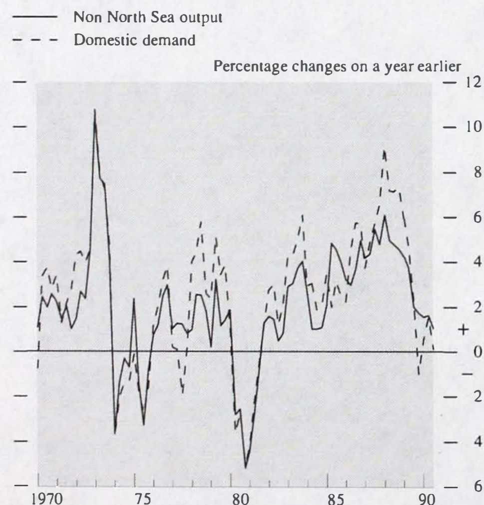
The domestic economy

- *Output fell in the third quarter of last year, and weakness is expected to continue into this year; a number of the factors that underlay the recession in the early 1980s are less acute, or not present, this time.*
- *On this occasion, however, an additional uncertainty arises from the balance sheet positions of the personal, corporate and banking sectors, which are all less robust.*
- *Adjustment to a more sustainable level of demand is now clearly under way: the personal sector is saving more and spending less, while companies are trying to cut spending, although they are not yet significantly reducing their financial deficit because income is also falling.*
- *Whether or not flexibility in the labour market has really improved is now coming under test: if further sharp rises in unemployment are to be avoided, greater wage flexibility must be demonstrated.*
- *The rise in underlying inflation between mid-1989 and mid-1990, and divergence from our major EC partners, may have been halted.*

As more statistics have become available for the second half of 1990, it has become clearer that the slowdown in the economy, which seemed to pause in the first half of last year, has resumed. It has done so to the point that a 1¼% fall in GDP in the third quarter is likely to be followed by further weakness, suggesting that the economy has entered a period of recession. Comparisons are inevitably sought with previous recessions, particularly that of the early 1980s, for the indications they may provide about the scale and duration of this one. There are a number of significant differences, which this commentary outlines, that may affect the path and timing of the recovery.

Output and domestic demand *have weakened but recession is not expected to be as deep as 1980-81*

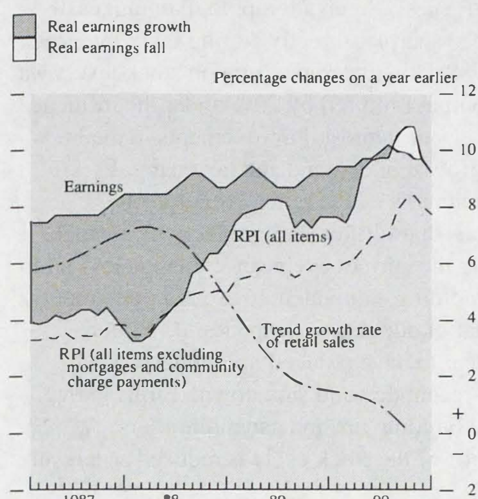


The perceived sharpness of the **third quarter downturn** *may be misleading . . .*

Comparison of the figures for the second and third quarters can give a misleading impression of the sharpness of the downturn and the severity of the likely fall in output. The path of output during 1990 was distorted by the impact of maintenance and safety work in the North Sea which temporarily depressed oil output. Excluding North Sea oil, output fell between the second and third quarters by only ½%. In October and November energy output was nearly 4% higher than in the third quarter and this, if sustained in December, would add nearly ½ a percentage point to GDP growth in the fourth quarter.

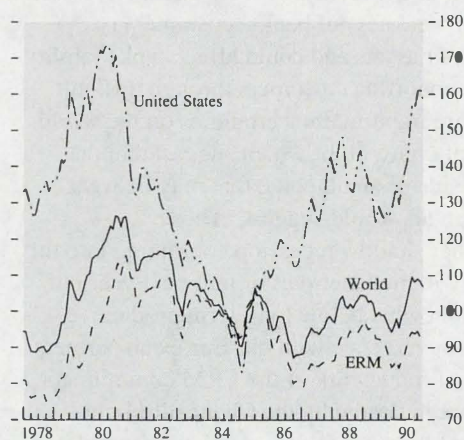
In fact, it was the buoyancy of demand in the first half of 1990 that was the more surprising development, following as it did eighteen months of monetary tightness during which earlier excessive demand growth was progressively reined back. The fall in the third quarter does little more than restore output to the level that, a year earlier, it might have been expected to reach by the third quarter of

Falls in **real earnings**[(a)] *may help explain the weakness in* **retail sales**



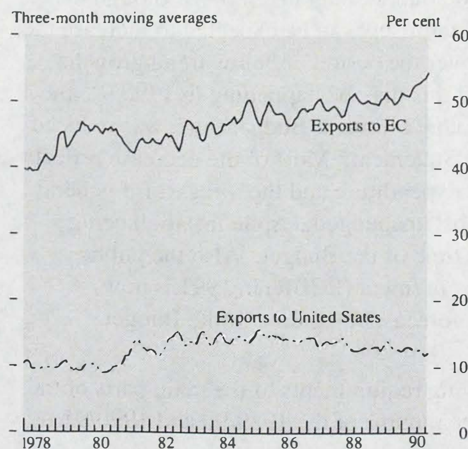
(a) Growth of average earnings deflated by the RPI (all items).

Sterling's competitiveness[(a)] *has not suffered this time against ERM currencies as it did in 1978-80—though it has lost ground against the dollar*



(a) The chart shows the real exchange rate (nominal effective rates corrected for relative inflation; 1985=100) for trade with the United States, ERM countries, and all export markets.

The EC **share of trade in UK exports** *is large and rising—in contrast to the US share*



1990. An explanation may be that exchange rate depreciation during 1989 offset to some extent interest rate tightness, at least for the traded goods sector, and this was not reversed until the summer of 1990. Thus there was a delay in the impact of policy tightness on sectors involved in international trade (but not much exposed to interest rates), which sustained aggregate demand and output, while adjustment continued in those sectors exposed more to interest rates (and less to the exchange rate) such as property and related services, and consumer durables. It was also the case that real earnings grew temporarily around the turn of last year as the rise in inflation was briefly reversed while nominal earnings growth continued to rise; this may explain the pause, early in 1990, in the decline in the growth of retail sales, with that decline resuming last summer when the gap between earnings and RPI growth closed again. It may be more helpful, therefore, to see the adjustment process not as a homogeneous one but rather as a set of adjustments by different sectors and regions, proceeding at different rates, but acting together from the third quarter of last year, perhaps for the first time. On this view, the sharpness of the turnround, from growth of 1½% between the second half of 1989 and the first half of 1990 to the 1¼% fall from the second to the third quarters of 1990, need not presage a contraction continuing at a similar rate.

