The domestic economy

- *Underlying inflation fell rapidly through the summer as the fragility of consumer spending encouraged heavy price discounting by many retailers.*

- *Total domestic demand has been rising slowly since the middle of last year but, with the net trade position deteriorating, output has shown little sign of picking up.*

- *Business and consumer confidence have fallen sharply since the spring and many companies now appear to be renewing their efforts to control costs through further cuts in their workforce.*

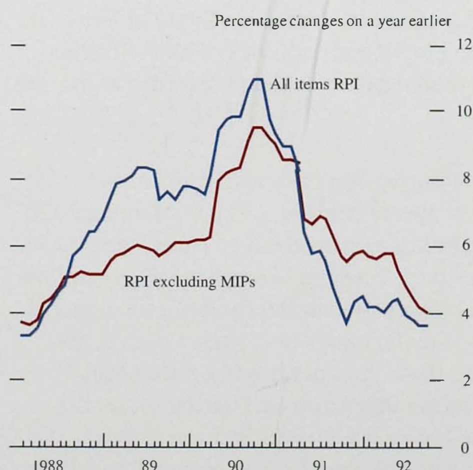
- *The faster growth of unemployment in recent months is adding to the financial worries of households. Scheduled debt repayments have continued to rise and individuals remain unwilling to make new borrowing commitments.*

- *Turnover in the housing market appears to have fallen back sharply following the ending of the stamp duty holiday, and the decline in prices has intensified.*

- *Against this depressed background, the easing of monetary policy following sterling's withdrawal from the exchange rate mechanism will assist the return to economic growth.*

- *Sterling's depreciation offers a sizable opportunity to UK exporters but it also reduces the downward pressure on inflation.*

Chart 1
The fall in **inflation** *has gathered pace in recent months*

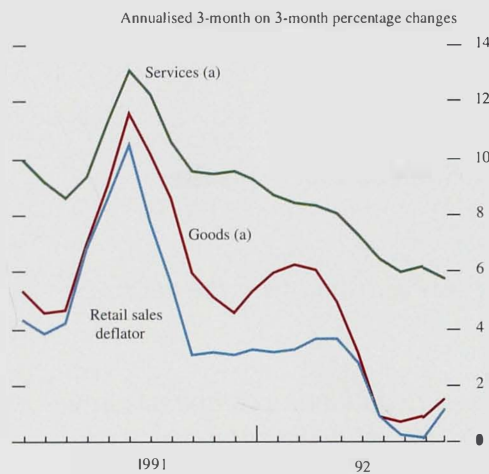


Inflation *has continued to fall . . .*

Progress towards lower inflation gathered pace through the summer, following six months in which both the headline and underlying rates had recorded a small rise. The twelve-month change in the all items Retail Prices Index (RPI) stood at 3.6% in September—down from 4.3% in April and May and more than seven percentage points below the cyclical peak in the autumn of 1990 (see Chart 1). Excluding mortgage interest payments, the underlying inflation rate has fallen more rapidly this year to stand at 4.0% in September against 5.7% in April.

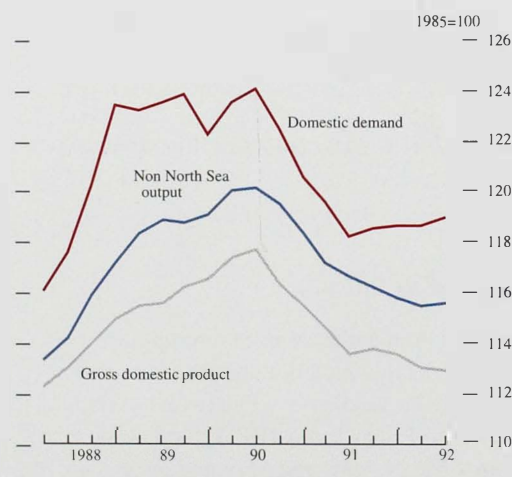
The fall was sharper than foreseen by most commentators and reflected the virtual levelling off of many shop prices (after allowance for normal seasonal factors) during recent months. This can be seen more clearly in Chart 2, where shorter, three-month changes in the prices of goods and of services are expressed at their equivalent annualised rates. Goods prices, which as little as a year ago were rising at an annualised rate of around 6%, have recently been growing at equivalent rates close to 1%. Heavy price discounting, mid-season sales, and the extension of summer sales beyond their traditional closing dates have been important factors behind the most recent fall in inflation. The implied average price of sales reported by retailers (also shown in Chart 2) has recorded little underlying growth through the summer. This suggests that the current twelve-month growth rate of 2% may be set to fall further.

Chart 2
Goods price inflation *is particularly subdued*



(a) Seasonally-adjusted Bank estimates.

Chart 3
Output *remains subdued but* **domestic demand** *is rising*



The prices of most services continue to rise at rates well above this. Yet progress in reducing inflation has been significant here too.

Short-run inflation measures of the type shown in Chart 2 are subject to technical limitations—most notably in their ability to distinguish temporary price discounts from underlying changes—yet they can signal changes in inflationary performance much earlier than conventional twelve-month growth rates. While the sharp deceleration in goods prices during the past year may owe something to temporary factors, such as the recent weakness of import prices, it also reflects the extent of the disinflationary pressures present in the economy as a result of the persistent weakness of activity relative to potential.

. . . *and* **activity** *shows few signs of picking up . . .*

Total output (GDP) has now fallen in seven out of the last eight quarters and currently stands some 4% below its peak in the second quarter of 1990. In the second quarter of this year, output fell by just 0.1%. But, with oil and gas extraction dropping more than 4% over this period, this concealed a 0.1% rise in the on-shore economy, the first in two years (see Chart 3).

