The domestic economy

- *The expected recovery is proving elusive. Conditions abroad—both real and financial—have turned out less favourably than expected, while confidence at home, particularly among consumers, has weakened.*

- *The CSO's composite leading indicators continue to rise, suggesting that the conditions that in the past have accompanied recovery are in place.*

- *Real incomes and consumption remain essentially flat. The latter may still be adjusting to the past excesses of a debt-financed consumption boom. Over a longer perspective, consumption growth has averaged 3½% per annum since 1985, compared with an average of about 2½% per annum over the previous 30 years.*

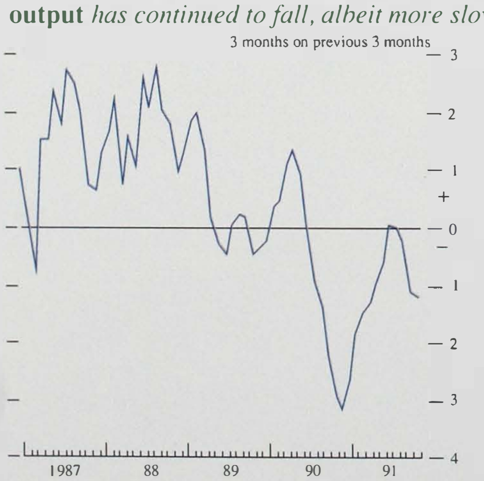
- *Corporate profitability and financial adjustment seem to have been sustained; and manufacturers appear to be intending to increase investment slightly in 1992.*

- *The recession has considerably narrowed regional disparities in unemployment and house prices. This may assist labour mobility and hence the balance and durability of the recovery when it comes.*

- *In manufacturing, progress has been maintained in reducing the growth of unit costs, and output price inflation continues to fall. Outside the traded goods sector, where the ERM discipline does not so directly impinge, reductions in inflation have been much more sluggish and this has slowed the underlying fall in retail price inflation.*

- *Monetary growth is subdued, as lenders and borrowers adopt a more cautious approach in the light of rising bad debt experiences.*

After stabilising last summer, **manufacturing output** *has continued to fall, albeit more slowly*

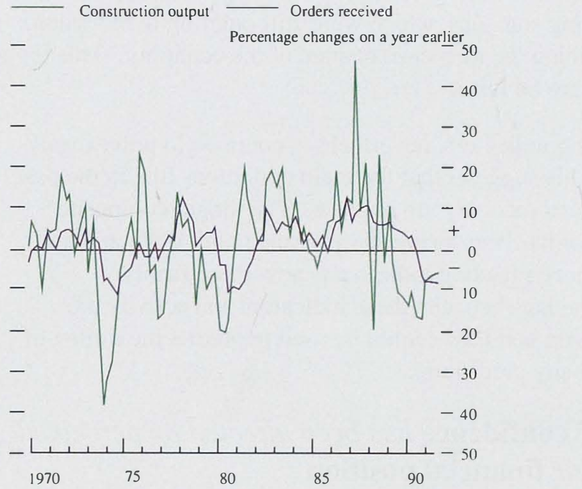


The economy *was weaker than expected in the second half of 1991 . . .*

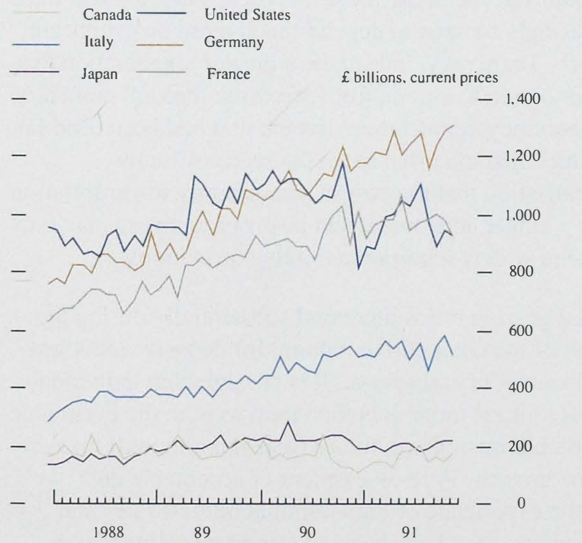
The slight rise in GDP in the third quarter came about because North Sea oil production recovered sharply, having been particularly depressed by essential safety and maintenance work in the previous quarter. As part of the product of the economy, oil output should not be disregarded; but its liability recently to erratic movements can obscure the underlying trend in aggregate activity. It may be more helpful, therefore, to look at non-oil output, which fell in the third quarter for the fifth consecutive quarter. This is as long a period of continuously falling output as on any previous occasion since the War, although the fall in total is smaller than in 1980–81 (when total GDP fell by 5%, compared with a 3½% fall in non-oil GDP until now).

From the second quarter, the fall in non-oil GDP has moderated. Manufacturing output has continued to decline, after appearing to stabilise in the summer, but also more slowly. The recession has affected different sectors of the economy at different times. For

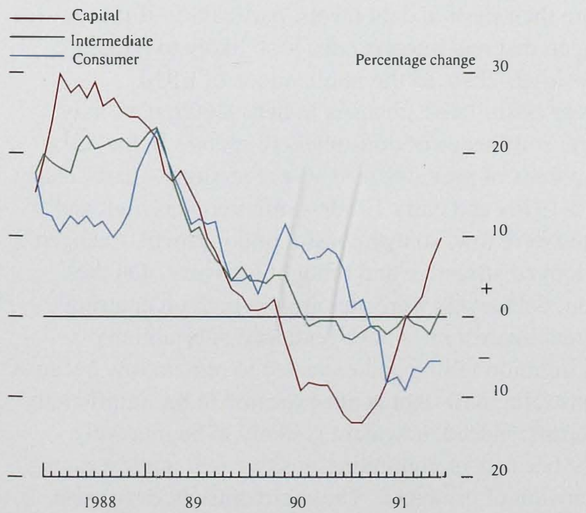
As in previous recessions, the **construction industry** *has suffered a sharp drop in* **orders and output**



UK exports *have performed well in the major European markets; but less well in the United States*



Much of the growth in **import volumes of finished manufactured goods** *has been in capital items*



example, in the vehicles industry, activity was sustained until mid-summer by strong export demand; but with the weakening in overseas economies, particularly Germany, this industry too is now feeling the recession more strongly. Service sector output appears to have stabilised in the third quarter, mainly because of the passing of specific factors that had earlier depressed the path of output in the distribution, hotel and catering industries such as the rise in VAT which had affected retail sales, and the effect of the Gulf War on tourism. This firming also is likely to prove something of a false dawn, although the underlying downward trend does appear to be flattening. Construction output, however, continues to be weak, and has fallen by over 12% since the first quarter of 1990. (The construction industry has tended historically to suffer particularly large cyclical variations: in both 1980–81 and 1973–74 output fell by some $17^1/_2$%.)