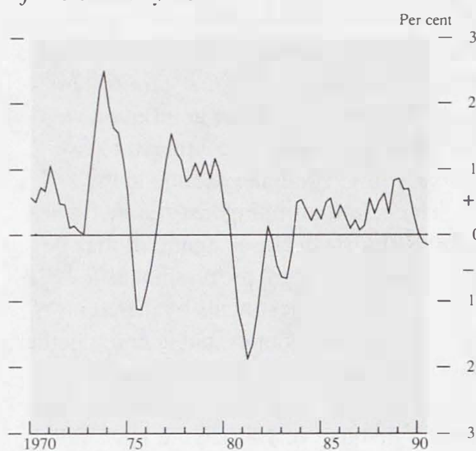
. . . and there are important differences compared with the early 1980s

A number of differences in underlying conditions between the present downturn and 1980 are noted in the Assessment. Between 1978 and 1980 the United Kingdom experienced a very marked loss of competitiveness, with sterling rising by some 40% in effective terms and slightly more against the ERM currencies. Subsequent falls through to the end of 1984 restored competitiveness broadly to where it had been in effective (world) terms in 1978 but the improvement against the dollar was much sharper, while against the ERM currencies sterling remained somewhat higher than in 1978. Since the end of 1984 sterling's real rate against ERM currencies has fluctuated around a broadly steady level; the appreciation last summer did no more than restore the position that had held during 1988 and early 1989. Certainly, there has not been a loss of competitiveness against the rest of Europe at all comparable to that between 1978 and end-1980. Furthermore, the share of EC trade within UK exports is large and has risen, so sterling's comparative stability against ERM currencies is much more important for overall competitiveness than the very large bilateral rise against the dollar. With sterling now in the ERM, and provided inflation rates converge quickly, this may be expected to continue. Thus the conditions of marked loss of competitiveness that contributed to the 1980–81 recession have not in general recurred this time.

UK trade in the early 1980s was also affected by static world demand as the major economies pursued non-accommodating policies following the second round of oil price rises. Although a number of important economies, particularly the United States, are now in recession or slowing down, world demand remains reasonably buoyant, particularly in Europe where the consequences of German unification are providing a substantial stimulus.

A third important difference from the recession of the early 1980s lies in the likely behaviour of stocks. In the three years to 1980, the stock-output ratio rose, encouraged by negative real interest rates

Lower **stockbuilding**[(a)] **in proportion to GDP (E)** *since 1984 suggests attenuation of the stock cycle*



(a) Directly estimated stockbuilding, excluding national accounts statistical adjustments, averaged over four quarters.

and a tax regime favourable towards stockholding. In 1980 real interest rates rose rapidly and expectations of demand fell with the deterioration in competitiveness. In an attempt to maintain cash flows, stocks were reduced sharply, directly cutting GDP by 2½% in 1980. Through the 1980s downward pressure on stock levels was maintained. The stock-output ratio fell by 20% under the influence of continuing high real rates of interest, improvements in methods of stock control, steady growth of demand and tax changes, particularly in 1981, which reduced the relief available on stockholdings. This means that further sharp reductions in stocks would be more difficult in the current cycle since there is less fat to trim (although UK stockholding, equivalent to around three months' output, remains above that of our major competitors). Better information systems appear to have reduced involuntary stockbuilding during the recent demand slowdown. Firms know much earlier if stocks are building up, and can alter orders accordingly; the amplitude of the stock cycle is reduced as a result.

On the other hand, the decade of financial liberalisation has allowed both the corporate and the personal sectors to adjust their balance sheets in quite radical ways and so far the exercise of this freedom has not been tempered by experience of difficult times as well as good. Consequently, they enter this recession in a much more vulnerable financial position and more exposed to high interest rates than in 1980. The financial weakness of banks' customers is reflected in the quality of their assets and could affect banks' ability or willingness to continue supporting customers through difficult times. Furthermore, there are important uncertainties on the world scene, most notably the Gulf crisis, all of which suggest that the balance of risks lies on the side of an outcome that may be weaker than the economic fundamentals would suggest. Those fundamentals point to a rather shallow recession continuing into this year with a modest recovery in the latter part or into next year but output growth remaining somewhat below long-term productive potential for some time as convergence with our European partners takes place within the overall framework of the ERM commitment. This is essentially the picture indicated by the Chancellor in his Autumn Statement last year (though evidence that has accumulated since then contributes to a slight shading downwards).

The **fiscal stance is tight,** *though the* **budgetary position has weakened** *as growth has slowed . . .*

The public finances are now sounder than in 1980–81, though the operation of the automatic stabilisers can be expected to increase the PSBR (reduce the PSDR) over the period of below trend growth. There is some evidence that this may be happening in 1990/91; the forecast PSDR, which was £6.9 billion at Budget time, was reduced to £3 billion in the Autumn Statement. Most of the decrease reflects higher general government expenditure and the forecast for general government receipts is almost unchanged despite inflation being higher than expected at the time of the Budget. Also the public corporations' borrowing requirement (PCBR) in 1991 is now expected to be higher than forecast at the time of the Budget.

The table compares borrowing requirements of the main parts of the public sector in the first nine months of the 1989/90 and 1990/91 financial years. A number of special factors (such as a grant to British Coal and consequences of changes in the system of local authority finance) have affected the distribution of borrowing

PSBR in the first 9 months of 1989/90 and 1990/91

£ billions

	April to December		Difference	Adjusted for special factors(a)
	1989/90	1990/91		
	(1)	*(2)*	*(2)–(1)*	
CGBR own account	-3.5	0.6	4.1	4.0
Adjusted CGBR own account(b)	0.1	4.3	4.2	4.1
LABR	-0.5	2.3	2.8	1.6
PCBR	0.6	-0.3	-0.9	0.4
PSBR	-3.4	2.6	6.1	6.1
Adjusted PSBR(b)	0.2	6.3	6.1	6.1

(a) ie factors that affect the distribution of borrowing between parts of the public sector, but not the total.

