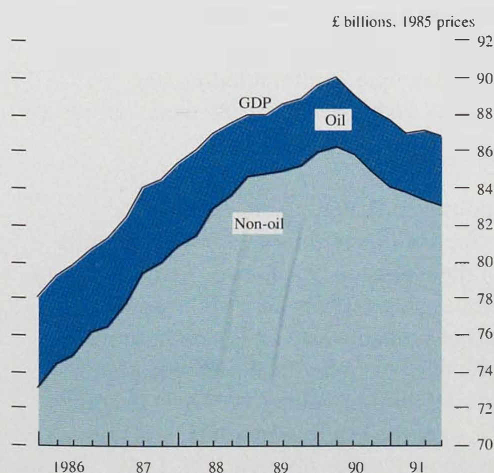
The domestic economy

- *The recession at home continued in the second half of last year with output in most major industrial sectors continuing to decline.*
- *But domestic demand may have stabilised and is likely to have remained broadly flat in the first three months of this year.*
- *Consumer confidence has grown in recent months, having weakened throughout the autumn. But the housing market has shown few signs of a pick-up. An apparent increase in enquiries has as yet had little positive effect on housing turnover.*
- *The commercial property market has been depressed, with implications for the bad debt provisions of the banking sector.*
- *Corporate demand for bank finance has been subdued, reflecting a reduced level of capital spending and continued balance sheet restructuring. But survey evidence points to a sharp improvement in business optimism back to levels seen last autumn.*
- *Competitive pressures on the corporate sector have led to a significant shake-out of labour, particularly within parts of the service sector, and to a continued squeeze on pay settlements.*
- *Continued progress has been made in subduing inflation. The United Kingdom, nevertheless, still has some way to go to match the best EC performance.*

Chart 1
Output *was boosted in the second half of 1991 by a pick-up in* **oil production**



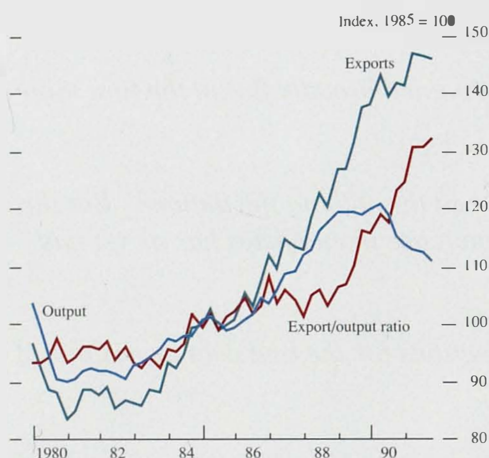
Non-oil output *continued to fall in the second half of 1991 . . .*

The fourth quarter decline in gross domestic product (GDP) left total output little changed from its level in the second quarter of last year. The temporary shutdown of some oil production capacity in the spring and early summer of 1991 had led to an exaggerated fall in output during the first half of the year and, as can be seen from Chart 1, suggested a correspondingly flatter profile in the second half as capacity came back on-stream. Non-oil output, however, declined further by around $^{3}/_{4}$% during the second half of the year. Output fell in most of the major industrial sectors, although transport and communication continued to recover from the effects of the Gulf War. Construction registered the sharpest fall; manufacturing output also fell abruptly during the closing months of the year but may have stabilised more recently.

Non-oil output has fallen for six consecutive quarters—the longest continuous fall since the 1940s—to nearly 4% below its peak in the second quarter of 1990. The fall in non-oil output, however, was larger in 1980–81, and the sectoral and regional composition of the decline has been different. As a whole, the service sector has performed worse than in the early 1980s, with financial services particularly affected; but manufacturing has not been as badly affected. In the early 1980s manufacturing output fell by more than 15% with the loss of some 850,000 manufacturing jobs. In this

recession, the loss of output has been around 8% and the reduction in employment less than 500,000—although some commentators have suggested that the fall in output may have been greater than official statistics suggest (see the box opposite).

Chart 2
Overseas markets *have become increasingly important*

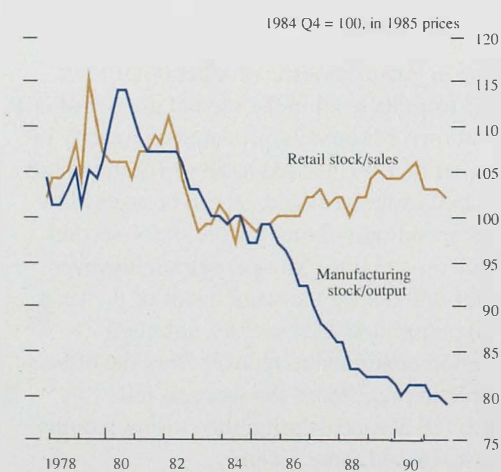


With domestic demand subdued, producers have increasingly focussed on overseas markets. Chart 2 shows that between 1989 and 1991 exports of manufactures, expressed as a share of domestic output, have risen more sharply than in 1980 when output was entering recession. A number of structural factors have probably contributed to this, including the growing importance of export-oriented direct investment in the United Kingdom; the stimulus to demand associated with German unification; and reduced uncertainty for exporters following sterling's membership of the ERM. Recent performance also reflects the success which UK companies have had in controlling their costs and the extent to which they have been prepared to narrow their margins. Nonetheless, even with these mitigating factors, the overall decline in total activity has been severe.

. . . *but* **domestic demand** *may have stopped falling*

Revised estimates for the composition of spending during 1991, and subsequent survey information, suggest that the decline in domestic demand may now be stabilising. Over the year as a whole, domestic demand fell by 3.1%—the sharpest annual decline since the 1940s—with a 1.7% fall in consumer spending and larger falls in capital spending on fixed investment (10.3%) and stocks. Domestic demand reached its trough in the second quarter, and recovered by some 0.3% in the third quarter before falling back by just 0.1% in the fourth, as consumer demand stabilised in the second half of the year. Early indications are that this may have broadly continued into the first quarter of this year. Since the middle of last year, declining spending on fixed investment has therefore provided the only downward pressure on domestic demand. Heavy de-stocking continued through the year, although at a declining rate: current data suggest a cumulative rundown in 1991 of £2.9 billion at 1985 prices (equivalent to 0.8% of GDP). This compares with de-stocking of £3.2 billion in 1981 (1.2% of GDP).