... due to an unexpectedly sharp slowdown abroad *...*

Although the fall in non-oil output may have moderated during 1991, the outturn is likely to be considerably lower than seemed likely a year ago. At that time, the majority of forecasters were expecting to see a clear upturn in the second half which does not now seem likely.

Two things have changed since then. First, activity in the other major economies of the world has been more subdued than expected. The US recovery has faltered, Japanese growth has decelerated rather faster, and the European economies, especially Germany, have also slowed. (This weakness in the major economies is, nevertheless, considerably less than occurred in the mid-1970s and early 1980s.)

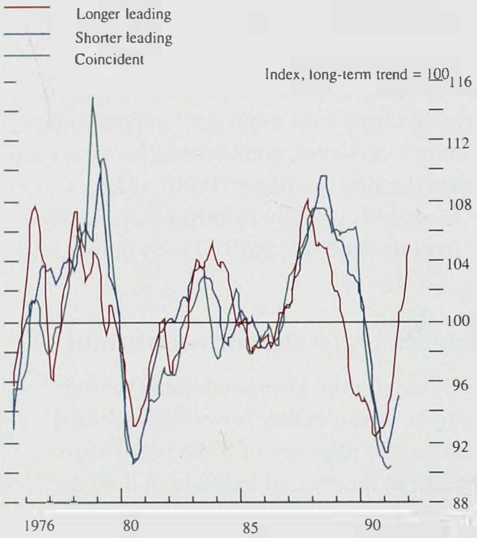
Because of this, the strong performance of UK exports, which had helped earlier to sustain production despite weak domestic demand, paused in the second half of 1991. UK competitiveness has been broadly maintained in markets of ERM members, but in other—primarily dollar—markets there has been a deterioration, largely reflecting exchange rate movements. UK net trade should still be benefiting, if less than before, from the relative cyclical position, although this has not been enough to offset the effects of the depreciation of the dollar and exports to the United States have fallen in recent months. Net trade may now therefore have ceased to be an important stimulus to growth and, indeed, was somewhat depressing in the third quarter, although an improvement in the fourth reduced the visible balance for 1991 to £10 billion and the current balance to under £6 billion. Markets abroad have remained very competitive and UK export prices have had to be kept steady, so exporters have generally had little scope to increase their margins.

The growth in import volumes has been rather more surprising, given conditions in UK markets. Much of the growth appears to have been in capital goods, and may therefore reflect the specialised nature of certain investment goods which are not produced in this country; imports of chemicals have also been strong reflecting a somewhat counter-cyclical pattern in production in this industry where output has grown by some $8^1/_2$% in the last year.

... and a drop in confidence at home

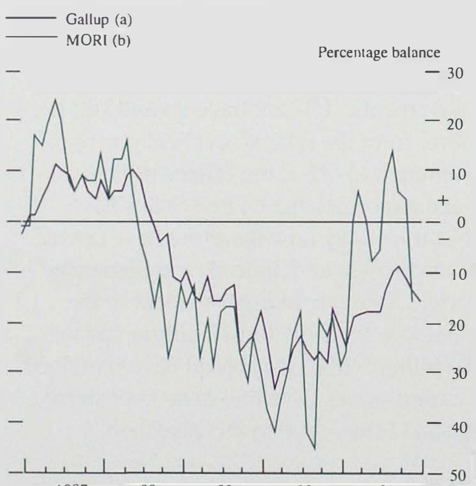
The second, and perhaps more significant deterioration, has been in domestic confidence—of both consumers and businesses—but with

Composite leading indicators[a] *point firmly to an upturn*



(a) The longer leading index has been advanced by 10 months and the shorter leading index by 4 months. This allows a comparison, based on past experience, of whether the indices are in step.

Consumer confidence *has suffered a set-back*



(a) Based upon five questions concerned with households' finance and their assessment of economic conditions.

(b) Response to enquiry concerning the general economic condition of the country.

somewhat distinct causes. In the first half of 1991, indicators of both of these were rising, as were the composite leading indicators compiled by the CSO. These statistics encouraged the hope that the backward-looking statistics, which were still pointing to recession, were not describing the then current state of the economy. This hope turned out to be false.

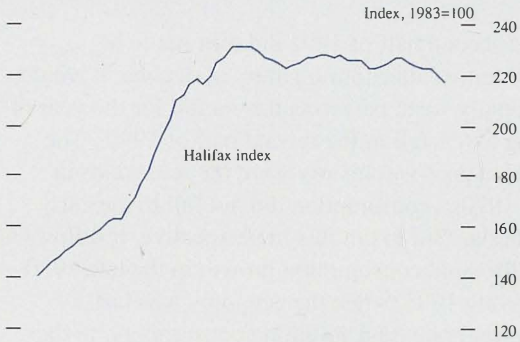
The CSO leading indicators, nevertheless, continue to point firmly to an upturn. This suggests that the main conditions that in the past have accompanied recovery are in place. The longer composite leading indicator has been rising sharply since mid-1990, and an upturn in the shorter leading indicator is now more firmly established. The lags between these indicators and activity are variable, however, and they cannot be used to predict the timing of the upturn with any precision.

Consumers' confidence *has been affected by perceived threats to their* financial position . . .