(b) Adjusted to exclude privatisation receipts.

requirements between sectors without affecting the total; these are adjusted for in the right hand column. As regards central government spending (on own account) departmental spending, excluding special factors, was 12% higher in the first nine months of 1990/91 than in the same period last year, and the Autumn Statement indicates higher spending on defence, housing, agricultural support and debt interest. The Gulf crisis could significantly increase expenditure, at least in the short term. It is difficult to assess whether the automatic stabilisers are stronger or weaker now than in 1980. In some respects they may be somewhat weaker. Unemployment benefit is linked to the RPI and so constant in real terms but rather lower now in relation to per capita GDP. Similarly, in so far as income tax has become less progressive, its sensitivity as an automatic stabiliser has been reduced. Yet on the other hand the operation of cash planning may have strengthened automatic stabilisation.

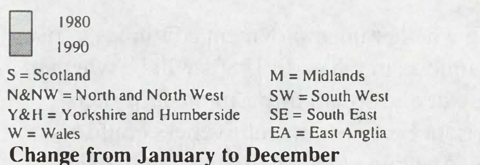
Local authority borrowing (LABR) was higher in the first nine months of this financial year than last, but was mainly attributable to lower receipts as a result of the introduction of payment by instalments for business rates and delays in collecting the community charge; both of these factors result in a more even spread of receipts through the financial year than in previous years. The borrowing requirement of public corporations is slightly higher because the slowdown in the economy has affected their gross trading surplus.

Unlike 1980, the **rise in unemployment rates** *during 1990 . . .*

1980
1990

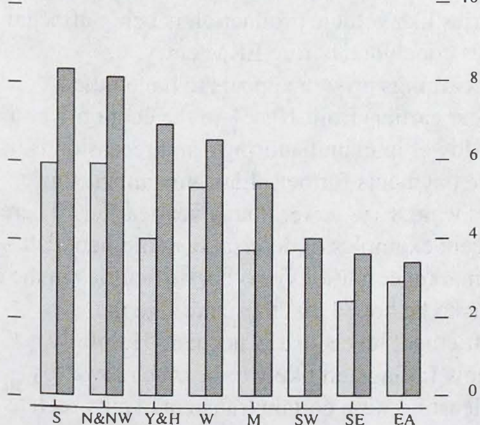
S = Scotland
N&NW = North and North West
Y&H = Yorkshire and Humberside
W = Wales
M = Midlands
SW = South West
SE = South East
EA = East Anglia

Change from January to December



. . . was concentrated more in regions where **starting rates** *were lower*

Unemployment rates in January



. . . and the **labour market** *may now be more flexible . . .*

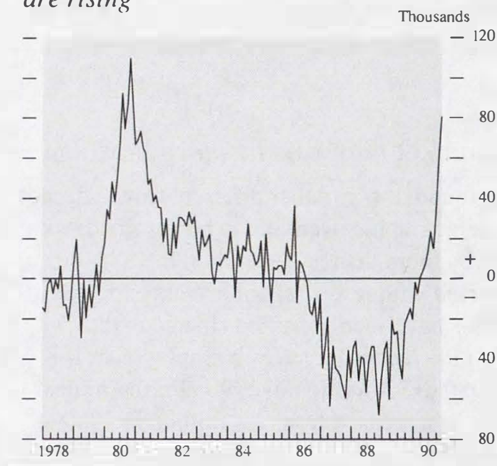
The labour market background now is rather different from a decade ago. Then, there was a demographic overhang to be absorbed, with the workforce increasing by more than half a million in 1978–80. Now, the position is reversed with fewer school leavers expected in the early 1990s. The 1980s have seen a marked change in the structure and flexibility of the labour force. Self employment has risen from 2 million in 1980 to 3.4 million in 1990. Furthermore, the number of part-time jobs increased from 4½ million in 1980 to over 5½ million in 1990. The majority of these are held by women, illustrating another notable shift in the composition of the workforce, namely that 48.5% of employees in September 1990 were female compared with 42.1% in 1980. Trade union membership has also fallen, perhaps reflecting these other trends, from 56% of employees in employment in 1980 to 46% in 1988. At a practical level the change in industrial relations is seen most dramatically in the fall in the number of working days lost to disputes: in an average year in the 1970s some 570 days per thousand employees were lost, while in the 1980s this fell to 330. In 1989, the last complete year for which figures are available, the figure was under 190 and the number of stoppages was the lowest in any year since 1935.

There has been a shift in employment away from manufacturing and towards service sectors, which has assisted the movement towards more flexible work styles. In the early 1980s many of the job losses were in traditional industries such as mining and heavy manufacturing where working practices tended to be rigid and cost structures had become particularly uncompetitive. They were also predominantly in the northern part of the country and Wales, and it was in these regions that unemployment rose most. To some extent these regions have replaced lost jobs with ones in newer, expanding industries, or have imported new management skills and working

cultures. This time, the rises in unemployment so far have been concentrated in the southern part of the country where unemployment rates are lowest. This is consistent with the impact of the tightening being felt mainly, at least initially, in the non-traded (service) sector where much of the earlier (excessive) expansion had been concentrated.

There is a conflict, however, between the unemployment figures and the recent official employment figures which show employment in a number of service sectors continuing to rise in the third quarter. For example, in retailing there was an 11,000 rise (following +5,000 in the second quarter) and in hotels and catering an 18,000 rise (+65,000 in the second quarter). Overall, the rise in service sector employment in the third quarter (+47,000) was, however, very much less than in the second (+162,000). On the other hand, the fall in manufacturing employment (3,000 in the second quarter and 21,000 in the third) has been small in relation to the 237,000 increase in registered unemployment since March 1990, suggesting that some of the shakeout has indeed fallen on the service sector. Of the rise, 209,000 are male and only 28,000 female, possibly because for various reasons women are less inclined (or eligible) to register as unemployed. Given this lower propensity to register, and the greater concentration of women in the service sector, it may be that the contraction of the labour market is larger than the unemployment figures show. The continuing rise in service sector employment, if it is confirmed by the Labour Force Survey due out shortly, might then reflect further adjustment in the proportions of full-time and part-time jobs.