While technically this increase may have marked the end of the recession for the non-oil economy, it does not yet appear to have heralded a return to higher levels of activity. The increase in output in the second quarter resulted from a ½% rise in manufactured output while activity in the service sector was flat and the construction sector recorded a further 1% fall. Construction output is now some 15% below its peak at the beginning of 1990. Moreover, the indications are that the stronger performance of the manufacturing sector through the first half of the year has not been sustained. Manufacturing output fell by 0.3% between June and August and recent CBI surveys suggest that output has continued to fall through the autumn.

Barclays Bank report that builders sold 30,000 new homes in the third quarter, 61% below the corresponding figure for 1991 and 12% below the second quarter number. There were also no signs of an increase in house-building activity. Builders may have viewed any boost to demand associated with the ending of the Stamp Duty holiday as temporary and, with a sizable cushion of work in progress, this made a rise in private housing starts unnecessary. The number of private starts was 39,300 in the second quarter and 37,500 in the third. The Building Employers Confederation State of Trade enquiry for the third quarter was correspondingly gloomy. It reported a further decline in output and enquiries, with confidence about future workloads slipping back to the level recorded at the end of 1991.

The continuing weakness of output contrasts with a slow but perceptible upturn in total domestic demand. The 0.2% increase in the second quarter was the fourth consecutive rise (see Chart 3) and leaves demand 0.6% higher than a year ago compared with a fall of 0.6% for GDP. While it is relatively unusual for domestic demand and output to move in opposite directions over such a period, the absolute difference between these growth rates is by no means unprecedented. Table A shows that, in an accounting sense, the growth of demand over the last year has resulted from slower destocking, without which demand would have continued to fall.

Table A
Contributions to GDP growth

Per cent

	Q2/Q1	1992 Q2/ 1991 Q2
Consumers' expenditure	0.4	—
Public consumption	0.3	-0.1
Fixed investment	-0.5	-0.7
Stock changes	0.1	1.5
Domestic demand	0.2	0.7
Net trade	-0.4	-1.6
Factor cost adjustment	0.1	0.3
Gross domestic product	-0.1	-0.6

Chart 4
The volume of **retail sales** *has picked up in recent months*

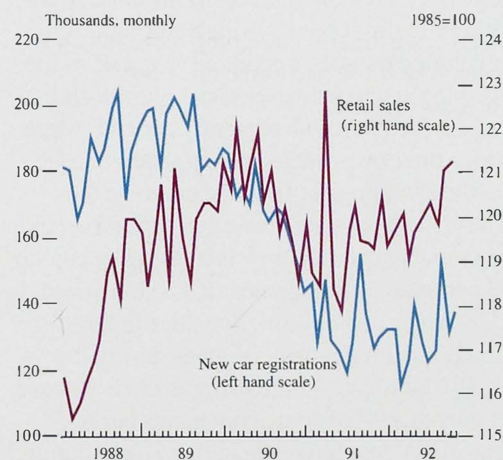
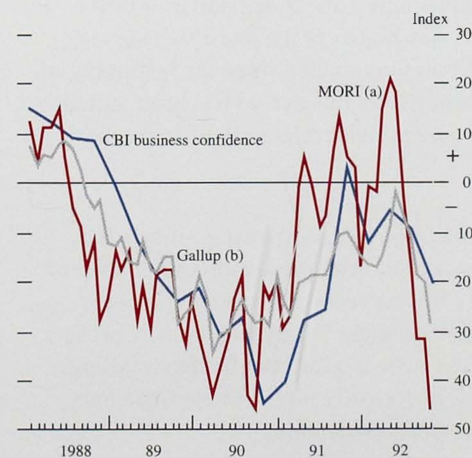


Chart 5
Consumer confidence *is back down to the levels last seen in 1990*



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

But slower destocking has also been a factor behind the negative contribution to output from net trade, since a high proportion of manufacturers' stocks are accounted for by imported materials and components.

More recently, the growth in domestic demand has reflected the modest rise in consumer spending in the second quarter and a rise in government final consumption. Total fixed investment has continued to fall. The profile of consumer spending through the first half of the year is thought to have been influenced by a number of special factors—notably the general election, the changes to car tax in the Budget and the lateness of the Easter holiday—which may have encouraged the delaying of some expenditure from the first to the second quarter. The ½% rise in consumer demand between these periods probably resulted from such switching and may, as a consequence, offer a poor guide to the underlying movement of demand. The composition of spending was broadly consistent with this interpretation: expenditure on durables rose most sharply, largely reflecting a 2½% rise in spending on cars and other vehicles, while expenditure on services fell.

Early indications nevertheless suggest that consumer spending in the third quarter has at least maintained its second quarter level. Retailers engaged in aggressive promotional price discounting throughout the summer and, despite generally disappointing sales figures in July—the traditional key month for summer sales—volumes in the three months to September were ½% above those in the post-election period between April and June (see Chart 4). Sales volumes in the clothing and footwear sector, where sales discounts have returned prices to the level of a year ago, grew by 1¾% between the second and third quarters. Sales of household goods, however, rose by 2½%: while heavy price discounting may have influenced some purchases, it is likely that part of this rise was associated with the sharp, but temporary, rise in housing transactions during the summer (see below).