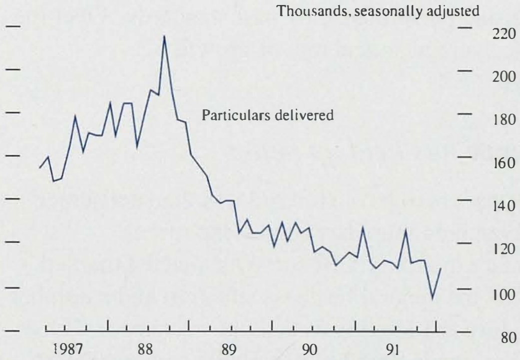
Four factors could have been affecting consumer confidence. First, with UK interest rates now close to those in Germany and other narrow band countries, the ERM constraint means that interest rates may now increasingly be seen to depend much more on events and decisions abroad. There may, indeed, be a greater appreciation that it is no longer an option to escape from recession through monetary expansion and currency depreciation, a route that had been used in the past (and which had too often sown the seeds of future inflation). A realisation that the cost of permanently lower inflation may need to be a longer adjustment and a slower recovery may only recently have been widely incorporated into expectations.

Second, personal gearing ratios increased substantially during the 1980s as a result of the competitive bidding for deposits and loans that followed financial liberalisation. It is possible that individuals over-reacted and took on more debt than they were in the event able to manage—possibly misjudging future (real and nominal) interest rates and income growth. A re-assessment of acceptable debt levels, against the experience of high nominal interest rates and rising unemployment, may have been an important influence on spending and saving decisions since 1989, when the saving ratio started to rise. Lower inflation expectations may also affect the nominal debt service burden that individuals are prepared to take on, and therefore their desired debt levels, particularly if those expectations mean that real interest rates look likely to remain substantially positive. If so, as the implications of ERM membership were assimilated, changes in debt preferences may have affected the confidence of consumers to spend. In the corresponding phases of previous post-war recessions—particularly those in the mid-1970s and early 1980s—inflation was high and real interest rates were low, so that consumption growth, financed by borrowing, looked attractive and brought recovery. On the present occasion, debt levels were abnormally high on entering recession, and real interest rates have remained substantially positive. With inflation falling and expected to remain low because of the ERM constraint, new debt is not expected to be significantly eroded in real terms; indeed, new debt is likely to be relatively costly to service because of continuing positive real interest rates and little real erosion of principal. These circumstances suggest that consumers may be less ready than in the past to borrow to finance growth in spending. Indeed, they could seek to repay debt, in which case consumption could remain depressed for some time.

The **housing market** *shows no sign of revival, with weakness continuing in* **house prices** *. . .*



. . . and **turnover**



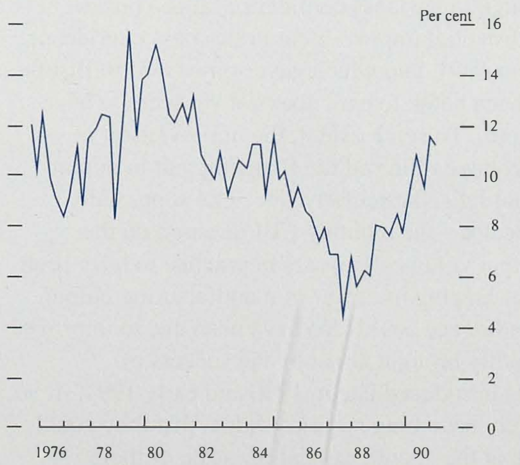
The third factor affecting consumer confidence, and associated with debt adjustment, is weakness in the housing market. The imbalance between supply and demand, brought about by new house construction and repossessions together exceeding net new purchases (and the failure of prices to adjust fully), may have increased. Repossessions, in particular, have risen sharply. The building societies have taken steps to address the problem of a supply overhang, which risked driving down house prices and further impairing the lenders' security, by keeping a significant number of houses where large mortgage arrears have built up from coming to the market. But the publicity that has attended the repossessions issue may have adversely affected confidence. The Chancellor's announcement in December, that stamp duty would be temporarily suspended on house purchases below £250,000, should assist turnover in the market, which would bring with it some associated consumption.

Finally, consumer confidence will have been affected by electoral uncertainty, and the associated uncertainty concerning future taxation—both the overall level of personal taxation and benefits, and its distribution.

... and **consumption** *is likely to be flat in the second half of 1991, after falling for a year*

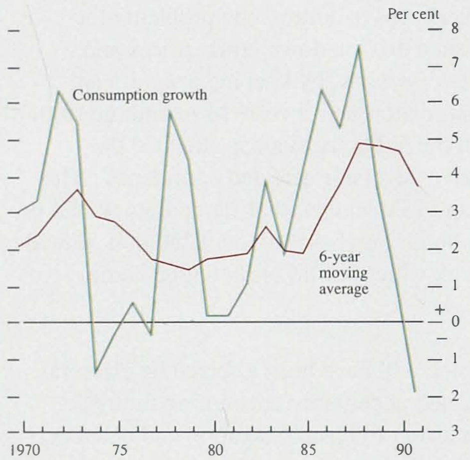
Consumption is also influenced by personal incomes, and saving decisions. Since mid-1990, total income from employment in real terms has been flat or falling. Underlying average earnings were growing at an annual rate of 7¾% in the third quarter of last year (and slightly less in the fourth); but continued rises in unemployment, albeit at a slower rate than earlier last year, have reduced growth in total wages and salaries over the year to the third quarter to 4.1%—about the same as the headline RPI, and rather less than underlying measures of inflation. At the same time, much stronger growth in transfer payments from central government, reflecting rising unemployment, has been offset by the weakness of other personal income (particularly self-employment income).

