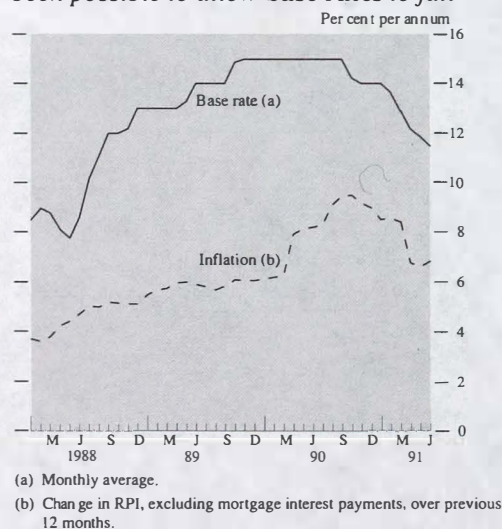


## The domestic economy

- *The rate of decline in activity recorded in recent statistics is moderating. These statistics, which necessarily lag to some extent the current position, show no tangible evidence yet of recovery.*
- *Weakness in consumption has been associated with a sharp reduction in the rate of personal borrowing; with little prospect of a rise in real income, in the short term its revival would seem to depend on consumers' willingness to resume borrowing (of which as yet there is no sign), and that on a fuller restoration of confidence.*
- *Because of the lags in the operation of monetary policy, the effects of interest rate reductions already made have yet to be fully felt.*
- *Output may not respond immediately and fully to any pick-up in demand because stocks still appear to be above desired levels.*
- *Nevertheless, with the current external balance improving sharply and the public sector moving into (cyclical) deficit, private sector saving is rising; with personal savings stabilising (or falling) the indications are that this is now at last feeding through to a reduction in the corporate sector deficit.*
- *There has been a further significant improvement in inflation, with the twelve-month growth in the RPI continuing to fall, clear progress in reducing producers' output price inflation, reductions in the rate of growth of settlements and earnings, and a narrowing of the differential between UK inflation and that in our major trading partners.*

With inflation coming under control, it has been possible to allow base rates to fall



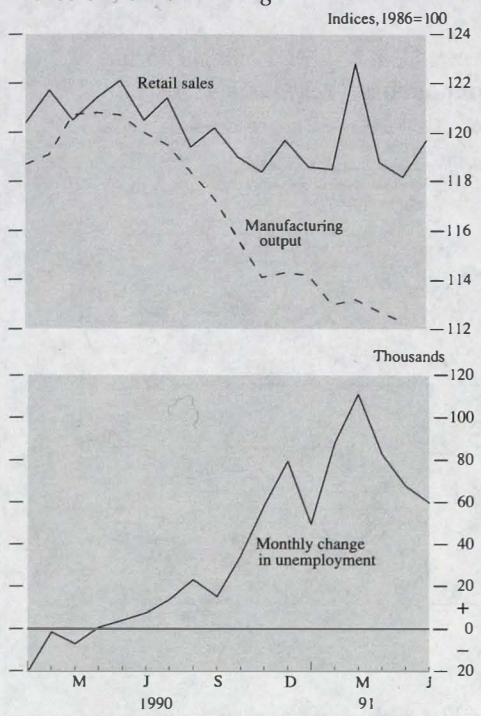
In response to the tightening of monetary policy, which started in 1988, demand growth has been progressively reduced. In the second half of 1990 the economy moved into recession more rapidly than expected. The response of inflation to this tightening is now clearly evident. Inflation peaked in the course of last year and has fallen throughout this year. With these pressures under control, it has been possible to ease policy and interest rates have fallen by 4 percentage points since last October. The relaxation of monetary conditions is also evident in the weakening of the exchange rate, particularly against the dollar. It will take time for this relaxation in policy to be reflected fully in economic activity.

Meanwhile, the uncertainties surrounding the responsiveness of the economy in the face of financial pressures remain. Virtually all forecasters look to a revival in consumption to lead the economy out of recession. This would seem to imply a fall in the saving ratio. The saving ratio did indeed fall at a comparable stage in previous cycles. This commentary compares circumstances now with those following the recessions in the mid-1970s and early 1980s.

### Leading indicators have been pointing to recovery . . .

Many of the recent monthly economic indicators have been suggesting that the underlying rate of decline in the economy has been moderating. For example, the trend in total retail sales, having

### Recent monthly indicators suggest the recession is moderating



fallen through the second half of last year, has been flat for most of this year; the rate of increase in unemployment appears to have peaked in March; and manufacturing output appears to be declining at a slower rate now than in the second half of last year. These indicators inevitably lag current conditions by a month or so; nevertheless, there are few, if any, contemporaneous indicators yet clearly showing recovery. GDP in the second quarter may be particularly depressed because of the impact of North Sea oil maintenance work.

Some grounds for optimism have been drawn from movements in the longer composite leading indicator published by the CSO. This appeared to stop falling in about April 1990 and rose between January and April 1991 (though the recovery has since paused). This index is constructed by averaging deviations from trend of five series shown to have the best record of predicting turning points. The pick-up reflected the fall in interest rates from last October and recovery in share prices, and the recent pause the downturn in confidence reported in the CBI survey (see page 334). Historically this indicator has tended to lead the co-incident index of cyclical conditions by an average of one year. A degree of caution, however, is called for in interpreting the data. The range of lead times is wide—between 7 and 39 months. Moreover, the index is still below 100 which means that on average the components are still below their trends, and those trends are themselves now being adjusted downwards to reflect recent 'weaker' behaviour in the series concerned. The index is also subject to revision and at present there is particular uncertainty over the course of the corporate sector financial deficit in the second quarter.

There is no confirmation yet of a turning point from the composite shorter leading index whose average lead time is five months, although there is some evidence that its rate of decline is slowing and therefore a presumption that it will soon turn up.

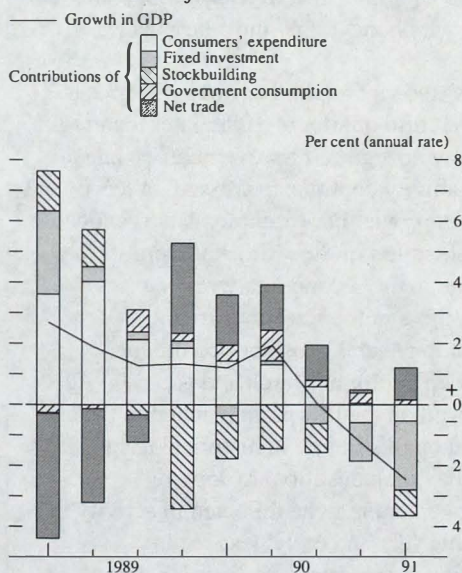
### ... though GDP fell again in the first quarter

The national accounts statistics, which give a comprehensive measure of activity, are published with something of a lag and showed GDP falling in the first quarter of the year by just over ½% to a level 2½% lower than a year earlier. The fall, particularly from the second half of 1990 onwards, has been largely concentrated in consumers' expenditure and fixed investment, these falling respectively by 1¾% and 8½% between the second quarter of last year and the first of this, but partly accommodated by a reduction (4½%) in imports. Despite its much smaller percentage decline, the reduction in consumption accounted for a similar share of the fall in GDP to investment because consumption comprises nearly four-fifths of the GDP total.