Chart 3
Stock-output ratios *have not risen as in previous recessions*



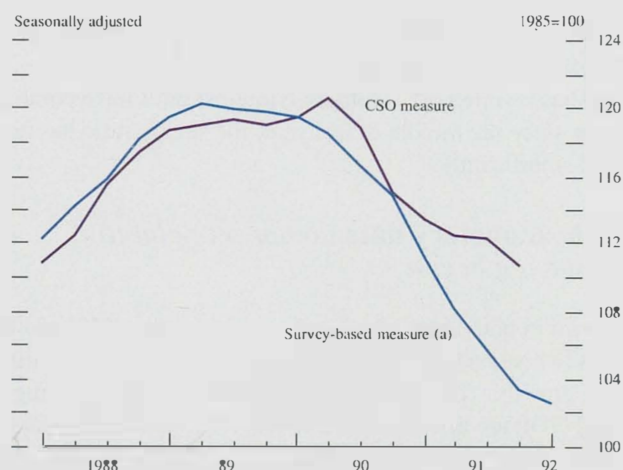
The sharpness of the stock rundown has been surprising, particularly in manufacturing where declining stock-output ratios throughout most of the 1980s, evident from Chart 3, had suggested that the scope for large falls might have diminished. But, although the manufacturing stock-output ratio has broadly stabilised recently, it has not risen as it did in previous recessions. This may be because the improved stock control techniques of the 1980s are continuing to exert a strong influence. However, these changes have not been repeated in all sectors. For example, within retailing, the stock-sales ratio, although still well below its 1980 peak, has turned up in the past five years.

The trade statistics also point to a flattening out of domestic demand. The decline in the volume of imported basic materials during the early stages of the recession was far less marked than in the early 1980s. This presumably reflects the different sectoral impacts discussed above, but probably also adds weight to the official estimates of the depth of the manufacturing recession discussed in the box opposite. Import volumes of basic materials have risen by around 10% over the last four quarters, and imports of capital goods have also been increasing since early in 1991. These

Manufacturing output

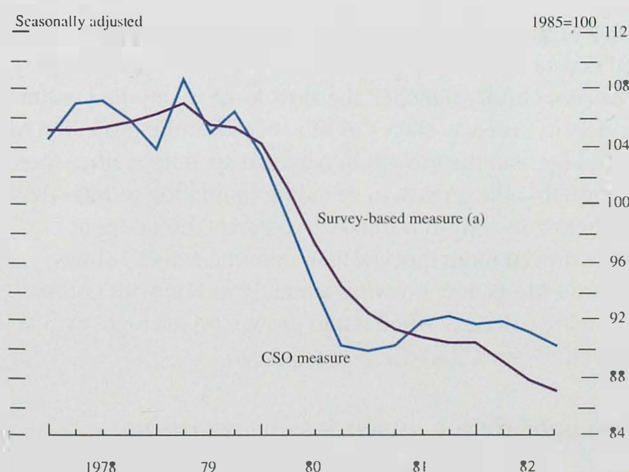
Manufacturing output, based on CSO data, has fallen by 8% from its peak in the second quarter of 1990. The decline has been broadly-based, although the chemicals industry has seen an early recovery. It has recently been suggested that the fall in output has been significantly worse than the CSO data indicate if measures based on results of the CBI Industrial Trends Survey (ITS) are used instead. These suggest that output peaked some 12 months earlier than recorded by the CSO, and fell thereafter by up to 14½% (see Chart A). The CSO and CBI-derived measures also show different profiles for the recession. According to the official CSO series, the recession was at its sharpest during the second half of 1990, after which the rate of decline slowed down. CBI-derived data show the recession gathering pace through 1990 and 1991, and moderating only recently. In contrast, in the early 1980s both measures were broadly in line with each other, with the CSO data down by 17½%, and the survey-based data down by 18¾% (see Chart B).

Chart A
CSO and survey-based measure of manufacturing output



(a) Derived from backward-looking output measure in CBI survey.

Chart B
CSO and survey-based measures of manufacturing output



(a) Derived from backward-looking output measure in CBI survey.

The CBI Industrial Trends Survey is qualitative. It asks respondents whether the trend of their output during the preceeding four months was above, below or about the same as in the previous period. No further quantification is sought and the results are presented as a percentage balance of firms reporting a rise, less those reporting a fall. Various attempts have been made to quantify the survey balances to give a more precise measure of changes in output. The simplest of these uses regression analysis to find a relationship between the CSO output data and the CBI output balances.[1] The survey-based measure of manufacturing output in Charts A and B has been derived using this methodology.

If the CSO and survey-based output measures tracked one another reasonably closely in the early 1980s, why do they appear to have diverged in the current recession? One reason is that the survey asks firms about the change in the underlying *trend* in their output, whereas the CSO record the actual level observed. In so far as trend and observed output are not identical, the CSO and CBI-derived measure are likely to diverge from time to time—particularly around turning points in activity. There is also some tentative evidence to suggest that the CBI responses may be less robust than they were in the early 1980s; for instance, a comparison of the expected and reported output balances in the ITS reveals that the average expectational error made by firms in the current recession is significantly greater than in 1980–81. Of course this does not necessarily mean that *actual* errors have also deteriorated. Lastly, the quality of CSO output data has been improved recently with the introduction of a more comprehensive monthly sales enquiry in 1989.

Other data offer some evidence that the recession in manufacturing is likely to be shallower than in the early 1980s. During 1991, the volume of manufacturing exports (excluding erratics) grew by 3¾% and, since the beginning of the recession, by over 4%. Good trade performance has helped to stabilise output and compares favourably with the recession in the early 1980s when manufactured exports fell by 15½%. Furthermore, although real consumers' expenditure in the fourth quarter was almost 2½% lower than its peak in the middle of 1990, the weakness of consumption has been partially offset by the relative buoyancy of the investment sector—which is of particular significance to manufacturing industry. Although the volume of manufacturing investment has fallen in the current recession, it nonetheless remained, in 1991, a full one third above its level in 1981.