. . . while **business** *and* **consumer confidence** *have fallen sharply through the summer and autumn*

By contrast, consumer confidence has fallen sharply since the spring as individuals have revised down their expectations for economic recovery and for their own personal finances. Chart 5 shows that both the Gallup and MORI indices have fallen to levels not seen since late in 1990, having touched three and five-year highs following the general election.

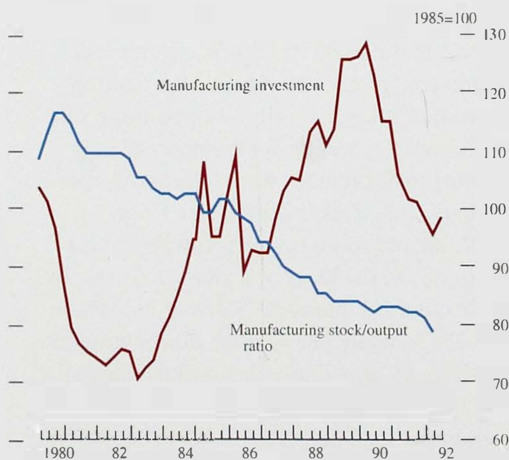
The relationship between the confidence indicators and actual expenditure is far from precise, not least because the surveys do not ask directly about spending intentions. Even so, the contrast between the fall in confidence since the spring and the more stable profile of retail spending is at first sight surprising. Part of the explanation may lie in the recent scale of price discounting and the temporary rise in housing transactions, without which retail sales might have been weaker. It is also likely that the peak in confidence would have required clearer evidence of recovery, including more buoyant retail spending, in order to be sustained. Viewed in this way, the decline in confidence represents a return to more realistic expectations after the optimism which followed the election, and need not imply a further weakening of demand.

Greater confidence is, nevertheless, still likely to be required to support a sustained rise in spending. But this may now depend in turn upon clearer evidence of economic recovery. The 'false dawns' in consumer confidence and business optimism in the autumn of 1991 and the spring of this year both suggest that, while confidence may be a precondition for recovery, it is also highly reactive—perhaps the more so after recent disappointments—with both consumers and businesses unprepared to back their judgements about recovery until they are confirmed by the responses of others. Breaking into this circle will be difficult so long as the costs of being wrong—for example increasing indebtedness ahead of a fall in demand or the loss of household income—are perceived to be skewed in favour of caution.

Companies *have continued to match their operations to reduced* **expectations** *of demand . . .*

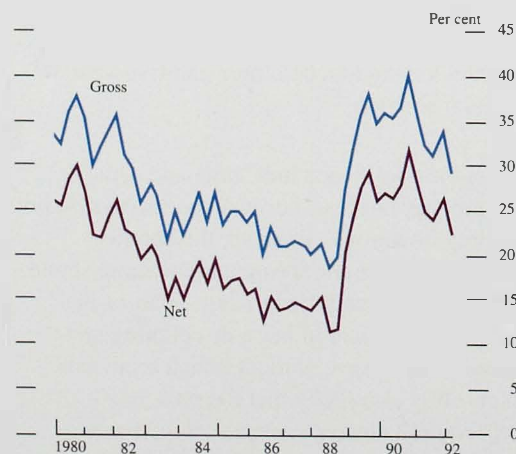
The failure of demand to recover more vigorously in the second quarter led companies to revise down their expectations through the summer. A modest recovery in order books in early spring encouraged higher manufactured output through the first half of the year. But, with retailers struggling to increase sales volumes and export markets weakening, orders were subsequently cut and, while retailers were able to reduce their own stocks, manufacturers faced an unplanned build-up in their holdings of finished goods in the three months to June. These developments came at a time when the corporate sector was showing tentative signs of increasing its capital spending. Industrial and commercial companies (ICCs) borrowed some £1½ billion from UK banks and building societies in the second quarter, having made a net repayment of loans during the preceeding nine months. Part of the new borrowing is likely to have been for working capital purposes—for some companies bank lending will have been the direct counterpart to higher stockholding. But many companies, particularly within the manufacturing sector, seem also to have raised their spending on fixed investment. As Chart 6 shows, the volume of manufacturing investment rose by more than 3% in the second quarter.

Chart 6
Stocks *and* **investment** *have been pared back during the recession*



By contrast, the evidence from the third quarter suggests renewed retrenchment. ICCs made net repayments of borrowing from banks and building societies of £1.3 billion and also raised significantly less finance through capital issues. This retrenchment is reflected in the downturn in business optimism reported by the CBI. The proportion of firms citing uncertainty about demand as a factor limiting capital expenditure was higher in the latest two surveys than in all but one of the surveys conducted since the beginning of the recession. Capital spending over this period has been aimed mostly at efficiency improvement, with relatively little emphasis on expanding capacity.

Chart 7
Corporate income gearing (a) *remains at historically high levels*



(a) Ratio of interest payments to income.

Longer term, the net repayment of bank borrowing reflects the wider pressures on costs associated with the sector's high level of indebtedness. This strategy has succeeded in reducing income gearing (see Chart 7). Yet, despite the relative strength of profits, the progress in repaying bank debt and the benefits from falling interest rates, gearing is still historically high and the financial pressures on companies remain considerable.

Nevertheless, profitability within the sector as a whole has held up surprisingly well compared with the previous recession (see

Chart 8
Despite falling back since 1989, **company profitability**[(a)] *is well above its level of the early 1980s*

(a) Pre-tax real rate of return.

