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26 January 1990

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Paul

see attached folder.

... I enclose three copies of the new Treasury forecast and a note that we have prepared as the basis for discussion at the Prime Minister's seminar on Tuesday.

Yours,
JG.

JOHN GIEVE

SECRET COPY NO. 12

January Forecast 1990

HM TREASURY
JANUARY, 1990

SECRET

TREASURY ECONOMIC FORECAST

JANUARY 1990

Chapter 1 provides a full self-contained account of the major features of the January economic forecast. Readers interested in more detailed discussion of the judgements and uncertainties underlying the forecast can find the relevant material in the chapters on the separate aspects of the forecast.

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Table 1.1 Summary of the forecast

Percentage changes on a year earlier unless otherwise stated

	FSBR 1989	October Internal	Autumn Statement	January Internal
GDP VOLUME				
(non-oil in brackets)				
1988	4.3 (5.1)	4.3 (5.1)	4.3 (5.1)	4.4 (5.1)
1989	2.3 (2.8)	2.0 (3.1)	1.9 (3.1)	2.7 (3.8)
1990	2.1 (1.9)	0.4 (-0.1)	1.3 (0.8)	0.8 (0.4)
1991	2.6 (2.7)	2.3 (0.5)	1.8 (2.0)	1.3 (1.6)
DOMESTIC DEMAND				
1988	6.5	7.3	7.3	7.4
1989	2.5	3.4	3.7	4.0
1990	1.3	-0.9	-0.1	-0.9
1991	1.8	2.0	1.6	1.3
RPI				
(ex MIPs in brackets)				
1988 Q4	6.6 (5.2)	6.5 (5.2)	6.5 (5.2)	6.5 (5.1)
1989 Q4	5.6 (5.1)	7.4 (5.8)	7.6 (6.1)	7.6 (6.1)
1990 Q4	3.3 (3.7)	6.5 (5.9)	5.8 (5.5)	6.7 (6.0)
1991 Q4	2.8 (3.1)	4.0 (4.2)	3.9 (4.0)	4.1 (4.7)
GDP DEFLATOR*				
1988-89	7.2	7.0	7.0	6.9
1989-90	5.4	6.8	6.9	6.0
1990-91	3.9	5.7	5.0	5.4
1991-92	3.0	4.9	4.9	5.2
MONEY GDP*				
1988-89	11.0	10.8	10.8	10.9
1989-90	7.8	8.6	8.6	8.7
1990-91	5.9	6.5	6.8	5.9
1991-92	5.9	7.4	6.6	7.0
BASE INTEREST RATES				
(%)				
1988 Q4	12.4	12.4	12.4	12.4
1989 Q4	12.0	15.0	15.0	15.0
1990 Q4	10.0	14.0	14.0	14.5
1991 Q4	8.5	12.5	12.5	12.5
MO				
1988-89	7.2	7.1	7.1	7.1
1989-90	3.6	5.4	5.3	5.8
1990-91	2.7	3.7	4.0	4.3
1991-92	2.4	3.1	3.3	3.0
STERLING INDEX				
1988 Q4	96.7	96.7	96.7	96.7
1989 Q4	95.3	90.0	89.0	88.0
1990 Q4	93.8	90.0	89.0	86.4
1991 Q4	92.9	90.0	89.0	85.0
CURRENT BALANCE £bn				
1988	-14.7	-14.6	-14.6	-14.7
1989	-14.5	-18.9	-20.2	-20.5
1990	-12.1	-13.4	-14.8	-14.0
1991	-8.6	-10.2	-10.7	-12.3
PSDR				
(Fiscal adjustments in brackets)				
1988-89	13.9 (0)	14.4 (0)	14.3 (0)	14.4 (0)
1989-90	13.8 (0)	13.3 (0)	12.6 (0)	8.0 (0)
1990-91	10.0 (1.0)	9.5 (1.0)	10.0 (1.0)	5.0 (0)
1991-92	6.0 (2.0)	3.1 (1.0)		-1.1 (0)

**On the Autumn Statement basis - see footnote to Table 1.4*

CHAPTER 1: THE JANUARY FORECAST

1.1 Table 1.1 summarises the forecast and compares it with the FSBR, October and Autumn Statement forecasts. **GDP growth** is expected to turn out at 2¾ per cent in 1989, faster than we expected in the October and Autumn Statement forecasts (both about 2 per cent). Despite this, the main message of the latest forecast is that **demand prospects** for 1990 are still likely to be as weak as foreseen in October, and more depressed than in the published Autumn Statement forecast. The prospect for **retail price inflation** through 1990 has worsened notably since the Autumn Statement, but recent favourable trends in visible trade point to a slightly better prospect for the **current account. Fiscal prospects** for both the current year and next have deteriorated quite sharply.

Demand and output

1.2 Table 1.2 summarises the forecast for demand and output.

Table 1.2 GDP and domestic demand at constant 1985 prices

	Percentage changes on a year earlier			
	1988	1989	1990	1991
Domestic Demand	7.4	4.0	-0.9	1.3
of which:				
Consumers' expenditure	6.9	4.3	0.8	1.4
Public authorities' consumption	0.4	0.1	0.9	1.4
Fixed investment	13.7	7.1	-1.3	-0.4
Change in stockbuilding (per cent of GDP)	0.8	0.0	-1.6	0.3
Exports of goods and services	0.8	5.2	6.0	3.3
Imports of goods and services	12.4	8.6	-0.1	3.1
Gross domestic product	4.4	2.7	0.8	1.3
Non-North sea GDP	5.1	3.8	0.4	1.6
Manufacturing output	7.1	4.6	-0.5	2.1

1.3 **Consumer spending** clearly slowed in 1989 in response to high interest rates. The slow-down is most evident in **retail sales** and in depressed **demand for new cars** since September. Retail sales recovered unexpectedly sharply in December, up 2¼ per cent on November. But we do not believe this indicates a more sustained recovery. Rather, it probably reflects some spending delayed from November (which was very low) and some advance of planned January spending in response to an earlier than usual start to winter sales. Early indicators for January are consistent with this view.

1.4 **Consumer confidence** fell more sharply than expected in October in response to the last interest rate increase and remained weak in November and December. However, it recovered somewhat in January. With a further ½ per cent rise in mortgage rates assumed to occur in April (reflecting recent building society warnings of the need to restore margins if base rates do not fall before then), confidence may be further depressed in the spring. Against this background, and the prospect of rising unemployment later in the year, consumer spending is projected to grow slowly in 1990 and 1991 (¾ and 1½ per cent respectively).

1.5 **Companies' real spending** remained strong in 1989, with **business investment** likely to have risen by 10-11 per cent (after an average increase of 14 per cent a year in 1987 and 1988), though it seems to have flattened in recent quarters. There was also further strong **stockbuilding**.

1.6 **Industrial and commercial company sector finances,** however, weakened much more than expected in 1989. With the slow-down in growth during 1989, and the rise in unit labour costs, companies' **real rates of return** are likely to have flattened off - though still at high levels by the standards of the 1970s and early 1980s. The rapid growth in company spending (investment and stockbuilding) over the last two years has led to large **financial deficits** by industrial and commercial companies in 1988 and 1989. Although the data are uncertain, they suggest that the deficit in 1989 is likely to have been the largest since the war; and two years of such deficit are unprecedented over the last 40 years. Companies' **net liquidity** has also deteriorated sharply over the last two years, to historically very low levels.

1.7 Industrial and commercial companies will continue to face a difficult financial outlook in 1990, with a further slackening of demand growth and falling capacity utilisation in prospect. As is usual in a cyclical slow-down, companies are likely to try to improve their financial position by cutting back on their spending and employment. However, their reactions could be more muted than in previous periods of financial squeeze. Financial deregulation has probably led to greater willingness by companies to borrow to see them through temporary disturbances, while financial institutions are also more willing to lend. Even so, business spending is likely to be more depressed in 1990 than we expected in October, with **business investment** falling slightly (down nearly 1 per cent) and **destocking** of over £2 billion. Business investment could fall a further 1 per cent in 1991.

1.8 **Exports of goods** are currently growing significantly faster than imports in volume terms. Falling capacity utilisation in the domestic consumer and intermediate goods sectors (especially cars) has resulted in an apparent switch of production to satisfy export markets rather than domestic demand. Import growth took more time to respond, though there is now clear evidence of quite a sharp slow-down. These improving trends in trade are expected to continue, and net exports are likely to make a more significant contribution to GDP growth than we foresaw in October.

1.9 **In summary,** personal spending and business investment are both projected to be weaker in 1990 than we expected in October. However public authorities' consumption could be a little stronger. Together with less destocking than we previously forecast, this implies the same outlook for domestic demand in 1990, down nearly 1 per cent, as we

saw in the October forecast. Even so, GDP is likely to rise a little faster in 1990 (¾ per cent) than we expected in October (½ per cent). This reflects a greater contribution from net exports. Growth of GDP picks up in 1991, but only to a fairly muted 1¼ per cent.

1.10 In 1988 and 1989 the private sector (persons and companies) ran sharply increasing financial deficits. This contrasts with a long previous history of the private sector running financial surpluses. The slide into deficit resulted from the unprecedented combination of **falling** savings and **rising** investment (savings and investment usually rise and fall together). The counterpart to recently rising private sector deficits has been a sharp deterioration in the current account deficit. There are already signs that the private sector deficit was turning round during 1989. With both the personal and company sectors reining in on expenditure in the forecast, this process is expected to continue and the deficit comes down significantly through the next two years, from 4¼ per cent of GDP in 1989 to ¾ per cent in 1991.

Pay and Inflation

1.11 **Private sector pay settlements** are likely to continue at recent fairly high levels in the first three quarters of 1990 as retail price inflation stays well above 7 per cent. Some downward pressure may emerge later as inflation begins to moderate and as firms take a more stringent approach to pay bargaining against the background of declining profit margins, a tight financial position, and rising unemployment. Private sector pay settlements are expected to average 8¼ per cent in the 1989-90 pay round and 7 per cent in the 1990-91 pay round. **Underlying average earnings growth** should abate both with the slow-down in pay settlements and as overtime and performance related bonuses come down in line with sluggish demand and output. Whole economy underlying earnings are expected to rise by 9¼ per cent in 1990 and 8½ per cent in 1991.

1.12 Developments on both **producer output and retail price inflation** in the final quarter of 1989 were in line with the Autumn Statement forecast, with some emerging evidence that margins are already being squeezed by slackening demand growth and rising unit labour costs.

1.13 The prospects for **RPI inflation** through 1990 have, however, deteriorated since the Autumn Statement. The lack of any marked progress on inflation during 1990 mainly reflects:

- higher and surprisingly sustained food price inflation, which may take some time to abate (it may even pick up further in the immediate months ahead);
- a lower average level of the exchange rate;
- a high assumed starting level for the community charge - now put at nearly £330 per head compared to £317 assumed in the October internal forecast and £305 in the Autumn Statement;
- an assumed ½ per cent rise in mortgage rates from the beginning of April and;

- the assumed revalorisation of specific duties and excise taxes in the 1990 budget (after no revalorisation in the 1989 budget).

These factors should be partly, but only partly, offset by a substantial squeeze on profit margins. Moreover, the prospect for food price inflation is highly uncertain. Since it has risen much more sharply than we expected, and is still difficult to explain, there must be a chance that it will subside more quickly than we have currently allowed.

1.14 But overall we expect **RPI inflation** to rise to 7¾ per cent in the second and third quarters of this year, before moderating to 6¾ per cent by 1990Q4 as interest rates come down. The **underlying RPI inflation rate (ie excluding mortgage interest payments)** is likely to rise to 6 ¼ per cent for most of the summer under the influence of rents, community charge, etc. It falls to 6 per cent by 1990Q4 as the decline in marketed retail price inflation begins to offset these factors. Inflation abates sharply through 1991 with further falls in interest rates and sustained slow growth in demand.

Table 1.3 Inflation

	Percentage changes on a year earlier		
	Manufacturers producers output prices[1]	RPI less mortgage interest payments	Total RPI
1988Q4	5.0	5.1	6.5
1989Q2	5.4	6.0	8.2
1989Q4	5.5	6.1	7.6
1990Q2	5.0	6.3	7.8
1990Q4	4.3	6.0	6.7
1991Q2	3.9	4.9	4.7
1991Q4	3.9	4.7	4.1

[1] *less food, drink and tobacco*

Money GDP

1.15 Recorded **money GDP** in the first half of 1989-90 was 9¾ per cent up on a year earlier. For 1989-90 as a whole we expect money GDP growth of a little under 9 per cent, down from 11 per cent last year. Money GDP growth in 1990-91 is expected to weaken further to 6 per cent, mainly because of lower real growth. But it may rebound somewhat thereafter as output itself recovers.

Table 1.4 Money GDP and the GDP deflator[1]

	Percentage changes on a year earlier					
	Money GDP			GDP Deflator		
	FSBR	Autumn Statement	January Forecast	FSBR	Autumn Statement	January Forecast
1988-89	11.0	10.8	10.9	7.2	7.0	6.9
1989-90	7.8	8.6	8.7	5.4	6.9	6.0
1990-91	5.9	6.8	5.9	3.9	5.0	5.4
1991-92	5.9	6.6	7.0	3.0	4.9	5.2

[1] *These are calculated on the Autumn Statement basis, ie not allowing for the introduction of the community charge in England and Wales .*

The balance of payments

1.16 The **current account deficit** in 1989 was close to the Autumn Statement forecast of £20 billion. **Visible trade** performance was better than expected, with exports continuing to rise strongly in the final months of the year and imports showing clear signs of slowing in response to slower domestic demand growth. However, the **invisibles balance** in 1989 seems to have been much weaker than expected because of high net transfers overseas (mainly net contributions to the EC) and a sharp drop in the net earnings on overseas assets.

1.17 The current account deficit is still forecast to fall sharply, to around £14 billion in 1990 - slightly below the Autumn Statement forecast - even though, in the light of the recent weakness, we are now much more cautious about the prospects for a recovery in invisibles. The visibles balance is forecast to improve substantially as growth in domestic demand and imports fall. Export growth is likely to slow from the exceptional rate recorded in 1989, as world trade growth eases. But the **UK share of world trade in manufactures** may rise a little further, following the strong recovery in 1989, as reductions in capacity utilisation continue to allow firms to divert production to overseas markets. The North Sea oil price is assumed to fall back from its recent high level, to an average of just over $18 a barrel in 1990 - only slightly above the average in 1989. But the oil trade balance is likely to be higher in 1990 than in 1989, because of the recovery in oil production.

