The domestic economy

- *Manufacturing output appears now at least to have stopped falling; confidence surveys suggest a more positive picture for the fourth quarter (as does the CSO's shorter leading indicator).*

- *The weakness of demand at the end of last year and the first half of this was driven mainly by destocking, which proved more of a depressant than expected (though mitigated by an improvement in net trade).*

- *The more recent firming in manufacturing output suggests destocking may now be much reduced; but stockbuilding and trade are less likely to reverse falling output in the much larger services sector.*

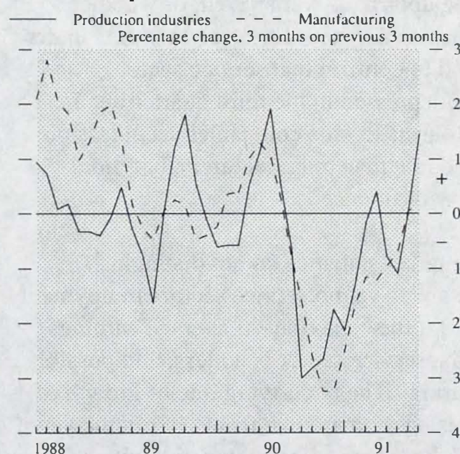
- *Real personal disposable incomes remain depressed and consumption is sluggish, though it has benefited from a fall in the rate of saving financed from lower asset acquisition (rather than renewed borrowing). With supply continuing to exceed demand in the housing market, recovery there continues to look unlikely in the near future.*

- *Corporate sector adjustment is now bearing fruit; liquidity and profitability have started to rise and the financial deficit to fall. Balance sheets are being strengthened.*

- *Progress against inflation remains good. Productivity is starting to recover and unit wage costs in some sectors are being contained. Competitiveness has improved, both within Europe and more especially in dollar markets as the dollar has risen since the turn of the year.*

Reading the state of the economic cycle is particularly difficult at the present time. There is undeniably a considerable body of evidence that the worst of the recession (defined as a sustained period of falling output) is now past. The uncertainty concerns whether, in aggregate, positive growth has yet resumed. This is difficult to determine because timely indicators of activity are volatile, sometimes subject to revision, and concentrated on a fairly narrow part of the economy (essentially traded goods). Much of the survey and anecdotal evidence also tends to be slanted towards the same sectors.

Manufacturing output *has stabilised, while the oil sector has enabled* **industrial production** *to rise*



Output *in the* **traded goods** *sector has turned up . . .*

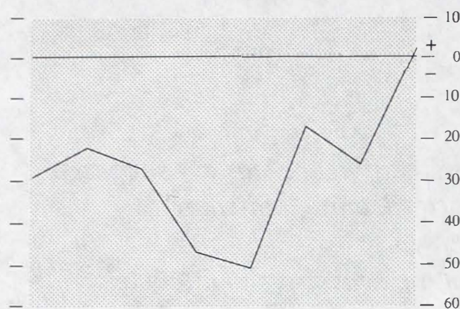
The key short-term (monthly) indicator of output is the index of industrial production. In the three months to August it was 1½% higher than in the previous three months. The index is based on statistical enquiries to manufacturers and to the energy and water supply industries. The former accounts for less than a quarter of gross domestic product and the latter for just over a tenth; the remaining two thirds of output is predominantly in the service industries and there are no monthly output statistics for these.

A number of elements within services, such as public administration, education, health and ownership of dwellings (accounting for over 20% of total output), are relatively impervious to cyclical influences. Others such as transport, communications,

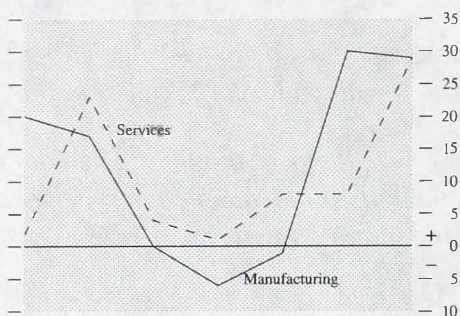
Surveys of business confidence *point unambiguously towards recovery*

Percentage balance of firms

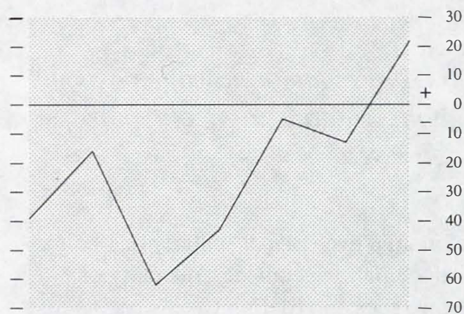
CBI Industrial Trends Survey (a)



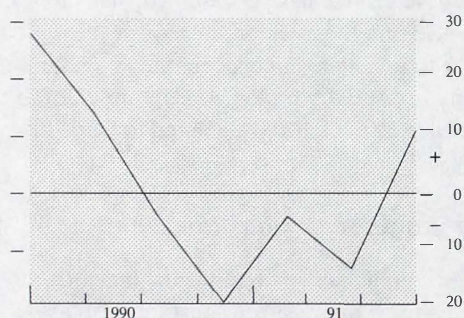
British Chamber of Commerce (b)



CBI/Coopers and Lybrand Deloitte (c)



Dun & Bradstreet (d)



(a) Firms more optimistic than 4 months earlier about the general business situation.
(b) Firms expecting profitability to improve in the next 12 months.
(c) Optimism regarding the overall business situation over the next 3 months.
(d) Firms expecting net sales to improve during the next 3 months.

distribution, hotels and catering (a further 20%) and financial and business services (another 15%), are much more sensitive. These sectors are affected to different degrees, directly and indirectly, by domestic interest rates and external conditions, including the exchange rate.