Monthly **changes in unemployment** *are rising*

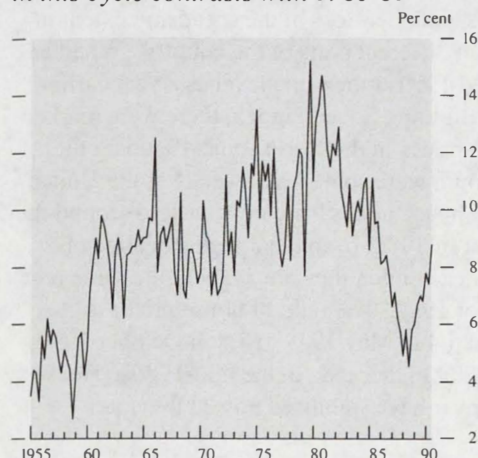


. . . though this is not yet evident in wage settlements

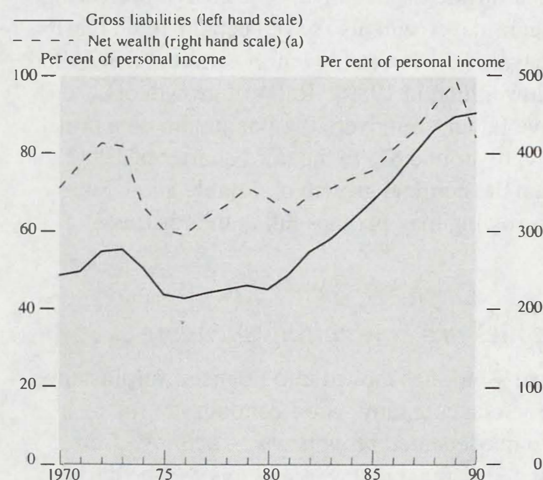
Important in determining whether unemployment continues to rise as much and as fast this time as in the early 1980s will be whether wage flexibility is any greater now than then. In the past such flexibility was less important because competitiveness could be restored by depreciation. The knowledge now that membership of the ERM carries a commitment to maintain an exchange rate should concentrate the minds of wage negotiators who cannot this time expect depreciation to correct for excesses in pay settlements. So far there is little concrete evidence that this 'régime change' message is being incorporated into pay settlements and if that were to remain the case then the convergence process would result in a higher and longer-lasting level of unemployment than need be the case were pay responses more sensitive. Earnings, on the other hand, are a little more sensitive. Although it may still be a little early to expect to see evidence of a marked slowdown in earnings growth, which in industries like vehicle production is being affected by multi-year agreements concluded before ERM entry, nevertheless underlying earnings growth appears to have fallen slightly to 9¾% (on a year earlier) from 10¼% in the economy as a whole last July (slightly lower in manufacturing), and recession is likely to reduce overtime payments further. Last November, for example, overtime hours were 8.1% lower than a year earlier. There have also been a few recent examples of deferral of settlement dates, brought about by weak market conditions or other difficulties in the firms concerned, and it is to be hoped that these presage the substantial change in settlement levels that is needed. Helpfully, retail price inflation is now falling and likely to be much lower by the end of the year, not least because certain transient events such as rises in mortgage interest rates and the replacement of domestic

rates by the community charge will drop out of the annual comparison.

The behaviour of the **personal saving ratio** *in this cycle contrasts with 1980-81*

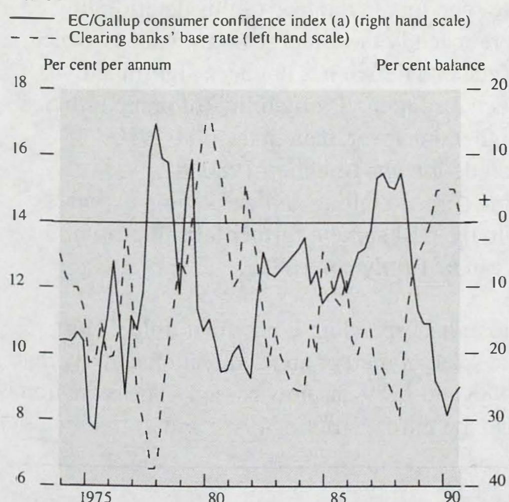


In relation to income, **gross personal liabilities** *have doubled since 1980;* **net wealth**[(a)] *has risen less*



(a) Total personal assets (including real estate) as a percentage of quarterly personal income. Figures for 1990 are estimates.

Consumer confidence *reflects interest rates*



(a) The EC/Gallup measure of the balances of positive and negative answers to five questions concerned with households' finance and their assessment of economic conditions.

The personal sector is adjusting by **saving** *more . . .*

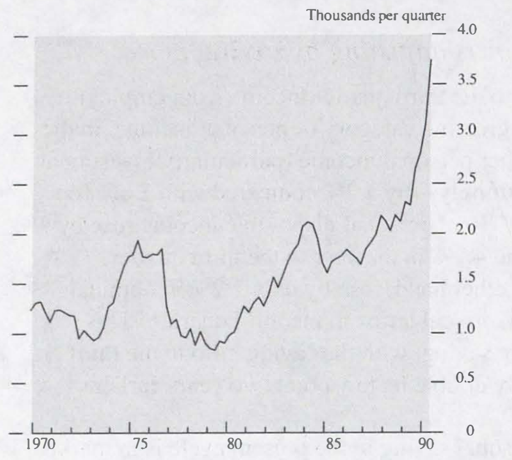
Although in the year to the third quarter income from employment was the most rapidly growing category of personal income, in the third quarter alone other personal income (particularly investment income) grew most strongly—by 4.2% compared with 2.6% for total personal income. Real personal disposable income rose by 1% in the third quarter and 4.2% in the year to the third quarter. Consumption, on the other hand, rose by only 1.2% in nominal terms and fell by 0.6% in real terms in the third quarter. This allowed a sharp rise in saving, with the saving ratio in the third quarter at 8.8%, nearly double its low point two years earlier.

