The domestic economy

- *Underlying retail price inflation has been rising since early 1988, and although recently wholesale price rises have been contained by market pressure, oil price rises may not yet have fully fed through.*

- *Consumption growth continues to slow, and saving to recover, as the personal sector adjusts to slower real income growth and higher interest rates.*

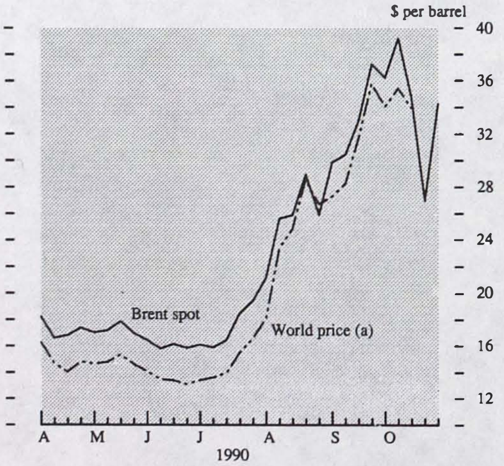
- *Profitability is now falling and the company sector deficit mounting, bringing more pressure for adjustment there; the sooner unit labour costs are contained the less will be the longer-term damage to corporate prospects.*

- *The trade account continues to improve as domestic demand and supply come into better balance. But deteriorating competitiveness, and prospective weakening of demand abroad as a result of the Gulf crisis, emphasise the importance of this balance being maintained.*

Earlier this year the adjustment path of the UK economy, which had become established in 1989, was called into question by the conflicting evidence of short-term economic indicators. There appeared to be a recovery, albeit modest, in consumption growth, destocking seemed to pause after a sharp burst at the end of 1989, fixed investment growth picked up somewhat despite apparently severe financial pressure on the corporate sector and, after improving for some time last year, the current account relapsed. More recently, however, economic indicators have been suggesting more consistently and clearly that the slowdown in the real economy has been continuing, with signs now that output and demand may have fallen in the third quarter.

The explanation of the temporary aberration in the adjustment path of the real economy may be connected with incipient inflationary pressures, which started to become visible towards the end of last year and are now showing through strongly in the price indicators. These pressures included most importantly the sharp deterioration in the exchange rate through 1989, much of which has since been reversed; but short-term variations in the overall balance of pressures on the private sector need to take into account also the level of interest rates and the fiscal position.

Oil prices *have retreated from their peak but remain about double pre-crisis levels*

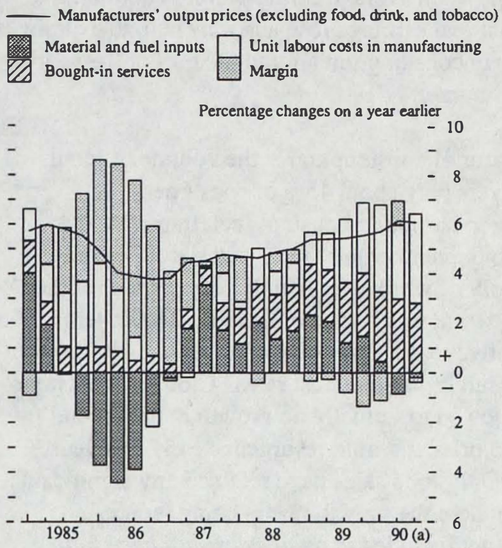


(a) World oil price is an average of OPEC and non-OPEC crudes.

These underlying pressures have been jolted in the last three months by the Gulf crisis which, by radically altering the relative price of a key input, has involved resource transfers and produced gainers and losers both within and between economies. Prospectively also, the entry of sterling into the exchange rate mechanism of the EMS signals a regime change to which markets for goods and services (including labour) will need to react.

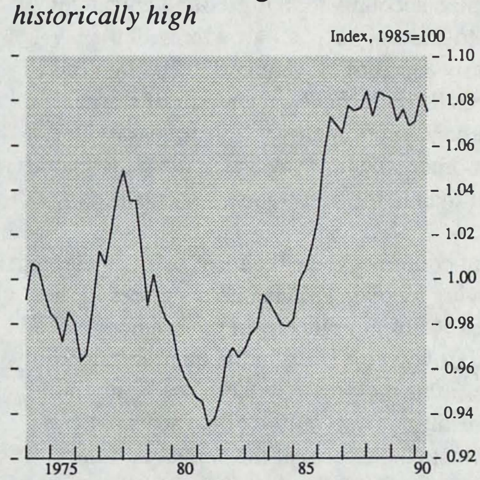
Pressures and shocks affect different markets with varying lags: in the traded goods sector their impact tends to be quick whereas in the non-traded goods sector the transmission of these effects can be quite slow. The labour market also tends to lag responses in the markets for traded goods and the response of inflation indicators can

Labour costs have been the main contributor to recent rises in **manufacturers' output prices**

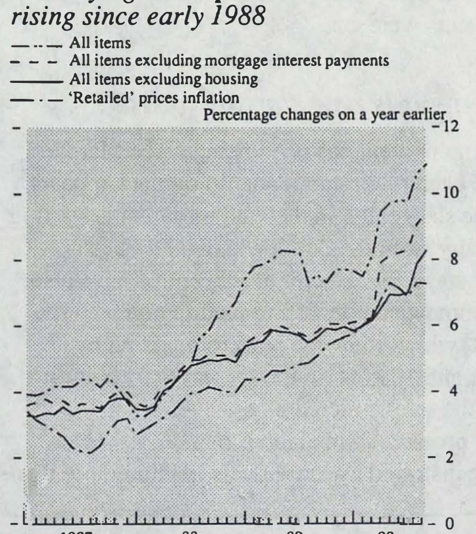


(a) Figures for 1990 Q3 are estimates.