It is not clear that the upward trend in the **personal savings ratio** *has yet turned*



With real personal disposable income at best flat, a rise in the volume of consumption will require a fall in the saving ratio. Revisions to statistics for the first half of 1991 have cast doubt on the earlier assessment that the saving ratio may have started to turn down at the start of last year. Although in the third quarter the saving ratio did fall slightly, it is not now clear that the upward trend, which started in 1988, has yet turned. Indeed, it is unlikely that such a reversal will happen until there is a clear and sustained improvement in consumer confidence. Identified financial transactions of the personal sector tend to support this view: personal sector deposits rose sharply again in the fourth quarter, while consumer credit has been growing by less than 2% per annum in nominal terms during 1991. Mortgage lending also continues to slow; but its growth rate of some 10% per annum still seems high in relation to current levels of confidence and activity in the housing market, although this may to some extent reflect the accumulation of arrears on existing debt.

The direct evidence on consumption suggests that the essentially flat position in the third quarter will continue into the fourth. Retail sales, for example, were slightly weaker in the fourth quarter than in the third, while car sales were clearly lower; on the other hand, *The recent fall in* **consumption** *should be seen in the context of earlier strong and substantial* **growth**



some upturn might be expected in energy consumption in the fourth quarter.

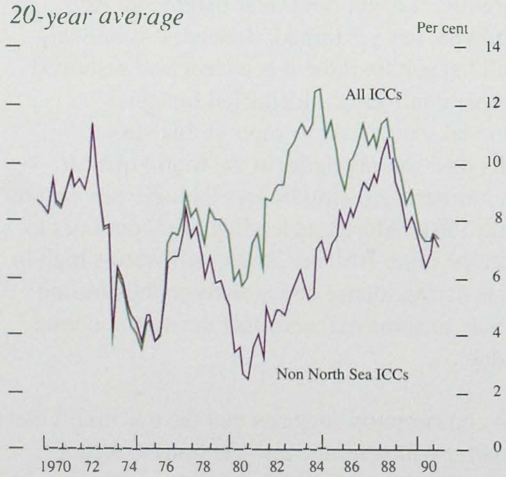
If consumption in the second half of 1991 did turn out to be essentially flat in real terms, after four quarters of decline, it would represent an exceptionally weak performance—a fall for the year of around 2%, following a $^3/_4$% fall in the second half of 1990. The only comparable falls in post-war history were the recessions in 1951 and in the mid-1970s; consumption did not fall in the early 1980s on an annual basis. But to put this in perspective, it follows a period of exceptionally rapid consumption growth in the late 1980s. In the six years following 1985, when the economy was last growing at a more normal rate (and assuming consumption in the second half of 1991 is flat), the average rate of growth has been $3^1/_2$% per annum, a strong performance by past standards. Over the previous 30 years, the average annual rate of growth of consumption had been $2^1/_2$%.

Business confidence *has held up better . . .*

Business confidence appears to have suffered less than consumer confidence, though even here there has been some recent weakening. The January quarterly CBI survey showed a marked drop in optimism about the general business situation and a number of the survey's other forward-looking indicators weakened. These survey results, however, are inclined to be volatile and, even with the falls, the overall picture is one of some improvement on six months earlier, and a substantial improvement on a year earlier. In retrospect, the October survey may have been over-optimistic, heralding a false down; but the underlying improvement in sentiment that took place earlier in 1991 has broadly been maintained. This is broadly borne out in other business surveys.

The slowdown in world activity will have affected exporters' prospects; nevertheless, the CBI monthly survey has shown that the balance of firms with below normal export orders, which was tending to rise in the first half of last year, fell slightly in the second. The more recent deterioration in consumer confidence may not yet have fed through to business confidence. It is a puzzle, however, why the substantial improvement in business confidence that occurred earlier in 1991, and which gave some comfort that the recession may have been about to end, does not yet seem to have resulted in rising output. To some extent, the improvement in sentiment may simply have reflected the flattening out in output after earlier substantial falls, particularly since one supposedly forward-looking indicator—the monthly CBI question on the expected trend in output volume—appears in practice to have been a contemporaneous or lagging indicator of manufacturing output. Stronger business confidence could also have been due to improved profitability and liquidity brought about by the success of cost-cutting measures introduced late in 1990 and early 1991. If so, businesses were merely becoming more confident that they could survive, rather than that they could expand the scale of their activities.

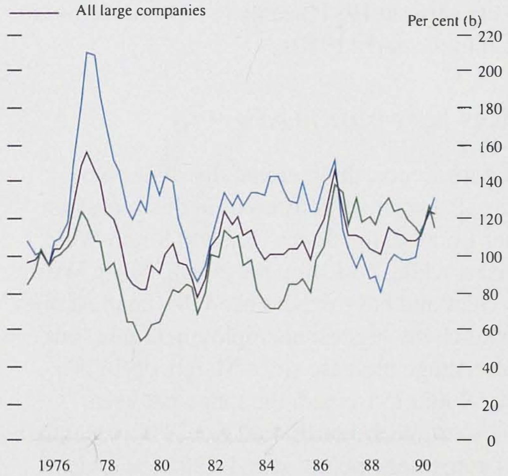
Despite falling sharply since 1988, **profitability**[(a)] **of non North Sea ICCs** *remains near its 20-year average*



(a) Pre-tax real rate of return.

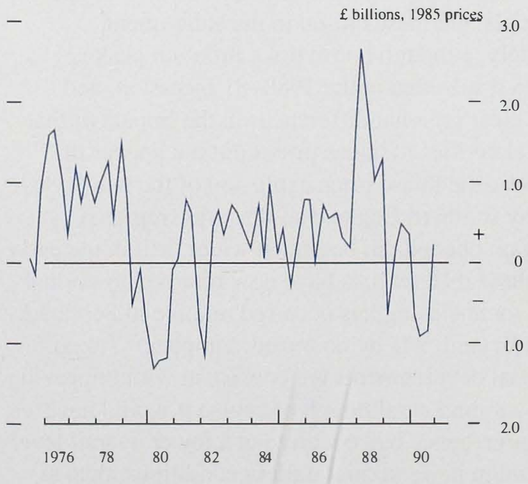
Profitability of (non North Sea) industrial and commercial companies fell very slightly in the third quarter of 1991, but remains above the trough at the end of 1990 and close to the average of the last 20 years. Total distributions of income rose slightly in the third quarter, but remained comfortably below the

Liquidity[(a)] *of large manufacturing companies has been broadly maintained; non-manufacturing companies have improved their liquidity*



(a) Seasonally adjusted.
(b) Total current assets as a percentage of total current liabilities.