### Consumers' expenditure has been weak ...

In fact consumer spending in the first quarter appears to have been inflated temporarily by a burst of expenditure in late March prompted by the Chancellor's Budget announcement in mid-March that the rate of VAT charged on most items would be raised from 1 April by 2½ percentage points to 17½% in order to finance reductions in the community charge. This distortion is likely to have been almost entirely offset within the first quarter by a reduction in stocks, which in total fell by nearly £600 million (at

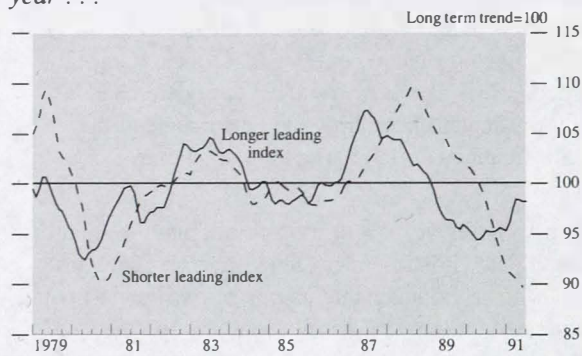
### Lower private sector spending has caused GDP to fall



## Leading indicators of activity in the UK economy

The importance of economic recovery has directed attention onto leading indicators of activity. These are based on observed regularities in previous cycles and may be used to complement macroeconomic forecasts. The Central Statistical Office (CSO) publish two leading, one coincident and one lagging indicator of activity. Each is a composite of five series chosen because they exhibit relatively stable cyclical behaviour. On average, the CSO's longer leading indicator leads the coincident activity index by twelve months and reached a low point in April 1990. However it is difficult to date an upturn in the activity index precisely, as the longer leader did not turn sharply. Rather, it was broadly unchanged from late 1989 to early 1991. This could suggest that the trough in the coincident index may be u-shaped rather than v-shaped (ie it may be of longer rather than shorter duration). The initial upturn in June 1990 was a weak affair and may not be significant.

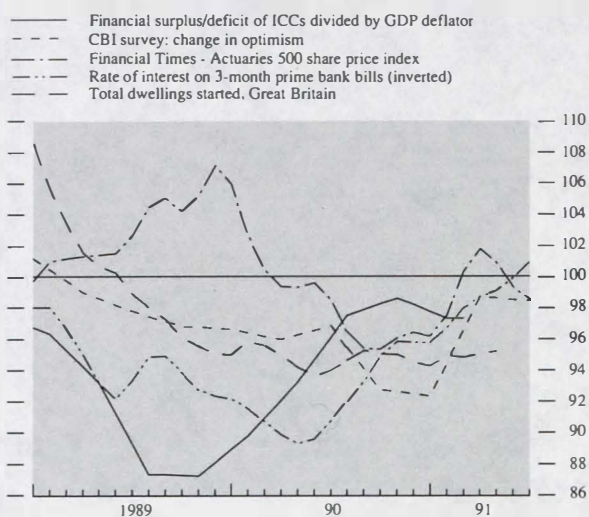
### The longer leading index clearly rose early this year . . .



Clearer evidence of an upturn in the CSO longer leader did not come until February 1991 when lower interest rates, rising share prices and improving business confidence in the CBI Industrial Trends Survey began to affect the index. This suggests that a clear upturn in activity could be delayed until the first quarter of 1992, although the timing of the link is not precise and has been as short as 7 and as long as 39 months. Recent figures show a pause in the recovery.

The strength of recovery of the index in 1991 is likely to be affected by the speed of consolidation of company finances (and by whether business confidence, which weakened again in the July Survey, is restored). Companies' financial deficit rose to a record level in the first quarter of 1991 while non North Sea gross trading profits fell. Furthermore, UK stock market prices did not sustain the rate of increase observed in the first quarter, as the confidence effects of lower interest rates and the successful conclusion to the Gulf war began to diminish, though they have since recovered. There is now also some evidence (see page 343) that, in the second quarter,

### . . . with interest rates, share prices and corporate optimism the components<sup>(a)</sup> responsible



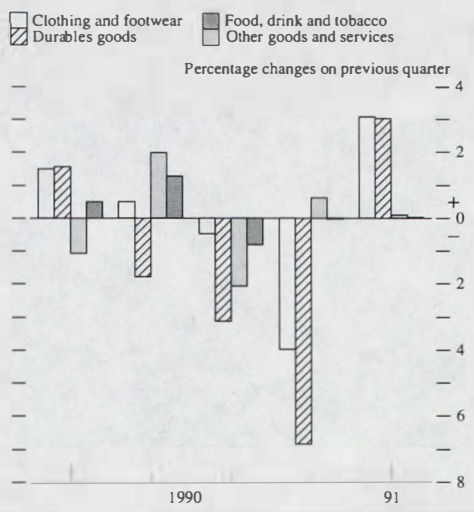
(a) Smoothed, rescaled and detrended.

companies' financial deficit could show a decisive improvement which would give a marked lift to the index.

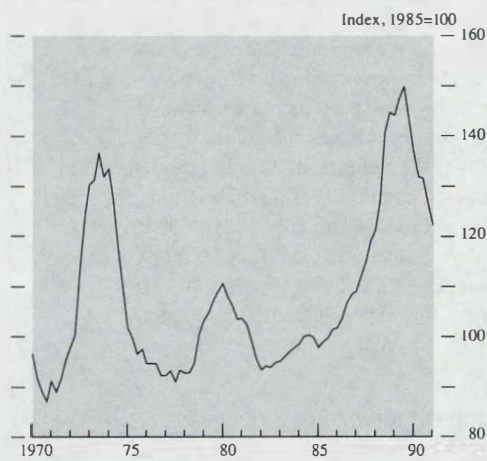
Monthly estimates of the leading indicator series remain provisional until quarterly data on the company sector become available. More timely, *ad hoc* indicators of activity can sometimes be identified to give earlier warning of turning points. There is a potentially large range of possibilities, including weekly or monthly data on telephone and letter traffic, deliveries of motor fuels, banking transactions, air and rail cargo, etc. Most of these indicators are likely to move roughly contemporaneously with the broader activity cycle. But their advantage over other sources of data is their timeliness. The chief disadvantage of higher frequency data is their volatility. This may hinder the rapid identification of turning points in activity without some form of smoothing, which inevitably introduces lags.