Data on employment also lend some support to the view that the current recession in manufacturing may be shallower than that in 1980/81. In the current recession manufacturing employment has fallen 8¾%, compared to a noticeably larger decline of 12½% in 1980/81—although a caveat to these comparisons is that over-manning was thought to be a major problem in the early 1980s.

(1) More complex procedures are also available. See for example B Pesaran and C B Wright, 'Using and assessing CBI data at the Bank of England', Bank of England *Discussion Paper (Technical Series) No 37*.

Chart 4
The scale of improvement in the **current account** *has been comparable with earlier periods*

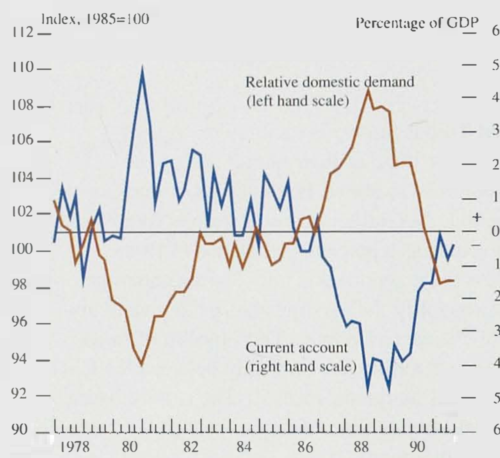
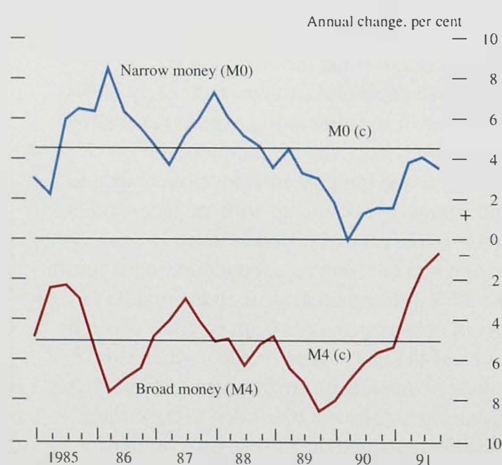


Chart 5
Velocity (a)(b) **growth** *of broad and narrow money has converged during this recession*



(a) The value of personal spending/M0 and nominal GDP/M4.
(b) M0 velocity was affected by the announcement of VAT changes in March 1991.
(c) Average velocity growth in the 1980s.

trends are encouraging, but have limited the improvement in the current account which has remained in deficit throughout the recession. The scale of the recent improvement has, nevertheless, been broadly comparable with earlier periods when relative demand was depressed. Moreover, as Chart 4 depicts, the recent fall in relative demand has to be judged in relation to the buoyant performance of the UK economy, particularly during 1988 and 1989, which was greater than that experienced a decade earlier.

The return to this more stable pattern of expenditure is the counterpart to financial adjustment within both the personal and corporate sectors. Higher levels of indebtedness, coupled with a prolonged period of high interest rates, were accompanied by an increased level of saving. This restored the personal sector to financial surplus during 1989 and reduced the corporate sector's financial deficit very substantially during 1991. As interest rates have fallen the rate of saving has eased a little, and the fall in expenditure has levelled off. Although interest rates have come down further since the middle of last year, the saving ratio has not yet declined significantly.

Even so, the **monetary data** *do not yet point to* **recovery** *having begun*

The slowdown in both broad (M4) and narrow money (M0) growth over the last two years has partly reflected the reduction in nominal expenditure growth. The 12-month growth rates in M4, lending and nominal GDP are at their lowest levels for over twenty years. Net lending to the private sector by banks and building societies in March was negative for the first time on record—perhaps reflecting a pre-election postponement of spending—and the annual growth of both M0 (2.2%) and M4 (5.6%) also showed no sign of an upturn.

During this economic downturn, however, velocity growth has not remained constant. This implies that the slowdown in monetary growth has not closely matched the slowdown in nominal output. In particular, in the early stages of this recession the growth in M0 fell less rapidly than the growth in personal spending; since then velocity growth—the growth in spending in relation to M0—has remained below its long-run trend. In contrast, broad money growth has slowed more quickly than nominal activity since mid-1990 and M4 is now growing annually in line with nominal GDP following a decade when it had grown, on average, by 5% more than GDP (see Chart 5).

Although **confidence** *appears to be returning . . .*

After falling at the end of last year, and continuing to weaken until February, consumer confidence has subsequently shown signs of picking up. Spending patterns, for the first quarter at least, seem to have changed very little from the second half of last year, with consumers continuing to take advantage of unusually large promotional discounts. Consumption is likely to have been broadly flat at best. Retail sales in the first three months of the year were unchanged from their level at the end of 1991, with spending in March falling by 3/4%. And early indications suggest that some other categories, such as energy and motor vehicles may, if anything, have fallen a little in the first quarter.

However, recent survey evidence reveals a notable improvement in confidence. Both the latest Gallup and Mori surveys show a significant upswing in consumers' future expectations about the general economic climate.

Chart 6
The personal sector's borrowing *from banks and building societies remains well in excess of its deposits . . .*

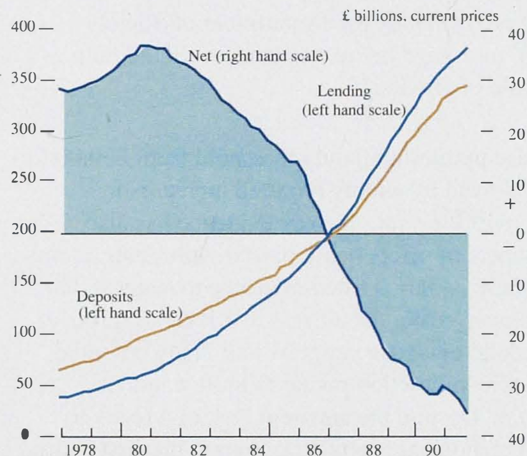
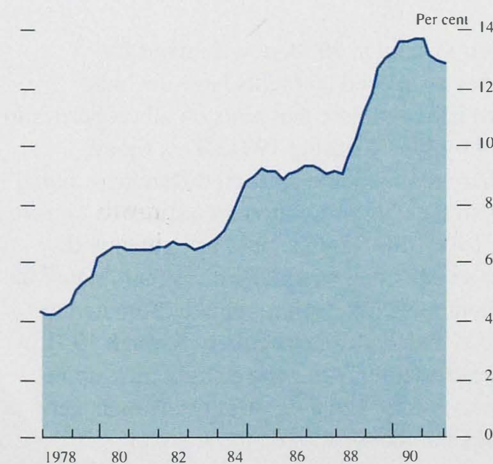


Chart 7
. . . and **personal sector income gearing** [(a)] *has remained high*



(a) Households' gross interest payments as a percentage of disposable income.