The profile of output in the energy sector has been dominated recently by fluctuations in the oil industry. These have reflected safety and maintenance work in the North Sea, which depressed output in the second quarter but, on completion, have enabled it to bounce back sufficiently to make it likely that GDP will rise in the third quarter, bringing a technical end to the recession. These movements are erratic, however, and do not provide a good guide to underlying activity, for which non-oil output gives a better measure.

Manufacturing output fell sharply, by 6.6%, between the second quarters of 1990 and 1991. More recently it has flattened out and may even have risen very slightly, though the aggregate statistics are ruffled by activity in the car industry, which was particularly buoyant in July and depressed in August. Prospects are distinctly brighter according to the October CBI survey, which recorded positive balances of firms expecting output and orders to rise for the first time since April 1990.

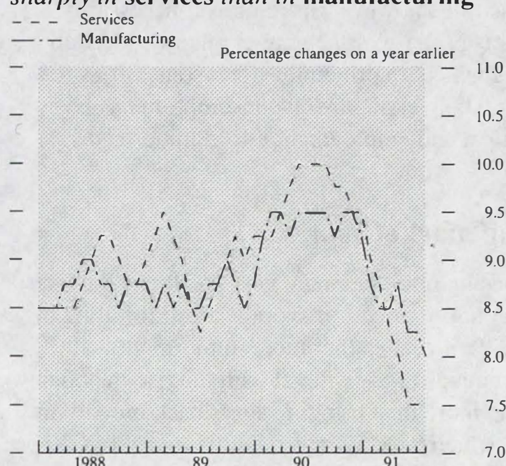
Weakness in domestic final demand for manufactured goods up to the second quarter appears to have been accentuated by an unexpectedly sharp reduction in stocks throughout the economy, amounting to over £4 billion (at 1985 prices, including statistical adjustment) in the last quarter of 1990 and the first half of 1991. The firming of manufacturing output since the summer may indicate that this stock adjustment has now largely run its course. This seems to be supported by CBI surveys showing a fall in the balance of firms with excessive stocks, and by stock-output ratios which have returned to more normal levels. The stock cycle may now be a positive factor for growth. Encouragingly, growth has also been generated by a strong export performance although more recent figures suggest this may have slowed.

. . . while elsewhere the position is less clear

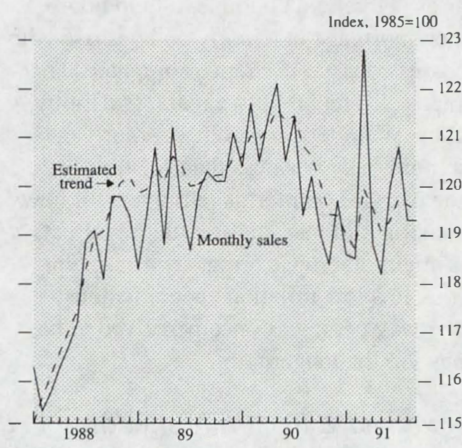
The stock cycle and export sources of demand are far less important, however, in the remaining two thirds of the economy. Here, there is very little recent statistical evidence on which to base a judgement on whether the upturn has yet arrived, or whether services will remain sluggish as the recovery elsewhere gets under way. Business surveys tend to confirm that service sector companies continued to be depressed in the third quarter but are more confident about the fourth: service companies seem less pre-occupied with the exchange rate than manufacturers, but more concerned about availability of finance.

The main monthly labour market statistics do not distinguish between sectors, and there are as yet no service sector employment data for the third quarter. But the behaviour of average earnings suggests that pressure on the service sector is no less, and possibly greater, than on manufacturing. The underlying rate of growth of average earnings in services has come down from 10% in the year to September 1990 to 7½% by August 1991 compared with a fall in the growth of manufacturing underlying earnings from 9½% to 8% in the same period.

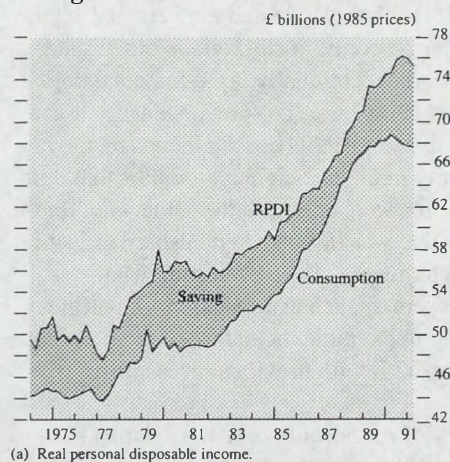
The **growth of earnings** *has moderated: more sharply in* **services** *than in* **manufacturing**



The trend in **retail sales** *may now be starting to rise*



With **RPDI**[(a)] *falling,* **consumption** *is being sustained this year by lower* **saving**



(a) Real personal disposable income.