Deliveries of DERV and air freight, for example, appear to have peaked in the third quarter of 1990, later than real GDP, and as yet show no sign of improvement. While some indicators of activity continue to worsen, others may have begun to improve. For example, data produced by the National Association of Steel Stockholders show a marked improvement in the second quarter in expectations for business in the steel consuming industries. The Gallup general consumer confidence index began to pick up gently in March and is now considerably improved on the low point reached in the spring of last year, though still low in historical terms. Since the Gallup index includes forward-looking responses, its improvement may be reflected in activity in the second half of this year and early next. Some apparent contradiction in the data is perhaps a hallmark of the uncertainty associated with a turning point in activity.

*The pick-up in consumption in the first quarter of 1991 reflects the Budget increase in VAT*



*The house price to earnings ratio has fallen but remains above its historic average*



1985 prices), distributors' stocks accounting for about £400 million of this.

The composition of consumption bears out this interpretation. Spending on durable goods—which is the type of spending most likely to be brought forward to avoid the tax increase—fell by 10% in the second half of 1990 but rose by 3% in the first quarter. There were also more modest increases, going against the previous trends, for clothing and footwear, but other items in the first quarter broadly followed their previous trends. The monthly retail sales statistics suggest the rises were largely concentrated in March and that most categories of spending have reverted to a weak downward trend since March although, interestingly, sales of household goods seem to have settled a little above their pre-March levels. This could reflect heavy promotional activity by retailers following a prolonged period of weakness using price discounts, sometimes in the guise of deferral of the VAT increase.

Motor vehicles are not included in retail sales. Although there are figures published in the quarterly consumers' expenditure breakdown, it is difficult to disentangle private car sales from business fleet sales within the more up-to-date monthly manufacturers' figures, but overall car sales have been very depressed. Trade sources estimate that in the six months to June 1991 car sales have been nearly 25% lower than in the same period last year.

*... reflecting weakness in the housing market ...*

Demand for household durable goods has tended to be associated with activity in the housing market and weak demand reflects the collapse of turnover in this market which started in late-1988. The rapid increase that preceded that collapse left house prices exceptionally high in relation to earnings and, although subsequent price falls and earnings growth have reduced the ratio somewhat, it remains higher than for most of the last twenty years. Regional relativities in house prices (and in the house price to earnings ratios), which widened sharply in favour of the southern part of the country during the boom, have now narrowed somewhat. Prices in the south have fallen most as the impact of high interest rates has borne most on the more heavily mortgaged southern house owners. Also the recession started earlier, and may have been more severe (particularly in comparison to previous ones), in the south, adding to the uncertainty and discouraging transactions.

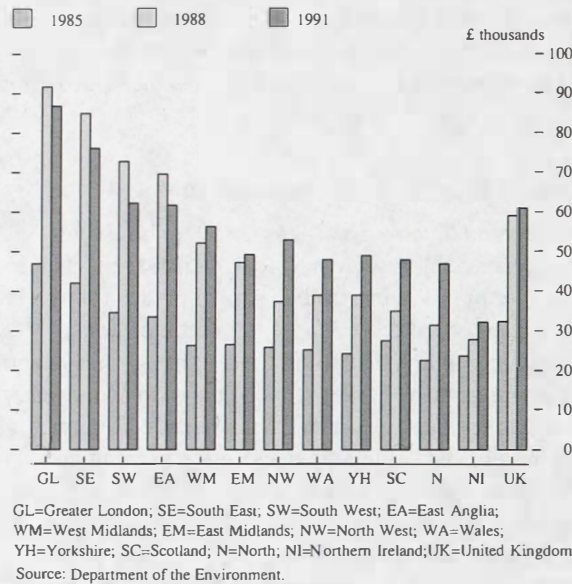
House prices have continued to fall in real terms throughout the United Kingdom and turnover shows no sign of reviving from the exceptionally depressed levels that have continued now for two years. This weakness has been reflected in new housebuilding starts, which continue at the lowest rate for a decade. Completions on the other hand have been running at a somewhat higher rate as new building work has declined and builders have come under pressure to convert their work in progress into cash. Last year completions were only 15% lower than in the peak year of 1988 (starts were 36% lower), adding to the unsold stock, which may be in the region of 30,000. More significantly, there is a large and growing number of repossessions which lenders will be seeking to sell. (One estimate,<sup>(1)</sup> which may be on the high side, is 80,000.) These are likely to be included within the figure of 159,000 of

(1) Phillips and Drew: *Housing market: Ready for lift off?*; May 1991.

## Recent developments in the UK housing market

House prices rose rapidly between 1985 and 1989, well in excess of the general rate of inflation. The main reasons underlying this rise are thought to have been rapid growth of disposable incomes, greater confidence, lower interest rates and greater competition in the mortgage lending market. (Some commentators have also suggested that demographic factors may have played a part.) The inflationary pressure may have been given further impetus in the summer of 1988 by the announcement in the Budget, some 4½ months ahead of implementation, that from 1 August that year tax relief on mortgage interest would apply to the residence rather than to individual borrowers. As a result, some first-time buyers may have brought forward their entry to the market. Because the period of real house price rises was more prolonged than in any previous period in the last twenty years, house prices rose to a new peak in relation to earnings.

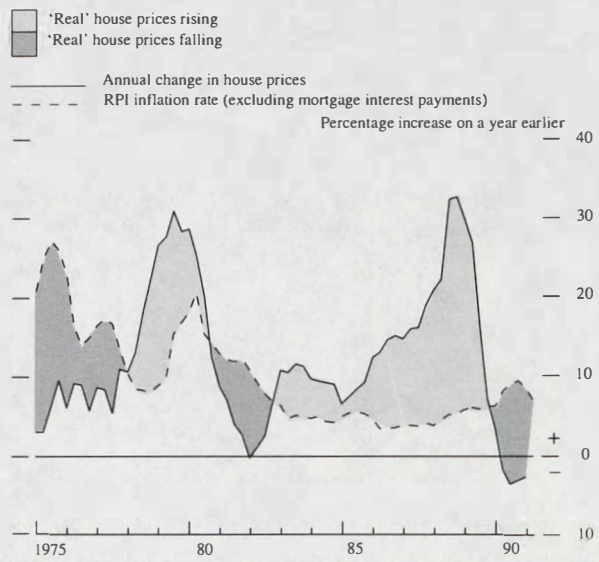
### Regional relativities in average house prices have been restored



House price inflation was likely in any case to have slowed after August 1988, and this was accentuated by successive rises in interest rates. The average building society mortgage rate rose from 9¾% in June 1988 to 12¾% by the end of the year, peaking at 15¼% early in 1990 where it remained until the autumn. It has since fallen to under 12½%. In the south, where prices had risen most, and gearing was therefore highest, prices started to fall from the beginning of 1989 and these falls spread; by the second quarter of 1990 the annual rate for the whole country was negative. The bar chart shows that the regional dispersion of house prices widened sharply in the boom and has narrowed again since, so that although nominal average house prices now are nearly twice those in 1985, a similar pattern of regional relativities has been re-established. In the southern part of England this has involved falls of up to 15%.