The behaviour of personal saving in the present cycle is in marked contrast to the early 1980s. Then, the saving ratio had been high on entering recession, having risen progressively over the previous twenty years, and although it rose somewhat further in the early phase, to over 15% at its peak in late 1979, from 1981 onwards it fell, to a low point in mid-1988. This time, it starts from that low—a level not seen since the 1950s—and enters the recession on a rising trend. This change may be associated with changes in the structure of personal balance sheets over a decade of financial deregulation. Net personal wealth is affected by asset prices so it is difficult to disentangle temporary from underlying changes, but as a multiple of annual income it may have risen over the 1980s from around 3.5 to about 4.5. Gross liabilities, on the other hand, which are little affected by price changes, practically doubled during the decade from 45% of annual income to nearly 90%. In fact, since 1986, and perhaps for the first time, the personal sector now has more debts than assets at floating interest rates and is therefore much more exposed when interest rates rise than hitherto (see the May 1990 *Bulletin*, page 198). As a percentage of disposable income, the personal sector's net floating-rate liabilities had risen to over 15% by mid-1990. It is not surprising therefore that consumer confidence should fall as interest rates rise (and vice versa) and that this in turn should affect the saving ratio.

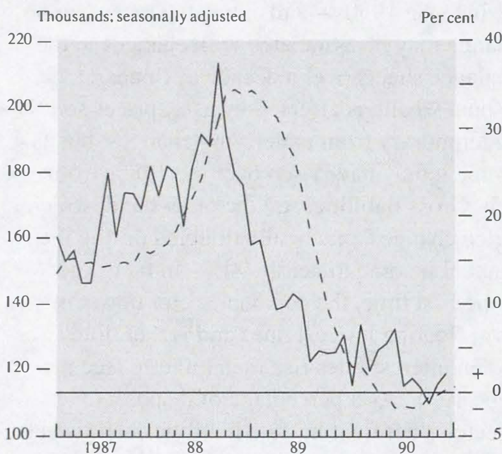
. . . as confidence and **consumption** *weaken . . .*

The path of consumption through 1991 is likely to prove an important determinant of the depth and length of recession. On the one hand it is likely that the rate of growth of the retail price index will fall faster this year than that of earnings so that real earnings (deflated by the RPI), growth of which may have sustained consumption early last year (see the chart on page 17), will rise. This could start to induce further growth in consumption later this year, helping to bring about a recovery. This would be the more likely if, by then, a significant reduction in interest rates had proved possible, particularly if that should lead to some firming in the housing market. On the other hand, if more sharply rising unemployment resulting from an inadequate wage response, coupled perhaps with less scope for interest rate reduction and the high level of personal indebtedness, were to continue to depress consumer confidence, then the saving ratio could continue to rise and consumption remain sluggish for longer. The sharply rising trend in individual bankruptcies, much sharper than in 1980 and from a higher base, may also affect confidence, although the numbers involved are small.

Personal bankruptcies *have risen much more sharply than in 1980*

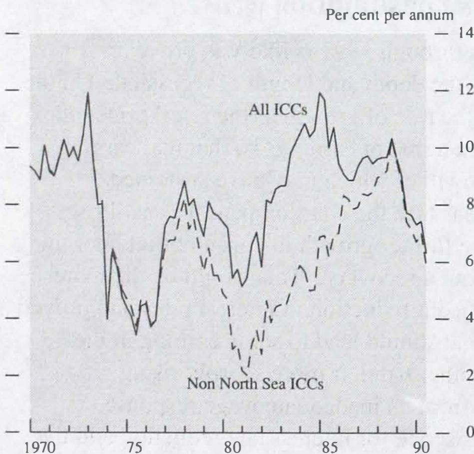


The volume of **housing transactions** *is closely associated with* **house price changes**



(a) Halifax Building Society index.

Profitability of non North Sea companies[(a)] *is still well above levels in recent recessions*



(a) Pre-tax real rate of return.

The transmission mechanism between interest rates and consumption has operated most markedly via the housing market. Rises in interest rates from mid-1988 were quickly reflected in a slowdown in the rate of growth and, recently, in falls in house prices. Regional differences in the level of house prices are reflected in gearing levels, and therefore in the speed and extent of the transmission process in different parts of the country. Whereas overall house prices ended 1990 at the same level as a year earlier, according to the Halifax Building Society index, there were marked regional differences, with prices in the North some 4% up on the year while those in the South were some 4% lower. For the United Kingdom as a whole, real house prices[(1)] are now back to around the level in the second quarter of 1988, from their peak a decline of some 13%, while in Greater London they are at about the same real level as at the beginning of 1987. The ratio of house prices to earnings[(2)] has fallen from 4.4 in May 1989 to 3.8 in October 1990, though it is still substantially higher than in the mid-1980s. House building (starts) and turnover have stabilised now at low rates.

Those consumer goods most closely associated with housing demand (such as furniture and carpets) have suffered the sharpest reductions in spending. Often, purchasing them involves borrowing too, which has been a further disincentive. The cost of borrowing and low consumer confidence will also have been the main reasons why vehicle sales have fallen so sharply (car registrations in 1990 were some 12½% lower than in 1989). Rates of growth of consumer credit have fallen from over 20% per annum on a broad measure in mid-1988 to around 8% in the third quarter of 1990; but this is still faster than the nominal growth of durable goods sales, suggesting some borrowing may perhaps fall in the 'distress' category.

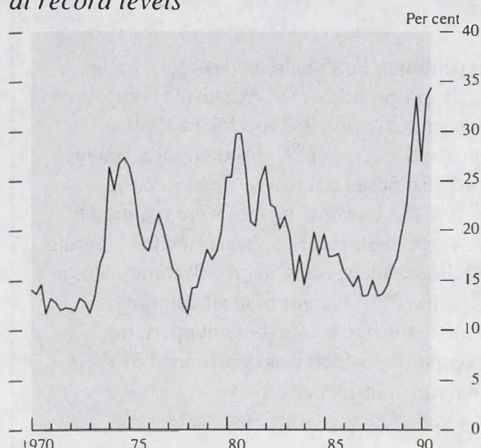
. . . *while* **companies** *are now cutting spending . . .*

Whereas the personal sector has moved into financial surplus, the industrial and commercial company sector continues to run a financial deficit of unprecedented proportions. The move from surplus to deficit started in the mid-1980s and in 1988 the deficit had already reached a near record level in real terms. In 1989 it soared to £22.2 billion, more than double the previous record (adjusted for inflation); even this total was exceeded in the first three quarters of 1990. Until last year there was little sign of adjustment in corporate spending in the face of this deteriorating financial position. More recently there has been growing evidence of adjustment but the financial deficit has not been significantly reduced because profits have fallen. Profitability (of non North Sea companies) remains higher, however, than in the mid-1970s' recession and more than double the trough in 1980–81. Nevertheless, with home demand falling and weakening export prospects, as reported in the CBI survey, further falls in profitability are likely unless costs can be firmly controlled.