It is very hard at this stage, therefore, to draw a firm conclusion as to whether the turning point has yet been passed because it could be misleading to assume that the encouraging signs in manufacturing will necessarily be repeated simultaneously across the rest of the non-oil economy. But there is no reason to expect that a return of confidence in manufacturing will not, in due course, filter through to other sectors.

Consumption *remains subdued . . .*

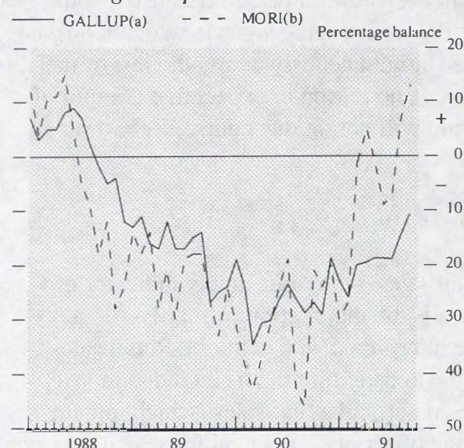
Short-term changes in retail sales—the most timely indicator of consumption (which in turn is the major component of demand)—also need to be interpreted with caution. Retail sales cover only about 40% of the expenditure that is included in consumption and exclude, in particular, car sales (which remain depressed) and a wide range of services, demand for which may not necessarily move closely in line with retail sales.

Retail sales have proved particularly volatile this year, when sales of certain categories of goods seem to have been influenced by particular price opportunities to consumers such as that in March before the VAT increase took effect, and by heavy and extended price discounting in the summer. Some measures of the trend of sales now point to a modest pick-up. But the difficulty of deciding what are exceptional movements and how they should be smoothed means it is hard yet to be sure that the underlying movement is indeed upwards. This is likely to become clear only well after the event.

Looking more generally at influences on consumption, the latest estimates of real personal disposable income (RPDI) show a further fall of nearly 1% in the second quarter. Consumer spending also fell in the second quarter, but only slightly, and by less than in the three previous quarters. Consequently the saving ratio, which has been rising from its low point of 4.1% in early 1988, declined from 10.8% in the first quarter of this year to 10.1% in the second. The counterpart to the fall in the saving ratio appears to have been a slower accumulation of liquid assets, perhaps prompted by slowing inflation, rather than renewed borrowing. If so, the continued success in reducing inflation, and growing confidence that inflation will remain low, should assist directly in the recovery, while allowing the personal sector to make progress in reducing its high level of gearing. Such behaviour, involving less recourse to the banking system for a given level of activity, may help to explain the deceleration in monetary growth.

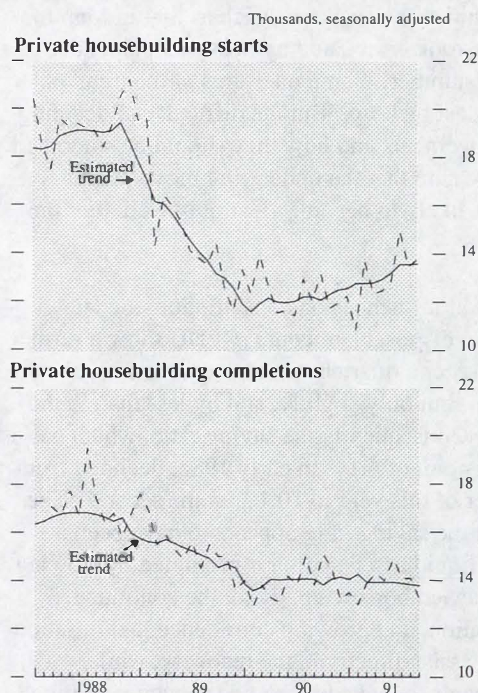
Since the second quarter, RPDI will have reflected the continued deceleration in earnings and a further, though smaller, fall in employment. Other personal income may have fallen further as dividends have been cut, with little (if any) offsetting growth in self-employment income. On the other hand, current grants from government are likely to have increased and the consumers' expenditure deflator used to calculate RPDI should also be showing a smaller rise. On balance, these factors suggest that in the third quarter RPDI may have fallen further. The outcome for consumption therefore will depend on the extent to which the saving ratio also fell further. In this regard, the evidence from monetary statistics continues to point to restrained borrowing and an even slower accumulation of deposits, so on this partial evidence it seems likely that the saving ratio did fall again.

... *and* **consumer confidence** *is continuing to improve*

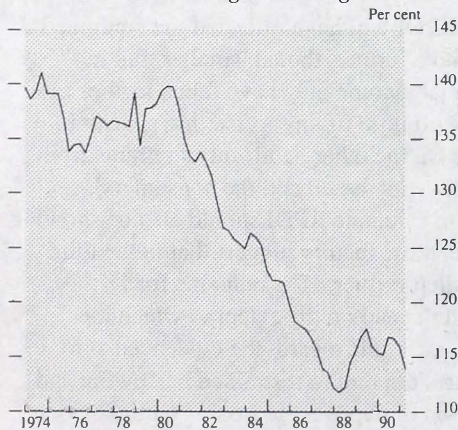


(a) Response to enquiry concerning the general economic condition of the country.
(b) Based upon five questions concerned with households' finance and their assessment of economic conditions.