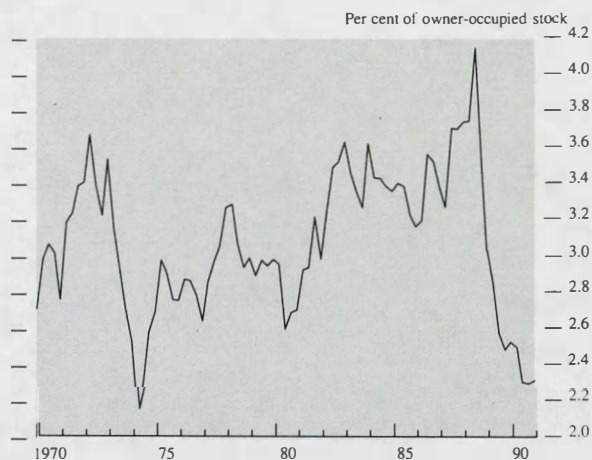
Turnover has contracted very sharply since 1988 and this contraction has again been sustained longer than at any time

### House prices are falling in nominal as well as real terms

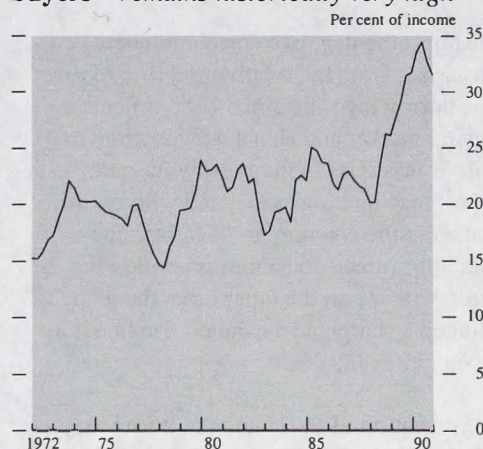


in the last twenty years. There are some indications that a modest recovery may be occurring in isolated areas, eg East Anglia, but no overall pick-up. The ratio of house prices to earnings is now falling and is some 25% below its peak but the debt service burden for first-time buyers remains high. Regional house price/earnings ratios have also narrowed and returned to more normal relativities. There is an argument that financial liberalisation could mean that personal portfolio preferences may now be more achievable, and that the desired price/earnings ratio may now be somewhat higher than in 1985 but no indication of what the new level might be. Meanwhile, the balance of supply and demand in the housing market (see page 337) and an apparent unwillingness of individuals to increase indebtedness argue for a period of relative house price stability. Clearly, however, local areas where the balance of supply and demand is different could experience different price behaviour.

### The fall in housing turnover has been more sustained than in previous cycles



### The debt service burden for first-time buyers<sup>(a)</sup> remains historically very high



(a) Interest payment on average mortgage, as a percentage of post-tax average income, for first-time buyers.

### Personal sector finance

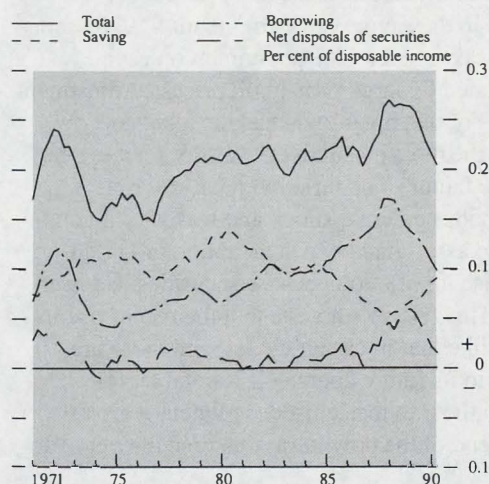
Percentage of personal disposable income

	1986	1987	1988	1989	1990	1991 Q1 (a)
<b>Sources of finance:</b>						
Saving	8.1	6.5	5.2	6.6	8.7	11.5
Borrowing	12.4	13.8	17.1	13.8	10.8	7.5
Net sales of securities	0.8	1.1	4.5	5.9	2.1	0.9
<b>Total</b>	<b>21.4</b>	<b>21.4</b>	<b>26.9</b>	<b>26.4</b>	<b>21.6</b>	<b>19.9</b>
<b>Investment in:</b>						
Liquid assets	9.0	8.7	12.6	11.1	9.3	9.9
Fixed assets	7.0	7.9	9.1	8.0	6.7	4.9
Life assurance and pension funds	8.0	7.7	7.1	8.7	8.3	7.8
Other uses (net)(b)	-2.6	-2.9	-1.9	-1.6	-2.7	-2.6

(a) Not seasonally adjusted.

(b) Capital transfers, accruals adjustment and balancing item.

### Changes in the personal saving ratio have been closely associated with borrowing behaviour<sup>(a)</sup>...



(a) The chart shows four-quarter moving averages of the ratio to personal disposable income of the main sources of personal finance, as defined in the table.

mortgages that were six months or more in arrears at the end of 1990. These estimates suggest that the stock overhang could be equivalent to more than one month's transactions or, perhaps more relevant, nearly eight months' completions. In addition poor liquidity in the housing market could have generated an overhang of 'last time sales' from deceased estates.

There may also, of course, be an overhang of prospective first-time buyers, priced out of the market when the price/earnings ratio soared but able to return to it gradually as that ratio falls again. Estimates of this are especially tentative but, based on pre-1988 trends and some account of the advancement of purchases in 1988 to take advantage of the old arrangements for mortgage interest tax relief (changed in August of that year), it could be up to 70,000. To the extent that the supply overhang represents properties attractive to first-time buyers (and many of the repossessions are likely to have been mortgaged in the boom of 1987-88, perhaps to an above average degree by first-time buyers), its disposal may not necessarily have the full knock-on effect higher up the market that a more general revival in activity of similar scale might otherwise have. Two consequences are suggested by this analysis. First, if there is a revival in transactions it is unlikely, at least for some time, to generate the usual degree of upward pressure on prices or encourage speculative activity. Second, equity extraction is likely to be less if revival is concentrated mainly among first-time buyers, though it will occur where last-time sales are involved. In both cases the impact on consumption is likely to be less than was the case in the housing boom of the mid to late 1980s.