The **stock cycle**[(a)] *may now have ceased being a source of weakness in aggregate demand*



(a) The chart shows stockbuilding excluding the national accounts statistical adjustment.

average for 1990. Within the total, however, UK tax payments fell further, as did interest payments. Ordinary share dividends appear to have remained high (there is some uncertainty, however, about appropriate seasonal adjustments for individual quarters).

. . . as the correction to **companies' financial position** *has continued*

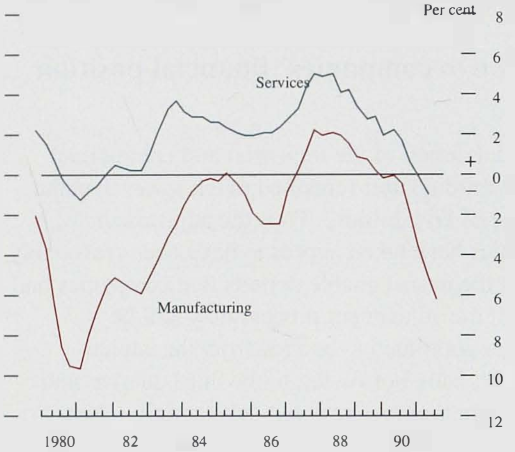
As a result, the financial deficit of the industrial and commercial company sector in the third quarter remained much lower than the 1990 quarterly average of £6½ billion. Thus the adjustment measures that companies have taken appear to have been reasonably successful in reducing the unsustainable deficits that companies had been running, although the adjustment process may still be continuing. Companies continued to borrow from the capital markets but again repaid bank borrowing in the third quarter, and their total borrowing from these sources fell substantially. Not surprisingly, therefore, the survey of liquidity of large companies shows that this fell slightly in the third quarter. The fall was concentrated entirely among manufacturing companies, and probably also reflects fluctuations in stocks which had fallen sharply in the second quarter but only slightly in the third. Liquidity of large non-manufacturing companies has been improving over the past year, and is now back close to its average for the mid-1980s. In the fourth quarter, borrowing from the banks and capital markets appears to have risen again sharply; but, since deposits have also risen, it is not clear that the adjustment process has been set back.

The stock cycle, which was a major source of weakness in demand in the early stages of the recession—stock levels fell by £3 billion (at 1985 prices) in the last quarter of 1990 and the first half of 1991—may now have largely dissipated. In the third quarter, stocks were virtually unchanged. The CBI survey suggests that the number of manufacturing companies with excessive stocks has continued at about the third quarter level since then, having fallen from a higher level in the first half of the year. There is perhaps, however, a hint of involuntary stockbuilding in the third quarter by retailers, whose stocks rose by £140 million. This is possibly supported by survey evidence which suggests that there could be some reversal in retail stocks in the fourth quarter.

Fixed investment has continued to fall; but that fall may now be moderating. In the third quarter of 1991, the 2½% decline appears to have been concentrated outside manufacturing, and was due mainly to lower investment in vehicles, ships and aircraft. Partial estimates of the supply of investment goods in the fourth quarter indicate a further fall in home produced capital goods (although exports continue to be maintained) but some pick-up in imported capital goods, particularly in November.

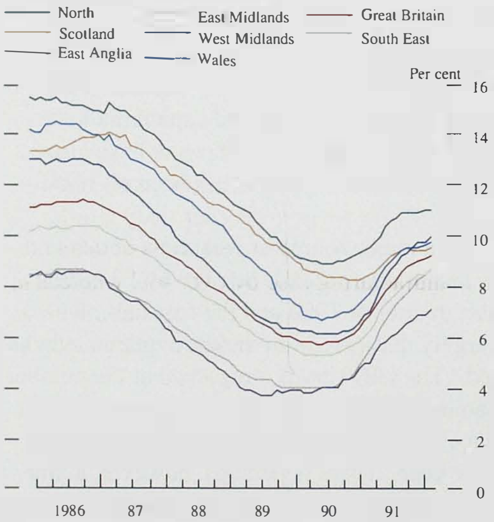
The outlook for investment in manufacturing is more encouraging. The CSO enquiry into investment intentions suggests a 2% rise in manufacturing investment in 1992, and a larger rise in 1993. The largest increases are expected to be in the process and chemicals industries—a further indication of the relative buoyancy of this sector—and in plant, machinery and vehicles rather than new building work (which is expected to fall further). The January CBI survey is rather less optimistic; but even here the balance of firms expecting to reduce investment in plant and machinery is only half that shown in the surveys between January and July 1990.

Reductions in **employment** *last year became more concentrated in* **manufacturing** *than* **services**



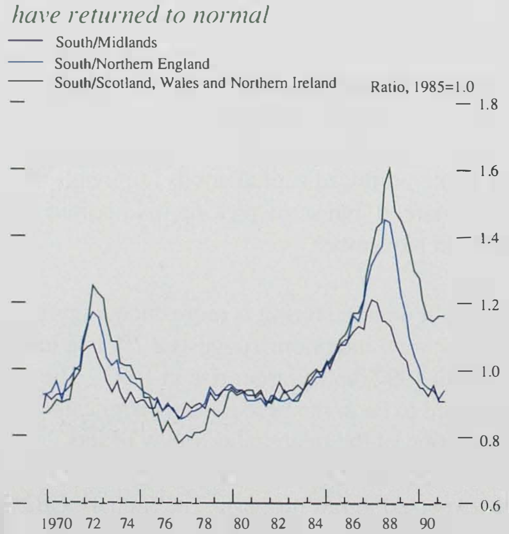
Source: Department of Employment Gazette.

Differentials between **regional unemployment rates**[(a)] *have continued to narrow . . .*



(a) Rates for the South West, Yorkshire and Humberside and the North West have been omitted to preserve clarity.

. . . and **house price relativities** *in England have returned to normal*



Source: Department of Environment. The chart shows movements relative to a base of average prices in 1985.