Housing construction *remains at a low level*



Manufacturers *were slow to adjust* **stock/output ratios** [(a)] *to weakening demand growth in 1988-89*



(a) Ratio of total stocks to quarterly production.

Survey evidence points to a continuing rise in consumer confidence. This largely reflects the falls in interest rates that have occurred earlier this year. Those falls, however, have not yet necessarily been fully felt in pockets because of the annual review procedures for mortgage payments which, in principle, affect some 30%–40% of mortgages. That may help explain why consumption has been slow to respond. Political and employment uncertainties also remain.

... *and the* **housing market** *depressed*

Transactions in the housing market remain very weak and the latest indications suggest that house prices on average are still falling in nominal terms by 2%–3% a year (rather more in the south). Construction activity remains at a low level with the rise in housing starts this year doing no more than bringing starts back broadly in line with completions, which have averaged a little under 14,000 per month since the beginning of 1990.

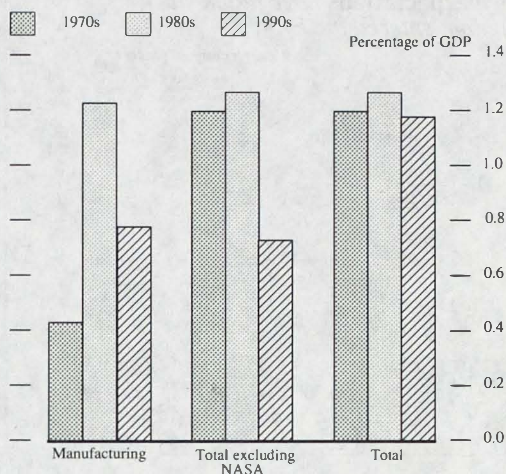
For the reasons set out in the August *Bulletin*, an imbalance between supply and demand for houses is likely to continue to hold house prices in check. As claims on mortgage indemnity policies rise with the growing number of repossessions, so insurance companies are reviewing indemnity premiums. Together with a reassessment by mortgage lenders in the light of their debt experience—mortgage lending is now seen to be a more risky business than previously assumed—this is causing the margins on mortgage finance for new borrowers to widen and countering, in part, the stimulating effects that the fall in interest rates might otherwise bring. To the extent that house buyers also see that in a low inflation economy house purchase is no longer the one-way bet it was once perceived to be, this too could dampen demand in the longer term.

Companies *have now succeeded in cutting* **spending** ...

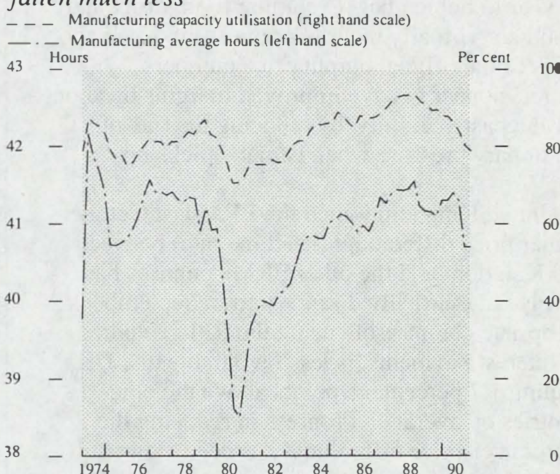
Adjustment by the personal sector to policy tightening, and the restoration of saving ratios more in line with the historical average, was comparatively swift. Debt levels, however, remain high and will take longer to correct, if that is indeed what the personal sector as a whole would prefer. The corporate sector, on the other hand, was much slower to adjust, and exceptionally large financial deficits have been a feature of the last 2½ years. To some extent, pressure was taken off companies until early 1990 because the exchange rate weakened and it has been only in the last eighteen months that both domestic and external pressures were acting in the same way. In the second quarter of this year there was, as expected, a sharp reduction in the financial deficit though this may have been somewhat accentuated by exceptional factors (such as repayment of petroleum revenue tax). It is interesting to examine the nature of the corporate adjustment process and compare it with previous recessions.

A year ago, as the possibility of recession loomed, it seemed likely to be much less severe than in 1980–81 for three reasons. First, world trade seemed likely to hold up better than last time—as it has; second, UK competitiveness had not deteriorated to anything like the extent that occurred in 1980, especially with our European trading partners; third, the stock cycle did not seem likely to drive the economy further into recession as had happened in 1981. The third of these reasons does not seem to have been borne out by events. Even though stock-output ratios fell throughout most of the 1980s as greater security of supply was established and new

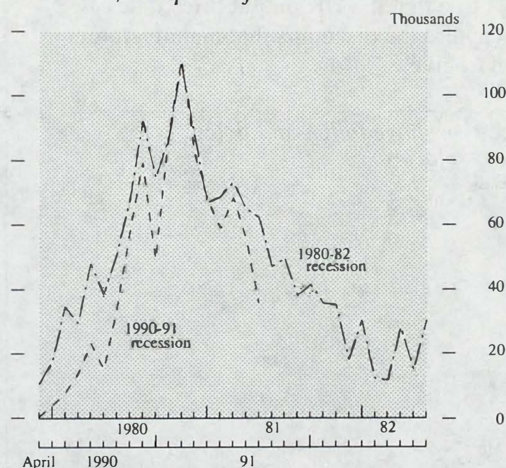
In relation to GDP, **destocking** *appears to have been as extensive as in previous recessions*