1.18 In 1991 exports of manufactures are forecast to grow in line with world trade, but import growth may pick up as domestic demand growth begins to recover. The current account deficit is expected to fall further, but only to £12½ billion - 2 per cent of GDP.

Table 1.5 Current account

	£ billion					
	Manu-factures	Oil	Other goods	Total visibles	Invisibles	Current balance
1988	-14.9	2.8	-8.7	-20.8	6.2	-14.7
1989	-16.1	1.3	-8.4	-23.2	2.6	-20.5
1990	-11.6	2.0	-7.9	-17.4	3.4	-14.0
1991	-11.1	1.5	-8.3	-17.8	5.6	-12.3

Monetary policy and conditions

1.19 Inflation remains well above the 1989 MTFS path throughout the forecast period and money GDP growth falls only briefly to the MTFS path in 1990-91, before rising in 1991-92. Against this background of a relatively slow inflation response to tight policy, the forecast assumes that **short term interest rates** will need to remain high - base rates are assumed to stay at 15 per cent until the beginning of the fourth quarter of 1990, and then fall slowly.

1.20 Even with rates remaining high relative to other G7 countries, some further downward pressure on the **exchange rate** seems likely. The forecast assumes a fall in the sterling index, from its present level, of 2 per cent a year over the next 2 years. This is consistent with a stable rate against the dollar, and a fall against the Deutschemark to 2.76 by the end of 1990, slightly above the lowest level reached in recent weeks. The fall in sterling is in line with the inflation differential between the UK and other G7 countries, implying a **constant real exchange rate**.

1.21 Sustained high interest rates and the slowdown in money GDP growth are likely to bring **M0 growth** down within its 0-4 target range for 1990-91 by the second half of the financial year, and keep it in the upper half of its range in 1991-92.

Public finances

1.22 The PSDR for 1989-90 is forecast to be £8 billion, compared with £12½ billion in the Autumn Statement. The downward revision largely reflects a shortfall in corporation tax receipts and higher borrowing by local authorities. There are still considerable uncertainties about the outcome, particularly about the level of receipts in the peak tax collecting month of January and the size of the surge in spending in March. The average error on forecasts made at this time of year is nearly £2 billion, and the largest single error was £3 billion.

Table 1.6 PSDR

	£ billion			
	1988-89	1989-90	1990-91	1991-92
PSDR	14.4	8.0	5.0	-1.1
PSDR excluding privatisation proceeds	7.4	3.8	0	-6.1
PSDR less all asset sales	1.8	-1.8	-4.5	-10.6

1.23 On the assumption that taxes are revalorised and indexed in the Budget, the PSDR is forecast to fall further in 1990-91 to around £5 billion. This largely reflects the slow-down in the economy, although the introduction of independent taxation and the full year effect of NICs' reform also contribute.

1.24 The share of taxes and national insurance contributions (NICs) in GDP is forecast to rise marginally in 1990-91, with a fall in the share of corporation tax more than offset by rises in the shares of income tax and domestic rates/community charge. The rising

share of income tax reflects the continued buoyancy of wages and salaries. In 1991-92 with wages and salaries growing at the same rate as money GDP and the share of corporation tax continuing to fall, the share of total taxes and NICs in GDP is forecast to fall.

Table 1.7 Ratios of public expenditure, receipts and debt repayment to money GDP

	Per cent			
	1988-89	1989-90	1990-91	1991-92
GGE (excl.priv.proceeds).	39.0	38.9	39.6	39.7
Non-oil taxes and NICs[1]	37.1	36.6	36.7	36.0
PSDR	3.0	1.6	0.9	-0.2

[1] *as share of non-oil money GDP*

1.25 The ratio of GGE (excluding privatisation proceeds) to GDP is forecast to rise by ¾ per cent in 1990-91 and to be broadly unchanged in 1991-92.

Risks and uncertainties

1.26 The prospects for growth in 1990 are particularly uncertain. On the one hand, we have persistently under-predicted the growth in domestic demand (both consumer and business spending) over the past three years. According to latest data, domestic demand has turned out faster in 1989 even than we perceived in October or in the Autumn Statement. This tendency may continue. There must, therefore, be a risk that domestic demand and activity will continue to be quite buoyant, with the private sector remaining in substantial deficit, despite sustained tight monetary and fiscal policies. If so, the improvement in the current account may be less than we are forecasting. And the pressure on firms to cut profit margins will be reduced, so that progress on reducing inflation may be slower than expected.

1.27 On the other hand, just as we tend to underpredict growth in periods of rapidly rising activity, so we may overstate growth when the economy is slowing fairly sharply and the private sector has to adjust to tightening financial constraints. In this case the current account deficit and inflation may both fall more sharply than forecast.

1.28 The uncertainty about the cyclical position of the economy over the next year carries over into the fiscal outlook. It is always difficult to forecast the public finances when the economy is changing gear; in the past, the tendency has been to underestimate cyclical effects on the PSDR. Uncertainties about the current and recent levels of profits and investment in particular pose major problems for forecasting corporation tax receipts. In addition there are considerable uncertainties stemming from the introduction of a new regime for local authority finance and of independent taxation.

CHAPTER 2 : THE WORLD ECONOMY

Policy

2.1 **Nominal interest rates** outside the US rose in stages through 1989. Average G7 rates are now at their highest level since 1984. The forecast assumes that they will remain at around present levels until the end of 1990. Thereafter lower inflation allows Japan and Germany, followed by France and Italy, to reduce rates by 1 to 1½ percentage points by the end of 1991. Real interest rates remain higher than in any year in the 1980s. **Real effective exchange rates** are assumed to remain constant at about end 1989 levels. Overall, some tightening of **fiscal policy** is assumed. Small reductions in the US Federal deficit are expected in 1990 and 1991, after three years in which the outturn remained around $150bn.

Forecast

Table 2.1 **Summary of world forecast**

	Percentage changes on a year earlier			
		Forecast		
	1988	1989	1990	1991
G7 activity and inflation				
Real GNP	4.5	3.4	2 ½	2 ¾
Domestic demand	4.7	3.4	2 ½	2 ½
Industrial production	6.0	4.1	2 ¾	3
Consumer prices	3.3	4.6	4	3 ¼
Trade				
Total world trade	8.4	7.4	5 ¼	5
World trade in manufactures	9.6	8.4	6	5 ½

Activity 2.2 **G7 GNP** growth in 1989 was about 3½ per cent, with North America and the UK being weaker than Japan and Continental Europe. **G7 GNP** growth is forecast to reach a trough of about 2½ per cent around the end of 1990. A slow recovery, led by the US and Canada, starts in the second half of 1991. Growth of **private consumption** continues steadily at just under 3 per cent, but **business investment** weakens sharply. **Capacity utilization** eases back to about the same levels as in 1986 and 1987. **World trade** is forecast to grow by a little over 5 per cent a year, still quite brisk but well down on the 1988 and 1989 average of about 8 per cent.

Inflation 2.3 **Oil prices** are now falling back from the early January peak, and for 1990 prices are assumed to average $18 pb (Brent), about $½pb up on last year. **Non-oil commodity prices** weakened through 1989, but are expected to remain close to current levels in 1990, ie falling slightly in real terms. Latest data on **G7 consumer price inflation** reveal little

evidence of a sustained slowdown yet; it remained at about 4½ to 4¾ per cent late last year. But inflation is expected to drop back to about 3½ per cent by the end of this year and 3¼ per cent in 1991, a little higher than the 3 per cent average over 1984-88

Current balances

2.4 The US and Japanese **current account balances** were smaller than expected in 1989, in the US mainly because of valuation effects and slower growth relative to elsewhere. Over the forecast, the US deficit and Japanese surplus are expected to increase again, but only slightly as a share of GNP. The forecast of the German current account surplus is influenced by immigration from the East which raises domestic demand. The forecast surplus in both years is similar to the 1989 outturn.

Chart 2.1 G7 interest rates and inflation

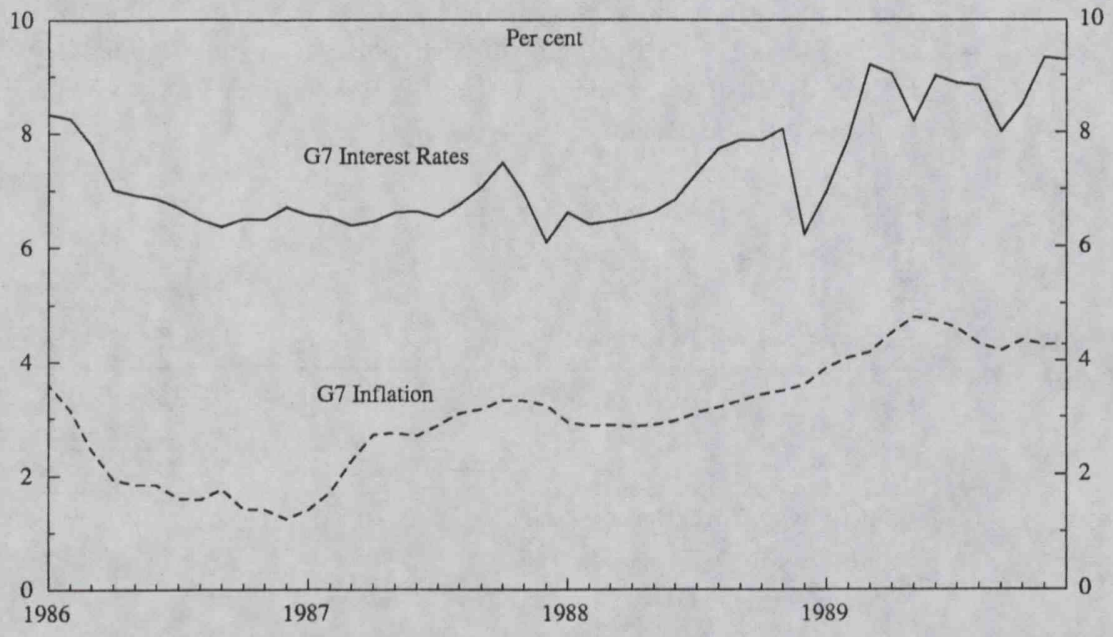


Chart 2.2 Total world trade and G7 industrial production

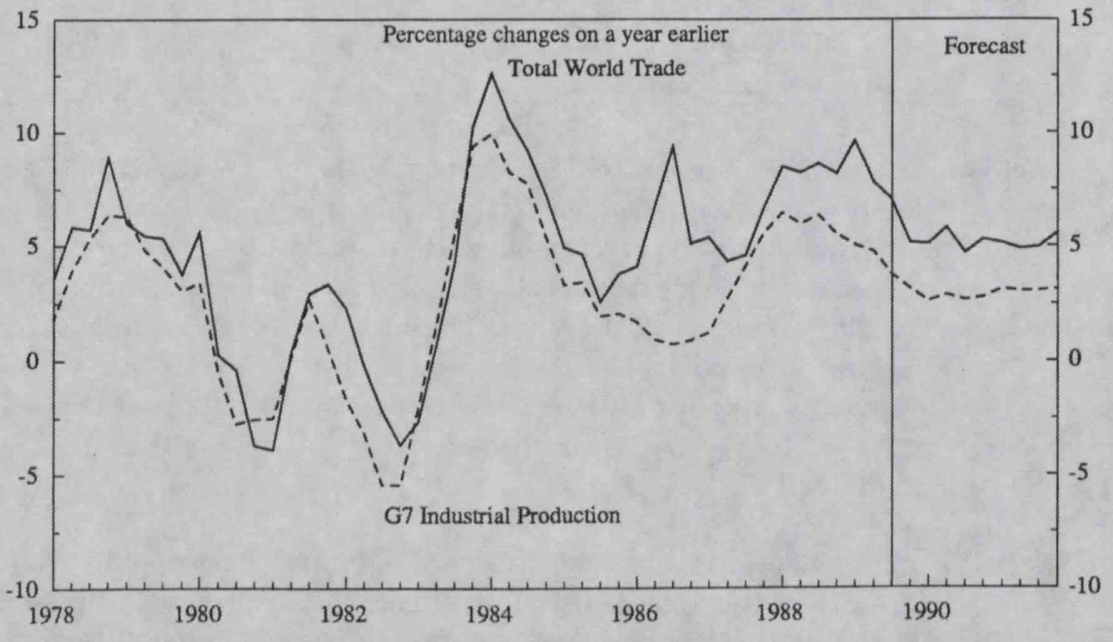


Chart 2.3 Real commodity prices*

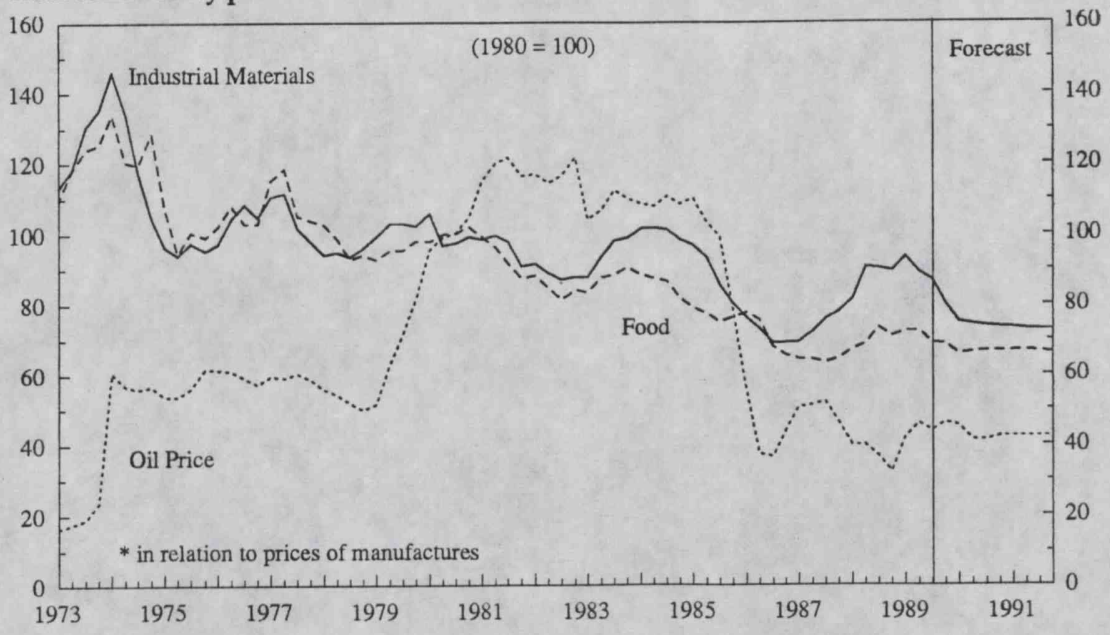
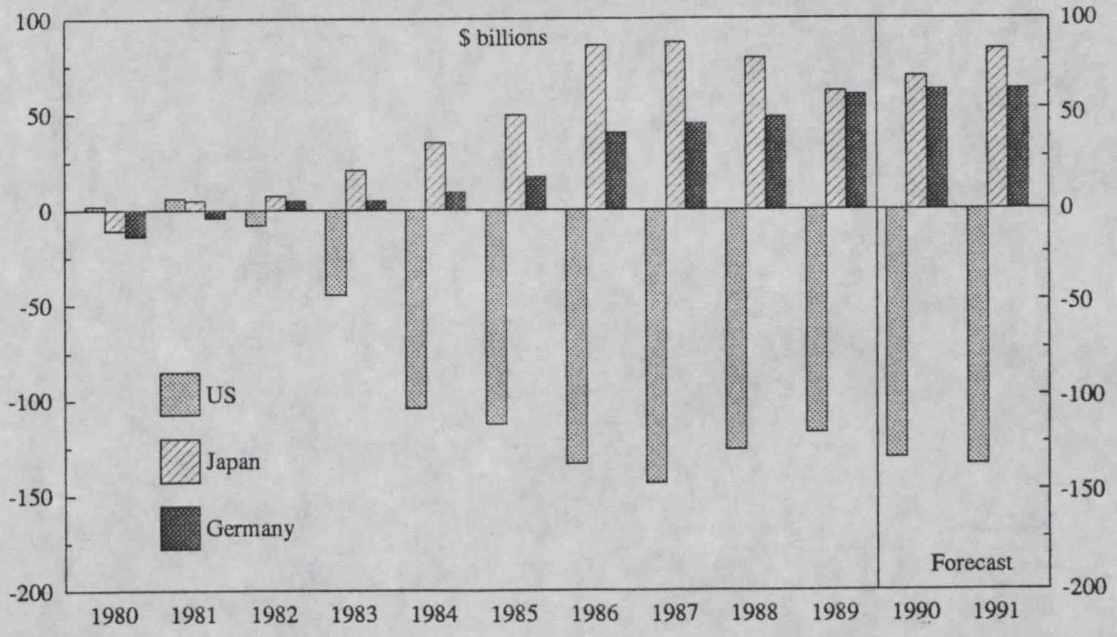