. . . the **personal sector** *is still highly indebted . . .*

Financial deregulation during the 1980s was followed by far-reaching balance sheet adjustments by the personal sector. Total outstanding borrowing, mostly mortgage debt, expanded more rapidly than personal sector deposits with banks and building societies (see Chart 6). More significantly, however, new debt commitments were relatively concentrated, rather than spread widely. Those buying into the housing market in the latter half of the 1980s, particularly in the south, became the most indebted.

The process of adjustment over the last three years—a sharp decline in new borrowing, a marked slowdown in income growth and declining property prices—has in many ways mirrored the changes of the preceding period. Although this adjustment was initially associated with a sharp rise in interest rates, the subsequent fall in nominal rates has not yet significantly strengthened confidence. In the first quarter of the year the personal sector continued to increase its savings with the banks and building societies.

The muted response to lower interest rates over the last year is linked to a number of factors which were lacking in previous recessions, in particular falling nominal house prices. As Chart 7 shows, the personal sector's gross income gearing ratio at end-1991 was still around 13%, against its 1990 peak of almost 14%; and expectations about the rate at which inflation would erode the real value of outstanding debt had probably been substantially diminished.

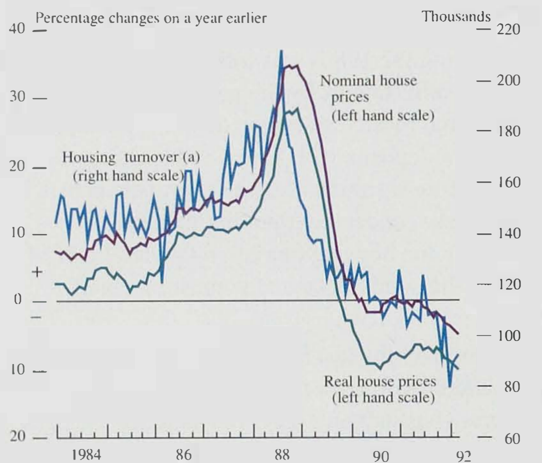
Current data indicate that the saving ratio rose in 1991 as a whole, but fell back during the second half of the year from its second quarter peak of 11.3%. The personal sector's financial balance followed a similar pattern, with smaller surpluses in the third and fourth quarters of last year, while remaining at levels well above those in 1990.

. . . and the **housing market** *remains subdued*

Among existing borrowers, it is the concentration of debt among highly geared households which is particularly significant. Falling nominal house prices and slower income growth have put particular pressure on the most geared. The rapid increase in mortgage arrears shows that, against the backdrop of a weaker economic environment, debt levels have, for many, become unsustainable.

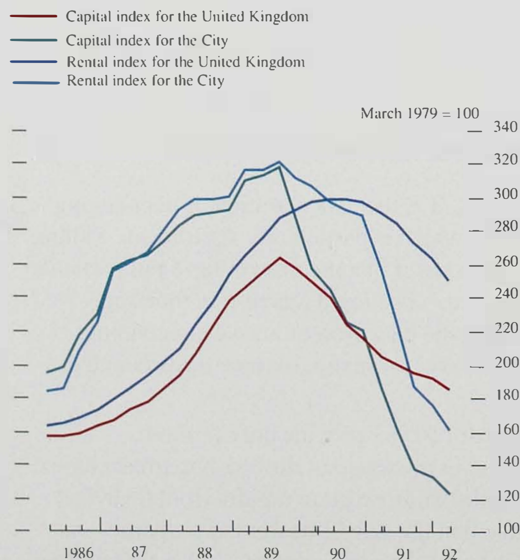
Figures for the second half of 1991 provide only limited encouragement. The rise in possessions slowed, but arrears cases in excess of twelve months still rose quite rapidly from their first half level. It is possible that the sale of possessed properties may have contributed to the decline in house prices. In the first quarter of 1992, prices nationally fell by 1.9% from the fourth quarter of last year (according to the Halifax house price index, seasonally adjusted—see Chart 8) to 5.5% below their peak of 1989 Q2, with the south of England still showing the largest falls (see the box on regional house price developments on page 149).

Chart 8
The housing market *has yet to show any firm signs of recovery . . .*



(a) Particulars delivered on a monthly basis. House prices are deflated by the RPI excluding mortgage interest payments.

Chart 9
. . . and **commercial property values** *remain depressed . . .*



Source: Richard Ellis Capital and Rental Value Indices for all commercial properties.

However, following the announcement by the Chancellor in December of the measures to reduce possessions, mortgage lenders have been taking more steps to provide help for borrowers in difficulties. Although the bulk of the sums so far committed by lenders has not yet been deployed, and although it appears that early estimates of the full effect of mortgage-to-rent and other schemes were overly optimistic, the number of possessions in the early months of 1992 nonetheless appears to have fallen. There are also signs that the number of new arrears cases has declined; the introduction of direct payments by the Department of Social Security of claimants' mortgage interest to lenders should help further to limit the scale of arrears.

The temporary increase in the stamp duty threshold from £30,000 to £250,000 has been followed by widely reported increases in enquiries since the turn of the year. Survey evidence has also suggested higher numbers of offers being placed with estate agents. But, for the present, there is only limited evidence to suggest that this is leading to a recovery from the current low level of turnover in the market. Anecdotal evidence suggests that many potential deals are failing to reach completion owing to more cautious valuations by surveyors. Despite the apparent lack of a recovery elsewhere in the market, housing starts picked up in the first quarter of this year, running some 7% above last year's first quarter level.