Manufacturers' margins *remain historically high*



Underlying **retail price inflation** *has been rising since early 1988*



be even slower to work through, not least because of the way that past inflation tends to influence the annual cycle of pay negotiations, feeding back into costs. This commentary examines the adjustment path of the real economy, particularly over the past year, in the context of these pressures and shocks.

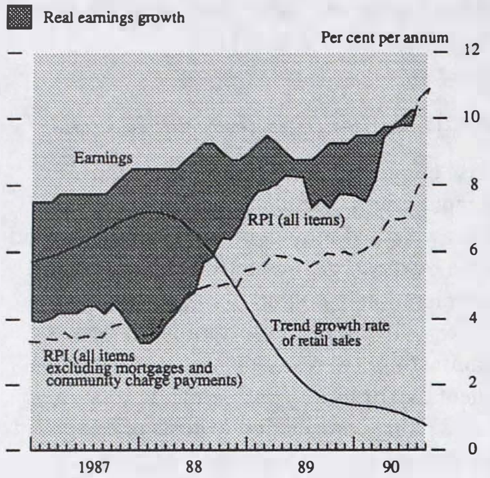
The **inflation threat** *has shifted from demand to costs*

A trough in manufacturers' output price inflation occurred in 1986–87 at a time when input prices (particularly oil prices) had been falling for more than a year and growth in unit labour costs had been brought sharply down by the large productivity gains that had accompanied the rapid acceleration in output. Indeed, output price inflation could have been very low or negative during this period but for the actions of manufacturers to restore margins to healthier levels. Over the subsequent two or three years demand pressure started to show through in a rising contribution to costs of bought-in inputs and services. Productivity growth associated with rapidly growing output meant that up to the beginning of 1989 manufacturers' unit labour costs were growing quite modestly and there was little pressure on them to reduce margins. As demand and output growth slowed last year productivity growth fell and unit labour costs started rising sharply. With output prices constrained by demand weakness, margins fell somewhat but remained at historically high levels. A brief respite earlier this year, when input prices for a while were falling, was used by manufacturers to rebuild margins. More recently, even though growth of manufacturers' output prices has stabilised at around 6% per annum, with market pressures seemingly constraining further rises, unit wage costs have continued to grow rapidly.

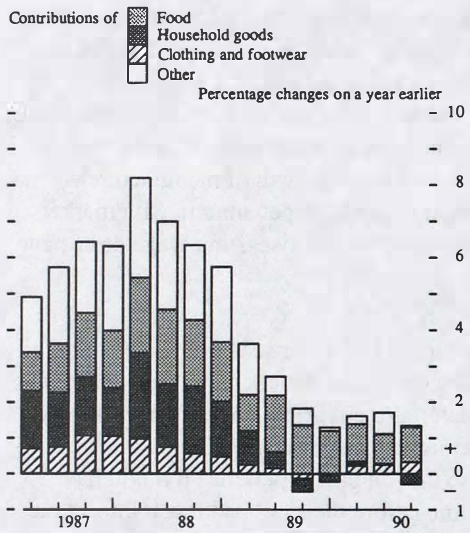
The Gulf crisis has added further to cost pressure through higher oil prices, and, notwithstanding the rise in the exchange rate during the summer, movements in material input prices are no longer helpful. Margins are therefore starting to be squeezed again, though from a historically strong level, so that on past experience it might have been some considerable time before their fall had much impact on labour costs as manufacturers might have expected that the exchange rate would have fallen. The discipline of the ERM reduces the scope for devaluation and it is important that manufacturers adjust quickly to this regime change. Tax, interest and dividend payments, all of which have been high, are also claims on margins and no doubt have increased the pressure on manufacturers to contain costs.

The link between manufacturers' output prices and retail prices is far from strong because the latter are affected by distributors' costs and margins, prices of imported consumer goods and prices of various services, particularly housing. Rising interest rates, from mid-1988, caused headline RPI inflation to start to rise relative to measures of underlying inflation that excluded mortgage interest payments, but the various underlying measures continued to show steady upward movement through last year at a time when the headline index was steadying as earlier mortgage rises dropped out of the annual comparison. A further sharp rise in the headline rate took place in the spring when the increase in the community charge compared with domestic rates, and a further round of mortgage interest rate rises, added substantially to housing costs. The annual rate excluding all 'housing' costs (ie rents, mortgage interest and community charge) also continued to rise, but less sharply.