Chart 2.4 Current account inbalances



CHAPTER 3 : PERSONAL SECTOR

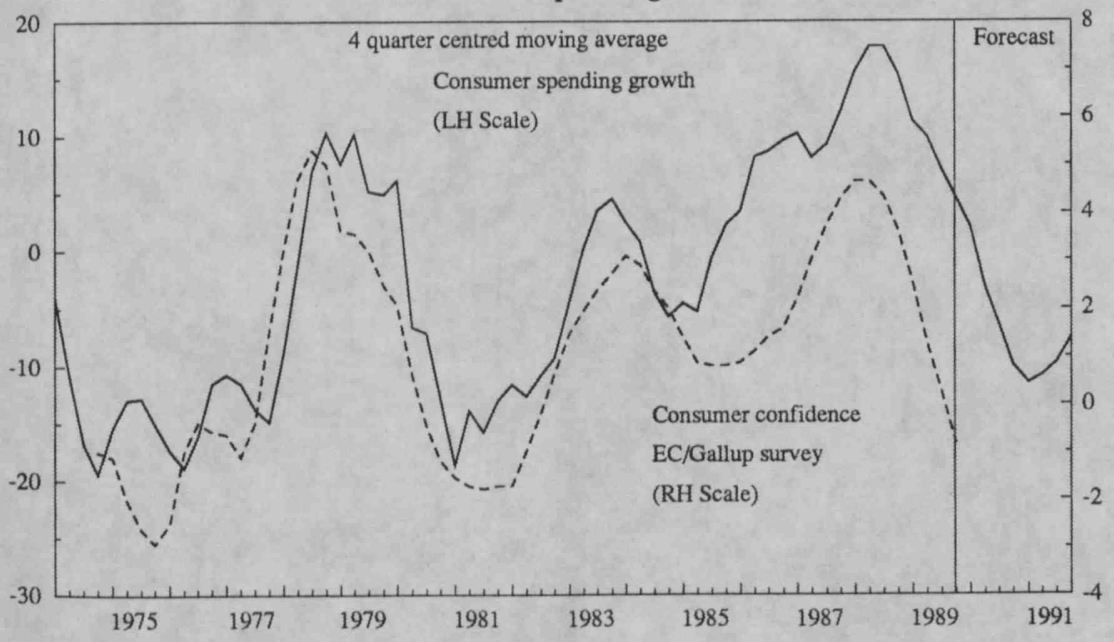
Consumer spending

3.1 **Retail sales** volume growth fell sharply through 1989 (despite the rise in December), from an annual growth rate of 3.8 per cent in the first three months of the year to 1.2 per cent in the final quarter - one of the smallest annual increases since mid-1982. The 2 per cent jump in December may reflect deferred expenditure from November, when expenditure was very low, and an unusually early start to the January clearance sales. **Spending on cars** took longer to slow down than retail sales, but the trend in new car registrations is now also clearly downward.

3.2 According to latest estimates, total consumers' expenditure rose 4¼ per cent in 1989 (though the data contain some upward adjustments by CSO - see **Annex B**). Consumer spending was unchanged between the second and third quarters of 1989, but the first estimate for 1989Q4 shows a rise of 1-1¼ per cent on the third quarter. However, this latest estimate is highly provisional, and is based on little actual data apart from retail sales and new car registration figures.

3.3 **Consumer confidence**, usually a fairly reliable indicator of short-term consumer spending prospects, fell very sharply in October, after the last interest rate increase. It recovered in January but remains at historically low levels. Consumer confidence is expected to remain depressed in the next couple of months. However, it is likely to fall further in April if the assumed ½ per cent rise in mortgage rates materialises. This points to a fairly depressed short-term outlook for personal spending.

Chart 3.1 Consumer confidence and real consumer spending



3.4 Other factors point in the same direction for 1990 as a whole. **Real personal disposable income** (RPDI)is likely to rise by only 1 per cent in 1990 and 2¼ per cent in 1991. This comes after average growth of 5 per cent a year in 1988 and 1989. Incomes are squeezed by a sharp fall in dividend growth and a rise in net interest payments, mainly

mortgage interest. Moreover, the wealth of households is expected to fall, especially with a further drop in house prices. The sharp rise in wealth, particularly housing wealth, between 1986 and 1988 is thought to be a major factor behind the recent protracted consumer boom. Conversely, therefore, the fall in wealth may well exert a fairly powerful constraining influence this year and next.

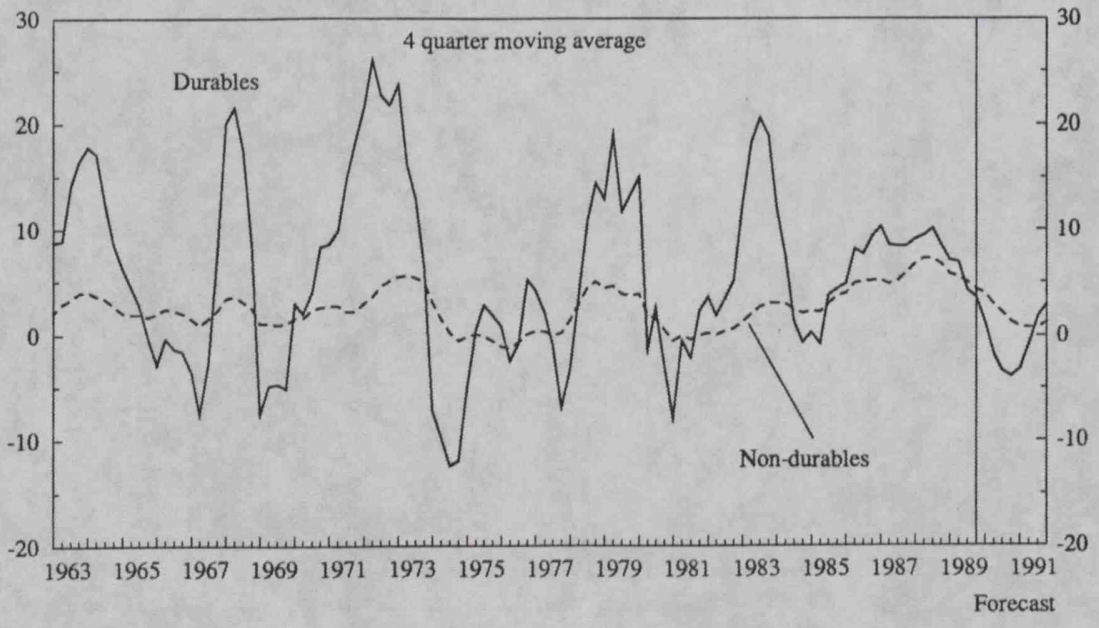
Table 3.1 Real consumer spending, RPDI and the saving ratio

Percentage changes on a year earlier

	Consumer Spending			RPDI	Saving Ratio
	Total	Durables	Non-Durables		%
1988	6.9	8.5	6.7	5.4	4.4
1989	4.3	3.5	4.4	4.6	4.6
1990	0.8	-3.9	1.3	0.9	4.7
1991	1.4	2.9	1.3	2.3	5.6

3.5 Personal consumption is forecast to grow by only ¾ per cent in 1990, and by a fairly slow 1½ per cent in 1991. Spending on **durables** could be more depressed; it is forecast to fall by nearly 4 per cent in 1990. However, this is less of a fall than we might normally expect. One of the surprising features of the recent consumer boom is that spending on durables has been much less buoyant (though more protracted) than in previous cycles. It is spending on non-durables that mainly accounts for the recent exceptional strength of consumer demand (**Chart 3.2**). The **personal saving ratio** recovers a little from around 4½ per cent in 1988 and 1989 to nearly 6 per cent by the end of 1991 (**Chart 3.4**).

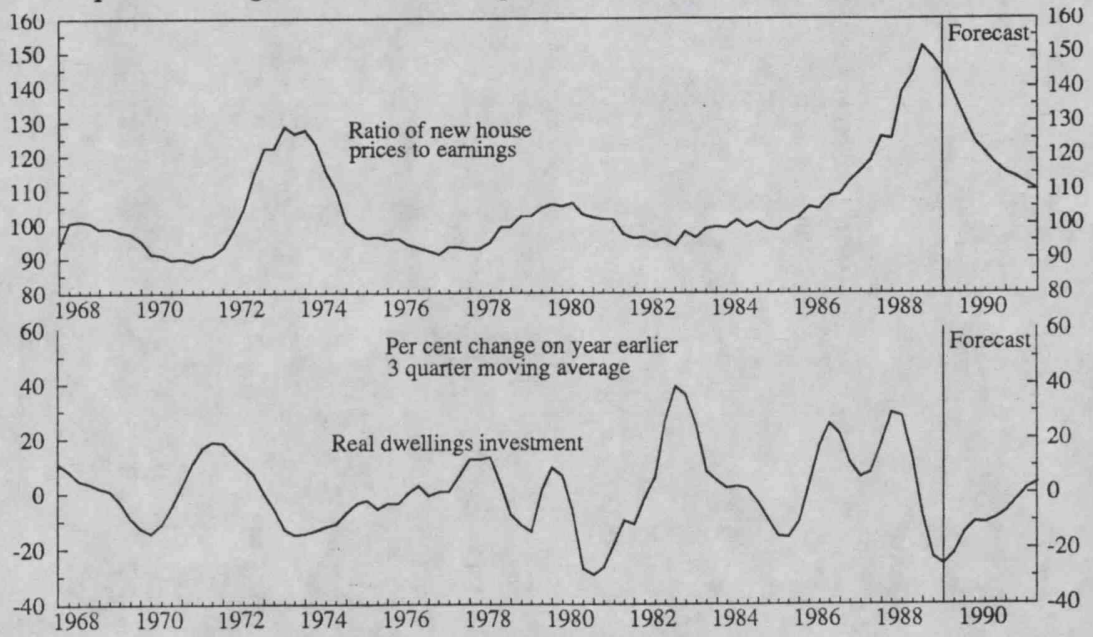
Chart 3.2 Durables and non-durables growth cycles



Housing market 3.6 The housing market has continued to weaken, with total **housing investment** (new dwellings and improvements) nearly 8 per cent lower in the first three quarters of 1989 than in the same period of 1988. And nominal house prices continue to fall; the **Halifax house price index** (seasonally adjusted) fell for the seventh consecutive month in December to stand less than 3 per cent above its December 1988 level.

3.7 It is likely that the housing market will be further depressed in 1990, with a forecast 7 per cent fall in **house prices** in the year to 1990Q4 and only a small rise in the following year. **Investment in dwellings** is expected to fall by nearly 5 per cent in 1990, and to begin to recover only in the second half of 1991.

Chart 3.3 House price earnings ratio and housing investment



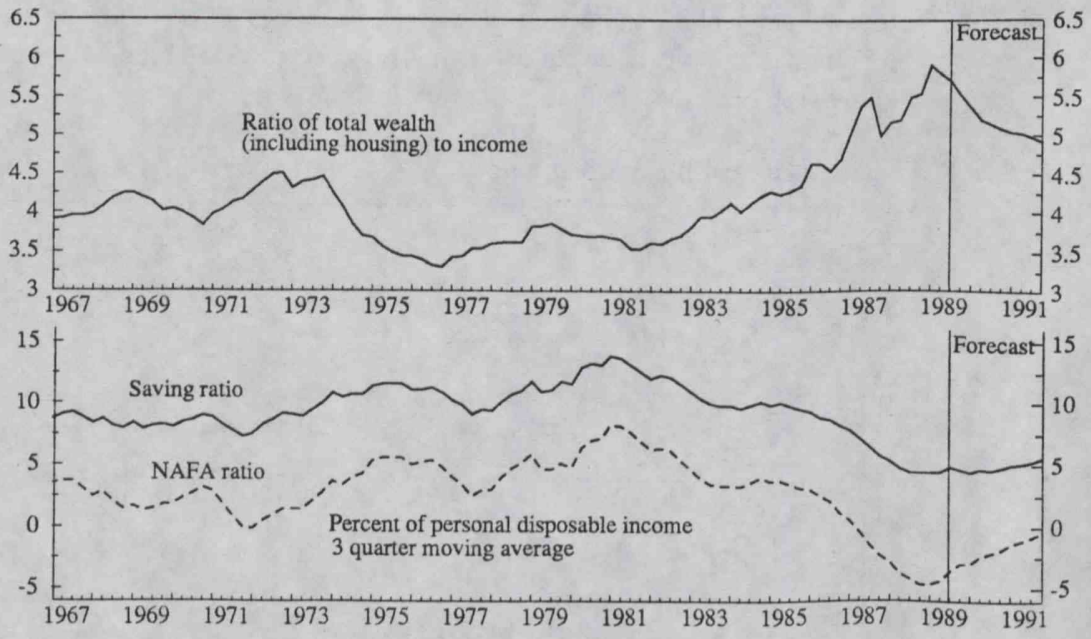
Personal sector financial position

3.8 The personal sector faces a tight financial position; its **financial deficit** increased to over 3 per cent of GDP in 1988 and, even with a fall in investment spending and slower growth in consumption, it is estimated to have been close to 2 per cent of GDP in 1989. The sharp cutback in expenditure, both consumption and investment, in 1990 and 1991 is insufficient to eliminate the deficit completely, though it is much reduced as a share of GDP. The ratio of **personal sector wealth** (including housing wealth) to income is forecast to fall in 1990 and 1991 as a result of lower house and share prices. Even so, total wealth-income ratios remain at historically very high levels (1987 and 1988 apart) in the forecast period.