The **commercial property market** *has been depressed . . .*

Since the economy began to slow in 1990, new demand for commercial properties has weakened and rents have declined. Estate managers Richard Ellis estimate that rents on all properties in the United Kingdom fell by 11.3% during 1991. This figure, however, hides some sharp regional and sectoral differences; rental values for all properties in the City of London are estimated to have fallen by 38.9% during 1991 (this figure should be treated with caution as it is based on a very small sample) while retail, industrial and office rents throughout the United Kingdom are estimated to have fallen by 3.2%, 2.5% and 20.4% respectively through 1991. Evidence for 1992 suggests that there may be a slight pick-up in demand for office property within London. But estate managers Debenham, Tewson and Chinnocks estimate the stock of 'ready-to-let' office property in London constitutes some 17% of total office space in the capital. Until supply and demand are brought back into line, rents will remain low or fall further.

The banks are exposed to these movements within the property market. Direct bank lending to property companies is currently £39.2 billion, or about 10% of total bank lending to the M4 private sector. An additional £14 billion of loans is outstanding to the banks from the construction industry. And much additional bank lending is secured against property. The Richard Ellis index of capital values provides a guide to changes in the value of commercial property. After reaching a peak during the third quarter of 1989, the index has declined by some 30% and, as can be seen from Chart 9, now stands lower than in the first quarter of 1988. With the existing excess supply due to be augmented by additional projects that are already in the pipeline, the outlook for the commercial property market remains depressed.

Regional house prices and possessions

Since 1985 the British housing market has experienced two distinct phases. From the mid-1980s to mid-1989, house prices rose very sharply, substantially outstripping general inflation. Then from mid-1989 onwards nominal house prices fell, partially reversing the earlier increase.

But national house price figures mask significant regional variations over this period. One of the most notable features of regional developments in the housing market has been the so-called 'ripple' effect with rapid house price inflation and subsequent deflation occurring first in the South, then the Midlands and finally the North. While following a similar pattern, the periphery saw a smaller rise in prices and no subsequent fall.

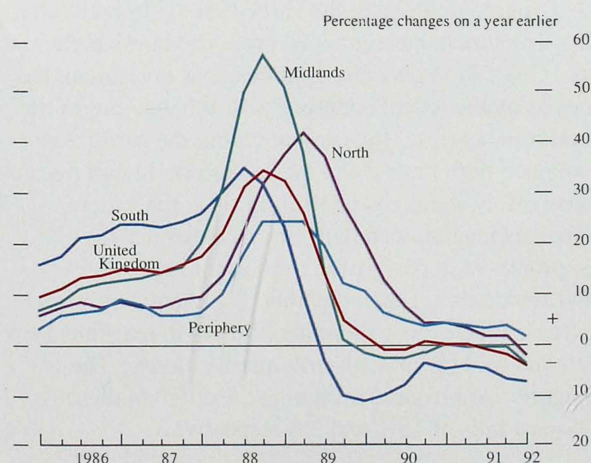
The ripple effect began with a sharp increase in prices in London during the mid-1980s as sectors such as banking and finance expanded rapidly in the capital. An increase in the number of commuters and the growth of local business helped to spread the gains to the rest of the South East. In the late 1980s the improved economic climate in the Midlands and North then spurred price gains in these regions, which had by then fallen significantly behind prices in the South.

Despite a period of higher annual house price inflation in the Midlands and North, by 1989 prices had not reached the level of the South. Correspondingly, data from the Council of Mortgage Lenders show that the average advance-to-earnings ratio for loans made in the second quarter of 1989 was 2.3 in the South, 2.1 in the Midlands and 1.9 in the North. Thus, on average, the South was more vulnerable to higher interest rates. In addition, as the regional employment box indicates, the impact of the slowdown of the economy in 1990 and 1991 was, at least initially, uneven, with the Southern areas experiencing sharper falls in employment than elsewhere, most notably in banking and finance.

These two factors, borrower fragility and the regional impact of the recession, alone would have caused a sharper fall in Southern house prices than those elsewhere. But their impact was compounded by a much more rapid increase in possessions in the South. Figures from the Lord Chancellor's Department show court orders for possession by lenders have risen sharply in the South while remaining broadly flat in the North and Midlands (see Chart B). As a percentage of its stock of owner-occupied dwellings, the South had experienced the fewest court orders in 1987 (about 0.20%), but in 1991 the most (about 0.35%). While possessions to a large extent reflect the fragility of borrowers and broader economic factors mentioned above (see the article on page 173), they also create additional downward pressure on prices, which in turn adds to problems of fragility. Moreover, many possessed properties are at the first-time buyer end of the market and are therefore reducing the number of new buyers reaching the rest of the market.

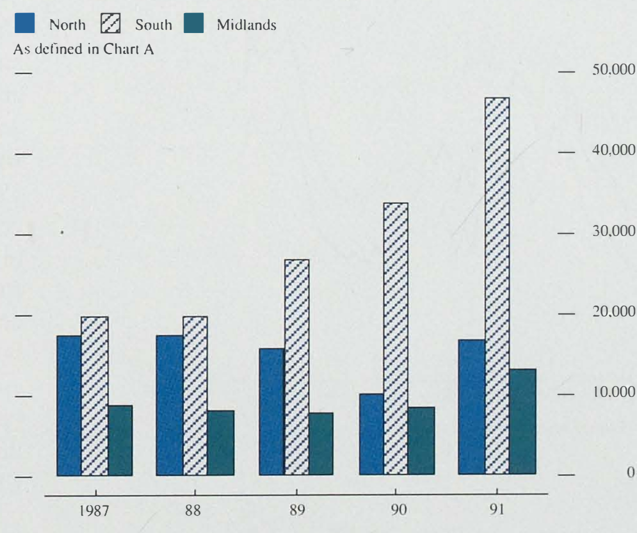
The impact of higher interest rates followed by falling employment and rising possessions, have all acted to reinforce each other in a fashion that has seen prices in the South fall by 24% since the peak compared with a more modest 9.3% and 3.6% respectively in the Midlands and North. As a result, regional house price differentials have narrowed significantly.

