to expect. One area where there has been a major adjustment to limit borrowing and interest payments is the virtual disappearance in the first quarter of takeover activity, which in 1989 amounted to £26 billion. But this does not reduce the financial deficit of the sector as a whole.

Public sector borrowing *has been higher in the first part of this financial year than last . . .*

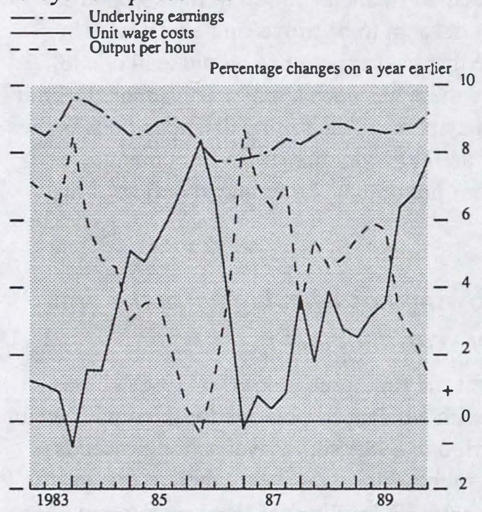
The cumulative PSBR for the first three months of 1990/91 was £6.5 billion, compared with a balanced position for the public sector in the corresponding period in 1989/90. Privatisation proceeds contributed £1.8 billion in this period last year whereas this year there were none. Over half (£2.7 billion) of the remaining increase in the PSBR compared with last year was due to higher borrowing by local authorities where there have been delays in collecting community charge which should be largely made good by the end of the year. There may also have been some slippage in local authority spending from last year.

Excluding privatisation proceeds, the central government's own borrowing requirement was £1.6 billion higher than the same period last year; Inland Revenue receipts, of which about two-thirds are income tax, were 11½% higher, reflecting strong earnings growth, and Customs and Excise receipts were 10% up, reflecting nominal spending in earlier months (VAT in particular is paid with a lag). Social security contributions grew by only 5½% on a year earlier because the National Insurance reforms announced in the 1989 Budget were not implemented until October of that year. Net departmental outlays (which exclude privatisation proceeds) grew by 21% in the first three months of the financial year compared with a year earlier. This reflects the change in timing of the grant to local authorities, a greater proportion of which is now paid earlier in the financial year. Also, the replacement of non-domestic rates with the uniform business rate, which is collected and distributed by central government, has increased departmental outlays (and receipts). Excluding the effect of these special factors, net departmental outlays were 12% higher in the first three months of 1990/91 than in the same period of last year.

. . . and progress on reducing **inflation** *remains elusive*

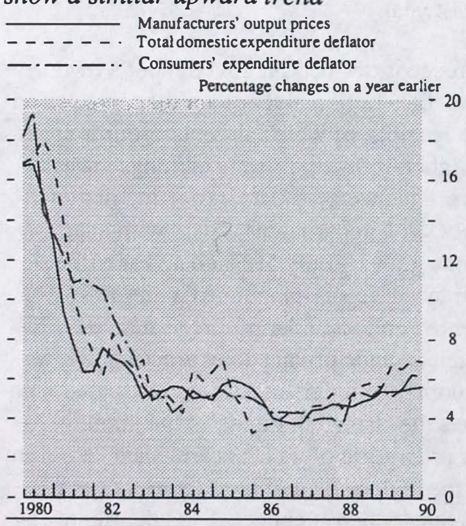
Adjustment of the economy is proceeding, albeit unevenly both in time and in its impact on different industries, regions and socio-demographic groups, but has yet to reach the point of delivering reductions in the underlying rate of inflation. Headline retail price inflation as measured by the twelve-month change in the RPI has risen sharply, to 9.8% in June, and may yet go a little higher before starting to decline, possibly towards the end of the year but more sharply into next. This is a setback since, notwithstanding the nature of the factors generating the rise, wage negotiators may too often have been using the RPI growth as a benchmark for wage negotiations which would tend to add to costs and threaten UK competitiveness. The path of inflation is likely to be affected by both oil prices and the exchange rate and has thus become more uncertain as a result of the Gulf crisis.