The adjustment to spending that was needed to bring down the corporate sector financial deficit has also concentrated on reducing labour costs. In contrast to the recession of the early 1980s, employment growth up to mid-1990 had slowed more sharply in the service sector than in manufacturing. Since then, and especially during 1991, cut backs have increasingly come from the manufacturing sector. This may be because, with the exchange rate weakening, demand for manufactured goods held up very well until mid-1990 and protected the manufacturing sector from recession. Thereafter, appreciation of sterling (particularly against the dollar) started to restrict exports. The rise in unemployment, which became particularly acute early in 1991, seems to have moderated much more quickly than in the early 1980s.

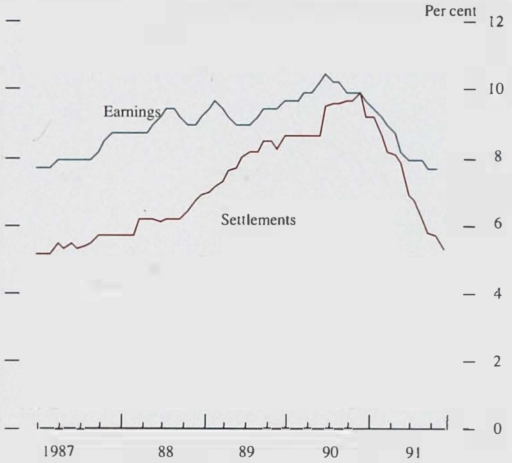
Regional imbalances *have narrowed*

Reflecting the industrial incidence, the regional distribution of unemployment rises has also been very different in this recession. Regions such as Greater London, the South East and South West have seen the largest rises, while Yorkshire the North, North West, Wales and particularly Scotland have experienced the smallest ones. Northern Ireland, with much the highest unemployment rate (but also the smallest net percentage increase since March 1990) is a special case. Excluding Northern Ireland, the range between regional unemployment rates has been reduced from $7\frac{1}{2}$ percentage points at end-1985 to 4 percentage points at end-1991 (or under 3 percentage points if East Anglia, the next outlier, is excluded). This narrowing in differentials is consistent with the labour market having become more flexible, and the labour force more mobile.

Mobility will have been assisted by the parallel narrowing of differentials in house prices. The chart shows the behaviour of house prices in the South relative to prices in three main regions (the Midlands, the North of England, and Scotland, Wales and Northern Ireland). The house price boom in the early 1970s opened up regional differentials, but these closed in the subsequent recession. Interestingly, although house price inflation peaked again in 1979, and then subsided in the 1980–81 recession, and although there were clear regional differences in the impact of that recession, regional relativities in house prices did not appear to change. More recently, the house price explosion of the late 1980s was led very much by southern England so that wide regional differentials were again opened up, but much wider than in the early 1970s. In England these differentials have now returned to normal levels, but although some closing has occurred relative to Scotland, Wales and Northern Ireland, it is by no means complete. Taken together, these regional developments are consistent with improving efficiency in the labour market, although of course it would have been preferable if convergence had occurred at a lower overall level of unemployment, and in more normal trading conditions, than at the depth of recession.

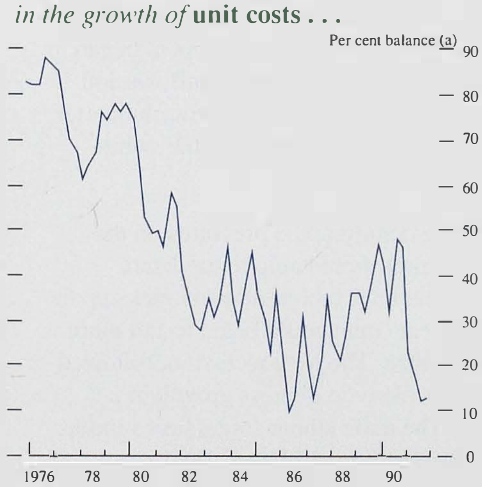
The box on page 28 suggests that, while recovery from the early 1980s' recession was against an unhelpful demographic background, with the number of school leavers peaking in 1981, and declining thereafter only gradually, the demographic trends this time are more favourable (that is to say, this time unemployment is unlikely to continue rising strongly for several years after the recession). Outflows from the unemployment register appear

The sharp decline in **wage settlements** *suggests that* **underlying average earnings growth** *may have further to fall*



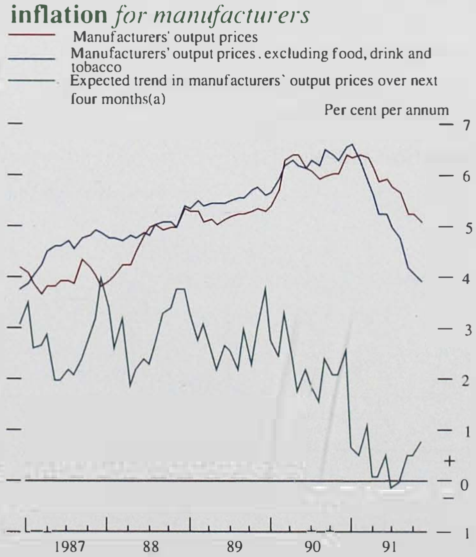
Sources: Earnings, Department of Employment.
Settlements, Industrial Relations Service.

The **CBI survey** *shows the sharp reduction in the growth of* **unit costs . . .**



(a) Percentage of firms reporting on increase over the past four months *less* percentage reporting a decrease.

. . . which is reflected in falling **output price inflation** *for manufacturers*



(a) CBI survey, percentage balance, divided by 10.

already to have turned up, and although growth in activity rates is projected[1] to fall into 1992 and beyond, the level is not expected to do so, certainly not to anything like the same extent as in 1980 and 1981. They also start from a significantly higher base. Vacancies at job centres ceased falling in mid-1991.