Chart A
Regional house price inflation



North: North, North West, Yorkshire and Humberside
South: Greater London, East Anglia, South East, South West
Midlands: East and West Midlands
Periphery: Wales, Scotland, Northern Ireland

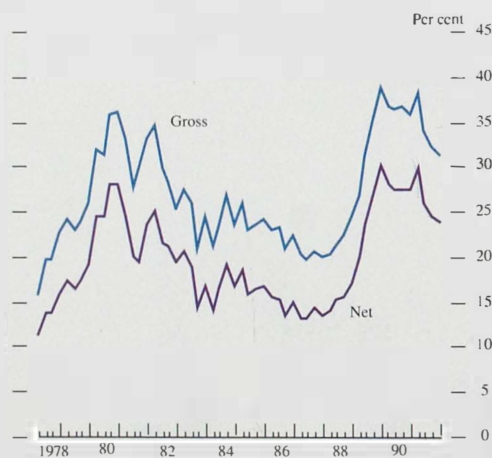
Chart B
Court orders made for possessions, by region



. . . *reinforcing the bad debt experience of the* **banks**

Banks' profitability in 1991 was hit by sharp increases in bad debts, notably in the domestic corporate sector. The resulting low or negative retentions, and falls in their own property values, have reduced banks' capital and reserves. Nevertheless, risk asset ratios in the large British banks remain well in excess of the 8% minimum required by the Basle Accord, at a combined ratio of 9.7% for 1991 (up from 9.2% in 1990). This is mainly due to tighter balance sheet control and the generally weak growth in lending which has resulted in minimal growth in risk assets. Several banks have also raised funds from capital issues. Given this capital headroom, the concerns that creditworthy borrowers are being, or are likely to be, constrained by a supply-side shortage of bank capital do not appear justified. Some small and medium-sized company borrowers, however, may be subject to higher margins and more cautious lending criteria, prompted by the high level of bad debts.

Chart 10
. . . *but* **ICCs' income gearing** [(a)] *has improved* . . .



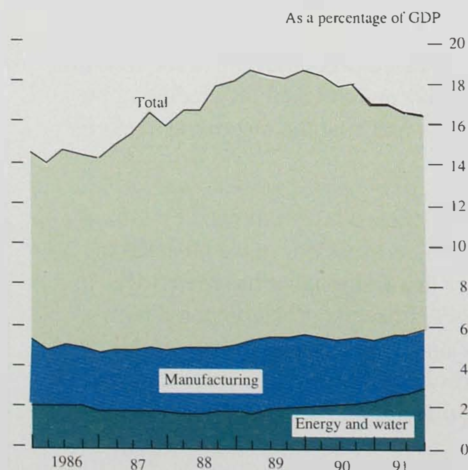
(a) Ratio of interest payments to income.

The financial position of the **corporate sector** *has improved* . . .

The demand for bank finance has been subdued for some time. Companies have drawn back from major expenditure programmes and have restructured their balance sheets to reduce their capital and income gearing. In aggregate, industrial and commercial companies (ICCs) repaid some £3 billion to UK banks and building societies during 1991. ICCs' profits fell by around 6% between 1990 and 1991, after allowing for the newly privatised electricity companies entering the 1991 data. But retained earnings were higher and capital spending was sharply lower, so that the sector substantially reduced its financial deficit. Lower interest payments combined with a reduction in ICCs' stock of outstanding bank borrowing and an increase in their liquid and other financial assets contributed to a fall in net interest payments of some £2 billion (around 7%) for the year as a whole. This led to a steady decline throughout the year in both gross and net income gearing (see Chart 10).

Business investment has fallen less as a percentage of GDP than in earlier cycles. At around 16½% of GDP, it remains significantly above the 13% trough recorded in the early 1980s. In particular, manufacturing investment has remained proportionately higher than a decade ago. Chart 11 shows that total business investment has also been buoyed by the recent counter-cyclical behaviour of the energy and water industries. Investment within the North Sea sector has remained high throughout the recession, in part because of work to raise safety standards on drilling rigs; the water companies have also maintained their capital expenditure programmes, prompted in part by the need to meet EC environmental standards. Taken together, the energy and water industries increased their real expenditure on fixed investment by 24% last year, and by 11% in the fourth quarter alone. The comparable figures for business investment, excluding these industries, showed falls of 15% and 3% respectively.

Chart 11
. . . *and* **business investment** *has been supported by the* **energy and water industries**



Although overall business investment may have remained weak in the first quarter, the CBI's April Survey, predominantly reflecting sentiment immediately before the general election, reported a better outlook for investment than it had in January, although the balance

of firms still expected to reduce their spending during the coming year. The recent strong pick-up in business optimism provides further evidence that the worst of the recession may now be past.

. . . but **overseas markets** *are becoming less buoyant . . .*

Last autumn's expectations of an early return to growth were partly undermined by the slowdown in world markets and the more subdued performance of UK exports compared with the spring and summer of last year. High levels of spare capacity at home, and continuing progress in reducing the real exchange rate through the control of domestic costs, have left UK producers well placed to supply overseas markets. However, with demand initially contracting in the United States and, more recently, slowing within Europe, the immediate prospects for exports remain rather more subdued.

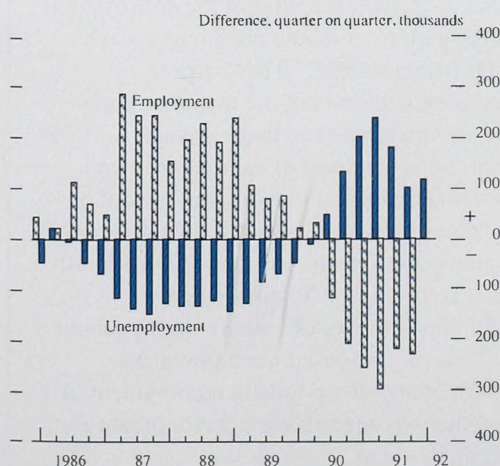
Having sustained output through much of the recession, it is these overseas markets which are now contributing to the uncertainty surrounding the strength and timing of recovery. UK companies have sought to develop new markets to compensate for the slower growth of these traditional destinations—for example, UK exports to the newly industrialised economies of the Pacific Rim have increased substantially during the past year. Yet, while the investments made by individual companies to win such contracts have clearly been important, at an aggregate level the United States and Europe remain the principal engine to sustain the United Kingdom's export performance.