Evidence of attempts to reduce spending is now manifold. Most obviously, and first, the spate of merger and acquisition activity that was so prominent in 1988 and 1989 has now ceased. The reduction in output and stocks[(3)] in the third quarter of 1990, and

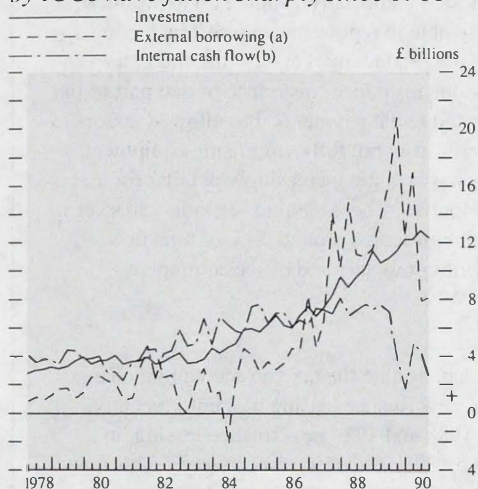
(1) Deflated using the RPI.
(2) The ratio of the monthly Halifax house price index (seasonally adjusted, 1985=100) to the Department of Employment index of average earnings for the whole economy (seasonally adjusted).
(3) There is some uncertainty on whether stocks did in fact fall, as directly estimated stockbuilding was positive, though more than offset by a negative statistical adjustment.

Net income gearing[a] *of ICCs remains at record levels*



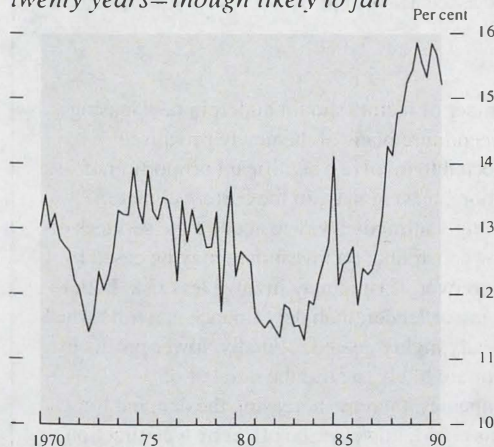
(a) Interest payments (net) as a percentage of non-interest income after stock appreciation and tax payments.

Internal sources of **finance for investment** *by ICCs have fallen sharply since 1988*



(a) ICCs' net borrowing requirement.
(b) ICCs' cash flow adjusted for unremitted profits.

Business investment *is a much higher* **proportion of GDP**[a] *than for more than twenty years—though likely to fall*



(a) Investment by industrial, commercial and financial companies and public corporations as a percentage of GDP (O).

accompanying rise in unemployment, are also clear signs of retrenchment on operating costs. Tax and interest payments remain high, with income gearing at record levels, but these are outgoings over which companies have little control; it is perhaps surprising that dividend payments remain high with the amount paid in the third quarter of 1990 only marginally less than the record first quarter figure, and 8.7% up on a year earlier, despite a 3% fall in nominal profits.

The smaller scope for stock adjustment this time than a decade ago has already been noted. Nevertheless, much higher debt, and levels of income gearing, are now putting greater pressure on some companies. Acting against this, greater uncertainty, both about the path of the economy and regarding the international situation, may tend to encourage stockholding of finished goods. The national accounts show a fall in stocks of nearly £1 billion (in current prices) in the third quarter, though in real terms stock levels were only slightly lower by the third quarter than at the end of the previous year.

. . . and **investment** *is likely to fall*

Investment is more difficult to adjust quickly, though certain elements which are more flexible, such as vehicles particularly, started to be reduced earlier last year. In the third quarter, business fixed investment[1] fell by nearly 4%; and further falls are likely because capacity utilisation is falling as demand weakens, and because of financing constraints. Internal sources of finance have fallen sharply since 1988. Although until recently external borrowing has been actively used, to finance not only fixed investment but also mergers and acquisitions, this could become less readily available (and relatively more costly) as banks and other lenders address concerns about the quality of their corporate sector assets and declining prudential ratios.

Business investment as a proportion of GDP rose sharply in the last three years, to a level substantially higher than has been seen for more than twenty years. There is, therefore, rather more scope now than in the early 1980s for cutbacks in investment to bring about financial adjustment. The extent to which this happens will depend in part on longer-term confidence about profitability of operations in the United Kingdom, and on continued availability of external finance. In the present climate, companies may look increasingly to leasing contracts, which have been of growing importance over the past decade (see the note on page 24), though leasing fell somewhat during 1990.

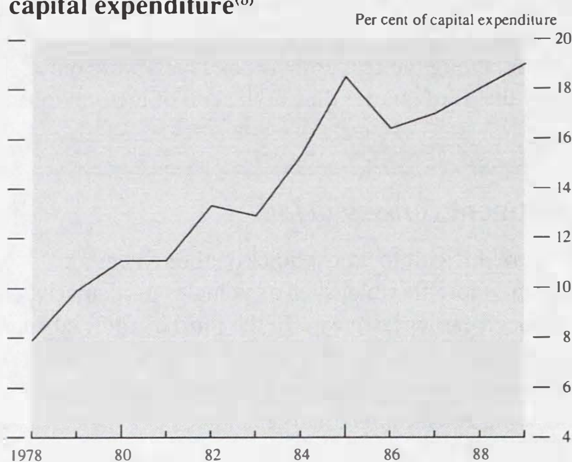
Those sectors, such as property and retailing, most exposed (directly or indirectly) to high interest rates have been under pressure for more than two years now. Some companies will have built up their exposure through rapid expansion in easier times. The number of companies established during the 1980s was about a third higher than in the 1970s. It is not surprising, therefore, that the incidence of insolvencies, particularly among those described as 'shallow rooted', increased sharply last year. In relation to the number of companies the rate of liquidations is not currently as high as in 1983 though it is likely to continue to rise. Even this measure may be misleading if a higher proportion of newer companies is 'at risk'

(1) ie by industrial, commercial and financial companies, and public corporations.