Table B
Contributions to manufacturers' output prices[(a)]

Percentage points

	Unit labour costs	Input prices	Bought-in services(c)	Margins(b) (residual)	Output prices(d)
1991 Q2	3.6	-0.3	2.2	0.4	5.9
1991 Q4	1.9	-1.2	1.9	2.3	5.0
1992 Q2	0.7	-0.9	1.5	2.3	3.6

(a) Excluding food, drink and tobacco.
(b) Figures may not add to totals because of rounding.
(c) Proxied by unit labour costs in the service sector.
(d) Percentage change on a year earlier.

Chart 9
Companies *have pared back* **staffing levels** *over the recession*

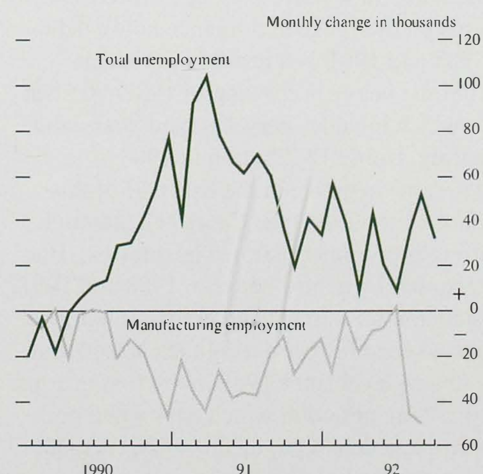


Chart 8) as companies have attempted to maintain strict control over their costs. Within the manufacturing sector, for example, prices charged in the domestic market are now rising less rapidly than at any time since 1968; yet, in the year to the second quarter, labour and material costs seem not fully to account for even this rise. As Table B suggests, manufacturers have made considerable progress in reducing the rate of growth of their labour costs, both as a result of lower settlements and of increased efficiency. But they have also benefited from falls in the prices of many imported materials and appear to have absorbed these gains into their margins. For companies supplying the export market, exchange rate developments before the recent depreciation of sterling had been generally less accommodating and typically resulted in a narrowing of margins.

The aggregate income and expenditure data, however, mask a range of experience: the sample of 1,000 companies held on the EXTEL database indicates the extent to which small and medium-sized firms have fared relatively poorly compared with the largest companies. For those which have so far announced results in 1992, the data show that real turnover of small firms has fallen markedly since 1990. This has contributed to a sharp deterioration in the profitability of smaller firms relative to large ones between 1990 and 1992. For many smaller companies, the burden of indebtedness has been unsustainable. The retained profits of smaller companies have been squeezed and the number of liquidations and personal bankruptcies has continued to rise.

Total company insolvencies in the first three quarters of this year were almost 15% above the level in the equivalent period in 1991. Personal bankruptcies (largely partnerships and unincorporated businesses) have risen much more sharply this year, standing around 50% above the same period in 1991. For many more companies, there is growing evidence of adjustments being made to improve cost structures, in the absence of a more discernible upturn in demand.

. . . and there are signs that the pace of **labour shedding** *has recently intensified . . .*

Part of this adjustment may take the form of some further downward movement in pay settlements. The average settlement rate declined from around $9^1/_2$% at the end of 1990 to about 5% at the end of 1991 but has since stayed at a little above 4%. This pattern is similar to that seen in headline inflation and illustrates the weight which pay bargainers attach to past inflation when negotiating for the year ahead. Earnings growth, which reflects the level of settlements throughout the year, fell less rapidly in 1991 but has continued to decline this year, reaching $5^3/_4$% by August. The current average settlement rate suggests some further fall in earnings growth by the end of this year. Thereafter, any additional falls are likely to require some further downward movement of settlements. The recent path of inflation should facilitate this process. But, with many existing settlements within the manufacturing sector already being presented as self-financing, the scope for further sizable reductions may begin to diminish.

Companies are continuing to pare back staffing levels (see Chart 9), and many have signalled the necessity of more radical cuts in response to continuing weak demand. Employees in employment

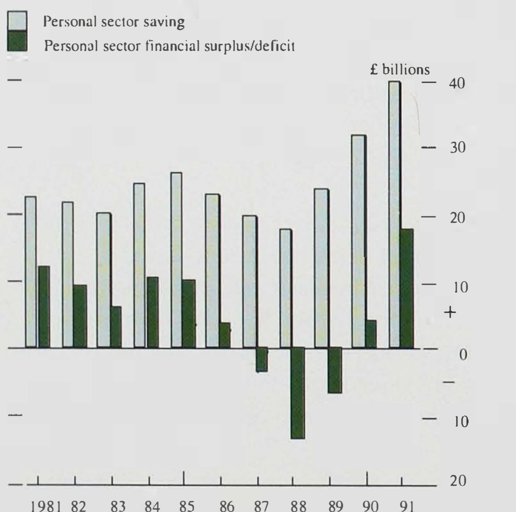
fell by almost 800,000 through 1991 but showed signs of levelling out in the early months of this year before falling more sharply again in the second quarter. There are now indications that this decline has further intensified. Within the manufacturing sector, for example, employment was reduced by around 96,000 in the three months to August, compared with 38,000 in the three months to May (see Chart 9). The recent spate of redundancy announcements suggests that this process is still far from complete.

The impression of a faster rate of labour shedding is also consistent with recent large monthly increases in unemployment. After rising at an average monthly rate of 58,000 through 1991, the rate of increase of unemployment slowed substantially to just 29,000 in the first half of this year. This rate has since picked up to around 40,000 in the third quarter. The changing composition of unemployment is discussed in the box opposite.

. . . *adding to the uncertainties faced by* **households** . . .