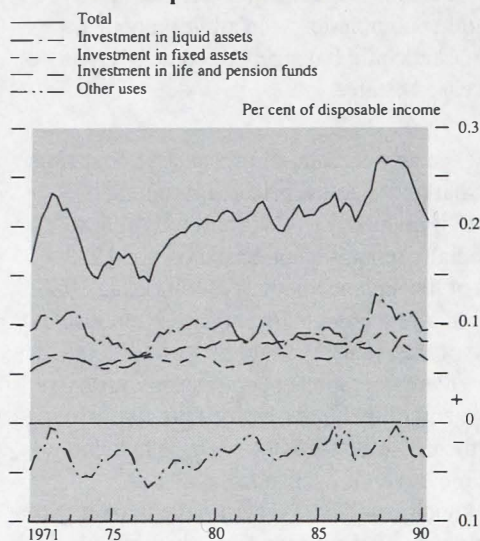
### ... and growing unwillingness to borrow

The fall in consumption last year was associated with a sharp rise in the saving ratio, to 10.7% in the fourth quarter. This ratio, which had fallen to under 5% in 1988, has been restored to a level more in line with the average over the past thirty years. In the first quarter the saving ratio fell to 9.8% but this fall appears to be fully accounted for by the 0.6% fall in real personal disposable income and the increase in spending in March which can be attributed to the VAT change. Underlying consumption appears to have been flat.

Personal saving is that part of disposable income that is not consumed; a decision to save may be associated with a decision to acquire assets (fixed or financial). But decisions on asset acquisition can to some extent be taken independently of consumption decisions because it is possible to finance either by borrowing. In proportion to income, the main forms of investment by the personal sector—investment in fixed assets (mainly dwellings), liquid assets (eg bank and building society deposits) and life assurance and pension funds—have been much more stable than the sources that have financed them. The table and charts show that the uses of funds by the personal sector totalled around 20% of disposable income during most of the 1980s, although this total rose in 1988 with a sharp increase in liquid assets which reflected unusually high net sales of securities as corporate acquisition activity rose sharply.<sup>(1)</sup> Because historically there have been continuing net sales of securities, these have been treated here as a

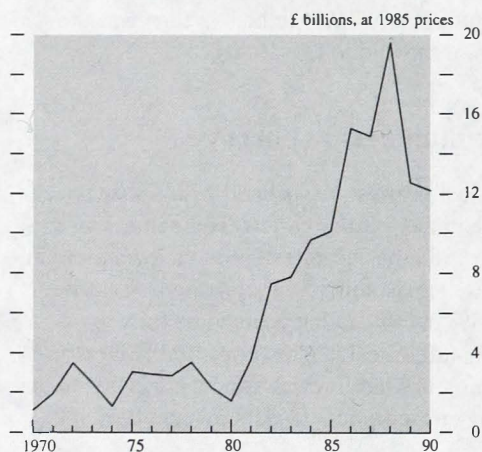
(1) Cash acquisitions of independent companies rose from £3.2 billion in 1987 to £11.6 billion in 1988 and £17.0 billion in 1989 before falling back to £3.7 billion in 1990, mirroring the profile of personal sector disposals of company securities.

... with the main uses of funds by the personal sector remaining quite steady in relationship to income<sup>(a)</sup>

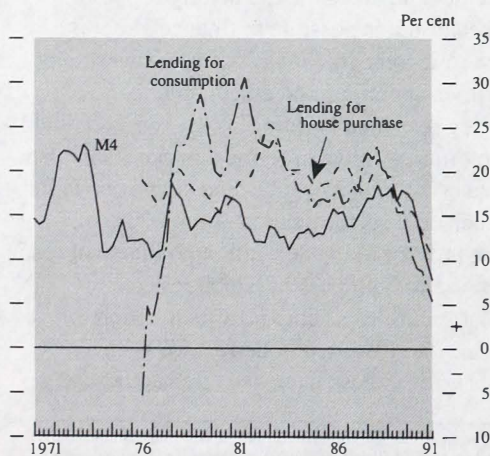


(a) The chart shows four-quarter moving averages of the ratio to personal disposable income of the main uses of personal finance, as defined in the table.

The sharp upward trend in equity withdrawal from housing assets has been reversed



Monetary growth (M4) and lending to individuals are decelerating sharply<sup>(a)</sup>



(a) Growth over previous 12 months.

source of finance rather than the more conventional treatment as a (negative) use. The other main sources are savings and borrowing.

The most striking relationship is the negative correlation between saving and borrowing; this arises from the relative stability of asset acquisition. The fall in the borrowing ratio since 1988 reflects the depressed state of the housing market and also a slowdown in the growth of consumer credit. It was rises in the borrowing ratio, particularly increases in mortgage lending associated with recovery in the housing market, that were the counterpart of falls in the saving ratio, and corresponding rises in consumption, following the recessions of 1974-75 and 1980-81. In the latter case, the ready availability of credit facilitated a sharp and sustained rise in equity extraction that reached a peak in 1988.

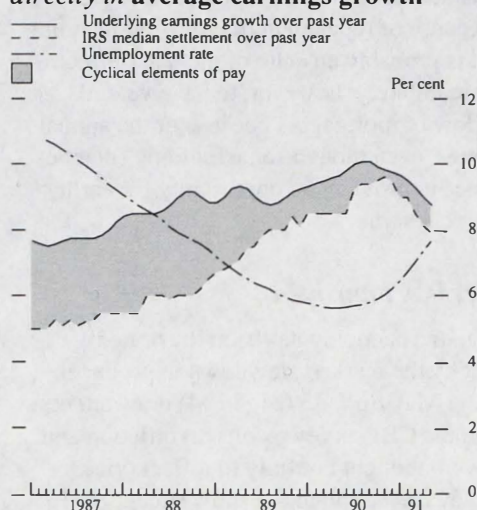
An important part of the explanation of the change in borrowing behaviour is the rôle of (de)regulation and competition within the financial services sector. The introduction of *Competition and credit control* in the early 1970s removed a constraint on lending to the personal sector. The abolition of the supplementary special deposits scheme in 1980, and ending of exchange controls the previous year, together with the abolition of hire purchase controls and changes in the regulation of building societies in the early 1980s, led to a period of fierce competition for the business of lending to the personal sector which continued to grow at around 20% per annum until 1988 despite inflation being substantially reduced and averaging under 5% between 1983 and 1988. (There was also competitively driven innovation in the range of savings products offered.) All of this allowed the personal sector to adjust its balance sheet to a portfolio position no longer constrained by the restrictions of the past. This adjustment may now have run its course and borrowers and lenders alike are in some cases having to come to terms with mistakes, including realising the extent of their exposure to changes in interest rates.