Risks and uncertainties

3.9 As always, there is considerable uncertainty about the prospects for consumers' expenditure. We risk underestimating the resilience of consumer demand yet again. As we have said, personal sector wealth, though falling over the next two years, remains historically high. Borrowing capacity is likely to remain strong therefore, and consumers may be prepared to increase their borrowing further to sustain more buoyant consumption than we foresee. If they do, however, they will increase their interest burden and simply may defer adjustment to a later date. On the other hand we may well be overstating likely personal spending. Consumers may perceive a greater need to adjust than we have allowed for, with a tight financial prospect and interest payments likely to make a large and rising prior claim on income. It is quite possible that we have not given sufficient weight to the recent low levels consumer confidence and the prospect of a sharp drop in house prices. In that event, there is every chance that consumer spending will take a sharper knock than we expect in 1990, and recover more slowly in 1991.

Chart 3.4 Personal sector wealth and saving ratio



CHAPTER 4 : COMPANY SECTOR

4.1 Latest estimates of business investment and stockbuilding include considerable upward adjustments by the CSO (see **Annex B**). While there must be some uncertainty about recent developments, it seems clear that business spending remained strong in 1989. **Business investment** is likely to have risen by 10½ per cent in 1989, though it levelled off in mid-year (**Chart 4.1**). More recent indicators, such as commercial vehicle registrations, suggest that it may have fallen in the fourth quarter.

4.2 **Stockbuilding** continued at a rapid pace in 1989, as it did in 1988. The rise in stockbuilding over the last two years has led to a steep reversal of the downward trend in the stock:output ratio evident between 1980 and 1987(**Chart 4.2**). Some rise in the stock:output ratio is entirely plausible. It is possible that firms may have been taken by surprise by the strength of demand in 1987 and early 1988. They may, therefore, have had to run stocks down more than they desired relative to output, and to have rebuilt them to more optimal levels subsequently. Even so, there may still be an involuntary aspect to the most recent stockbuilding data. Firms may again have been surprised, this time by the extent of the slow-down in demand, and accumulated more stocks than they expected.

4.3 With the slow-down in demand, high interest rates and an emerging squeeze on profit margins, **industrial and commercial companies (ICCs) financial position** deteriorated markedly in 1989. Growth in non-oil **ICCs profits** (and total income) slowed sharply, after exceptionally strong growth, averaging close to 18 per cent a year between 1981 and 1988. As a result, their **real rate of return** probably stabilised in 1989, albeit at high levels not seen since the late 1960s (**Chart 4.3**). But with continued strong growth in dividend and interest payments, and buoyant investment and stockbuilding, ICCs ran an unprecedentedly large **financial deficit** last year (**Chart 4.4**), the second successive year of financial deficit. **ICCs net liquidity** (net liquidity largely represents companies' bank deposits less their bank borrowing) also deteriorated sharply in 1989, reflecting both the large deficit and a large number of take-overs financed by cash (**Chart 4.5**).

4.4 Industrial and commercial companies continue to face a very difficult financial outlook in the next two years with:

- sluggish demand prospects;
- a further, perhaps intensifying, squeeze on margins;
- falling real rates of return (**Chart 4.3**);
- declining liquidity (**Chart 4.5**) and;
- falling capacity utilisation.

4.5 These developments will clearly colour the prospects for real spending in investment and stockbuilding. As they usually do in a period of sharp slowdown, firms are likely to try to defend their financial position by cutting back on spending and shaking out labour. However, their reaction may be less strenuous than in previous periods of retrenchment. Financial deregulation has led to marked changes in the financial environment. For example, banks and financial institutions are now much more willing to lend for long term purposes, such as investment, than during the 1960s and 1970s. Companies' retained profits, the main source of investment finance in earlier decades, are therefore likely to be much less of a constraint now than then.

4.6 Even so, some slow-down in business spending is still likely. Recent CBI surveys (including the survey to be published on January 30) point to a fall in manufacturing confidence and a marked decline in expected investment authorisations over the next year, especially in new buildings. There is evidence from chambers of commerce and the Institute of Directors which also indicate a significant weakening of business sentiment. Against this background, **total business investment** is projected to fall by 1 per cent in 1990 and 1991 (**Chart 4.1**). It is prevented from falling further by extensive investment by public corporations, particularly the transport industries. **Manufacturing investment**, which is usually much more cyclical than other sectors, is likely to fall 7.5 per cent in 1990 and 5 per cent in 1991.

Table 4.1 Gross domestic fixed capital formation

	Percentage changes on previous year					
	1986	1987	1988	1989	1990	1991
Business[1]	-0.5	10.8	17.6	10.4	-1.0	-1.0
of which:						
North Sea	-11.9	-22.5	-3.4	10.7	30.2	-3.5
Manufacturing	-6.0	5.1	11.7	9.0	-7.5	-5.0
Private non-manufacturing[2]	5.2	21.1	23.2	11.1	-1.7	-0.3
Private Dwellings[3]	10.5	6.5	10.3	-6.8	-4.7	0.4
General Government[4]	4.5	1.2	-0.1	17.9	-5.1	1.7
Total Investment	2.1	8.5	13.7	7.1	-1.3	-0.4

[1] *includes public corporations*
[2] *excludes effects of privatisation*
[3] *includes purchases less sales of land and existing buildings for whole economy*
[4] *excludes purchases less sales of land and existing buildings*

4.7 Companies are also expected to **destock** on a fairly large scale. This implies some resumption of the downward trend in the stock:GDP ratio, though from a much higher level than implied by the trend from 1980 to 1987 (**Chart 4.2**).

Chart 4.1 Business investment

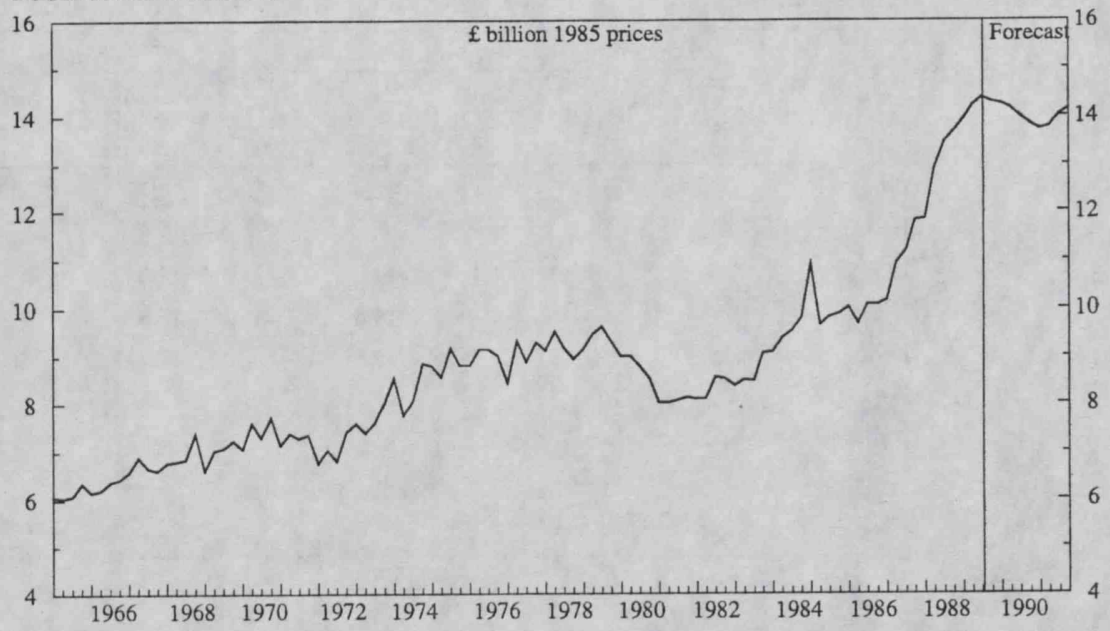
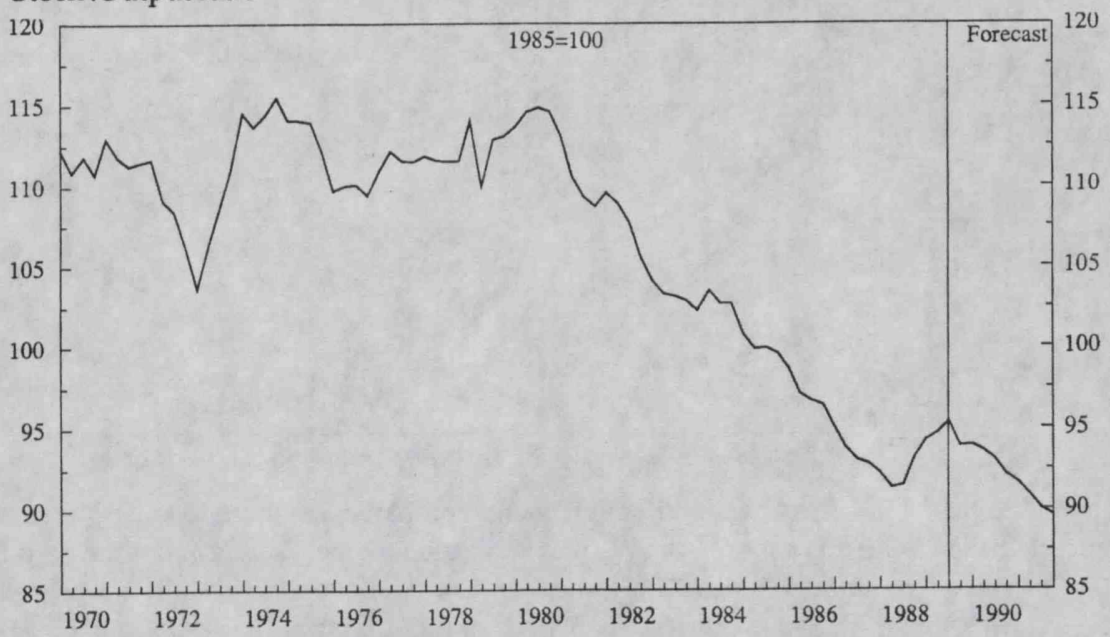


Chart 4.2 Stock :Output ratio



4.8 Despite this retrenchment in spending, industrial and commercial companies are projected to remain in **deficit** throughout 1990 and 1991, though the deficit does decline (**Chart 4.4**). Four years of financial deficits is unprecendented since the war. The **net liquidity ratio** (net liquidity as a proportion of total final expenditure) continues to deteriorate to unprecedentedly low levels (**Chart 4.5**). And **income gearing** (interest payments as a share of income) rises further in 1990 before moderating slightly thereafter(**Chart 4.6**).

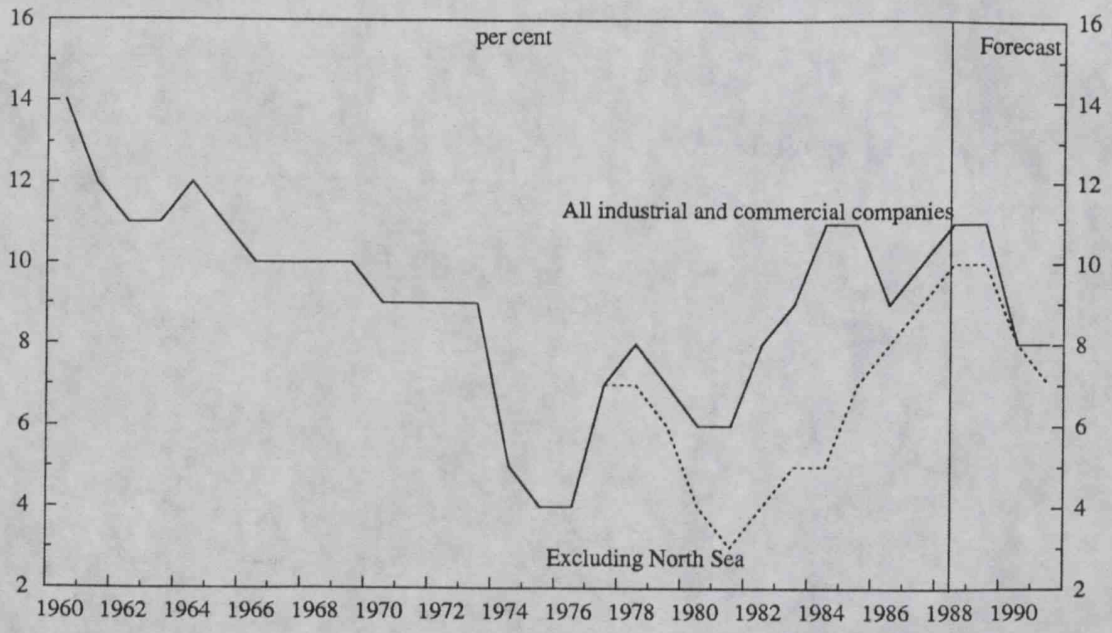
Table 4.2 Profit shares and rates of return

Per cent

	Total	Non-oil	Non-oil (excl-privatised) companies	Net rate of return on assets, non-oil ICCs [1]
1986	14.4	12.2	11.1	8.0
1987	16.0	13.7	11.9	9.0
1988	16.2	14.8	12.8	10.0
1989	16.1	14.8	12.8	10.0
1990	14.9	13.5	11.4	8.0
1991	15.4	14.1	11.1	7.0

[1] *Excluding companies to be privatised*

Chart 4.3 Companies' real rates of return



Risks and uncertainties

4.9 It is always difficult to gauge companies reactions to emerging financial problems with any confidence. We may have been too pessimistic about the need for retrenchment. Certainly, there are not the same widespread public signs of distress that we witnessed in previous periods of financial stress such as 1974 or 1980, although producers and retailers of domestic electrical appliances and furniture are becoming more vociferous about their particular plight (all associated with recent declining housing turnover). Companies in general, however, may be prepared to sustain spending more than we foresee by further borrowing, especially if they perceive the slowdown in economic activity to be fairly short lived. On the other hand, once companies have perceived a need to adjust, they usually do so very rapidly. Previous financial deficits, for example, have usually been eliminated within a year. Various survey evidence points to weakening confidence and some retrenchment of investment and employment. Moreover, financial institutions may begin to show some reluctance to increase lending significantly to companies with high and rising income gearing. We may not have given enough weight to these factors, and adjustment could be more severe than we currently expect.