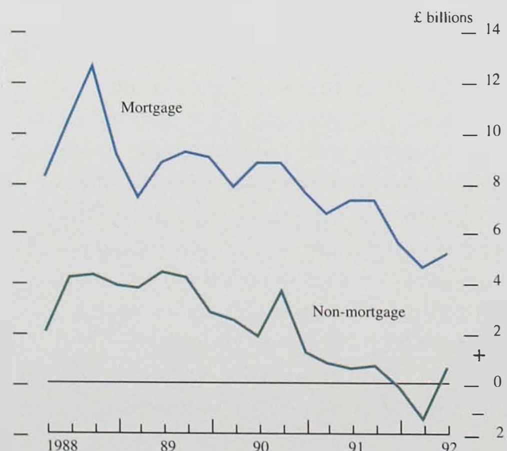
The renewed weakness of the labour market has undoubtedly been one of the main factors undermining the confidence of households since the spring. Additionally, wage settlements for those in work have been lower this year than last, while total overtime working has remained subdued. These pressures have probably induced a readjustment of expectations about future income. As a result, many households have become more cautious about undertaking major expenditure.

Chart 10
The personal sector *has sharply increased* **saving** *since the late 1980s*



During this recession, changes in spending patterns have been associated with a sharp decline in new borrowing, while the net build-up of savings balances has actually slowed. The combined effect of an increase in the saving ratio and lower residential investment has been sharply higher personal sector financial surpluses, as can be seen in Chart 10. Within this net position, the flow of new borrowing (net of repayments) fell from £41.6 billion in 1990 to £28.4 billion in 1991, while the net increase in liquid assets held by the personal sector also fell, to £25.8 billion from £35.9 billion. During the first half of 1992, the flow of new borrowing fell to £8.7 billion while the personal sector's holdings of liquid assets increased by £17.0 billion, 12% less than the figure for the first half of 1991.

Chart 11
The level of **new borrowing**, *net of repayments, has fallen sharply*

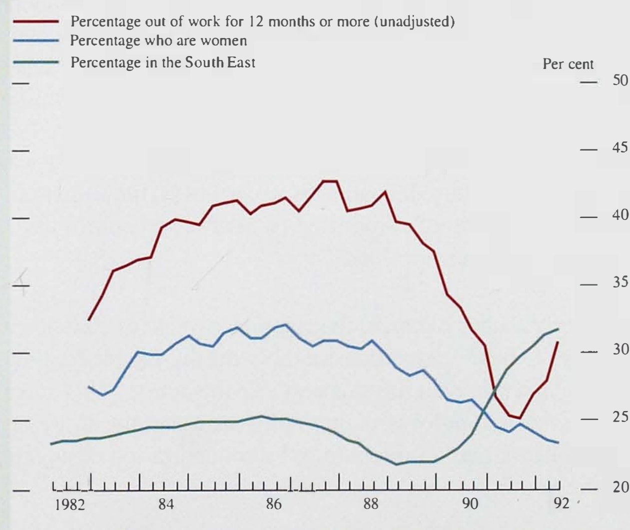


Within the borrowing figures two main factors have been responsible for the recorded fall; new borrowing has slowed sharply while scheduled repayments on mortgage and finance house debt rose by a third between 1988 and 1991 as a result of the much increased stock of debt after the heavy borrowing of 1987–90. Net non-mortgage borrowing, which includes personal bank loans and retail credit, has fallen sharply, from £14.2 billion in 1988 to £1.7 billion last year and became negative in the first half of this year with a net repayment of £1.0 billion (see Chart 11), although this partly reflects the activities of unincorporated businesses. But net mortgage borrowing also fell by a third between 1988 and 1991, with a decline in both residential investment and equity withdrawal. Net mortgage borrowing weakened further during the early part of this year, and reached its lowest level since 1985 in the first quarter, partly reflecting the end of a long period in which equity had been withdrawn. Lump sum mortgage debt repayments remain a small component of households' total saving.

Compositional aspects of unemployment

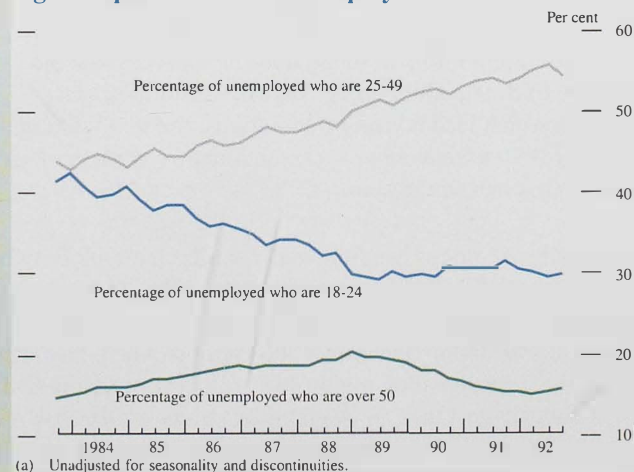
The current recession has brought about substantial adjustment within the labour market. Since June 1990 the workforce in employment has fallen by 1.6 million, while claimant unemployment has risen by over 1.2 million since its trough in April of that year. High or rising unemployment can influence expectations and behaviour throughout the economy. It can have a bearing on the process of wage bargaining and also influences measures of consumer confidence—and hence consumer demand—by affecting expectations about job security and future income. Although claimant unemployment now exceeds 2.8 million, compared to a peak of 3.1 million in 1986, the characteristics of those now losing their jobs have been changing. This box documents some of these changes and looks at how compositional shifts might affect the influence which unemployment can have on other areas of economic behaviour.