The trend growth rate in **retail sales** *appears to have responded to changes in* **real earnings** *growth*



Weakness in **retail sales** *extends now to all sectors except food*



Pressures continue to bear on the **personal sector . . .**

Although by no means a good guide to underlying inflationary pressure, the headline RPI does nevertheless approximate reasonably well the cash flow pressures on consumers.(1) Thus the pause in the annual rate of growth of the RPI in the latter part of last year and early this year, when average earnings were continuing to accelerate, suggests that real earnings rose and may help to explain the renewed buoyancy in consumption around the turn of the year and its reversal in the summer.

The most timely indicator of consumption is the volume of retail sales, although this covers only about 45% of consumers' expenditure, excluding in particular housing, fuel, transport and services. In the year to September total retail sales grew by only about ¼%. The category of retail sales mainly responsible for the fall in its overall growth rate was household goods. These items were particularly sensitive to the slowdown and recession in the housing market as a result of high interest rates. Clothing, footwear and other goods also slowed to virtually no growth in the second half of 1989 and after a brief and mild resurgence early this year have tailed off again. Only food sales have retained any significant buoyancy, though even here the growth rate is being reduced. Spending on vehicles (not included in retail sales) has been falling for the past year and car sales this August were more than 10% lower than a year earlier. On the other hand, spending on non-housing services, which accounts for a third of all consumer spending, has continued to show significant growth, with the level in the second quarter nearly 8% above a year earlier (though this item continues to be affected somewhat by the repair of storm damage). The pattern of consumption growth illustrates a wider feature of the adjustment process, with response in the traded goods sector very much quicker than in the non-traded, service, sector.

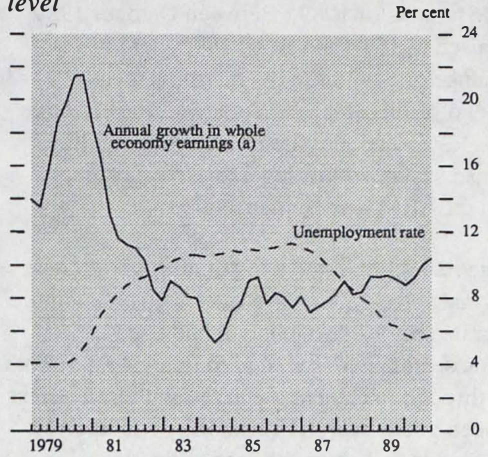
Income from employment continues to be the most buoyant element of personal income, growing by over 12% in current prices in the year to the second quarter. Current grants from government picked up in the second quarter, growing by 3¼% in the quarter but to only 6½% above a year earlier; this pick-up may therefore be no more than a timing distortion resulting from failure of the seasonal adjustments fully to eliminate the effects of the annual uprating of social security benefits in April. Other (property and self-employment) income grew by only 1½% (to 8% above a year earlier) as dividend payments were cut.

. . . where **unemployment** *is now starting to rise . . .*

In the labour market unemployment has been rising since March. The increases so far have been modest, but unemployment appears to be accelerating, and the slackening in the labour market is starting to spread out geographically from the South where it had been concentrated at an earlier stage. Vacancies at Jobcentres have also been falling. There is a somewhat conflicting picture given by the statistics for employment, which show the workforce rising by 94,000 in the first quarter and 163,000 in the second to its highest level recorded, although the rate of increase has fallen since last year. (As an indicator of pressure in the labour market, however, employment statistics are distorted by individuals holding more than

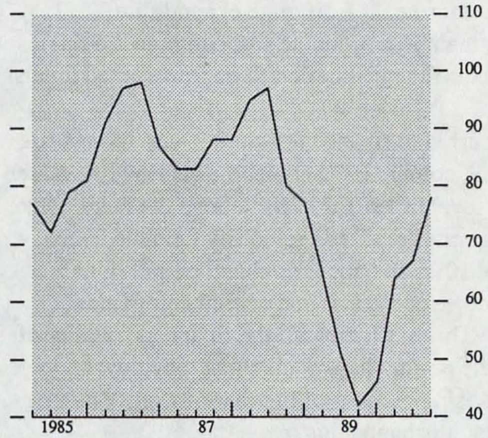
(1) There are some timing distortions, however—for example, because mortgage interest rate rises are reflected immediately in the RPI when the extra charges accrue, but affect some people's pockets with a delay.

Wage inflation *appears to respond more to changes in* **unemployment** *than to its level*



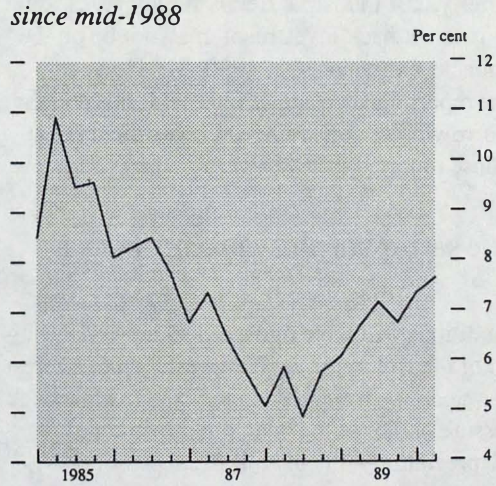
(a) Q3 figure for 1990 is an estimate based on two months data only. The data are percentage changes on a year earlier.