Peaks in saving around previous recessions were also associated with a build-up of assets with a fixed nominal value (especially liquid assets) the real value of which had been eroded by the bursts of inflation which preceded. As inflation subsided, so did the desire to continue to restore the real value of these assets and this contributed to variations in the saving ratio. In the mid-1970s and in 1980 these inflation peaks—over 20% per annum on each occasion—were precipitated by large rises in oil prices. Adjustment was slow because shocks of this magnitude had been outside previous experience. In the most recent cycle this does not appear to have been a detectable factor. The inflation peak was not generated by such an obvious external shock and was very much lower. In addition, liquid assets had been at an abnormally high level in advance of the rise in inflation because securities had been liquidated in 1988-89. This further suggests that the recent rise in the saving ratio was not like that in earlier cycles, and those are therefore less of a guide to its future course. It is notable, for example, that whereas in the previous episodes monetary growth accelerated towards the end of the downturn, this time the opposite has been the case.

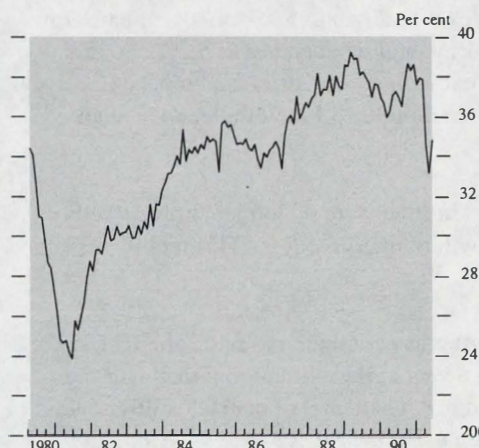
Personal income growth is expected to remain weak . . .

If consumption is to provide the means of recovery from the recession, it is not likely to do so as a result of rising real incomes. Real personal disposable income fell by 0.6% in the first quarter of

**With cyclical elements in pay remaining weak, the rate of settlements is reflected directly in average earnings growth**

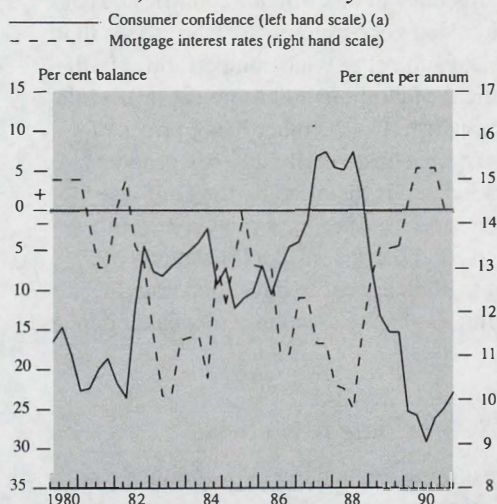


**Overtime working in manufacturing (a) has fallen sharply but remains much higher than in 1980-81**



(a) Percentage of manufacturing operatives working overtime in Great Britain, seasonally adjusted.

**There has been a modest recovery in consumer confidence, but it remains very weak**



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

this year. The sharp rise in unemployment, some moderation in wage settlements and continued weakness in the cyclically determined elements of pay (eg overtime and bonuses) combined to restrain income from employment. Current grants from government rose to reflect rising unemployment but other personal income fell as lower interest rates reduced investment income and income from self employment suffered from the recession. These trends seem set to continue for the time being.

Unemployment is currently the strongest influence on total wages and salaries. Although the rate of increase in unemployment seems to have moderated somewhat, it is still substantial and previous cyclical experience suggests that the level of unemployment will continue to rise for some time. There does appear, however, to have been a more rapid shedding of labour this time and it is encouraging that the responsiveness of pay settlements also appears to have increased. There is a wide dispersion of settlements concluded, with a substantial proportion of companies offering no increase or deferring settlement until conditions improve. The notion of a 'going rate' seems much less prevalent, certainly than in the recent past. These changes in responsiveness may reflect improvements in the supply side over the past decade, and a growing appreciation of the implications of ERM membership for the labour market (on both sides of the negotiating table). Falling inflation is, of course, also helping to reduce settlements.

Although overtime working in manufacturing has fallen sharply it is still very much higher than in 1980-81. This may reflect the greater readiness this time to shed staff but also possibly the fact that this recession is less concentrated in the manufacturing sector than was the last one.

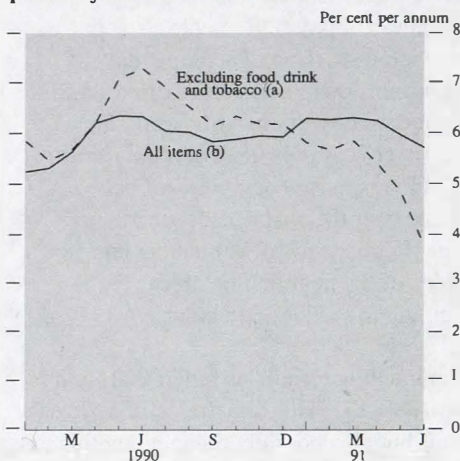
**... so confidence is likely to be the key to recovery**

Falls in inflation will certainly help to protect real personal disposable income but are unlikely to generate a sufficient rise to promote the sort of consumption growth needed for demand as a whole to grow at a rate approaching the historic average growth rate of productive potential. For that to happen there will have to be a fall in the saving ratio. For the reasons already outlined this cannot be taken as assured. Such a fall, if it occurs, is likely to involve a rise in borrowing, although it is possible that the personal sector could draw on its liquid assets, or further run down its holdings of securities; it is conceivable even that its investment in fixed assets could decline further. Falling interest rates will reduce income gearing, and the declining rate of borrowing in the recent past will at least have stopped debt to income ratios rising, so at some point a pick-up in borrowing could be expected. This is more likely to happen once immediate worries about job security are dispelled, and that may hinge on whether the adjustment in the labour market does indeed prove to be short and sharp.

Confidence would appear to be the key, and the behaviour of personal borrowing is likely to be a critical and sensitive indicator of recovery; it should, for example, track the return of liquidity to the housing market. The index of consumer confidence compiled by Gallup, although still weak by past standards, has been rising for the past year and a half, particularly since last autumn, and has historically been closely associated with movements in mortgage interest rates: on the other hand, confidence can be fickle and could become infected by events such as the collapse of BCCI or the



### The marked slowdown in producer output price inflation is now clear



(a) Seasonally adjusted, 3-month change on previous 3 months, annualised.