Other indicators suggest that the labour market may be more flexible than it was a decade ago. In particular, working days lost through industrial disputes were just 0.8 million in the 12 months to November 1991, compared with 4.3 million in 1981 and 5.3 million in 1982. The downward trend in the rate of pay settlements may also reflect improved flexibility (although it is hard to judge whether this, rather than the rise in unemployment, is the cause) and is to be welcomed. Settlements appear to be currently averaging around 5% per annum, and are somewhat less in manufacturing which is more directly exposed to competitive pressures and the discipline of the exchange rate. There must now be some prospect that average earnings growth will break through the floor of 7½% that seemed to be established in the 1980s, even when inflation was at its lowest, at around 3%, in 1986.

Cost pressures *on manufacturers are being reduced . . .*

Unit wage costs are being contained, particularly in manufacturing where wage pressures are moderating and positive productivity growth is being re-established as employment adjusts relative to output. In the three months ending in November 1991, unit wage costs in manufacturing were 5% up on a year earlier, only a little higher than in Germany and Japan; and in the year to November 1991, output per head in manufacturing rose by over 4%, whereas in the first half of 1991 there were falls of nearly 2% compared with a year earlier. If output now starts to grow faster than employment, as would be expected at this stage of the cycle, then it should be possible to continue to achieve substantial rates of productivity growth such as were recorded during the 1980s.

A similar picture of falling unit costs emerges from the CBI quarterly trends survey, where the percentage balance expecting average unit costs to rise has been sharply reduced during 1991, and is now at about the levels recorded at the nadir of the inflation cycle in 1986.

Manufacturers' input prices have remained weak and, compared with a year earlier, showed falls for most months since April 1990, particularly when food, drink and tobacco are excluded. As the world economy slows, downward pressure on commodity prices is likely to continue. Oil prices fell by some 20% during the fourth quarter of 1991, and so far this year have sustained this lower level.

Against this background, manufacturers have made significant further progress in reducing the rate of growth of their output prices. By last December, output price inflation, compared with a year earlier, had been reduced to 5.0% (from 6.3% at the start of 1991); and excluding food, drink and tobacco it was 3.9% (compared with 6.5% at the start of 1991). The CBI percentage balance of firms expecting to raise prices has tended to point to a somewhat more encouraging picture than the official series (the two are more consistent if changes in the official series over a period shorter than

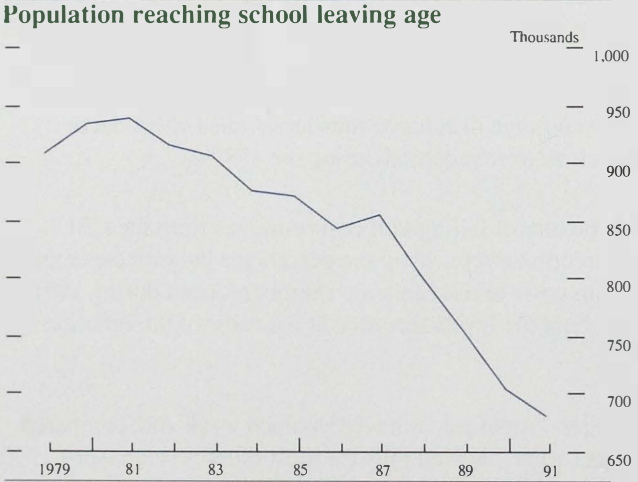
(1) By the Department of Employment—see chart on page 28.

The labour market

In November 1979, unemployment reached a low point of just over 1 million, outflows from the register having exceeded inflows onto the register for most of that year. The onset of recession in 1980 saw inflows surge, and, with outflows broadly unchanged, unemployment began to rise sharply. Outflows increased in 1982, responding to the turnaround in output, but remained below inflows until July 1986, when the level of unemployment peaked at just over 3.1 million. The long upswing in unemployment was initiated by a decline in labour demand during the recession, but continued against a backdrop of rising output.

The strong inflows of the early and mid-1980s can be traced partly to demographic pressures, in particular the high level of school leavers. The number reaching school-leaving age rose steadily during the 1970s, and, after peaking in 1981, declined only gradually between then and 1987. After 1983, a combination of improving economic conditions and social change stimulated labour force participation, and added to pressures from the supply side of the labour market. Most notably, the female participation rate increased by over 2.7 percentage points in 1984 and continued to grow rapidly throughout the eighties, partly because of the greater availability of part-time work.

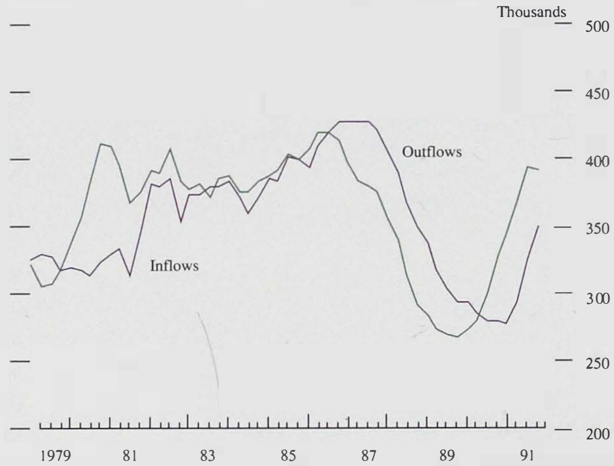
Population reaching school leaving age



From mid-1986, the headline unemployment count fell for almost four years, and in March 1990 reached a low point of just over 1.6 million. During this period both inflows and outflows fell sharply, with the latter lagging behind; the decline in inflows, particularly after 1987, was associated with the steeply falling numbers of school leavers. The various job creation initiatives will also have been an influence; since September 1988 those leaving school at 16 without a job have been guaranteed a place on a Youth Training Scheme.