Chart A
Composition of unemployment



Charts A and B show some of the ways in which the composition of the unemployed has changed over the last ten years. Some characteristics, such as the proportion of long-term unemployment within the total, vary with the economic cycle, falling in the early stages of recession and rising well into the recovery phase (Chart A). But a number of other changes have occurred which seem not to be cyclical in origin. The male/female composition of unemployment has changed since 1986 with the proportion of women declining. The regional pattern of unemployment has also changed markedly with a higher proportion of the unemployed located in the South East. And the age structure of the unemployed has also changed: those in the 18–24 year age group constitute a steadily declining share of the total while those in the 25–49 age group have increased.

Chart B
Age composition of the unemployed (a)



(a) Unadjusted for seasonality and discontinuities.

The Labour Force Survey (LFS) can provide much greater detail about the characteristics of the unemployed. The table illustrates a number of comparisons for short-term claimants (defined in the LFS as those claiming benefit who left their jobs less than six months previously). One of the most striking features is the change in the pattern of housing tenure among those claiming benefit. The percentage of male claimants in a mortgaged household has risen sharply from 34% in 1986 to 41% last year. In addition, short-term claimants now appear more highly qualified than in 1986, with the percentage holding A-level or higher qualifications rising over the period, while the proportion with no formal qualifications has fallen.

Selected characteristics of short-term claimants

Percentage of category

	Males		Females	
	1986	1991	1986	1991
Housing tenure:				
Owner-occupied with mortgage	34	41	45	47
Renting	51	46	41	41
Highest qualification:				
A-level and above	34	41	22	30
No qualifications	40	33	35	28
Previous occupation:				
Professional /intermediate	13	15	11	17
Skilled	51	53	54	50

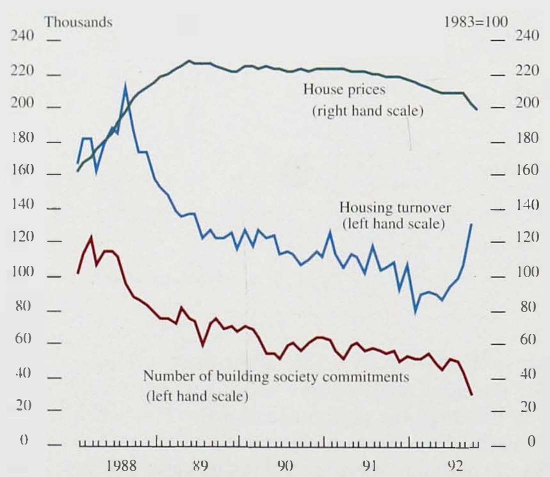
What such shifts in the composition of unemployment and the characteristics of the unemployed might mean for economic behaviour more widely cannot be assessed with confidence. But a number of possible implications can be identified. Those who have become unemployed in the current recession appear likely, either because of their past occupation or because of their qualifications, to have held more buoyant expectations about their long-term earnings potential than did their counterparts in the previous period of high unemployment. The shifts in housing tenure may also reflect these changes and suggest that the unemployed typically now have greater financial commitments.

Rising unemployment may, under these circumstances, have encouraged greater financial caution and a greater downgrading of expectations about future incomes than implied by the aggregate data. In part, this will reflect a direct effect as those becoming unemployed adjust their own behaviour. But it may also have an indirect element as other skilled workers or home-buyers perceive an increased risk to their own security. More encouraging, of course, is the fact that those now seeking employment are relatively more highly qualified and skilled than a few years ago. This should help their reintegration while maintaining competitive pressures within the pay bargaining process.

The interpretation of these data should be qualified by the existence of large balancing items between the real and financial accounts. But they are consistent with the view that households' financial retrenchment has been concentrated in lower new borrowing, with little evidence of additional balance sheet rebuilding, either in the form of a faster increase in liquid assets or in large-scale discretionary debt repayment. The squeeze on personal sector income may have prevented a more widespread balance sheet 'repair', with households unable to boost the build-up of liquid assets. The slower rate of inflation since 1990 has also reduced the need for increased nominal balances.

Saving flows—defined to include changes in liabilities as well as assets—can also be categorised as discretionary or committed. Committed saving is either involuntary, such as that undertaken on the individual's behalf (for example employers' contributions to pension funds) or contractual, the result of an earlier agreement (for example, hire purchase repayments). Saving in liquid assets and new borrowing are predominantly discretionary: scheduled debt repayments are predominantly committed. The net effect of a reduction in new borrowing and lower saving in liquid assets was to increase the flow of saving by just £5.5 billion from 1988 to 1991. Over the same period, committed repayments, and saving via life assurance and pension funds, increased by over £15 billion. Thus the majority of the increase in saving between 1988 and 1991 was not the result of voluntary decisions by households, but rather represented the build-up of committed payments and contributions to life assurance and pension funds.

Chart 12
The **housing market** *remains depressed*



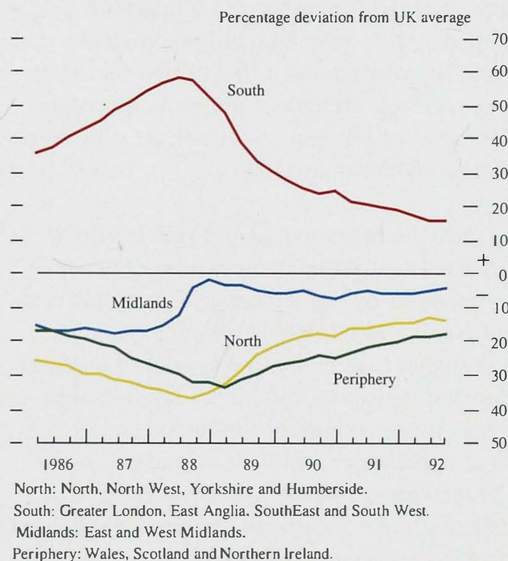
Although timely data are scarce, the regional profile of changes in saving appears to have varied considerably during the recession. Southern England has seen the sharpest rise in saving. This accords with both the sharper increase in unemployment and the depressed state of the housing market, including the concentration of negative equity, in the South.