Capacity utilisation *remains above the 1976 and 1981 levels, while* **average hours worked** *have fallen much less*



The profile of **unemployment rises** *suggests a shorter, sharper adjustment this time*



methods of stock control and production management were introduced, it appears that stock levels were still high enough for cutting stocks to be a quick and effective way to cut costs. It may be that companies were slow to adjust output and ordering to the slowdown in demand from 1988—the stock/output ratio rose in the second half of 1988 and the first half of 1989—so that when reductions were made they were unexpectedly sharp. Another difficulty in understanding what has been happening, however, is that over a third of the stock reduction has not been explicitly identified but represents the national accounts statistical adjustment (NASA) which could in principle reflect errors in other parts of the accounts. However, taken at face value, the amount of destocking this time, as a percentage of GDP, has been comparable to the two previous recessions—just over 1.2% in 1980–82 compared with just under 1.2% in 1975–76 and so far this time.

Fixed investment by ICCs increased strongly in the second half of the 1980s. The rate of fall recently—in the second quarter it was nearly 12% lower (in current prices) than a year earlier—has been comparable to 1980 (and more than in 1975) but this decline has not lasted as long and was from a much higher base. The level of investment, therefore, remains historically high. There are substantial sectoral variations: investment (in constant prices) by the energy and water industries has risen by 23% in the year to the second quarter; that by manufacturing fell by 19% and investment in services fell by 16%.

Although ICCs have cut output, their capacity utilisation does not appear to have fallen as low as in 1976 or 1981. This may be because through much of the 1980s, with fewer disputes and greater security of supplies, they managed to achieve high utilisation rates—perhaps in 1988 above what was sustainable without adding to inflationary pressure—and therefore had a higher starting position. Much more striking is that the average numbers of hours worked per operative in manufacturing has fallen much less than in 1980. This suggests that firms have been readier this time to reduce costs by shedding labour, and the behaviour of unemployment seems consistent with this shorter and sharper adjustment scenario.

. . . and improving their **financial position**

Profitability has fallen, but to nowhere near the depths that it reached in either 1975–76 or 1981. Indeed, excluding North Sea companies, profitability in the second quarter was above the average for the last twenty years. Companies having reduced costs, their profitability started to rise again in the second quarter and this has been reflected in improved business confidence and a sense that growing numbers of companies are beginning to see their way through the recession.

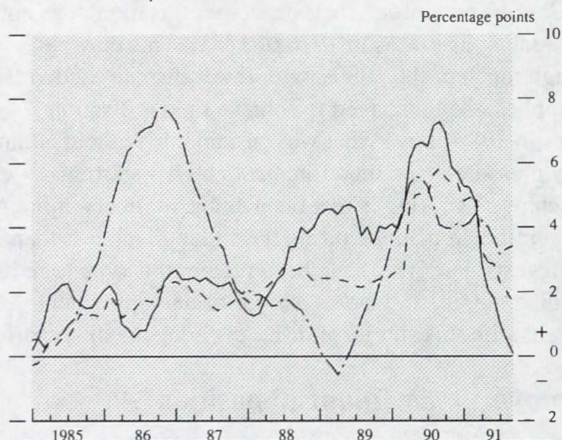
In terms of their cash flow, companies have fared no better this time—perhaps slightly worse—than in either 1974–76 or 1981. This is because a heavy reliance on debt in the late 1980s, particularly bank finance connected with acquisitions and mergers, raised income gearing and exposure to high interest rates, and these high rates needed to be held for longer this time. In addition, companies have sought to maintain, even increase, dividend payments in order to sustain their share prices, possibly through fear of further hostile takeovers. Tax payments, which lag behind profits, have also continued to be a drain on cash flow; although

Recent UK inflation experience

The headline rate of UK retail price inflation has fallen by almost seven percentage points since its peak last October. Almost half of the improvement is due to lower mortgage interest payments; but excluding mortgage interest payments, inflation has still fallen by almost 4 percentage points. Falls in petrol prices have also helped.

An improving inflation performance has rapidly fed into expectations and pay bargaining. In the monthly Gallup survey, the percentage of consumers expecting inflation to fall in the next 12 months jumped sharply in March and has remained high since. The more broadly-based 'Basix' survey by Barclays Bank (which includes price expectations of several groups including the general public, analysts and trades unions) shows average one-year-ahead price expectations falling steadily since ERM entry. However, two-year-ahead price expectations rose above the one-year expectation for the first time in three years in the June survey. This may suggest that some part of the progress towards lower inflation is seen as cyclical.