Productivity in manufacturing *has fallen, and* **unit wage costs** *have risen in response to cyclical pressures*



For the whole economy there is no offset to high settlements at present from productivity growth which, allowing for distortions arising from interruptions to North Sea oil production, has deteriorated since the beginning of last year and become negative. Manufacturing output per hour, on the other hand, did grow by about 1¾% in the first quarter of this year. Industrial disputes in the motor vehicles and engineering industries may have depressed annual productivity growth by perhaps half a percentage point, but the cyclical downturn in productivity is nevertheless clearly established. Unit wage costs in the whole economy were 10.1% higher in the first quarter than a year earlier whereas for manufacturing they were 7.8% higher on the same comparison. Monthly figures for manufacturing unit wage costs are more encouraging and show the 12-month change falling since February (to 6.5% in May), probably linked to a revival in manufacturing production.

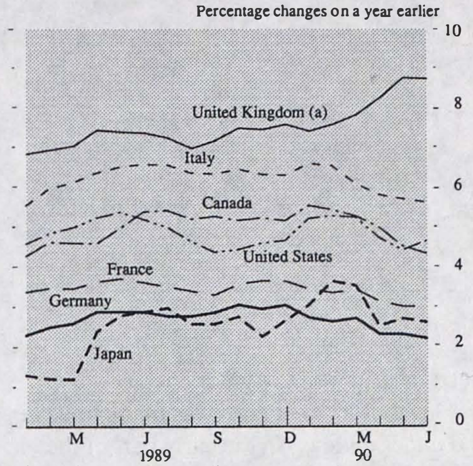
Various measures of **underlying inflation** *show a similar upward trend*



Manufacturers' input prices have been more helpful, with the index in June some 2¼% lower than a year earlier, and benefits continue from lower world metal prices. The recent strength of sterling will be of further assistance as research suggests that exchange rate movements have a direct and powerful impact on domestic inflation (see the note on page 316). Electricity prices also have helped keep costs down as the generating companies have competed for large industrial customers in the run-up to privatisation. Nevertheless, the 12-month increase in the index of output prices has continued to rise this year, reaching 6¼% in June. Excluding the food, drink and tobacco industries, whose price rises can be distorted by changes in excise duties, the index showed a 6% rise over the year.

This output price index is a better measure of underlying inflation at the present time than the RPI, or variants of it, though that index excluding housing costs shows a rather similar pattern. The GDP deflator (at factor cost to exclude indirect taxes and subsidies), which measures total home costs and is sometimes considered to be the best measure of domestic inflation, has become less representative over the past year or so as a result of changes in import and export prices reflecting large movements in the exchange rate (and to a lesser extent the oil price). The GDP deflator excludes import prices (which are clearly relevant to UK

Consumer price inflation *is tending to fall in other major countries - but not yet in the United Kingdom*



(a) Retail prices index excluding mortgages and community charge/domestic rates.

purchasers) but includes export prices (which are not). At the present time, therefore, a better measure of inflation affecting domestic agents may be the total domestic expenditure deflator (at market prices) which excludes exports from final expenditure but includes imports. This measure has edged up fairly steadily from around 3½% per annum in the year to the first quarter of 1988 to nearly 6½% in the first quarter of this year.

There is thus a broad measure of agreement between these indicators as to the rate of underlying inflation affecting domestic spending, and the fact that this rate has risen steadily over the past two years. It is also the case that this rate is significantly higher than in the other major countries and that the recent trend elsewhere has been for inflation to fall whereas in the United Kingdom it has been rising. The tightening of monetary conditions associated with the strengthening of sterling offers some prospect that the trend of inflation here can be decisively reversed. Recent developments in the Gulf, however, through higher oil prices, will add to inflation worldwide, though for the United Kingdom this pressure will be mitigated by the petro-currency status of sterling. But the inflation benefits of a strong currency could easily be undermined by a further ratcheting up of wage costs, if no account were taken of the difference between headline and underlying inflation.