The leasing industry

It was believed that the withdrawal of the favourable tax treatment of finance leasing in the 1984 Budget would adversely affect the industry. However, the available data suggest that the growth of leasing has, until recently, continued. The chart below shows the increased role that leasing has played in whole-economy capital expenditure (excluding expenditure on buildings) over the last few years. In 1980 new assets financed by leasing represented around 11% of total capital expenditure, while by 1989 this proportion had risen to 19%.[1]

Leasing[a] business *is taking a growing* share of capital expenditure[b]



Source: Equipment Leasing Association.

(a) The leasing data include both operating and finance leases.
(b) Whole-economy capital expenditure other than on buildings.

Normally, leasing contracts fall into two broad categories. Operating leases are akin to the traditional short-term rental arrangement, over which the cost of equipment is not fully amortised, and the residual value of the asset at the end of the contract belongs to the lessor. Finance leases, which remain the greater part of the total, are fully amortised over their lives, and hence the rental payments are at least equal to the cost of the equipment and will also include the lessor's profit margin.

The growth of finance leasing until 1984 was helped by the corporate tax environment. Certain sectors of the economy (especially the financial sector) typically generated high taxable profits while having relatively low capital expenditure and hence low tax allowances to set against corporation tax. Conversely, other more capital intensive sectors of the economy often generated fewer taxable revenues than were necessary to offset all of their capital expenditure against tax (ie they were tax-exhausted). Therefore, using its excess capital allowance, a lessor was able to buy an asset and lease it out. The lessor was then able, in effect, to pass on some of the tax saving to the lessee.

During the 1980s a number of the incentives to use finance leasing were removed. In 1984 100% first year allowances were phased out, and the lower tax rate meant that a given amount of capital expenditure now sheltered less corporation tax. Consequently, the proportion of tax-exhausted companies was reduced (from around 26% in 1984 to 11% in 1989 according to estimates by Devereux).[2] Furthermore, changes in accounting practice also posed a threat to finance leasing. From financial year 1987/88 onwards lessees were required to capitalise finance leases on their balance sheets (while operating leases remained off balance sheet, allowing the declaration of a higher rate of return). Finally, changes in local authority accounting in 1987 made finance leases (but not operating leases) part of the expenditure which was constrained by their budgets, thereby removing a further advantage.

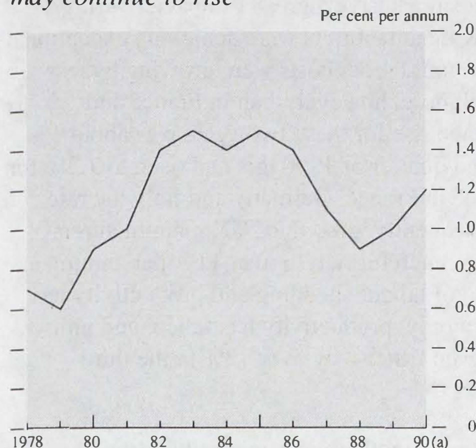
The continued expansion of leasing business since the withdrawal of these advantages is, in part, the result of the relative and increasing attractiveness of operating leases noted above. Moreover, the operating lessor, while taking some of the risk away from the lessee (especially with regard to product obsolescence), is also able to reduce his own risk by having a better knowledge of the product market. Furthermore, the growth of residual value insurance (insurance of that part of the asset not covered by the rental payments) has allowed lessors to lay off some of the risk from not fully amortising equipment. This form of leasing has become increasingly popular for assets such as cars and computers, where a liquid secondary market exists. In 1989 cars represented around 30% of total new leasing business, while computers and office equipment accounted for nearly 19%.[3]

Bank figures show that, despite the tax and accounting changes in the last few years, new finance leasing has, until recently, grown strongly. In 1988 and 1989 new finance leasing, in volume terms, grew by 29% and 16% respectively. This may reflect the residual tax advantages of leasing. Moreover, the development of specific forms of leases to take advantage of the lessee's particular tax or accounting position has also been an important factor. More recently, however, new finance leasing business has begun to fall. In the first three quarters of 1990 the volume of new assets leased fell by 14% from the equivalent period in 1989.

Despite this, a number of factors should underpin new leasing business. The expenditure plans of the newly privatised industries are expected to involve a significant proportion of leasing. Furthermore, leasing may, in the current climate, become an increasingly attractive way to acquire the services of capital. Cash flow constraints on investment may be eased by using leasing. Moreover, leasing may involve less risk, both to the lessee and the lessor/lender, than debt finance at a time when companies are already highly geared. Finally, lower profits in the industrial sector are likely to raise the number of tax-exhausted companies, thereby increasing the demand for leased assets. This could, however, be offset by a contraction in the funds available if lessors themselves come under financial pressure.

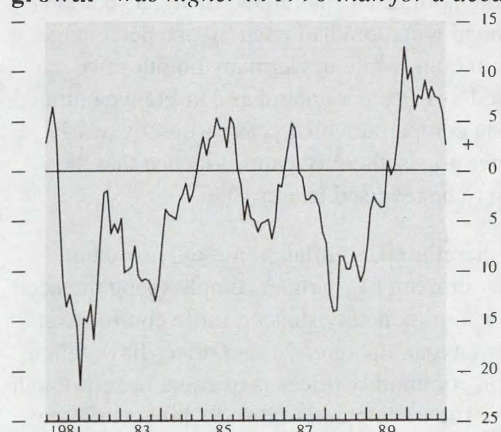
(1) This figure excludes long-term industrial hire purchase business. Its inclusion, as is the European convention, raises the proportion to 27% in 1989. Corresponding data are not available for before 1988.
(2) M Devereux, 'Corporation Tax: the effect of the 1984 reforms on the incentive to invest', *Fiscal Studies*, February 1988.
(3) These figures, from the Equipment Leasing Association, include finance as well as operating leases.

Liquidations, *as a percentage of companies, may continue to rise*



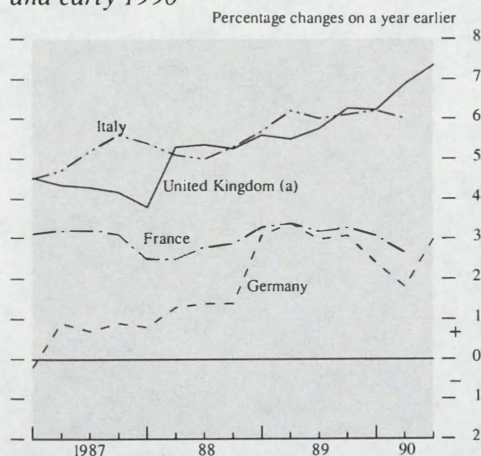
(a) 1990 is estimated.