Chart 4.4 All ICCs' NAFA and borrowing requirement (share of TFE)

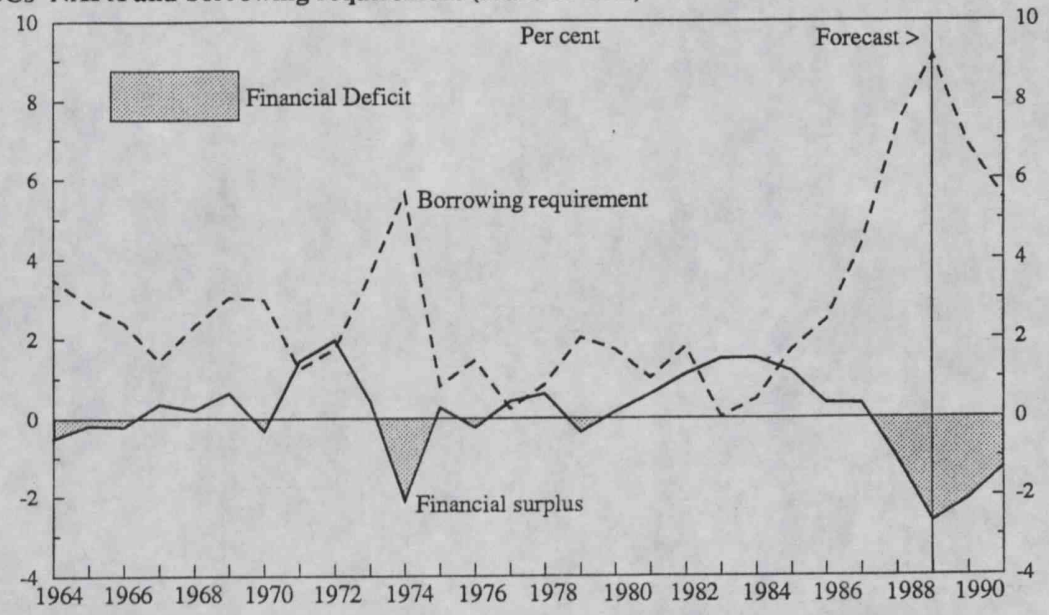


Chart 4.5 ICC's liquidity ratios *

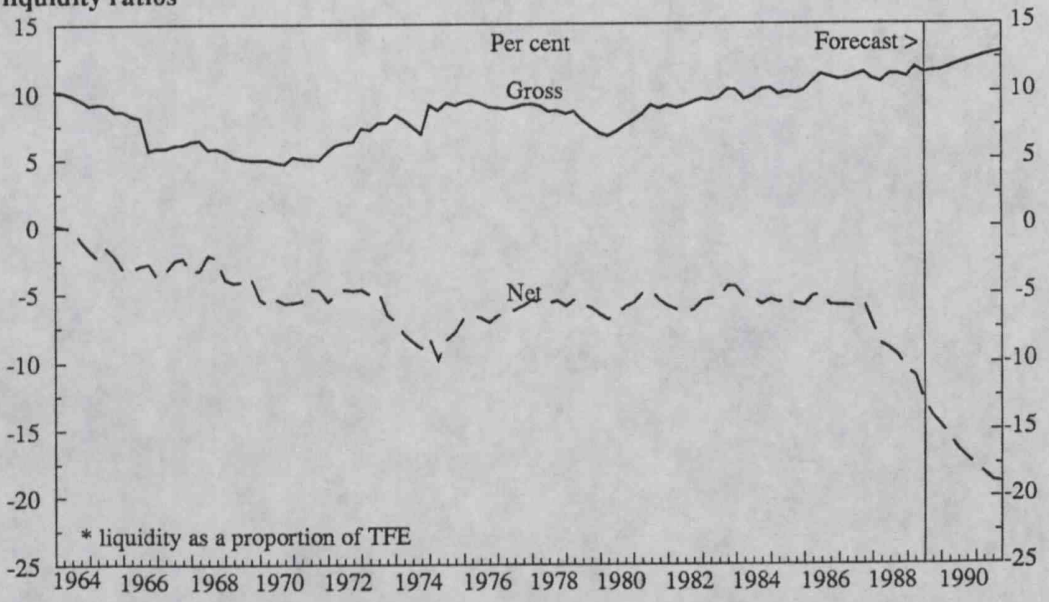
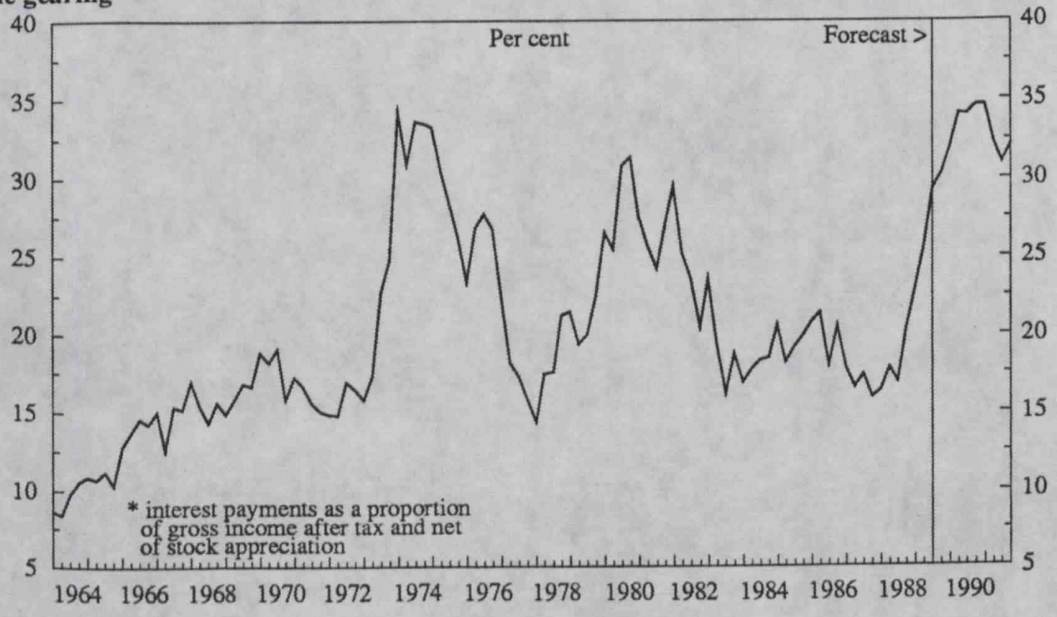


Chart 4.6 Income gearing*

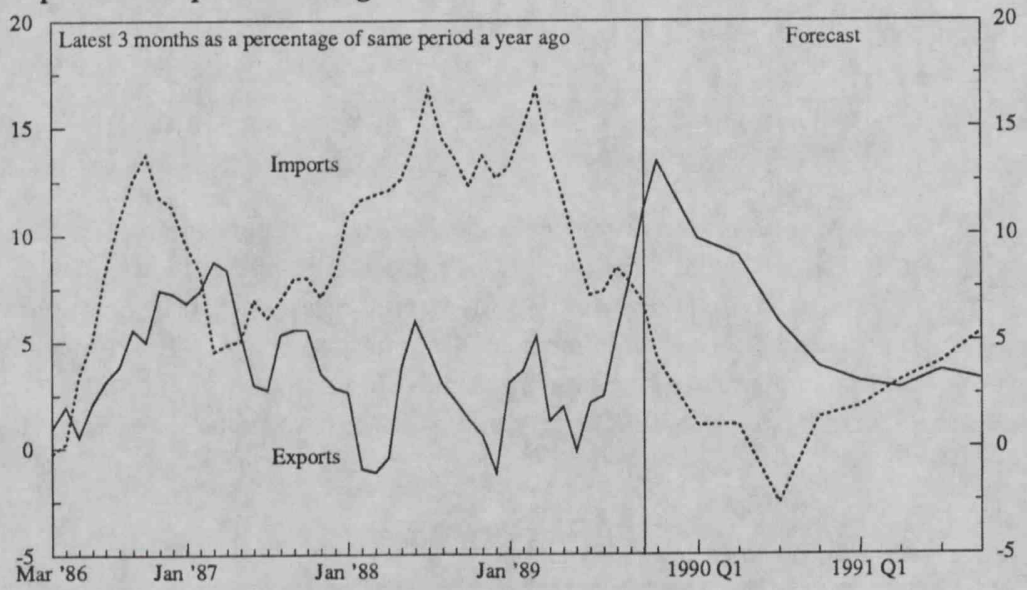


CHAPTER 5: TRADE AND THE BALANCE OF PAYMENTS

Summary

5.1 The outturn for the **current account deficit** in 1989 is likely to be just over £20 billion, close to the Autumn Statement forecast but £6 billion higher than the 1988 deficit. The current account deficit increased between the first and third quarters of 1989, largely reflecting a deterioration in **invisibles**. However the **visibles balance** and the current account have improved in every month since July, as export growth has picked up and import growth has responded to slower domestic demand growth (**Chart 5.1**).

Chart 5.1 Export and import volume growth (total visible trade)



5.2 Export volumes were growing substantially faster than import volumes by the end of 1989, and this gap is projected to remain wide in 1990, before narrowing during 1991 as domestic demand growth recovers. The current account is forecast to fall to £14 billion in 1990 and £12½ billion in 1991, helped by a slow recovery in the invisibles surplus.

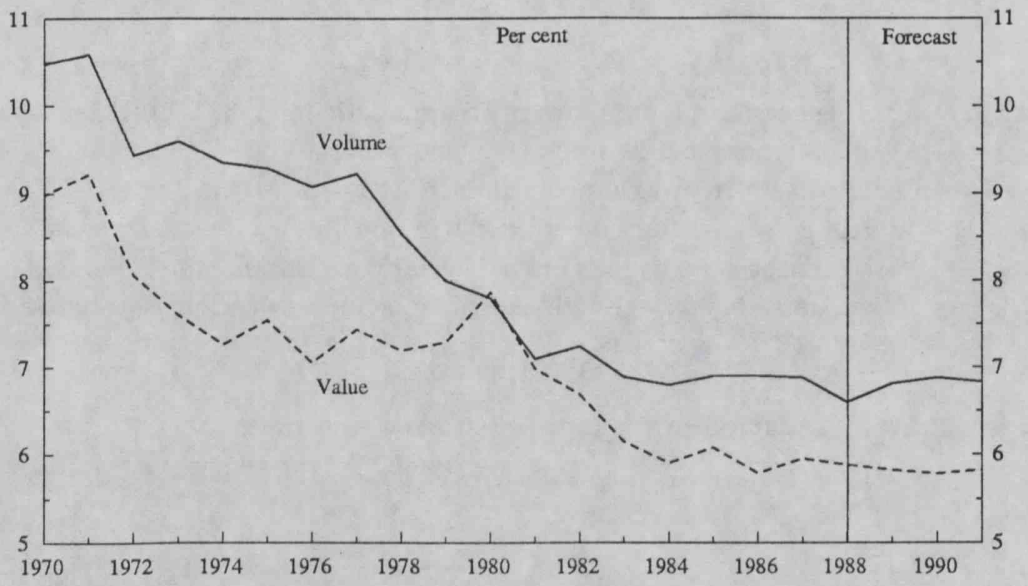
Non-oil trade

5.3 **Manufactured export volumes** grew by 12 per cent in 1989, nearly regaining the share of world trade lost in 1988. Exports have been helped by the easing of capacity pressures, which held back growth in 1988.

5.4 **Competitiveness** deteriorated sharply in 1988 but was unchanged in 1989, as exchange rate depreciation offset the effect of rapid UK unit labour cost growth. Despite further projected growth in unit labour costs relative to our competitors, the assumed exchange rate depreciation should be sufficient to maintain competitiveness close to its average 1989 level. Exports of manufactures are therefore forecast to grow in line with world trade on average over the next two years (**Chart 5.2**). The tendency for UK

exports to lose share slightly on average is offset in the forecast by a further easing of capacity constraints, particularly in 1990.

Chart 5.2 UK share of world trade in manufactures



5.5 **Manufactured import volumes** rose by 11½ per cent in 1989. But growth slowed through the year, and the underlying trend seems to have levelled out in the second half of the year. With falling domestic demand forecast in 1990, import volume growth is expected to be less than ½ per cent. It should recover in 1991, but remain below the growth of manufactured export volumes. **Imports of non-manufactures** could fall in 1990, reflecting in particular cuts in imports of basic materials as firms destock.

Table 5.1 Non-oil trade volumes

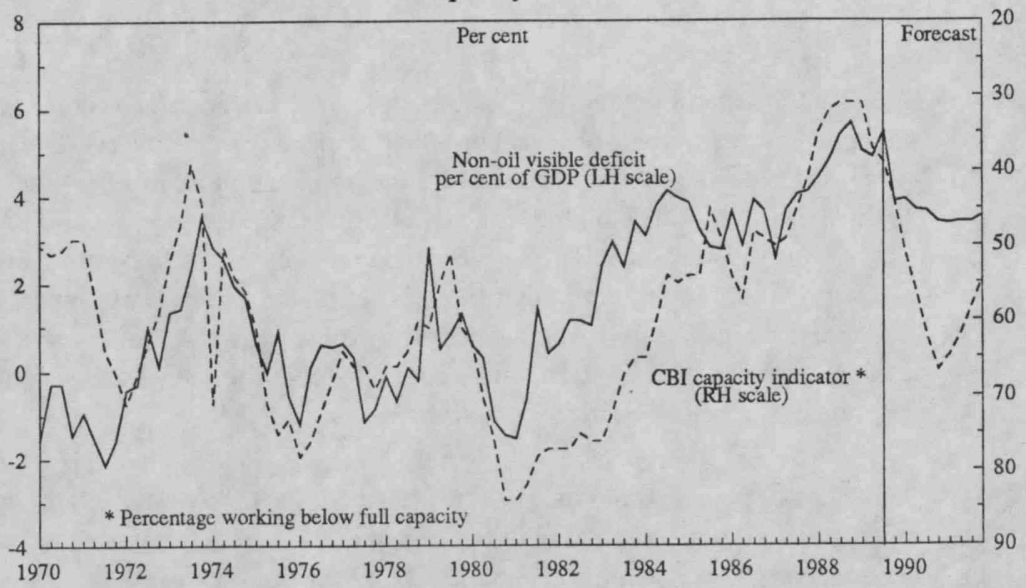
per cent changes on previous year

	Exports			Imports		
	Manufactures	Non manufactures	Total non-oil	Manufactures	Non manufactures	Total non-oil
1987	7.6	5.0	6.9	10.0	1.6	8.2
1988	5.1	-5.7	3.3	16.7	5.0	14.2
1989	11.9	11.1	11.8	11.5	2.0	9.5
1990	7.2	5.5	7.0	0.2	-1.9	0.2
1991	4.8	4.1	4.7	3.2	1.9	3.7

5.6 The **non-oil terms of trade** - export prices relative to import prices - are projected to remain constant at around their recent level. This is in line with experience in the 1980s, when substantial movements in the exchange rate had no long run impact on the terms of trade.