First-time buyers' **ability to buy housing**[(a)] *has risen*



(a) National House-Builders Council index which takes into account average size of deposits and mortgage repayments of first-time buyers in relation to average earnings.

The **personal savings ratio** *has been rising since mid-1988*



one job and take no account of hours worked.) In manufacturing, employment has continued to fall, but by much less in the second quarter than in the previous six months.

This picture can be reconciled with rising unemployment because employment gains have typically been among part-time and/or female workers, who are less likely to have been registered as unemployed, whereas employment losses have been mainly among male full-time workers who would have been entitled to claim benefit. In the year to the second quarter of 1990 rising female employment accounted for 87% of the increase in the aggregate employment figure, and 46% of the jobs created were part-time. The trend towards the creation of part-time jobs intensified in the second quarter, with 97% of the total increase in employment during that quarter coming from part-time employment, of which female part-time workers represented approximately three quarters.

The extent of the slackening in the labour market has so far been small compared with what occurred in 1980, when unemployment rose by some ¾ million before wage costs started to slow. Since March the average monthly rise has been only 10,000, whereas the average monthly fall in 1989 was some 35,000. The level of unemployment is still near to its lowest for a decade.

. . . *and* **asset prices** *are falling*

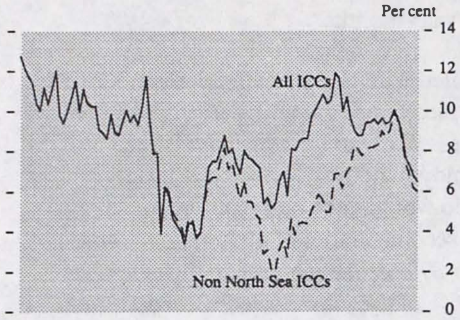
The personal sector has also come under pressure to adjust to changes in its net wealth resulting in particular from weakness in the housing market. According to the Halifax house price index, in the year to September house prices were still showing a slight fall overall, with substantially bigger falls in the southern half of the country. These falls, together with continued strong growth in earnings, have continued to lower the house price to earnings ratio, which reached 3.9 in August compared with 4.4 a year earlier. This has helped bring about some recovery in the ability to buy of first-time buyers, as measured by the National House-Building Council's index, which takes account of the average size of deposit and repayment for first-time buyers, divided by average earnings. Meanwhile, however, the supply of new houses has shown some levelling, with housing starts and completions both stabilising at a rate some 35% below the peak in 1988 for starts and 20% below for completions. The cut in mortgage interest rates, so far not embraced by all lenders, following the 1 percentage point cut in base interest rates announced in early October, may also help to strengthen the housing market, though underlying consumer confidence remains low and this may prove a greater obstacle to recovery than direct financial constraints.

Against this background it is to be expected that savings would be rising from the low point to which they had fallen in 1988. In fact revisions to the statistics mean that the low point of the saving ratio in 1988 is now estimated at 4.9% rather than 4%, and the ratio has risen by a half since then to around 7.5% (after adjusting for the small distortion arising from the accounting treatment of the community charge). The recovery path is now also seen to be smoother.

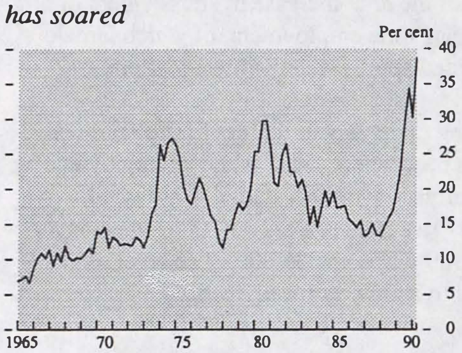
Companies *too are facing growing pressures*

Although company profitability fell last year—sharply in real terms—it remained above the level of the first half of the 1980s. To

ICCs' profitability[(a)] *has fallen . . .*



. . . while their **net income gearing**[(b)] *has soared*



(a) Pre-tax real rate of return.

(b) Interest payments (net) as a percentage of non-interest income after stock appreciation and tax payments.