The **differential between export and import growth**[(a)] *was higher in 1990 than for a decade*



(a) Growth of non-oil export volume *less* growth of non-oil import volume (3-month moving average).

The UK **consumers' expenditure deflator** *diverged from France and Germany in 1989 and early 1990*



(a) Adjusted for the effect of the community charge.

than of older ones. But on the other hand the use of insolvency as a means to deal with corporate difficulties may have diminished following the 1986 Insolvency Act which gave administrators greater scope to restructure companies in difficulty. To the extent that liquidations reflect financial misjudgements, however, rather than basic lack of profitability, it is not obvious that productive capacity will necessarily be lost.

The **balance of payments** *continues to improve . . .*

The relative cyclical position of the UK economy, and exchange rate movements, allowed the balance of payments to improve quite sharply in the latter part of 1989. Around the turn of that year the decline in demand growth paused while output growth continued to decelerate so that the improving trends in the current balance appeared to come to a halt. Nevertheless a positive, if slightly reduced, differential between growth rates of exports and imports has continued, and this was still higher than at virtually any time in the past decade, though it fell last December. Reversal of the 1989 exchange rate decline has restored the terms of trade and improved the current balance further in the second half of 1990; but to the extent that the earlier fall allowed companies to make uncompetitive cost commitments (particularly on wages) that ground must now be recovered if longer-term competitiveness is to be restored.

Despite the differential in favour of export growth, such is the difference in levels between exports and imports that current account deficits will be a feature for some time yet. Nevertheless, there are some bright spots. Exports of cars, for example, have risen by 30% in volume in the latest three months as UK producers, facing very weak domestic demand, have targeted foreign markets. Invisibles, on the other hand, are currently of little help, with the traditional surplus on this account having been reduced and now projected to be in balance.

. . . and a deterioration in **relative inflation performance** *has at least been halted*

The purpose of a tight monetary policy, and of the adjustment in the real economy it is inducing, is to lower inflation, particularly relative to inflation in our ERM partners. The headline RPI measure, to which most attention is given, has now started to fall and is expected to continue to do so through this year. The December index showed annual growth of 9.3%. It is widely recognised, however, that this measure does not represent underlying inflationary pressure, and nor is it comparable with other EC countries' indices, because of the treatment of housing costs. Another temporary distortion (though not one that affects the United Kingdom differently from other countries) arose in the latter part of last year from the rise in oil prices prompted by the Gulf crisis; this explains most of the hump in measures excluding house costs relative to 'retailed' prices. A less timely, but more comparable measure is the price deflator for consumers' expenditure in the national accounts. On that basis, between end-1986 and mid-1989 UK inflation has been comparable to Italy's, somewhat worse than France's, and more substantially worse than, but improving relative to, Germany's. Between mid-1989 and mid-1990 underlying UK consumer price inflation has tended to diverge from that in these three countries, though compared with Germany that divergence was reduced in the third quarter.

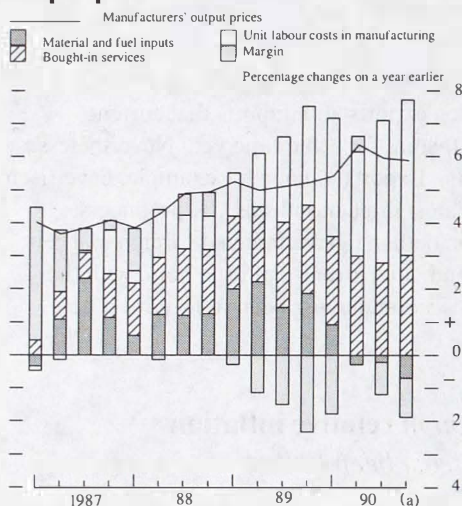
The divergence is also observed in manufacturing unit labour costs where relative cyclical positions have a greater impact. During 1987 and 1988, when UK manufacturers were achieving exceptional productivity growth, their unit labour costs were growing by less than 3% per annum—still more, however, than in France and Germany where the average rise for these two years was about 1% per annum. By the second quarter of 1990 this had risen to 7.2% for the United Kingdom while in France, Germany and Italy the rate was about half this. Subsequently, growth of UK manufacturers' unit labour costs has risen much further, to over 11% per annum, as output has declined ahead of labour shedding and productivity has fallen. For the whole economy, productivity has fallen, and unit labour costs have risen, even faster—by over 12% in the third quarter.

Producer price inflation in larger EC countries

Percentage changes, year on year

		United Kingdom	France	West Germany	Italy	Spain
1989	Q1	5.2	8.8	3.1	6.2	4.2
	Q2	5.0	8.0	3.3	6.9	4.3
	Q3	5.1	4.8	3.0	5.6	4.3
	Q4	5.2	0.9	3.1	7.0	3.9
1990	Q1	5.4	-1.7	1.7	6.4	2.8
	Q2	6.3	-2.4	1.5	4.6	2.0
	Q3	5.9	..	1.8	8.6	1.4

Tight trading conditions seem to have contained growth in **manufacturers' output prices**



(a) Contributions for 1990 Q4 are estimates.

Manufacturers' output prices, another measure of underlying inflationary pressure, show a similar picture. Whereas in the first half of 1989 output prices in the United Kingdom were rising some 3 percentage points per annum more slowly than in France and only 2 percentage points per annum faster than in Germany, a year later this measure for the United Kingdom had risen by one percentage point to around 6% per annum, while in Germany output price inflation had been halved to 1½% per annum and in France output prices had actually fallen compared with a year earlier, by nearly 2½%. As with consumer prices, there is some evidence that the divergence was starting to be reversed late in 1990.

On all three measures, therefore, UK inflation not only rose but diverged from trends in our main EC partners, emphasising the need for continued firmness in our monetary stance. Little comfort can be drawn from the fact that manufacturers' input prices have fallen, as the weakness in world commodity prices is of equal benefit to our competitors. Tight domestic trading conditions do, however, seem to have contained the growth of manufacturers' output prices, and perhaps prices in shops, as the rise in growth rates of both seems to have been arrested since the middle of last year. This has been at the expense of profit margins which have fallen. The latest CBI Industrial Trends Survey suggests that downward pressure on prices and margins is expected to continue in the short term since the balance of firms expecting to raise prices in the next four months is about half the balance expecting costs to rise.