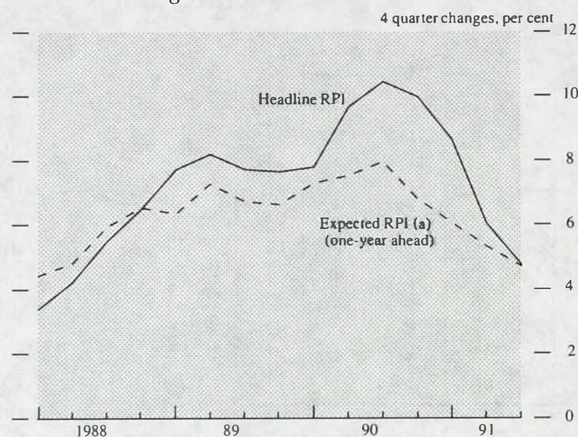
Price differentials *between the United Kingdom and other ERM countries have narrowed*



The labour market has adjusted to lower inflation, although rising unemployment has also been a factor. The IRS measure of whole-economy settlements fell to 6.4% in September, from a peak of 9.7% in December 1990. In manufacturing, the CBI (provisional) measure shows settlements down to 5½% in the third quarter. Lower settlements have been accompanied by continued weakness in the cyclical elements in pay, so growth in underlying average earnings fell steadily in the first half of 1991.

Weakening retail price inflation is being underpinned by the containment of producer prices. Excluding the food, drink and tobacco industries, manufacturers' output prices rose by 4.7% in the year to September, compared with 6.5% at the start of the year. There are some grounds for thinking that the underlying position may be better still because the CBI industrial trends survey has

Consumer price expectations *have fallen since the United Kingdom entered the ERM*

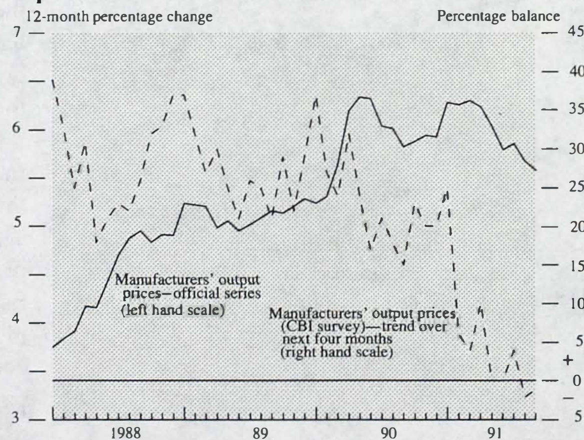


(a) Source: Barclays Economic Review.

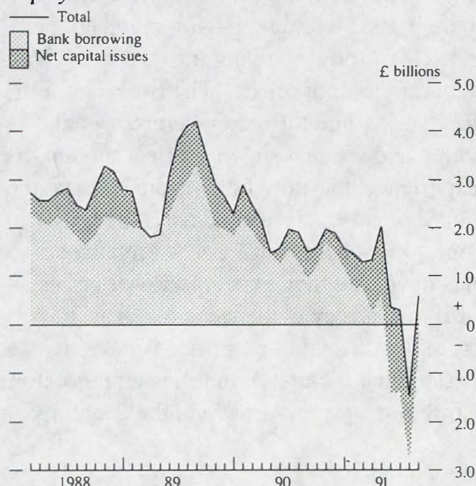
been reporting as many firms expecting to lower prices as to raise them since last May. Input prices have fallen by 5% in the year to September (excluding food, drink and tobacco) and are virtually the same now as six years ago. On the basis of the official output price numbers, manufacturers appear to have improved margins by about 2½% over the past year, thereby reducing the risk of latent inflationary pressure when demand picks up.

Since the United Kingdom joined the ERM last October, the consumer price differential (headline rate) between the United Kingdom and the other ERM countries has fallen sharply, and virtually disappeared in September. A more appropriate comparison, using the RPI excluding mortgage interest payments, is less favourable, the UK rate remaining 1.7 percentage points above the other ERM countries on average. Progress in reducing the headline producer-price differential has been slower. It currently stands at 3½ percentage points—down by around ½ a percentage point between October 1990 and September 1991—but this may understate the progress somewhat if it is true that the UK output price index is failing fully to capture the discounts that manufacturers are being forced to give.

Producer price rises *have fallen and* **price expectations** *even more so*



ICCs' borrowing[(a)] *has fallen this year and heavy* **capital issues** *have allowed them to repay* **banks**



(a) Three-month moving average of estimated M4 lending to ICCs, plus net sterling capital issues by ICCs.

they fell sharply in the second quarter this was mainly the result of a distortion to the flow of PRT payments.

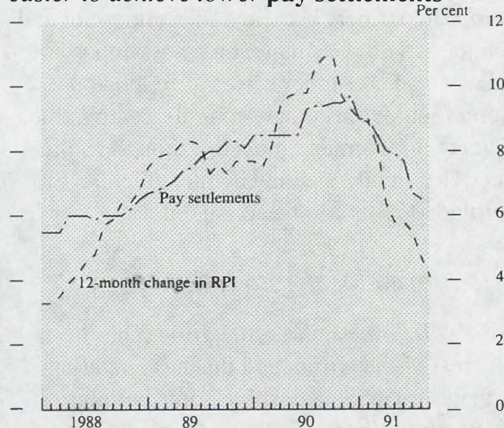
In the second quarter much of this changed and a dramatic reduction was made in the corporate sector's financial deficit. A firm equity market—perhaps partly a reflection of previous dividend policies—allowed companies to issue nearly £6 billion of new capital, particularly rights issues, and they used this to repay banks, increase liquidity and generally to strengthen balance sheets and reduce gearing. Issues have continued at a fairly high rate into the third quarter (though not as strongly as in the second) and there has been a modest net repayment of bank borrowing. On the other hand, bank deposits were reduced in the third quarter. This suggests that a lower corporate sector deficit has been broadly maintained (though exceptional factors may no longer be helping) and that the adjustment companies have undertaken will be lasting.