5.7 The **non-oil visible balance** is therefore forecast to improve sharply in 1990, reflecting the favourable trade volume movements. The improvement in the balance is consistent with the likely path of capacity utilisation, which eases further in 1990 as the economy continues to slow (**Chart 5.3**).

Chart 5.3 The non-oil visible balance and capacity utilisation



North Sea oil

5.8 Oil production and the oil trade balance recovered strongly in the second half of 1989 from the effects of accidents. This recovery is expected to continue over the next few months, before the slow downward trend in production resumes. However the projected level of production in 1991 and later years has been revised down again, compared to recent forecasts, to allow for longer shutdowns for safety and maintenance work which now look increasingly likely.

5.9 North Sea oil prices have recently been over $21 a barrel but have now fallen back to $19-20. They are forecast to average $19½ a barrel in the first quarter before falling further to average $18-18½ in 1990 and 1991 - only slightly higher than in 1989. The **oil trade balance** is forecast to rise from £1½ billion in 1989 to £2 billion in 1990, before falling back to £ 1½ billion in 1991. This mainly reflects the changes in oil production. **Domestic demand for oil** is likely to rise only sluggishly, restrained by slow economic growth.

Invisibles

5.10 On present estimates the invisibles surplus has fallen sharply from £6 billion in 1988 to £ 2½ billion in 1989, (though the first complete estimate for 1989 will not be published until early March, and revisions to past data could alter this picture significantly). The services balance has begun to recover, following a fall in 1988. But

Table 5.2 The invisibles balance

£ billion

	Services	Interest profits and dividends	Transfers	**Total invisibles**	Invisibles as % GDP
1987	5.7	4.8	-3.4	**7.1**	1.7
1988	4.2	5.5	-3.5	**6.2**	1.3
1989	4.5	2.8	-4.6	**2.6**	0.5
1990	5.5	2.4	-4.4	**3.4**	0.6
1991	6.8	3.3	-4.5	**5.6**	1.0

the transfers deficit rose, reflecting higher net contributions to the EC, and net earnings from interest profits and dividends (IPD) fell to around half the 1988 level.

5.11 In the light of the recent invisibles data, which were much weaker than expected, we have become more cautious about the prospects for a recovery. The invisibles surplus is expected to rise by only £1 billion, to £3½ billion, in 1990. This compares with a rise of £2 billion (to £6 billion) in the Autumn Statement forecast and £3 billion in the October internal forecast. The **services balance** is expected to continue its recent recovery, but more gradually than previously thought. The travel balance in particular is responding more slowly than expected to lower growth in consumers' expenditure, and net earnings of financial services could be hit in the months ahead by high insurance payouts in the US following recent disasters.

5.12 The deterioration in the **IPD surplus** during 1989 mainly reflects the servicing of strong sterling borrowing at high interest rates, required to finance the large current account deficit and net outflows of direct and portfolio investment. There is little prospect of any substantial improvement in IPD while these factors persist, though a small rise in the surplus is forecast in 1991, as sterling interest rates fall.

5.13 The fall in net earnings on overseas assets has occurred despite a probable rise in the measured level of **net overseas assets** during 1989 - from £88 billion at end-1988 to an estimated £114 billion at end-1989. The rise is more than accounted for by favourable revaluations, as world stock markets rose and sterling fell, boosting the sterling value of foreign currency assets. (Measured in foreign currencies, our net assets probably changed very little during 1989). Revaluations are forecast to be much smaller over the next two years, but sufficient to offset the effect of continued net capital inflows, so that identified net overseas assets may continue to rise slowly. However the large balancing items in the overseas accounts, which are assumed to continue, imply that CSO estimates, and consequently the forecast, may overstate the true level of net overseas assets.

5.14 The **transfers deficit** is likely to be a little lower in 1990 than in 1989. Net EC contributions should fall from £2¼ billion to £1¾ billion, with a particularly marked fall in EC contributions in the first half of 1990.

CHAPTER 6 : PRICES AND EARNINGS

Producer prices

6.1 **Producer output price inflation (excluding food, drink and tobacco)** was stable at around 5½ per cent throughout 1989. With unit labour costs picking up sharply in the second half of last year, profit margins have probably been squeezed recently. This pressure on margins is likely to continue - even intensify - in 1990, as companies face very sluggish demand growth and strong foreign competition. **Producer price inflation** is therefore expected to fall to 4¼ per cent by 1990Q4. It falls only slightly further, to 4 per cent, by the end of 1991, with rising import and fuel costs partly offsetting the beneficial effects of moderating unit labour cost inflation and sustained pressure on margins.

Table 6.1 Costs and prices in manufacturing

	Percentage changes on a year earlier			
	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices[1]
1987 Q4	3.1	5.1	2.0	4.8
1988 Q4	2.2	5.1	2.9	5.0
1989 Q4	4.5	4.3	5.5	5.5
1990 Q4	6.1	1.8	5.1	4.3
1991 Q4	4.0	4.8	4.2	3.9

[1] *Excluding food, drink and tobacco*

Retail prices

6.2 The **all-items RPI inflation rate** peaked in May/June at 8.3 per cent. It has fallen since to 7.7 per cent, largely because the effect of mortgage interest rate increases in late 1988 have dropped out of the calculation. The **underlying RPI inflation rate, excluding mortgage interest payments**, rose from 5.7 per cent in August to a steady 6.1 per cent throughout October-December. This largely reflected the continued acceleration of **food prices**, which began around April but gathered pace from the summer. Food price inflation averaged 3½ per cent in 1988 but rose from 4.2 per cent in March to 7.5 per cent in December, adding about 0.6 per cent to the underlying inflation rate. Annex A details the factors behind these developments in food prices

6.3 The prospects for RPI inflation through 1990 (see **Table 6.2**) are dominated by a number of unfavourable influences:

- Rapid food price inflation in the immediate months ahead; it may rise to 7.6 per cent in the first quarter of 1990 before falling sharply to 5 per cent by 1990Q4.
- Rising utilities' prices, including an assumed 12¾ per cent increase in water charges and a 9 per cent increase in electricity prices from April.
- A 26¼ per cent increase in the community charge/rates indicator, compared to 20½ per cent in October. This is based on an average community charge of

£329. But there is still a wide range of possible outcomes. CPIFA has recently forecast £344.

- A 10 per cent increase from April 1990 in local authority rents (which dominate the rents component of the RPI).
- The assumed revalorisation of excise duties in the 1990 Budget. Because there was no revalorisation in the 1989 Budget, this effect will add about ½ per cent to the index from April.
- An assumed ½ point rise in average building society mortgage rates from the beginning of April.

6.4 Food prices apart, these factors are mainly the result of administered, or quasi-administered, price changes (LA rents, community charge, utilities, revalorisation etc.). They clearly impart considerable inertia to the inflation prospect. Their impact may be partly moderated, but only partly, by a sustained squeeze on margins in the marketed retail sector.

Table 6.2 Evolution and Prospects for RPI Inflation

		percentage changes on a year earlier					
	Weight[1]	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4	1991Q4
Housing	%						
MIPs	*6.0*	4.2	6.4	36.4	32.6	17.2	-4.0
Rent	*3.2*	6.1	6.2	8.3	9.5	8.7	6.7
Rates/Community[2] Charge	*4.2*	13.6	7.7	8.4	9.6	26.2	7.2
Other	*3.4*	5.1	5.4	9.3	9.4	6.3	7.7
Utilities							
Electricity	*2.6*	0.8	-0.6	8.6	6.5	9.0	6.4
Water	*0.7*	8.1	6.9	8.1	12.7	12.6	12.0
Gas	*2.2*	1.4	-4.5	6.0	3.4	2.8	3.9
Other	*1.3*	7.0	5.6	4.9	6.8	7.6	7.1
"Retailed" Prices							
Food	*15.4*	3.2	3.4	3.9	7.4	5.0	4.0
Petrol	*3.4*	-12.6	1.3	-0.2	7.7	4.9	4.5
Other	*57.6*	4.0	4.3	4.8	4.9	4.4	4.2
Total	*76.4*	2.9	4.0	4.4	5.6	4.5	4.2
Total RPI Inflation	*100*	3.4	4.1	6.5	7.6	6.7	4.1
Total RPI Inflation excl MIPs	*94*	3.4	4.0	5.1	6.1	6.0	4.7

[1] *weights at Jan 1989*
[2] *includes 3.5 per cent for 'index household effect', worth about 0.15 per cent on all-items*

6.5 Overall, **all-items RPI inflation** is likely to rise to a local peak of almost 8 per cent in April before falling to 6¾ per cent in 1990Q4 as interest rates start to decline later in the year. (**Table 6.3** presents the expected monthly inflation profile through 1990.) Underlying inflation rises to 6¼ per cent in 1990Q2 before falling to 6 per cent in 1990Q4 (the same as 1989Q4). The fall in underlying inflation is the result of sharply declining

food price inflation and a fall in other marketed retail price inflation (from 5 per cent in 1989Q4 to about 4½ per cent in 1990Q4). Inflation moderates more quickly through 1991. The all-items RPI inflation rate falls to 4 per cent by 1991Q4, reflecting the steady fall in interest rates. Underlying inflation falls to about 4¾ per cent.

Table 6.3 **Monthly profile for RPI inflation**

	Percentage changes on a year earlier			
	All items RPI		RPI excluding mortgage interest payments	
	January	October	January	October
1989				
October	7.3	7.1	6.1	5.9
November	7.7	7.7	6.1	5.9
December	7.7	7.6	6.1	5.8
1990				
January	7.5	7.4	5.9	5.8
February	7.2	7.2	5.8	5.6
March	7.1	7.1	5.6	5.5
April	7.9	7.5	6.5	6.1
May	7.7	7.5	6.2	5.9
June	7.7	7.5	6.2	6.0
July	7.8	7.4	6.3	6.0
August	7.8	7.3	6.3	6.0
September	7.6	7.3	6.2	6.0
October	7.4	7.1	6.1	5.9
November	6.5	6.4	5.9	5.9
December	6.4	6.2	5.8	5.8

Wage settlements and earnings

6.6 Private sector settlements have averaged 8-8¼ per cent so far in the 1989-90 pay round, compared with 7¼ per cent for 1988-89. The cost of living appears to be the dominant factor behind the rise in settlements in the private sector, though the need to recruit and retain labour is also an important influence, particularly in the service sector. **Whole economy underlying average earnings growth** was flat at 9¼ per cent in November, having risen by ¼ per cent in both September and October. The recent pick up in average earnings reflects high settlements agreed last summer and autumn, but has been attenuated by declining overtime and bonus payments as the economy has slowed. **Public sector underlying earnings** growth also picked up towards the end of 1989.

6.7 With the headline RPI inflation rate forecast to remain high for the first three quarters of 1990, we are unlikely to see any significant reduction in **private sector settlements** until late 1990. Settlements are then expected to moderate in response to falling inflation, rising unemployment, and greater resistance from employers in the face of a poor financial prospect. Overall, **private sector settlements** are expected to average 8¼ in the 1989-90 pay round, falling to 7 per cent in 1990-91. With overtime falling, earnings drift is expected to continue to decline, but **private sector**

underlying earnings growth may still average 9¼ per cent in 1990 moderating to 8¼ per cent in 1991.

Table 6.4 **Settlements and earnings**

	Contributions to changes on a year earlier				
	1987 Q3	1988 Q3	1989 Q3	1990 Q3	1991 Q3
Private sector					
Settlements: *current*	5.3	5.7	7.8	8.0	6.2
12 month average	5.2	5.8	7.3	8.2	6.9
Drift	2.8	2.8	1.8	1.2	1.2
Underlying average earnings	8.0	8.6	9.1	9.4	8.1
Public sector					
Underlying average earnings	6.8	11.0	7.9	9.3	8.5
Whole economy					
Underlying average earnings	7.8	9.2	8.9	9.4	8.2

6.8 Public sector underlying earnings are expected to grow in line with the private sector through 1990. Thereafter, some recovery in the public sector/private sector earnings differential is expected, implying whole economy underlying earnings growth of 8 ½ per cent in 1991 as a whole.

The GDP deflator

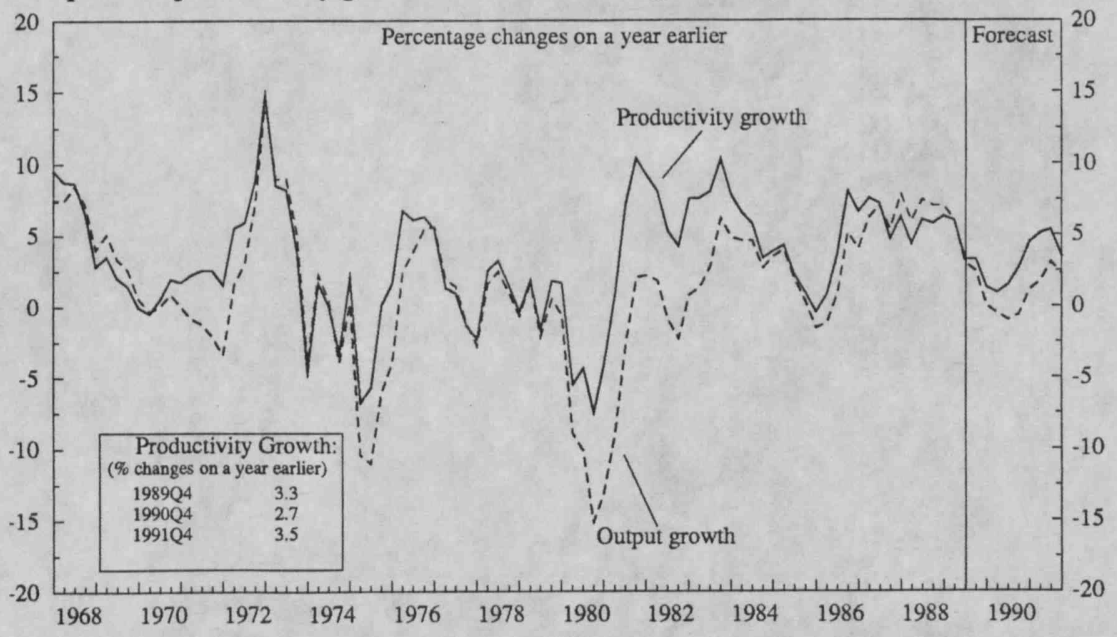
6.9 The **market price GDP deflator** is now estimated to have risen by 6.9 per cent in 1988-89. We expect it to rise by 6 per cent in 1989-90 and by 5½ per cent in 1990-91 on the Autumn Statement basis (ie, making no allowance for the effect of the introduction of the community charge in England and Wales).