. . . so that the need to **reduce costs** *remains*

Continued downward pressure on costs will be essential therefore if export opportunities are to be realised. Export prices in sterling rose by only 1.7% between the last quarter of 1991 and the first quarter of this year which suggests that profit margins in export markets may have been pared back even more than in domestic markets.

The April CBI survey confirmed that manufacturers plan to continue to scale back price increases in both export and domestic markets. Unit costs are also expected to moderate further and profit margins to be squeezed.

Chart 12
The number of **people in employment** *has fallen by around 1 million since the peak*



Overall, the annual growth in unit wage costs slowed during 1991 to around $5^3/_4$% in the fourth quarter, compared with almost 10% a year earlier, as companies rationalised their workforces and constrained pay awards. The number of people in employment has fallen by around 1 million since the peak (see Chart 12), with employment having been cut across a broad industrial spectrum. Similarly, the rise in unemployment has had a nationwide impact with regions such as the South East experiencing a large rise. This is discussed in the box on page 152.

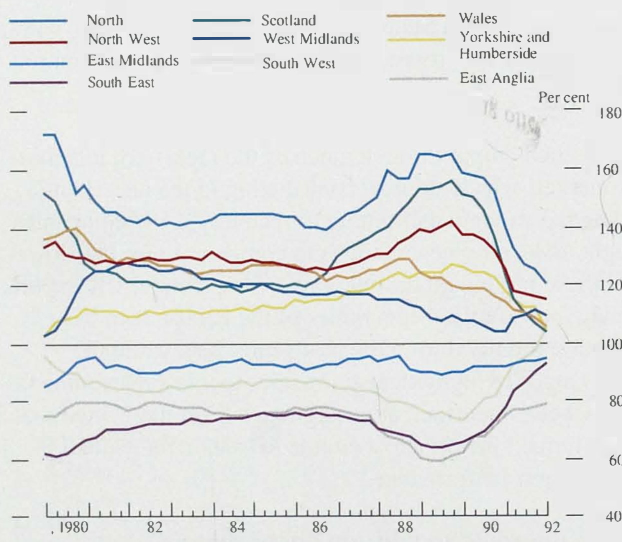
Downward pressure *on settlements continues to be the norm . . .*

With activity weak and unemployment levels rising, downward pressure on pay settlements was maintained during the second half of last year. By the first quarter, whole economy pay settlements had fallen to around $4^1/_2$%, from around 9% a year earlier. The fall

Regional unemployment

Since its trough in April 1990, unemployment has increased by more than one million. The rise has been concentrated in those regions which have persistently experienced lower rates of unemployment than the national average. As is evident from the chart, the position of those regions with historically the lowest unemployment rates compared with the United Kingdom as a whole began to deteriorate with the onset of the recession. The sharpest increases in unemployment have been concentrated in Greater London, the South East, the South West, and the West Midlands. In the two years since March 1990, the increase in unemployment rates in these regions has exceeded the United Kingdom average by a factor of 1.4, 1.4, 1.2 and 1.2, respectively. As a consequence, the dispersion in regional unemployment rates declined; the coefficient of variation fell from 51.9% in April 1990 to 18.9% in March 1992.

Regional unemployment rates relative to the national average



The industrial composition of employment does not exhibit a uniform pattern across the country. A region may have a high concentration of firms that are in the same industry. Where this is the case, shifts in demand for the output of that industry will have greater importance for the demand for labour in that region than for the economy as a whole. The pattern of regional specialisation in 1990 can be measured using an employment location quotient, (see R J Dixon and A P Thirlwall, 'Regional Growth and Unemployment in the United Kingdom' 1975). The employment location quotient is defined as the ratio of employment in an industry in a region to total employment in that region divided by the comparable national figures. A figure in excess of one hundred in Table 1 suggests that a region is specialised in an industry compared to the United Kingdom as a whole. A figure below one hundred suggests it is not specialised in that sector.

Table 1
Employment location quotient in 1990

Region	Agricult -ure	Energy and water	Manufact -uring	Constr -uction	Services
South East	62	66	74	88	111
Greater London	3	62	54	80	119
East Anglia	301	73	100	95	98
South West	181	80	93	91	102
West Midlands	95	84	142	95	87
East Midlands	131	154	136	91	87
York and Humberside	98	142	115	110	93
North West	49	91	117	99	96
North	82	169	109	133	93
Wales	161	131	108	100	95
Scotland	115	150	90	141	99

As is evident from service sector employment location quotients, the South East, Greater London and the South West have a disproportionately large share of employment in the tertiary sector relative to the national average. This implies that an evenly distributed fall in the demand for labour in the service sector would have a particularly adverse impact on these regions. Similarly, any contraction in manufacturing employment would have a harsh impact on the West Midlands.

Table 2
Percentage change in employment in certain sectors (90Q2–91Q4)

Region	Agricult -ure	Energy and water	Manufact -uring	Constr -uction	Services
South East	-10.0	-0.3	-9.0	-15.4	-5.4
Greater London	-9.4	1.9	-10.4	-15.3	-7.7
East Anglia	-8.4	-1.2	-10.3	-16.0	0.5
South West	-0.5	-3.2	-7.7	-15.4	-1.5
West Midlands	-6.0	-12.4	-13.2	-16.0	-2.9
East Midlands	2.5	-11.0	-6.8	-15.5	3.8
York and Humberside	-6.1	-9.2	-6.3	-16.3	-1.5
North West	3.7	-7.1	-6.3	-16.0	-0.4
North	1.5	-8.7	-2.2	-16.8	-0.5
Wales	0.5	-10.4	-7.6	-16.3	-1.8
Scotland	-4.7	-0.5	-4.0	-16.4	3.5
Great Britain	-4.2	-5.8	-7.9	-15.9	-2.1
Coefficient of variation	1.2	0.8	0.4	—	1.6
Proportion of total Employment in GB (per cent)	*1.3*	*2.0*	*22.6*	*4.6*	*69.5*

Table 2 shows that, with the exception of the construction industry, the spatial pattern of labour shedding in each sector has been far from uniform. The sharpest contractions in employment in both the manufacturing and service sectors (which between them account for 92% of all employment) have occurred in the regions which have a disproportionately large share of employment in that sector. The proportion of jobs lost in the tertiary sector has been greatest in Greater London and the South East. Likewise, it is the West Midlands where a disproportionately large amount of manufacturing labour has been shed. Thus recent spatial unemployment patterns reflect particularly sharp falls in employment in those sectors on which the regions are heavily reliant for the provision of employment.