... and compounding problems within the depressed **housing market**

The number of property transactions measured by the particulars delivered series rose strongly between May and September, to stand at 131,000, compared with an average of 88,000 a month in the first half of the year (see Chart 12). However, particulars delivered are a lagging indicator and the September total broadly reflects sales that were actually taking place in July and August. More timely data point to a sharp fall in turnover in the housing market since the reintroduction of Stamp Duty on 19 August. Building society commitments, which lead housing transactions, fell to 43,000 in August and 31,000 in September against a monthly average of 49,000 in the first half of the year.

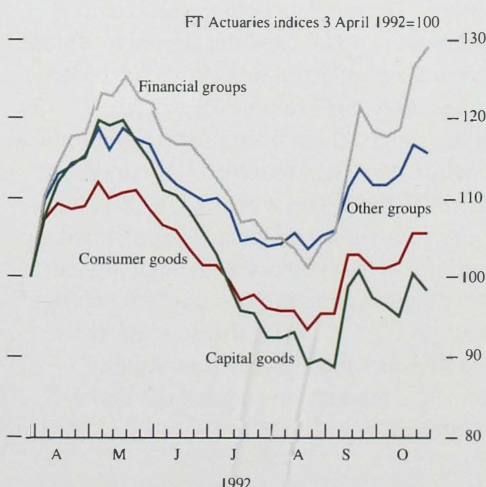
The change in house prices has followed a similar pattern. Between May and August the Halifax house price index fell by 0.4%—markedly slower than in the three months to May, when house prices fell by 2.2%, and in September and October when they fell by a total of 3.8%. Even allowing for the extra cost of Stamp Duty, the Halifax data suggest that, by September, purchases had become significantly cheaper than earlier in the summer. The third quarter data also point to a slightly altered profile of regional price movements, with sharp falls in Northern England, which had

Chart 13
The **differential** *between southern and national* **house** *prices has narrowed sharply*



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

Chart 14
Share prices *rose following* **sterling's** *suspension from the ERM*



previously held up well, while the Midlands showed an increase in contrast to its earlier weakness (see Chart 13). The South of England, however, again experienced one of the largest falls.

Largely as a result of the further falls in the South, it is likely that the number of households with negative housing equity rose again, to an estimated 1.2 million in the third quarter, from 1 million in the second quarter. In London and the South East the number may have reached 700,000, more than one in five of all mortgaged households.

Although data on arrears and possessions for the second half of the year are limited, building societies were reporting a decline in the incidence of new arrears in the first half of this year, with little new evidence to suggest a reversal of this development. Instances of serious arrears (over 12 months) have increased, however, which suggests that reductions in possessions primarily reflect lenders' forbearance. The number of court actions taken for possession fell in the third quarter to 34,000, against 51,000 in the third quarter of last year, according to data from the Lord Chancellor's office.

The easing of monetary policy following **sterling's withdrawal** *from the ERM should help to restore* **confidence** *in economic recovery . . .*

The reductions in base rates on 22 September and 16 October, and the subsequent lowering of mortgage interest rates, will help to relieve the build-up of mortgage arrears and to encourage more first-time buyers into the housing market. The lower cost of servicing much existing debt, both within the personal and corporate sectors, should be a positive factor in restoring confidence. The depreciation of sterling should also offer welcome relief for companies which are selling in export markets, competing with overseas suppliers, or attempting to repatriate overseas earnings.

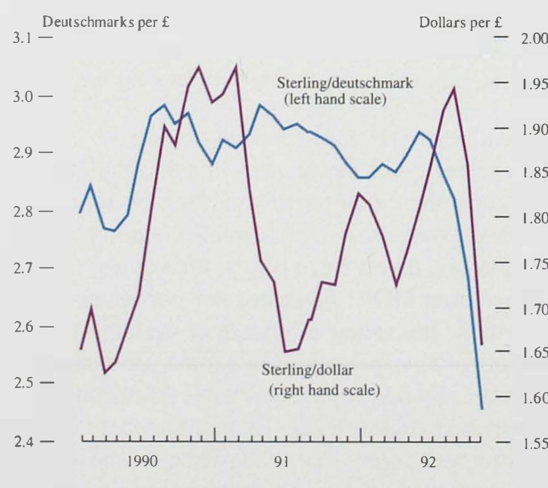
The chaotic market conditions which surrounded sterling's withdrawal from the exchange rate mechanism, and the resulting period of uncertainty about the future framework for monetary policy, have nevertheless given rise to considerable volatility in expectations, which may not, as yet, have fully settled down. Interim survey evidence from MORI suggested that consumer confidence picked up in the immediate aftermath of sterling's withdrawal, perhaps reflecting expectations of a more substantial reduction in interest rates. By late September, however, the index had returned to its depressed August level. By mid-October the Gallup index was recording a further sharp fall, while the most recent MORI survey, conducted after base rates were reduced to 8%, shows a further sharp decline.