(b) Percentage changes on year earlier.

### Consumer price differential (a)

Percentage changes on a year earlier

	1990			1991
	Q2	Q3	Q4	Q1
UK inflation relative to:				
EC	2.2	2.2	2.1	1.7
OECD	1.6	1.6	0.9	0.7
G7 (b)	3.3	3.1	2.6	2.2

(a) UK consumers' expenditure deflator less average consumer price inflation in international groupings (including the United Kingdom).

(b) Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

approaching general election. On personal borrowing, recent evidence is less reassuring. Building society mortgage commitments remain weak and consumer credit outstanding fell in May, although this was because of repayment of credit card lending which surged in April and is probably an echo of the VAT effect. The cuts in interest rates are unlikely, however, to have yet fed through fully to the cash flow of mortgagors because of the annual payment adjustment schemes, even though some building societies have modified their schemes to provide the opportunity for earlier adjustment for those who request it.

### The inflation prospect has improved

Improved responsiveness in the economy has been illustrated recently on the prices front by the marked slowdown in producer (output) price inflation. The May *Bulletin* (page 194) drew attention to the discrepancy between the CBI survey results on inflation and the official series, which were thought not fully to reflect price discounting. The CBI survey has continued to show exceptional price restraint with as many respondents expecting to reduce prices as to increase them. This augurs well for continued price moderation. Meanwhile, as expected, the official output price index is now starting to show a more marked reduction in its growth rate. Growth in the all-items index was down to 5.7% on a year earlier in June, and excluding food, drink and tobacco it was 5.2%. A new seasonally adjusted index, excluding food, drink and tobacco, showed growth over the three months to June of under 4% at an annual rate.

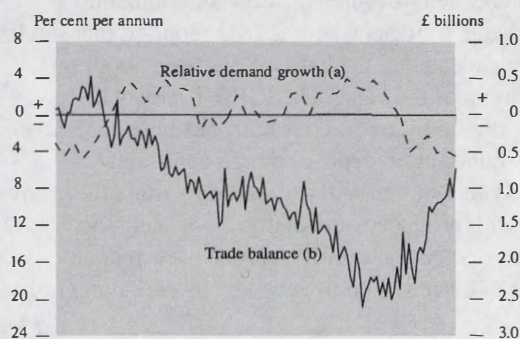
Manufacturers' input prices in June were no longer showing falls on a year earlier, but their growth remains modest. This mainly reflects exchange rate movements.

Price inflation to the consumer has continued to fall. The RPI in June was 5.8% higher than a year earlier, little more than half the peak rate of 10.9% last autumn. There are, of course, well-known distortions and difficulties in using the twelve-month change in the RPI, not least because its treatment of mortgage interest is not comparable with that in other major countries. The consumers' expenditure deflator is more comparable and the table shows the substantial progress towards convergence that has been achieved by the United Kingdom towards rates in other major countries. That progress owes most to the traded goods sector (ie those goods that are internationally traded and subject to wide competition). In the first quarter of this year prices of clothing and footwear fell, while durable goods showed no change. On the other hand, prices of 'non-traded' elements rose quite substantially. Energy products (excluding oil which is traded and is distorted by the Gulf war effect), and housing related services were important contributors, while other services, which had been a considerable source of inflationary pressure during 1990, appear to have moderated somewhat in the first quarter, perhaps in response to weaker demand in this sector.

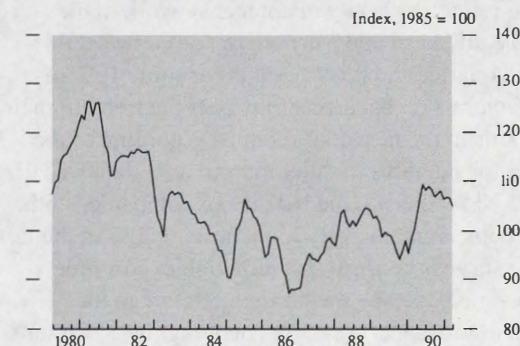
### Overseas trade could contribute to recovery . . .

With competitive pressures being felt acutely in the domestic market, it is not surprising that the trade balance has improved. Import volumes (excluding oil and erratics), which have fallen by some 6½% from the peak in April of last year, have remained weak, helped by a strengthening of the dollar's exchange rate. Nowhere

**The trade balance has reflected relative demand growth . . .**



**. . . while the real exchange rate<sup>(c)</sup> is not out of line with the 1980s average**



- (a) Differences in growth rates between UK and world demand (left hand scale).  
 (b) Monthly visible trade balance excluding oil and erratics (right hand scale).  
 (c) Using consumer prices.

has this been more so that in cars where the volume of imports in the first quarter was 35% lower than eighteen months earlier; exports of cars, on the other hand, rose by 55% over the same period. This rapid growth has been particularly underpinned by the strength of demand in Germany and will be difficult to sustain as demand there weakens along with elsewhere in Europe.

Overall demand growth in the United Kingdom relative to that abroad is at a level comparable to that in 1980 whereas the real exchange rate may be somewhat more favourable. The outlook for the major economies may have improved somewhat since the last *Bulletin*, in particular with the US economy now apparently emerging from its recession; Germany remains strong (though it is probably now starting to weaken), and Japan continues to grow, if less strongly than trend, helped by a modest relaxation of monetary policy. The recent strength of the dollar should assist UK exporters in a range of non-EC markets in which they had hitherto had a difficult time. If recovery in the United Kingdom were to become strong then the relative demand effect would work adversely and net trade could have a dampening effect.

On the invisibles account, travel credits are likely to recover in the second quarter having been depressed by the Gulf war in the first. The current balance figures for the second quarter are likely to have benefited from transfers of some £1 billion to help pay for the UK contribution to the Gulf war (there were also substantial transfer receipts in the first quarter). The oil balance will be depressed by maintenance work.