CHAPTER 7 : LABOUR MARKET

Employment and productivity

7.1 **Manufacturing employment** increased by an estimated 1¾ per cent between 1987Q1 and 1989Q3. This was much slower than the growth of output, and productivity rose at an annual average rate of 5.5 per cent over the same period. Since then manufacturing employment has started to fall as output growth has moderated, and productivity growth has also slowed. Productivity normally follows the cycle in output, because employers typically take some time to adjust their labour forces to changes in output. With much slower output growth in prospect in 1990 and 1991, manufacturing employment may fall more sharply, especially if, as we assume, employers shake-out labour to defend their financial position and improve unit labour cost performance. Productivity may rise by only 1½ per cent in 1990, picking up to 4½ per cent in 1991 as output growth recovers and firms continue to shake-out labour (**Chart 7.1**).

Chart 7.1 Output and productivity growth in manufacturing industry



7.2 Employment in the **private non-manufacturing sector** increased by 1¾ million or 12.1 per cent, between 1985Q1 and 1989Q2. Productivity growth has slowed from 4 per cent in 1986 (an exceptionally fast rate) to around 1¾ per cent currently (a bit low by historic standards). For much the same reasons as in the manufacturing sector, employment may start to fall soon. Productivity growth may be close to zero in 1990 before recovering with output growth and some further labour shake-out in 1991.

Unemployment

7.3 Strong employment growth has resulted in large falls in unemployment. However, the trend fall in unemployment is now clearly slowing from 38 thousand a month in the first half of 1989, to 20 thousand a month in the latest three months. With total employment expected to fall by 250,000 between end-1989 and mid-1991, and some rise in labour supply, unemployment is expected to start rising from 1.6 million in mid-1990, to 2.0 million by mid-1991. It rises to 2.1 million by end-1991 (**Chart 7.2**).

Chart 7.2 Unemployment

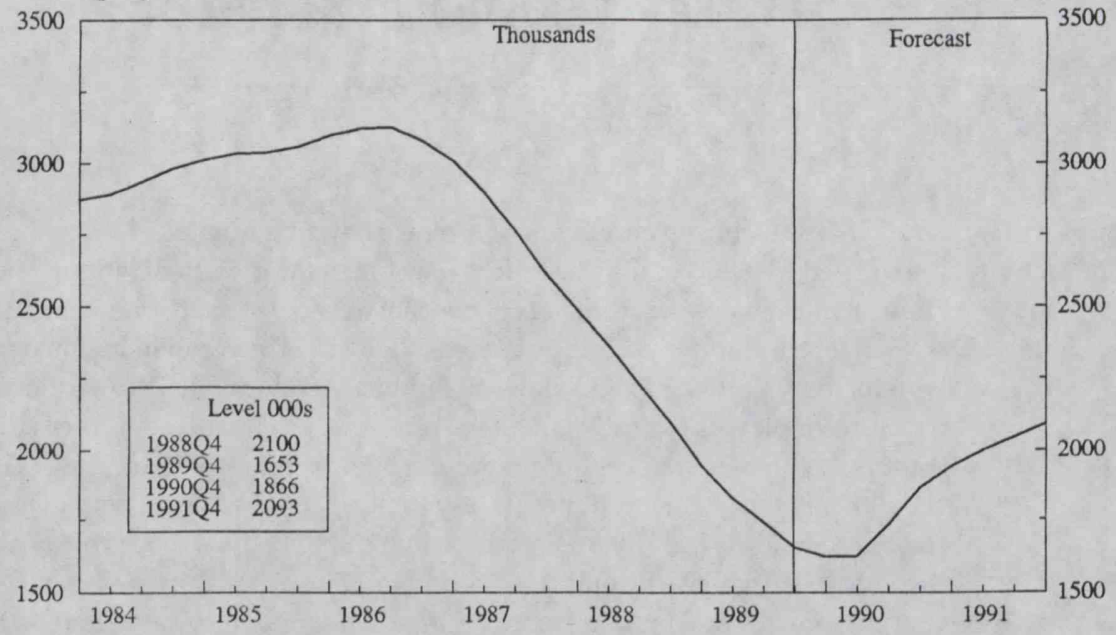
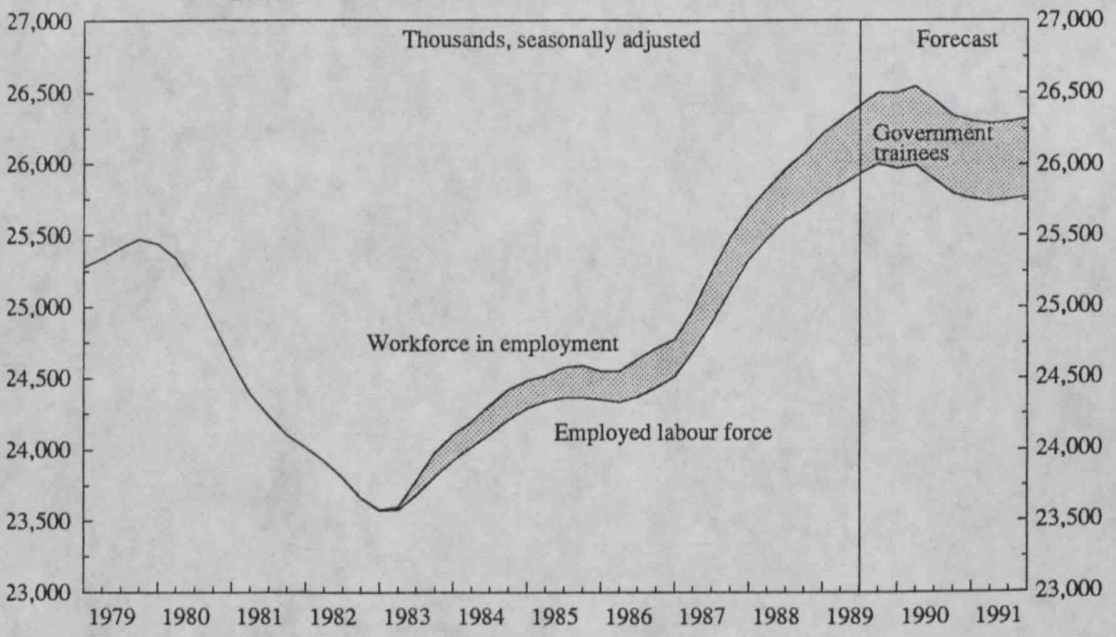


Chart 7.3 Workforce in employment (UK)



CHAPTER 8: MONETARY CONDITIONS

Exchange rates

8.1 The **sterling index** has fallen nearly 10 per cent since it peaked in the first quarter of 1989. The forecast assumes a **constant real exchange rate** at around its recent level. This means that the sterling index falls in line with the differential between UK and other G7 countries' inflation, forecast to be about 2 percent in 1990 and 1991. This is consistent with little change in the $/£ rate, and a small fall against the DM.

Table 8.1 Exchange rates and interest rates

	Sterling index (1985=100)	$/£	DM/£	Base rates
1987Q4	92.7	1.75	2.99	9.2
1988Q4	96.7	1.79	3.18	12.4
1989Q4	88.0	1.58	2.88	15.0
25 Jan	**87.9**	**1.66**	**2.80**	15.0
1990Q4	86.4	1.65	2.76	14.5
1991Q4	85.0	1.65	2.68	12.5

Interest rates

8.2 Inflation remains well above the MTFS path throughout the forecast. We have therefore assumed **interest rates** will need to remain high to maintain downward pressure on inflation. Base rates stay at 15 per cent until the beginning of the fourth quarter of 1990, and then fall ½ point a quarter through to the end of 1991-92. With world rates forecast to fall only very slowly, the **interest rate differential** begins to narrow in 1991. However it remains high by historical standards (**Chart 8.1**) and should be sufficient to attract the substantial inflows from overseas required to finance both the current account deficit and direct and portfolio capital outflows.

Chart 8.1 Sterling exchange rate and interest rate differential

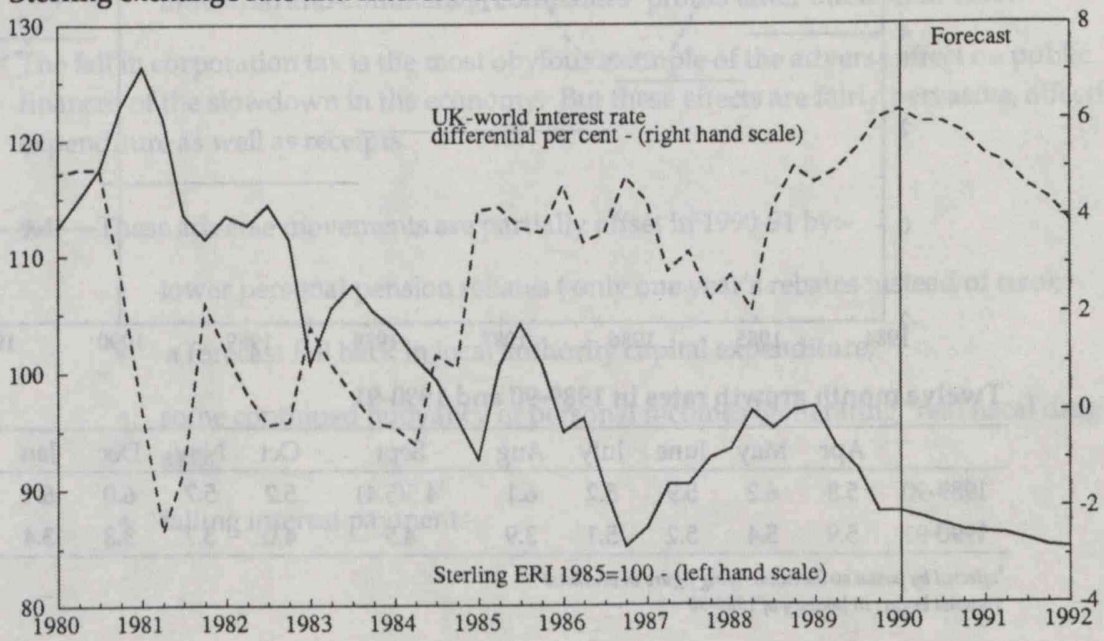
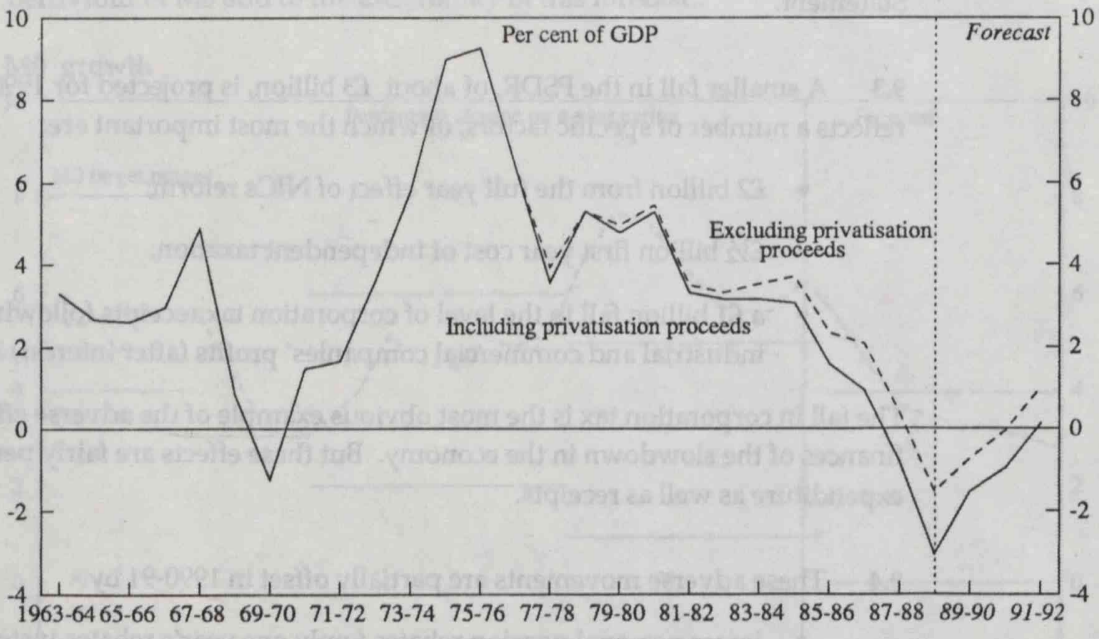


Table 9.1 Expenditure, receipts and debt repayment

£billion

	1988-89	1989-90			1990-91	1991-92
	Outturn	1989 FSBR	Autumn Statement	January Forecast	January Forecast	January Forecast
General government expenditure	178.8	194.3	196.3	197.7	212.4	228.4
General government receipts	190.2	206.4	206.9	204.3	216.5	227.1
Fiscal adjustment	-	-	-	-	0	0
General government debt repayment	11.5	12.1	10.6	6.6	4.1	-1.3
Public corporations' market and overseas debt repayment	3.0	1.7	1.9	1.4	0.9	0.2
PSDR	**14.4**	**13.8**	**12.6**	**8.0**	**5.0**	**-1.1**
(as per cent of GDP)	(3)	(2¾)	(2½)	(1½)	(1)	(-¼)
PSDR excluding privatisation proceeds	**7.4**	**8.8**	**8.3**	**3.8**	**0**	**-6.1**
(as per cent of GDP)	(1½)	(1¾)	(1½)	(¾)	(0)	(-1)

Chart 9.1 PSDR ratios



Public expenditure

9.5 GGE in 1989-90 is expected to be £1¼ billion higher than estimated in the (forthcoming) PEWP, due to higher estimates of both the planning total (old and new) and debt interest.