During 1990, as the recession took hold, outflows bottomed out, and inflows began to increase rapidly, raising unemployment. In the final quarter of 1990

Inflows and outflows into unemployment [(a)]

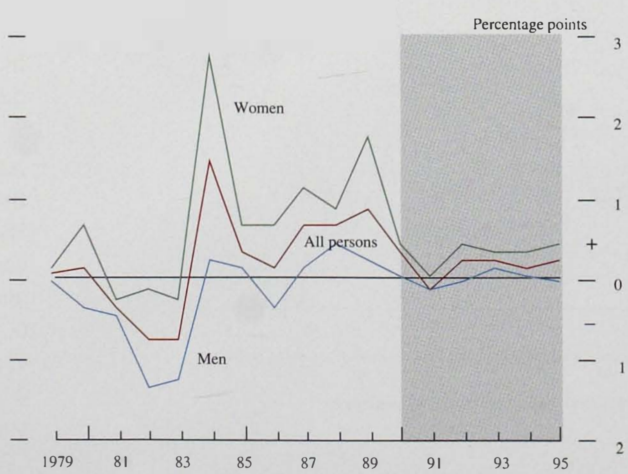


(a) UK seasonally adjusted, quarterly averages. Pre-1983 figures are GB basis rescaled to UK.

outflows started to pick up and rose strongly during 1991. The rate of increase in headline unemployment began to fall sharply in the second half of 1991, as inflows and outflows gradually converged; and by the fourth quarter of 1991, the level of inflows had begun to fall, while outflows continued to rise.

The absence of strong demographic pressures on the supply side of the market should help to moderate inflows in 1992, so that once labour demand picks up the headline unemployment count could begin to fall more rapidly than in the 1980s. The long recession, followed by a slow recovery, is likely to depress growth in participation rates. The male labour force, for example, is expected to decline between 1991 and 1994 (Department of Employment projections). Potential workers discouraged from labour market participation will drop out of the unemployment figures. The Department of Employment estimates (Employment Gazette, May 1991) that for every two newly registering unemployed people, one may leave the labour force entirely. This is consistent with the last recession when the participation rate fell 2 percentage points.

Changes in participation rates

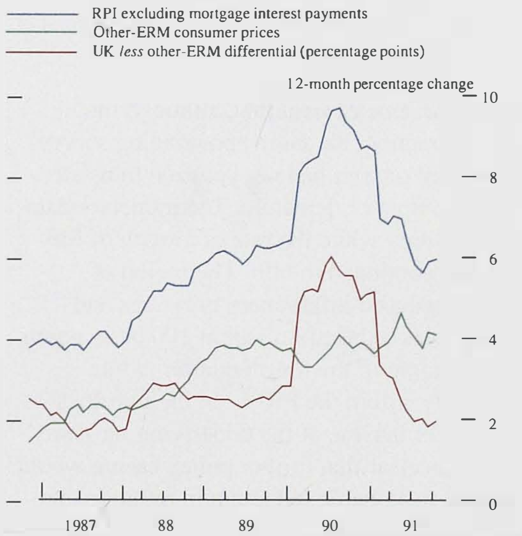


a year are annualised), although there has been a hint in recent months that rather more manufacturers may now be looking to raise prices. Estimates based on the official producer price series, however, suggest that manufacturers have managed to maintain margins.

. . . and underlying **retail price inflation** *continues its steady downward trend*

The substantial improvement in manufacturers' prices sets the context for the slowdown in retail prices. The headline rate of increase in the RPI reached 3.7% in October, but is now going through a small technical resurgence as erratic movements of a year ago are worked out of the calculation. Excluding mortgage interest payments, RPI inflation has shown steady, though less dramatic, downward progress. It too, however, is subject to some volatility arising from sharp movements in petrol prices in late 1990 and early 1991 during, and after, the Gulf crisis.

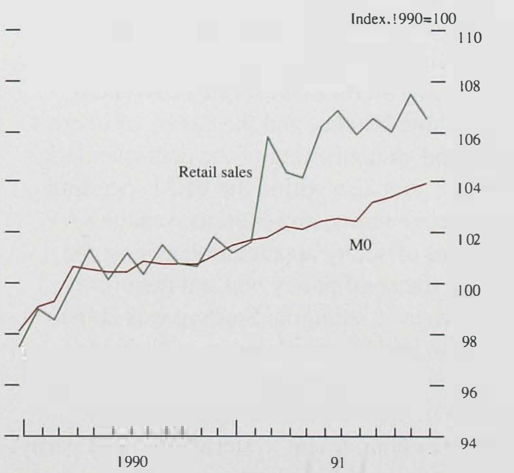
UK inflation *continues to converge towards that in* **other ERM countries**



Although the progress made on reducing manufacturers' output price inflation is more than matched in the traded goods components of the RPI, price rises have tended to be higher in the non-traded sectors which are less immediately exposed to the discipline of the ERM. This has held back the overall fall in retail price inflation. There has, nevertheless, been continued progress in closing the differential between inflation in the United Kingdom and other ERM countries.

Monetary indicators *reflect a cautious approach to financial intermediation*

Surprisingly, **M0** *has not responded to the VAT induced rise in the* **value of retail sales**



Progress in reducing inflation has been accompanied by a continued slowing of broader measures of monetary growth. Growth in the narrow measure, M0, has remained comfortably within its target range, and has averaged around 3% per annum or a little lower. In particular, it did not apparently respond to the step up in retail sales value that accompanied the VAT increase last April. This behaviour has not been satisfactorily explained but implies a rise in velocity. Some retail spending is, of course, zero-rated for VAT purposes and this would dampen the rise in M0 that might otherwise be expected. It may be also that the VAT increase did not immediately alter people's behaviour concerning the amounts of cash habitually drawn and held (which tend to be heavily rounded amounts from cash dispensers).

The reduction in the rate of growth of the broader M4 aggregate, which in recent months has fallen to around 5% per annum, has been dramatic. It is hard to interpret this because of the importance of savings balances within M4, some of which may have moved into other investments as interest rates fell (and bank margins widened). Weak demand for credit may be a further factor constraining the balance sheet growth of banks and building societies—their lending grew by under 6% in 1991—and the recent move by certain mortgage lenders to reduce their interest rates, even though wholesale rates had not fallen, suggests that they were seeing demand for mortgages fall away. The slowdown in M4 and lending also highlights the more cautious approach to financial intermediation that has been brought about in part by bad debt experience in the recession, and reinforced by a consciousness of the capital requirements of banking supervisors.