There is reason to think, therefore, that on both the personal and corporate sides the sharp slowdown in monetary growth reflects a correction of balance sheet distortions of the past, ie a clawing back of past excess rather than a portent of depressed real activity in the future. The crucial question, however, is how banks and the capital markets will respond to the need for working and investment capital in the upturn. Were they to feel that their fingers had been badly burnt there could be a risk that they would become extremely cautious about lending. On the other hand, the success that companies now seem to be having in improving margins and profitability, and in reducing interest and dividend payments, suggests more scope for internally financed investment. For smaller companies, another potential source of finance for working capital could be factoring.

Good progress continues on reducing **inflation . . .**

The recent behaviour of monetary growth, particularly M0, which grew by only 2¼% in the year to September, is consistent with the fall in retail price inflation. The rate of growth of the RPI in the twelve months to September was 4.1%. This is little different from the EC average rate, although a more comparable UK figure would be that excluding mortgage interest payments which, at 5.7% in September, is still somewhat higher. Progress in reducing the headline rate is expected to pause as events lowering the rate last autumn and earlier this year, such as mortgage interest cuts and reversal of the rise in petrol prices, progressively drop out of the twelve-month comparison. Nevertheless, subdued input prices and labour costs continue to indicate easing of underlying inflationary pressure.

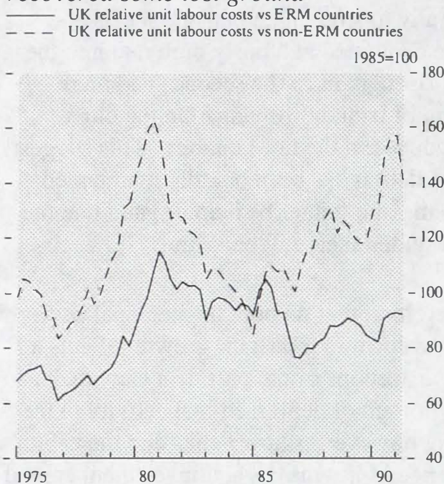
Falls in **headline RPI inflation** *have made it easier to achieve lower* **pay settlements**[(a)]



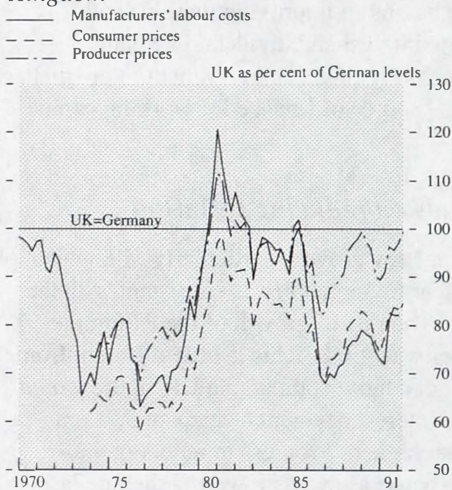
(a) Industrial Relations Service measure of median settlement.

Falls in the RPI headline rate have made it easier for employers to achieve moderate pay settlements which are essential to preserve competitiveness and jobs (see the note on page 474). In manufacturing, where the sharp falls in output last year and early this year led to falls in productivity and a doubling of unit wage cost growth from around 6% to 12% per annum, cost inflation has now been reined back. And as output begins to pick up, the ground is set for a resumption of the rates of productivity growth achieved in the 1980s. To the extent that the recession has also reduced manning levels in parts of the service sector that grew rapidly in the late 1980s, productivity may start to rise there too as demand strengthens.

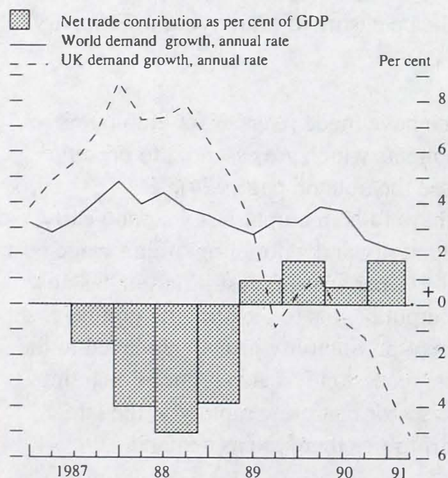
Competitiveness *in ERM markets has remained at about average for the 1980s, and elsewhere recovered some lost ground*



Competitiveness levels compared with Germany *continue to favour the United Kingdom*



Net trade *contributed to GDP growth as* **UK demand** *growth fell below* **world growth**



Cost structures now appear under better control. Evidence for this is the rising profitability mentioned earlier and the restoration of margins that has given rise to it. At the same time, with world demand growing well within capacity, commodity prices have remained subdued and input prices to manufacturers are currently only 2%–3% higher than their 1985 average, having reversed the rise that occurred in 1989. This is now showing through in a falling rate of growth of manufacturers' output prices. The twelve-month growth rate (excluding food, drink and tobacco where seasonal distortions can occur), which had seemed slow to reflect the reports of manufacturers' own experience, has now fallen from 6.5% at the start of the year to 4.7% in September. Evidence from the CBI survey is even more encouraging where, since April, on balance about as many respondents have said they expect to lower prices as expect to raise them. But if this survey evidence is taken as indicating continuing bias in the official output price figures, it would imply a rather less sanguine picture on margins and therefore rather more potential for inflationary pressure when the economy does recover.