Share prices rose sharply following sterling's suspension, with export-oriented sectors apparently performing strongest. By 24 September, the FTSE 100 index had risen by more than 10½% from its close on 15 September and, although it fell back by early October, it has subsequently risen strongly. Chart 14 illustrates the main sectoral composition of these changes.

Recent business surveys illustrate the range of influences on sentiment. The CBI's Industrial Trends Survey for October recorded a sharp drop in general business optimism, reflecting a fall in reported orders since the last survey. Concern about domestic markets, however, was tempered by an improvement in optimism about export prospects.

Chart 15
The growth of **import volumes** *has been disappointing*

Chart 16
Sterling's depreciation *has been considerable against the* **dollar** *as well as the* **deutschmark**



. . . with **depreciation** *offering sizable opportunities to* **UK exporters** *. . .*

The UK trade deficit has widened somewhat so far this year. Underlying the aggregate deficit—some £9.6 billion on visible trade in the first nine months of the year against £10.3 billion for the whole of 1991—is the continuing strength of import volumes and the much weaker performance of UK exports, which are now being held back by the fragility of overseas demand.

The growth of imports since the beginning of last year has been particularly striking when set against the main indicators of domestic demand. For example, by the second quarter of this year, the volume of imported goods and services (excluding oil and erratics) was some 8¼% higher than in the first quarter of last year while total domestic demand registered a small net fall over the same period. These trends imply a sharp rise in import penetration—the share of domestic expenditure accounted for by imports increased by 2¾ percentage points to stand at 34%. The third quarter saw a 1¼% rise in the volume of imported goods from the second quarter's buoyant level (see Chart 15).

Export volumes have grown more slowly. The slower growth of our major overseas markets has become an increasingly important factor over the past year. For those producers selling into the United States, however, the weakness of the dollar became a further constraint on business through the spring and summer, with the sterling rate breaching two dollars in early September.

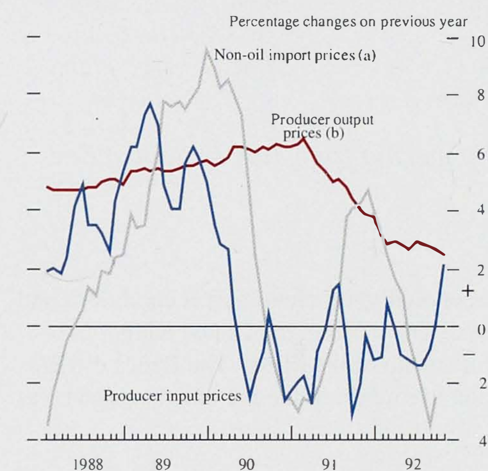
The United Kingdom's competitive position has, of course, been changed radically by the recent depreciation of sterling. Chart 16 shows an average £/DM rate of around DM 2.45 in October, 13% below its August level and 16% below its average throughout last year. The equivalent £/$ rate stood at around $1.65 in October, down 15% from August, but only 7% below the 1991 average, reflecting the weaker dollar through this year.

The speed and extent to which these changes affect trade flows will depend on a range of factors. These relate both to the extent of spare capacity among domestic suppliers and the degree to which the exchange rate movements are reflected in a change in relative prices. Higher import prices may, for example, be partially absorbed at any point in the supply chain from the foreign producer to the domestic retailer, while the extent to which UK exporters become more competitive will depend on whether UK producers seek to widen their margins. Econometric models suggest that the main impact on trade volumes is likely to come through higher exports, with a more muted reduction in imports partly resulting from the consequent boost to activity. They also suggest, however, that these gains would be transient if the rise in import prices eventually permeated domestic markets and eroded the initial competitive gain from depreciation.

. . . but carrying the risk of rekindling **inflationary pressures**

The prospects for domestic inflation, and the extent to which the recent depreciation will affect this outlook, are the central questions confronting monetary policy. Domestic cost pressures have eased substantially and should continue to do so, particularly if pay

Chart 17
Producer output *price increases are at historically low levels*



(a) Excluding erratics.
(b) Excluding food, drink and tobacco.

settlements respond to the most recent falls in headline inflation. But external influences on inflation, which have until recently been favourable, could now begin to build up more strongly. The price of imported goods (excluding oil) fell in the year to September but, as Chart 17 illustrates, the effects of depreciation were visible in manufacturers' input costs by October.

The pass-through from exchange rate movements to import prices and from import prices to domestic prices is subject to a range of uncertainties. At the simple level, the direct effect of depreciation would suggest a rise in the domestic price level equal to about one third of the fall in the value of sterling because imports account for about one third of domestic demand. Past experience suggests that this rise could, in practice, be staggered over many months, or even years, as sellers at all stages in the supply chain delay or limit the passing on of costs. However, the full impact on the domestic price level, and the rate of inflation, will depend on second round effects. In particular, it will depend on the extent to which the initial price rises result in higher wage settlements. The depth of the recession could potentially bear quite strongly on both the delaying of the direct effects and the subsequent feed-backs through wages and domestic prices. In the short run, much of the impact of depreciation could be absorbed within margins, to protect the fragile domestic market. The October CBI Survey offers tentative evidence that this is likely to occur over the next few months.

There is nevertheless a presumption that inflation over the year ahead will now be somewhat higher than would otherwise have been the case. The severity of the recession has borne down very firmly on costs and prices and, with signs of further corporate adjustment through the summer, it is likely that this process of downward adjustment will continue. Additionally, the headline inflation rate will benefit in the short run from the reductions in mortgage interest rates which take effect in November and December. Higher import prices, however, and their associated second round effects, will mitigate these disinflationary pressures through next year.