Industrial and commercial companies' financial position

£ billions

	1987	1988	1989	1990 Q1	1990 Q2
Companies' income(a)	76.3	86.3	95.3	23.7	23.5
of which, gross trading profits (a)	*57.1*	*63.1*	*64.0*	*15.5*	*15.3*
Allocations:					
Dividends	11.2	15.0	19.2	5.9	4.5
Interest	12.0	14.5	24.0	7.2	7.9
UK taxes	13.3	15.2	18.8	3.5	5.3
Profits due abroad	6.7	7.4	9.0	1.8	1.9
Undistributed income(a)	33.1	34.3	24.3	5.2	3.8
Less expenditure on:					
Fixed investment	32.2	40.4	46.0	13.0	13.1
Stocks	1.8	4.8	2.6	—	0.7
Capital transfers (net)	-0.1	-0.5	0.3	0.3	0.2
Financial deficit (-)	**-0.8**	**-10.4**	**-24.6**	**-8.2**	**-10.2**

(a) Net of stock appreciation.

some extent companies—particularly those in the traded goods sector—were protected by the 10% depreciation of sterling that occurred in the first nine months of 1989. Between October 1989, when base rates were raised to 15%, and April 1990 there were fluctuations in the exchange rate but little overall movement. Between April and the end of July this year, however, the effective exchange rate index rose 7½% and, despite fluctuations resulting from the Gulf crisis, it had sustained this level to early October when sterling's entry to the ERM was announced.

This rise in the exchange rate represented a restoration of tightness in monetary conditions that spread the pressure for adjustment more widely across the corporate sector. Previously it had been concentrated on domestic sectors exposed to high interest rates, both directly, and indirectly through the housing market, with little effect on other parts of the traded goods sector. Profitability[(1)] is likely, therefore, to have continued to fall since the second quarter. Tax payments, which lag profits, have continued broadly at the higher rates established in 1989. Dividends, however, fell somewhat in the second quarter of 1990, although from a very high level, while interest charges have continued to mount. As a result, undistributed income of companies in the year to the second quarter of 1990 was only half that of the previous year. Corporate expenditure, particularly fixed investment in nominal terms, continued to rise, raising the company sector financial deficit to unprecedented levels.

With mounting debt incurred to finance this deficit, and large-scale takeover activity in 1989, companies' net income gearing has soared to 38%, well above the level in 1981 and also above the level in the mid-1970s when interest rates reached previously unprecedented levels (remaining above 10%, and about double their previous post-war average, for some four years) and caused companies considerable problems. This has increased the financial fragility of the company sector to the point where adjustment may now become more urgent. Indeed, a rising number of liquidations suggests that in financial terms at least it is happening.

In the new exchange rate regime it is imperative that this adjustment should be concentrated as fully as possible on containing costs. Major cutbacks in investment would imperil the further prosperity of the sector. The quarterly CBI industrial trends survey gives some reason to hope that plans to cut back investment may not be on the scale of the radical cutbacks experienced in 1980–81. However, the proportions of firms reporting shortage of internal funds and the high cost of external borrowing as constraints on investment are at levels comparable to those reported in 1980–81.

. . . while the **public sector surplus** *appears to have fallen*

Although monetary conditions will have tightened somewhat during the summer, as a result of the rise in the exchange rate while interest rates remained at 15%—and may have needed to do so to claw back the higher demand pressure earlier in the year and the effect of earlier exchange rate depreciation—the overall fiscal position

(1) There is seemingly a contradiction between falling profitability and continuing high margins as shown in the chart on page 457. In part this reflects coverage, the margins estimates relating to manufacturing companies whereas the profitability figures include all ICCs and in particular those in industries such as property, construction and distribution that have been particularly hit by slowdown in the economy. Another reason is that margins are a nominal measure that reflects the difference between prices and costs whereas profitability also reflects the volume of sales, growth of which has been falling.

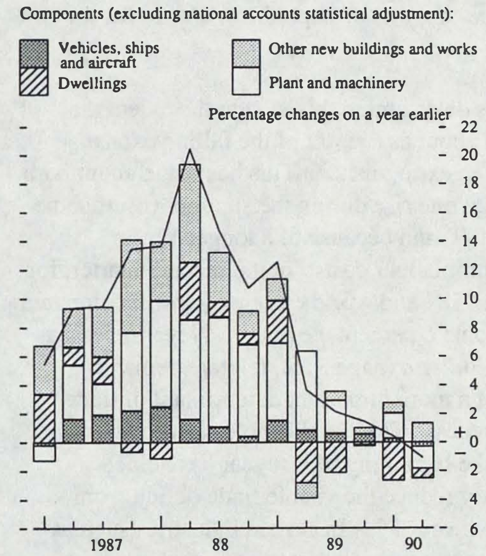
PSBR in the first halves of 1989/90 and 1990/91