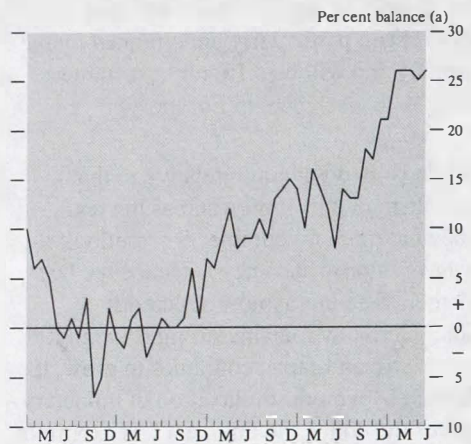
**. . . as, in a modest way, may the public sector . . .**

It is difficult to deduce the public sector's contribution to demand from the financial information contained in the monthly PSBR figures. The fact that borrowing (excluding privatisation receipts) in the first three months of the financial year has been considerably higher than in the same period last year (£9.2 billion compared with £5.8 billion last year) owes much to timing distortions: community charge collection has been delayed by re-billing following the Budget reduction of £140; the offsetting increase in the rate of VAT had, because of the lag, little effect on VAT receipts in the first three months of 1991/92. Total central government departmental cash outlays (excluding the main grants financing local authorities, which were increased to compensate for the Budget switch from community charge to VAT) were 8% higher in the first three months than a year earlier. Only about half of these outlays represent central government direct demand for goods and services—but nevertheless there has been some real growth in general government consumption over the past year. Although general government consumption of goods and services fell by nearly ½% in the first quarter of 1991, it was ¾% higher than a year earlier (and within this total local authority consumption rose by 3%); all other components of demand were lower than a year earlier in real terms in the first quarter.

**. . . although output may lag recovery in demand**

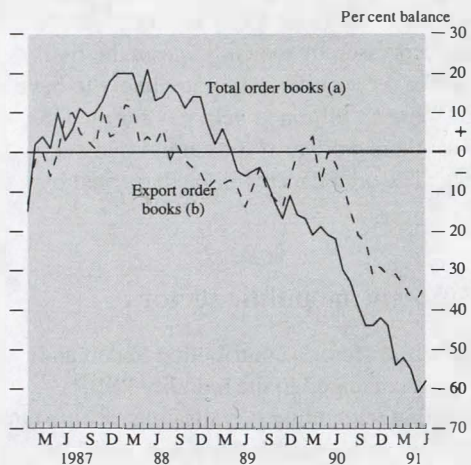
The responsiveness of output to an upturn in demand will depend on stock levels and producers' behaviour. Since mid-1988, when manufacturing output was broadly where it is now, stocks have

*Responses to the CBI survey suggest that stock levels are more than adequate*



(a) Percentage balance of companies reporting stocks of finished goods more than adequate less those reporting less than adequate.

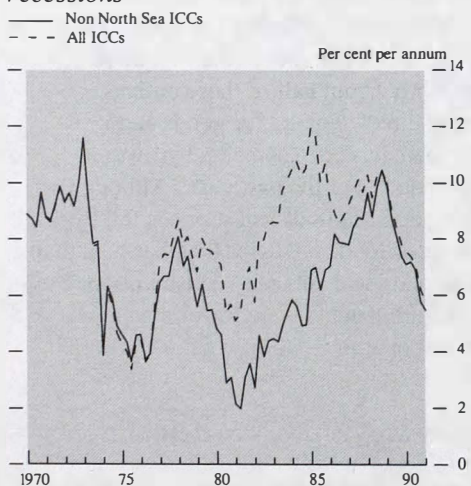
*Manufacturers face declining order books though export orders are holding up better than domestic ones*



Percentage balance of companies reporting:

- (a) Order books above normal less those reporting order books below normal.  
 (b) Export order books above normal less those reporting export orders below normal.

*Profitability<sup>(a)</sup> continues to fall but is still higher than the trough of previous recessions*



(a) Pre-tax real rate of return on capital employed.

increased (net) by nearly £5 billion.<sup>(1)</sup> This is mirrored in evidence of the CBI industrial trends survey which suggests that stocks are currently higher than needed. In June, only 2% of companies reported less than adequate stocks whereas 28% reported that stock levels were more than adequate; the balance has been about this level since the beginning of the year. The CBI/FT survey of distributors shows a similar picture. Thus until business confidence is restored (and it is rather more depressed than consumer confidence) it is likely that output will respond only mutedly to any pick-up in demand, with producers and distributors using the opportunity to reduce stocks. This reinforces the view that any consumption revival will need to be financed by lower saving rather than income growth.

In the second quarter output is likely to be further depressed by a fall in energy output, reflecting heavy maintenance work in the North Sea oil industry. In April and May energy output was 6½% lower than in the first quarter and this accounts for some 10% of total output. Manufacturers on balance still expect the trend in their output to be downwards in the next four months, according to the CBI survey, but by a considerably smaller margin now than was the case up until March. Nevertheless, the balance of companies with below normal order books remains very high, around 60% in the last three months. Those surveys confirm that although export orders are also judged to be on balance below normal, relative to the domestic market export prospects are more encouraging. Over half the companies reported normal or above normal export order books, whereas this was true of total order books for only a third of companies.

*The corporate sector's financial position may at last be starting to turn*

The financial position of the corporate sector as a whole disguises a quite wide range of experience. Those companies able to export are likely to be more comfortably placed than others. Smaller companies appear in general to be faring worst both because they are less likely to have the cushion of export markets and because borrowing costs and trade credit positions are likely to bear most heavily on them. Overall, profitability of industrial and commercial companies continues to fall but in the first quarter it was still a little higher than in 1974–75, and for non North Sea companies considerably higher than in 1980–81. This possibly reflects the quicker adjustment of costs this time through lower wage settlements and labour shedding.

Other areas of expenditure by ICCs do not seem to be as responsive. Investment expenditure (in current prices) was unchanged in the first quarter, if the newly privatised electricity distribution companies are omitted, and dividend payments actually rose to a new height. Companies' reluctance to cut investment is welcome in view of the long-term supply-side implications but in the short term this contributed to the unprecedented £7.8 billion financial deficit in the first quarter.

(1) This is true of the total stockbuilding figure, but half of the cumulative rise represents the national accounts statistical adjustment and is not allocated by industrial sector. Stockbuilding identified in manufacturing—arguably more comparable to the output measure—showed a cumulative fall of £1.7 billion over the period. Nevertheless, the CBI trends survey, which does relate more closely to manufacturing, supports the proposition that stocks are at higher levels than companies would choose.

*Corporate sector profitability and finance are discussed more fully in the article on page 361.*

In the second quarter partial financial information points to a radical turn-round in sources of funds and probably also in the overall corporate financial position. Borrowing from banks and building societies was repaid and deposits increased in roughly equal measure so that net recourse to banks and building societies for funds, which had been nearly £11 billion in 1990 and £4 billion in the first quarter of this year, was -£7 billion in the second. Some of this reversal was made possible by net capital issues (predominantly equity) of £3½ billion in the second quarter compared with very little in the first and only £2½ billion in the whole of 1990.

This evidence from recent borrowing statistics supports the picture that seems to be emerging from trends in sectoral savings positions. With the current account deficit being sharply reduced, and the public sector moving into deficit, it follows that the private sector as a whole must be saving more. If the rise in personal saving is now being halted (and may be reversed) then the corporate sector must at last be increasing its saving (ie reducing its huge deficit).