. . . *and* **competitiveness** *has improved . . .*

The improvement in unit costs has helped correct a corresponding earlier deterioration in UK cost competitiveness. The strengthening of the dollar during the first half of this year has also been particularly helpful, giving a 10% improvement in cost competitiveness this year against non-ERM countries. Within the ERM there has been a smaller improvement.

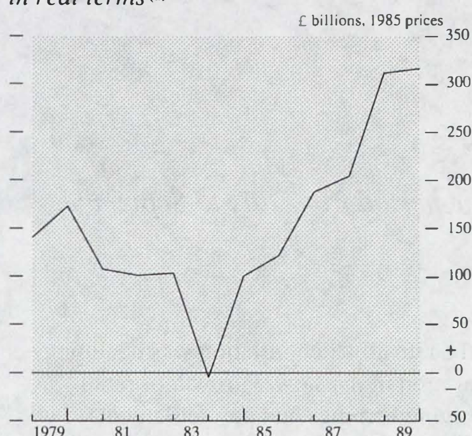
Export price competitiveness has also improved markedly, by 4½% in the second quarter, again largely a reflection of the dollar's recovery. This has enabled exporters to increase their margins, which had fallen sharply in 1990. The rise in the dollar has also increased import prices and made it easier for UK companies to compete in the home market.

In the context of ERM membership, levels of prices and costs relative to our main European partners become more important and the chart shows that compared with Germany, our most important trading partner, labour costs and consumer prices are each about 15% lower. Manufacturers' output prices are roughly comparable, suggesting greater efficiency of Germany industry, though cyclical improvements in productivity should enable UK manufacturers to recover an advantage provided costs can be contained.

. . . *allowing* **trade** *to move closer into balance*

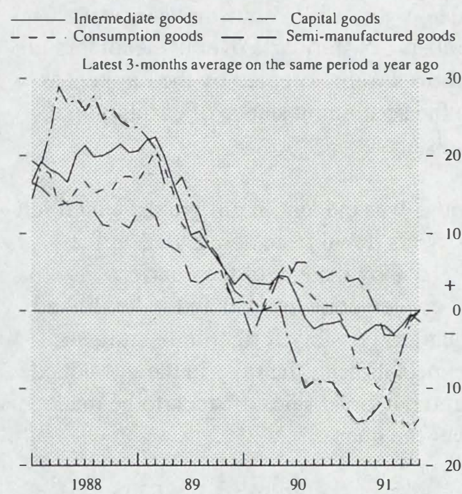
Since the second half of 1989, domestic demand growth has been lower than growth in the rest of the world and this has encouraged exports. Net trade has therefore made a positive contribution to growth over the past two years. UK manufactured exports have grown strongly with virtually all the rise in the last year going to Europe. Germany has provided much the strongest market, demand there being buoyed up by unification. Cars, chemicals and capital goods have been the areas of greatest success. This market may now have passed its peak and it will be important for UK exporters to look for new opportunities elsewhere. With the US economy starting to recover from recession and the improvement in UK competitiveness in dollar markets noted above, North America should be an area of opportunity.

Inward direct investment *has risen sharply in real terms*[a]



(a) Using deflator for gross domestic fixed capital formation.

Consumer goods have not caused recent increases in **import volumes**



The 1980s saw a reversal of the downward trend in the UK share of world manufacturing trade that dominated in the 1970s. A substantial part of the major loss of price competitiveness that occurred between 1978 and 1981 has been recovered while trade performance has also been influenced by non-price factors. These may include improvements in the quality and reliability of UK products and reflect the substantial restructuring of British industry that has taken place in the 1980s; also the influence of foreign direct investment which has improved the quality of the capital stock and management.

As manufacturing output has started to firm, import volumes have stopped falling and may now have started to grow again. In the three months to September the recent increase seems to have been concentrated in semi-finished goods and capital goods, rather than in consumer goods. This is consistent with the view that inventories are no longer being reduced significantly and that consumption growth is not at this stage the main engine of recovery.

The **public sector** *moves further into financial deficit*

Overall, then, the rate of improvement in the current account could now start to slow. With personal sector savings also now stabilising, the main counterpart to an improving corporate sector financial balance would appear to be a deterioration in the public sector financial position.

In the Autumn Statement the PSBR for the current financial year is estimated to be £10.5 billion, equivalent to 1¾% of GDP. This represents a £2.6 billion increase from the estimate made at the time of the Budget, notwithstanding a £2.5 billion upward revision to planned privatisation receipts. Within this total, central government receipts are now expected to be £1.1 billion lower than projected in the *Financial Statement* at Budget time (FSBR), while general government expenditure (before privatisation receipts) is forecast to be £3.8 billion higher. The increase in expenditure is considered primarily to reflect the impact of the economic cycle. The plans also reflect the new balance between local and central funding of local authority current spending announced in the Budget.

For 1992/93 the expenditure planning total, at £226.6 billion, has been revised up by £5.6 billion compared with that set in the FSBR and reflects increased planned spending particularly in areas of social security, health and transport.