£ billions

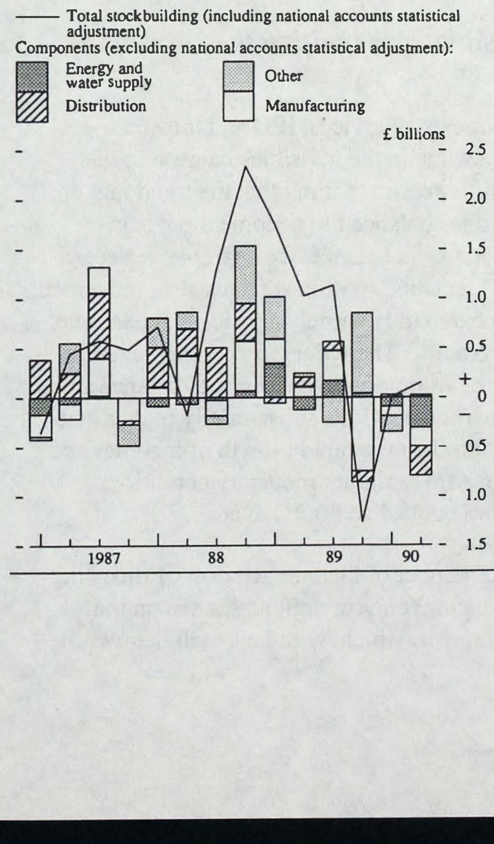
	April to September		Difference
	1989/90	1990/91	
	(1)	*(2)*	*(2)–(1)*
CGBR own account	-0.6	4.3	4.9
Adjusted CGBR own account(a)	2.3	6.0	3.7
LABR	-0.4	1.4	1.8
PCBR	0.6	-0.4	-1.0
PSBR	-0.5	5.2	5.7
Adjusted PSBR(a)	2.5	7.0	4.5

(a) Adjusted to exclude privatisation receipts.

Growth in **investment** *is being curtailed . . .*



. . . and **stocks** *reduced*



appears to be somewhat less tight in the first half of the present financial year than last year. To some extent this may reflect special factors that should be at least partially unwound later in the financial year. The change in the system of local authority finance has altered the timing of receipts—from both community charge and non-domestic rates. This in turn has led to earlier payment of the revenue support grant from central government to local authorities. As a consequence, the borrowing needs of central government have shifted forward in the financial year. Reform of national insurance contributions has also altered the timing of receipts, and particularly distorted year-on-year comparisons; and there have been other exceptional items. Nevertheless, judging from public authorities' current spending on goods and services, the volume of which grew by 2½% in the second quarter of this year and was then 3¾% above a year earlier, there may also have been some acceleration of the underlying rate of public spending, though it is difficult to be certain in the short term of the extent of this pick-up.

Improvement in the **balance of domestic supply and demand** *paused in the second quarter . . .*

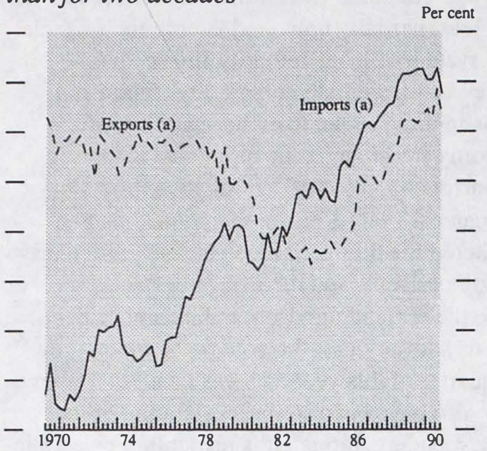
With public consumption growing by 2½% and private consumption by 1% in the second quarter, a rate of growth of domestic demand as low as 0.6% came about only because fixed investment fell by 3% in the quarter. The growth rate of investment had already slowed from a peak of nearly 20% in the year to the second quarter of 1988, and the fall in the most recent quarter contributed to the first fall in investment over a four-quarter period since the beginning of 1986. Investment in housing remained weak, falling by 5% in the latest quarter, and investment in vehicles and plant and machinery also fell, for the first time since early 1987. Corporate spending on stocks rose slightly in the second quarter, according to CSO estimates, though this reflects the large positive statistical adjustment that was needed to balance the accounts; estimated stock movements excluding the balancing adjustment, mostly from direct enquiries, were virtually all negative and totalled some £¾ billion of destocking.

The growth in domestic demand in the second quarter, despite the fall in investment spending, was still slightly faster than that of output, which grew by ½%. However, the output measure was distorted by strikes in the engineering and car assembly industries in the first quarter so a better comparison might be of the annual percentage changes in output and demand. On this basis, the growth in domestic demand in the second quarter remained slower than that of output as it had been in the two previous quarters. More recent monthly indicators suggest that demand growth may have subsequently slowed even more, so the underlying improvement in the external trade balance appears to be continuing. General business optimism, and expectations for changes in the volume of output and order books, as reported in the CBI trends survey in October, were all back to levels last seen in the early 1980s, though not as low as at the trough in 1980–81.

. . . though the **underlying visible trade balance** *is still improving . . .*

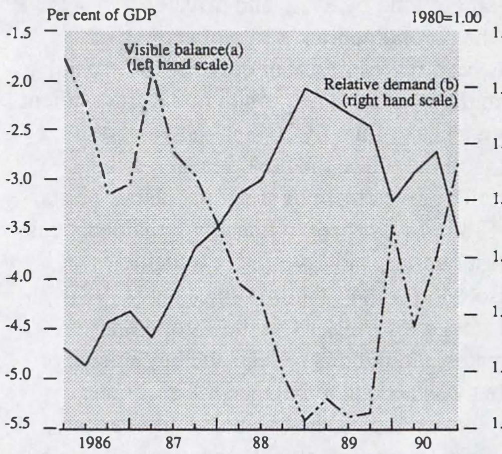
Such improvement as has occurred so far this year in the visible balance has been due largely to movements in manufactures. The share of manufactures in exports has continued to improve from the