Chart 13
Competitive pressures *have borne down on* **producer output prices**

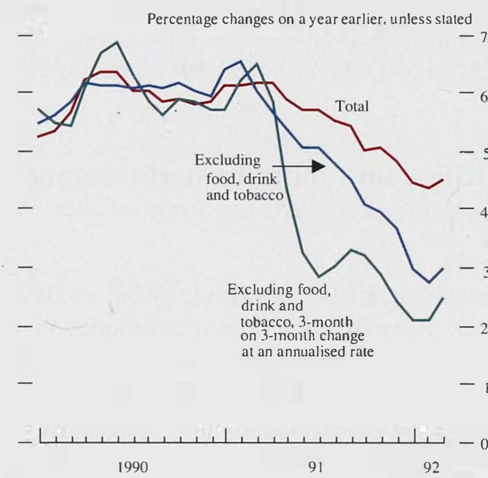
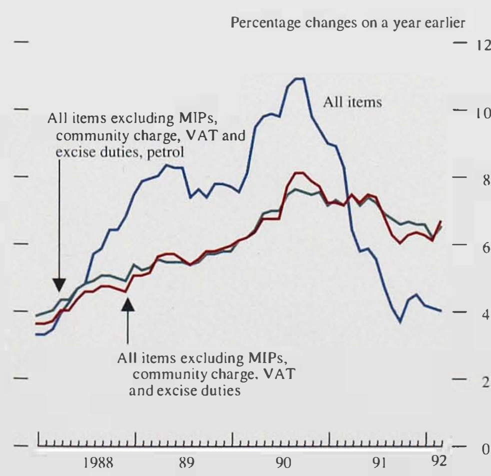


Chart 14
Previous temporary influences on **inflation** *are beginning to disappear*



in pay settlements has also contributed to a slowdown in the growth of average earnings. In the year to March, the underlying rise for the economy as whole was 7½%, boosted slightly by higher bonus payments from the 7¼% recorded at the turn of the year, but down from a peak of 10¼% in the middle of 1990. As settlement rates are forward-looking in nature, further moderation in the rate of earnings growth is likely in the near future. These gains have been achieved against a background of falling and then stable inflation rates. They are also reflected in lower rises in manufacturers' output prices (see Chart 13). Excluding the food, drink and tobacco industries, prices have risen by less than 3% over the past year, compared with an annual rise of around 6½% a little over a year ago, suggesting that downward pressure on RPI inflation is being maintained.

. . . and **underlying inflation** *has been improving*

With the exception of one month, when the rate dropped to 3.7%, RPI inflation has remained between 4 and 4½% since September of last year, after falling from a peak of 10.9% a year earlier. This sharp fall and subsequent flattening of the rate reflects the initial impact upon, and subsequent dropping out from, the 12-month growth rate of three important influences: the sharp rise in world oil prices which followed the Iraqi invasion of Kuwait in August 1990 and its subsequent reversal; the reduction in mortgage interest rates since November 1990; and the combined effect of the reduction in Community Charge payments (which had an immediate impact on recorded inflation) and the broadly off-setting rise in VAT (which appears to have been passed through more gradually), announced in the March 1991 Budget. All three of these factors overstated the apparent progress of recorded inflation through much of last year. The underlying improvement in the inflation rate has been more gradual than that of the headline measure. Much of the effect from these short-run factors, however, will soon have passed out of the headline figure; and alternative inflation measures, such as those illustrated in Chart 14, should once again begin to converge.

However, **price rises** *vary across sectors . . .*

Very different patterns, however, have developed for the prices of goods and services. Most goods prices have recorded a marked slowdown in their rate of increase as demand has fallen. For example, the 12-month rate of growth in the price of clothing and footwear has fallen from around 4.6% at the beginning of 1990 to around 1.3% at the beginning of 1992, despite the rise in VAT in the April 1991 Budget. In contrast, service sector inflation has not retreated to any great extent and has apparently accelerated in some areas, despite the weakness of demand. The prices of household services and leisure services were growing at around 9% and 12% respectively in the summer of 1991; since then the 12-month rate of increase in these prices has eased slightly.

The differential pattern of inflation rates between the goods and service sectors may partly reflect the impact of the rise in VAT last April, with a large proportion of goods being zero-rated. It must also to some extent reflect the different rate at which productivity has developed. The recent enlargement of the inflation differential between goods and service prices *may* also in part owe something to a transitional institutional change. The introduction of the Uniform Business Rate (UBR) from April 1990 may have modified the

overhead costs of retail businesses in a way that has operated unevenly between different types of retail outlet. Typically, the retail prices of many services are dominated by labour and overhead costs, suggesting a significant pass-on element of the UBR increase, per unit of service. In contrast a high proportion of the selling price on goods is a bought-in cost on which the UBR input may be negligible.

. . . *and the* **United Kingdom's inflation performance** *remains above comparable measures for some of our* **European partners**

The progress to date in reducing inflation within the traded goods sector has been substantial. But most wider measures of inflation continue to indicate that there are further adjustments to be made. Direct comparisons between the consumer price indices (CPIs) of our European partners and the United Kingdom's inflation record can be problematic because of important differences in both their methodology and coverage. Notwithstanding such differences it appears that considerable convergence has been achieved over the past year. There is still some way to go, however, to match the best EC performance.