Manufactures' share of trade *is higher than for two decades*



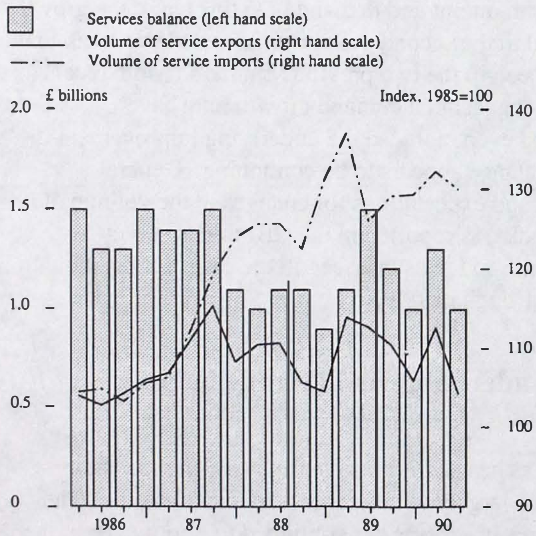
(a) Exports/imports of manufactured goods as a proportion of total exports/imports of goods and services.

The **visible balance** *responds to* **relative demand** *movements*



(a) Visible balance as a percentage of GDP.
(b) Ratio of index of domestic demand to index for other major 6 countries' domestic demand, 1980=1.0.

The **balance of trade in services** *has fallen as the volume of imports, particularly travel debits, has risen*



low reached in the early 1980s. To some extent the fall in the early 1980s reflected the build-up of oil exports, but it is noteworthy that the share of manufactured goods in exports, despite continuing net oil exports, is now higher than throughout the 1970s. Meanwhile, the share of manufactured goods in imports, which has been on an upward trend for many years, may have slowed. The balance of trade in cars has improved in response to depressed domestic market conditions, with car import volumes in the latest three months some 12½% lower than a year ago; the 23% rise in car exports between the third quarters of last year and this, although perhaps erratically high, may also partly reflect conditions in the UK market. Furthermore, stagnating retail sales are now starting to be reflected in the balance of trade in other consumer goods.

There is also evidence in the trade figures of a sharper slowdown in corporate spending recently. Between the second and third quarters of this year the balance on intermediate goods improved substantially, by £0.5 billion, while capital goods were in net surplus of around £0.1 billion per quarter this year compared with a quarterly deficit of £0.2 billion last year (OTS basis). The balance of trade in erratic items has also improved in the third quarter as a series of particularly large imports of aircraft has ceased for the time being.

Cost competitiveness has deteriorated this year to the extent that most of the gain brought about as a result of the falling exchange rate last year has now been extinguished. This has come about both as a result of the exchange rate rise during the summer (itself some two thirds of last year's fall) and because of a longer-run deterioration in relative unit labour costs; in the second quarter, for example, the gap between UK and world earnings growth compared with a year earlier was some 6 percentage points. Nevertheless, as explained in the August *Bulletin* (page 316), relative demand movements have become a more important determinant of trade volumes than competitiveness. The considerable slowdown in domestic demand since the beginning of last year has helped stabilise and more recently reduce the visible trade deficit from more than 5% of GDP to nearer 3%. In certain industries,such as cars, output appears to have been switched to serving the export market as domestic demand has sagged.

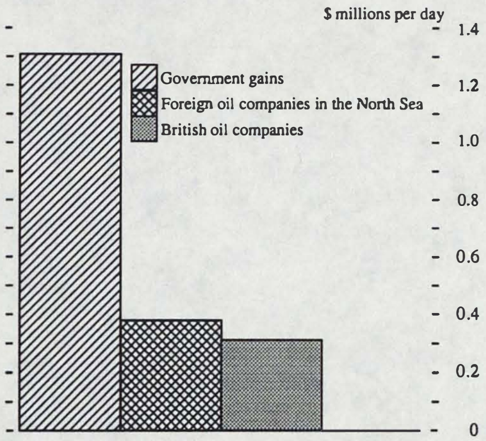
. . . *but* **weaker invisibles** *are limiting the current account recovery*

Although all three components—services, IPD and transfers—contributed to the sharp decline in the invisibles balance in the second quarter, there is little reason to think that the trend rate of deterioration in the invisibles balance has become more severe recently. The fall in the transfers balance, for example, reflects a delay in the timing of EC receipts. Within services also, movements in the second quarter appeared to be largely erratic—for example, unexpectedly low travel credits. There does appear, however, to have been an underlying deterioration in the services balance since mid-1987 associated in particular with a substantially higher level of tourism debits; this could reflect the rapid growth of incomes and lags in the response of tourism to tighter monetary conditions because many holidays are booked so far in advance.

IPD will be affected by a number of factors: the cost of financing the continuing (albeit reducing) current deficit; the rise in the exchange rate over the summer, which, with lags, will depress the sterling value of net credits arising in foreign currencies; the small fall in sterling interest rates, which will be modestly helpful in servicing net sterling banking liabilities; and relative cyclical effects on profits, which should also tend to favour the United Kingdom. The balance of these effects is difficult to judge but they are not all adverse.

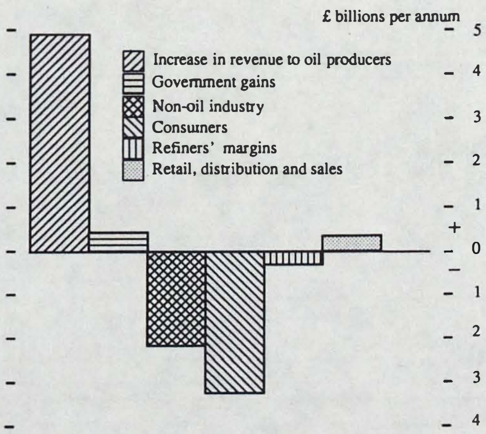
Military spending in the Gulf is likely to increase government service debits (which rose £0.4 billion during the Falklands conflict in 1982) though the scale of such expenditure is difficult to predict. Multilateral aid commitments related to the Gulf situation may also adversely affect the transfers balance.

Most of the **UK gain[(a)] from a $1 rise in crude oil prices** *accrues to the government*



(a) Assumes production of 2 mbd, constant investment and use of accrued tax allowances.

The **cost of recent oil price rises** *falls unevenly among domestic sectors*



Oil price rises *produce gainers as well as losers in the United Kingdom*

The sharp rise in oil prices following the Gulf crisis represents a further shock to which the UK economy, along with others, must adjust. It is not possible to predict where oil prices will settle, or how long they will be temporarily at higher levels, but the main relative resource shifts involved can be estimated and expressed in terms of each $1 change in the oil price.

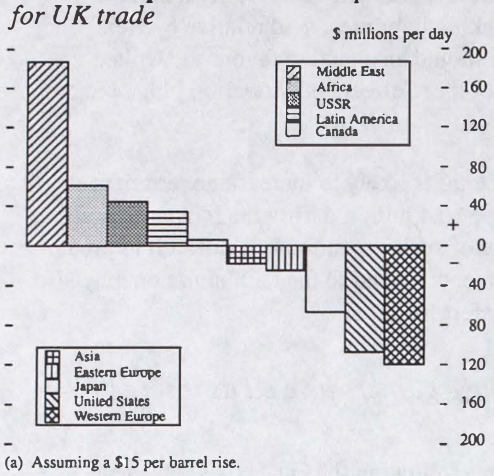
In broad terms, North Sea oil production potential may be taken to be in the region of 2 million barrels a day so that each extra $1 on the price would produce additional revenue in respect of UK oil production of $2 million per day, to be distributed between the Government (in taxes) and oil companies as shown in the chart. It is clear that the largest share accrues to the Government (which benefits additionally, for example, from VAT on petrol sales which is not included here) and nearly 80% of this is in the form of Petroleum Revenue Tax. There are lags in the collection of some of this revenue, however—particularly corporation tax where investment allowances affect the picture. Furthermore, changes in consumption patterns and in the level of investment make it likely that the Exchequer will benefit by less in the current financial year and perhaps by considerably less.

To the extent that benefits accrue to foreign oil companies operating in the North Sea their profits are likely in part to be remitted abroad. On the other hand, UK oil companies will gain from their production abroad. The benefit to British companies of a price rise from their oil investments abroad is likely to be larger than—perhaps in the region of double—the benefit from their production in the United Kingdom.

It is also possible in approximate terms to estimate the impact in product markets of price rises. For example, of the extra 25p per gallon of petrol being paid on average by the consumer, the bulk is passed through to offset refiners' higher crude oil costs; 15% accrues to the Government in VAT and distributors' and refiners' margins are likely to be affected in a modest way. Looking more broadly at the relative share of higher oil prices met by UK consumers and industry, it appears that the burden is shared initially in the approximate ratio 60:40. In the long run, of course, other things are likely to change as the economy adjusts to relative price changes and much of the smaller share that falls initially on non-oil industry will also be passed on to consumers.

The impact of the price rise on other countries is also relevant to the United Kingdom because of the likely effects on aggregate demand

The distribution of **gainers and losers from an oil price rise**[(a)] *has implications for UK trade*



(a) Assuming a $15 per barrel rise.

in those countries which in turn affects UK export opportunities. The main losers are Western Europe and the United States, both key export markets for the United Kingdom, followed by Japan. Relative to GNP, Western Europe is still the largest loser among these three but Japan on that basis moves into a close second place; other losers, particularly Eastern Europe, are likely to fare relatively worse compared to their GNP, being less efficient energy users, but these are less relevant to UK exports.

The distribution of gainers is more extreme and dominated by the Middle East where the Gulf tensions may affect the rate and extent to which gains are spent, but also dictate the type and location of expenditures that might be incurred. On the one hand there is likely to be a quick and sharp rise in military related expenditure some of which might involve UK exporters, but on the other perhaps no rush to increase investment in construction projects where UK companies have in the past had a strong presence.