9.6 In 1990-91 GGE is £2 billion higher than in the 1990 PEWP as a result of:-

- £½billion overspend on the new planning total;
- £½ billion increase in local authority self-financed expenditure and;

- £1½ billion increase in central government debt interest, reflecting both the carry forward of a higher level of interest payments in 1989-90 and lower levels of debt repayment.

A small reduction in accounting adjustments partially offsets these increases.

Table 9.2 New planning total and GGE

	£billion					
	1989-90		1990-91		1991-92	
	1990 PEWP	Forecast	1990 PEWP	Forecast	1990 PEWP	Forecast
New planning total	161.9	162.4	179.0	179.5	192.3	197.6
Local authority self-financed expenditure	13.1	13.7	11.8	12.4	11.9	11.6
CG debt interest	17.3	17.8	15.3	16.7	14.1	15.7
Accounting adjustments	4.2	3.8	4.3	3.8	3.8	3.4
GGE	196.4	197.7	**210.4**	**212.4**	**222.2**	**228.4**

9.7 The main claims on the Reserve next year are expected to come from:

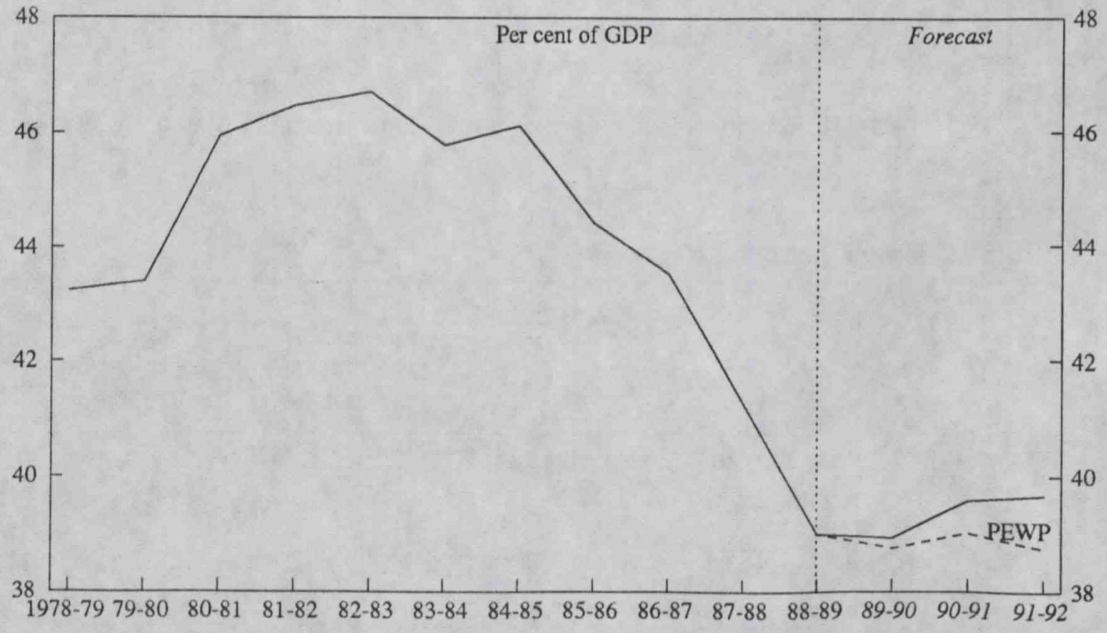
- central government pay, where the upward pressures could go wider than review body awards;
- community charge benefit grant where a forecast community charge per head of £329 compares with £274 underlying the published plans, and adds £½ billion to expenditure and;
- nationalised industries, where the adverse effect on profits of the slowdown in the economy is superimposed on top of structural problems for industries such as British Coal.

Apart from community charge benefit, social security may not absorb much, if any, of the Reserve next year. Benefit rates are fixed and unemployment in the forecast, though rising, is **below** the level assumed in the 1990 PEWP. In 1991-92 however forecast upratings and unemployment are above PEWP levels, directly adding £1 billion to spending.

9.8 The upward revision from the PEWP to the forecast of local authority spending is consistent with early indications about the level of budgets set by individual authorities for next year.

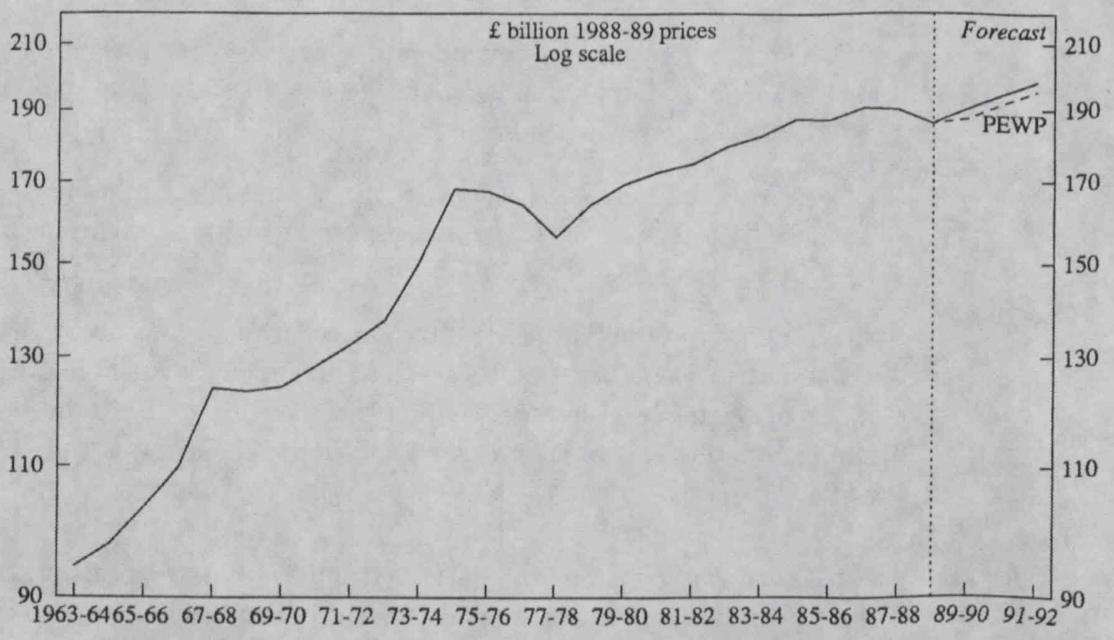
9.9 The upward revision to GGE in 1989-90 means that the GGE ratio (excluding privatisation proceeds) is now forecast to be unchanged from its 1988-89 level at 39 per cent, compared with a fall of ¼ per cent in the PEWP. Moreover the forecast rise in the GGE ratio in 1990-91 is ¾ per cent, compared with ¼ per cent in the PEWP. This is the result of a higher cash figure for GGE **and** slower growth of money GDP (all money GDP figures in this chapter treat the community charge in the same way as in the Autumn Statement). A tiny rise in the ratio is forecast for 1991-92.

Chart 9.2 GGE (excluding privatisation proceeds) ratio



9.10 Although money GDP is forecast to increase **less** than in the PEWP, the GDP deflator is forecast to rise **more** - ie the shortfall in money GDP is more than accounted for by a shortfall in output. The higher level of GGE in cash terms in the forecast more than compensates however for the higher prices and the forecast of spending in real terms is _ **above** the PEWP.

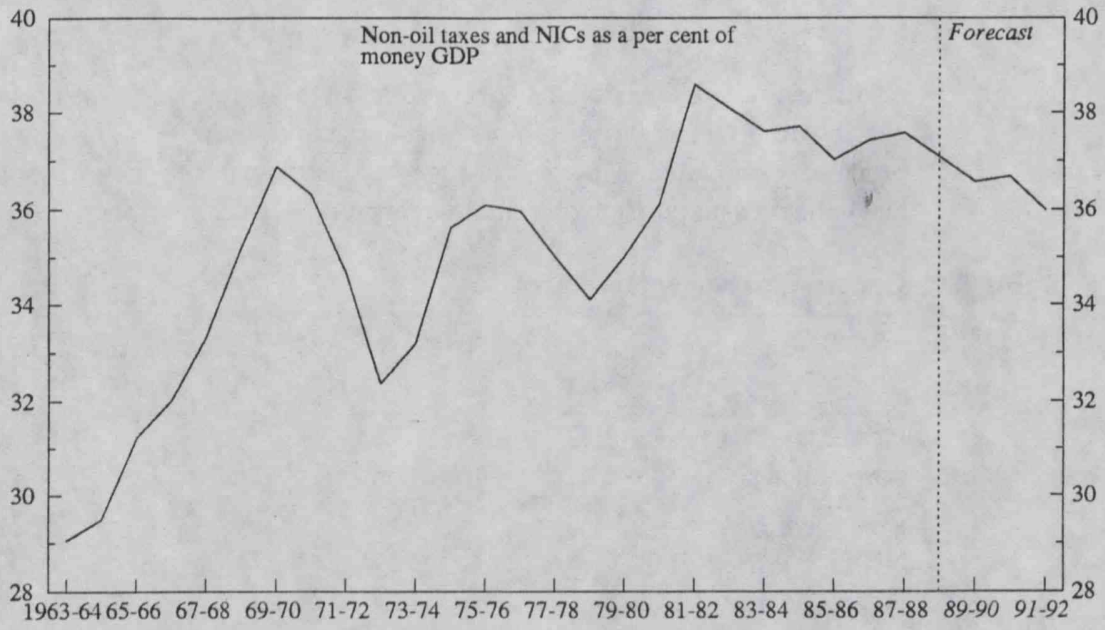
Chart 9.3 Real GGE (excluding privatisation proceeds)



Receipts **9.11** The growth of general government receipts appears to have slowed in 1989-90, and to be below that of money GDP. Within the total, income tax and corporation tax are growing relatively quickly and taxes on expenditure relatively slowly. This fits with the familiar picture of continued rapid growth of personal incomes and a slowdown in the growth of personal spending. The slow growth of expenditure taxes also partly reflects the non-revalorisation of the excise duties in the last Budget.

9.12 The continued buoyancy of corporation tax receipts is not surprising as, given the payments lags, receipts in 1989-90 reflect:

Chart 9.4 Non-oil tax burden



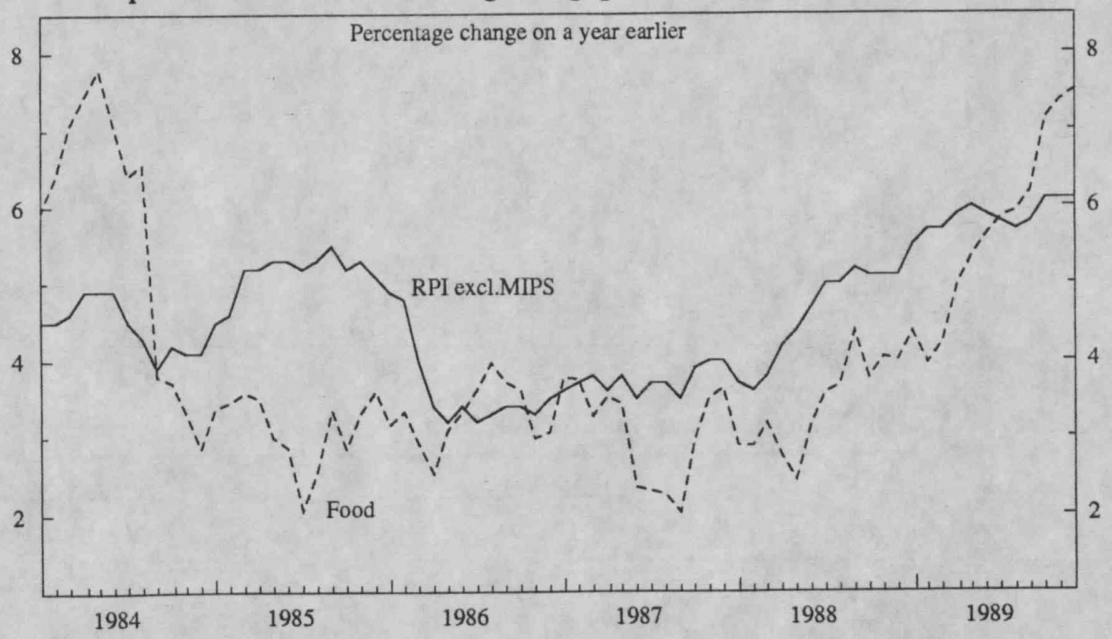
ANNEX A: THE EVOLUTION AND PROSPECTS FOR FOOD PRICE INFLATION

A.1 This annex examines the factors behind the rise in UK food price inflation in 1989 and discusses the outlook for food prices to 1991Q4.

Recent developments

A.2 The rate of growth of the **food component of the RPI** was fairly steady from the middle of 1984 to the beginning of 1989 at between 2 and 4 per cent. However, domestic food price inflation picked up through 1989 from 4.2 per cent in March to 7.5 per cent in December, adding 0.6 per cent to the underlying RPI inflation rate excluding mortgage interest payments (**Chart A1**).

Chart A1 UK food prices and the RPI excluding mortgage interest payments



A.3 The sharp rise in UK food price inflation through 1989 took most people by surprise. One factor has been sharply rising world prices of **pork** and **bacon.** This has been due to the so-called "hog-cycle". Producers cut back their herds or left the industry in response to low prices in 1988. But demand in 1989 subsequently outstripped the reduced supply and prices have consequently risen. **Tea** and **sugar** prices have also been strong recently.

A.4 Even so, **world food prices** in general have been very weak. For example, measured in dollar terms, aggregate world food prices in 1989Q4 were around 4¼ per cent lower than a year earlier. This fall in large part has reflected the effects of the recovery of **cattle supplies** after the US drought of 1988 on beef and dairy prices; the weakness of **coffee** prices following the suspension of export quotas; and the weakness of **cocoa** prices in the face of widespread over-production. The important question to

address is therefore why lower beef, dairy, coffee, and cocoa prices have not fed through to UK retail food prices.

A.5 A key factor is the **Common Agricultural Policy.** The CAP effectively insulates EC market prices from the wide movements that occur in many world prices, including beef and dairy prices. As **Chart A2** shows, UK food price inflation has remained fairly steady in recent years in the face of swings in world food price inflation from minus to plus 20 per cent. And the increase in food price inflation throughout the EC in 1989 - albeit from a generally lower base - suggests that the CAP has tended to hold up food prices in 1989.

Chart A2 UK and world food price inflation

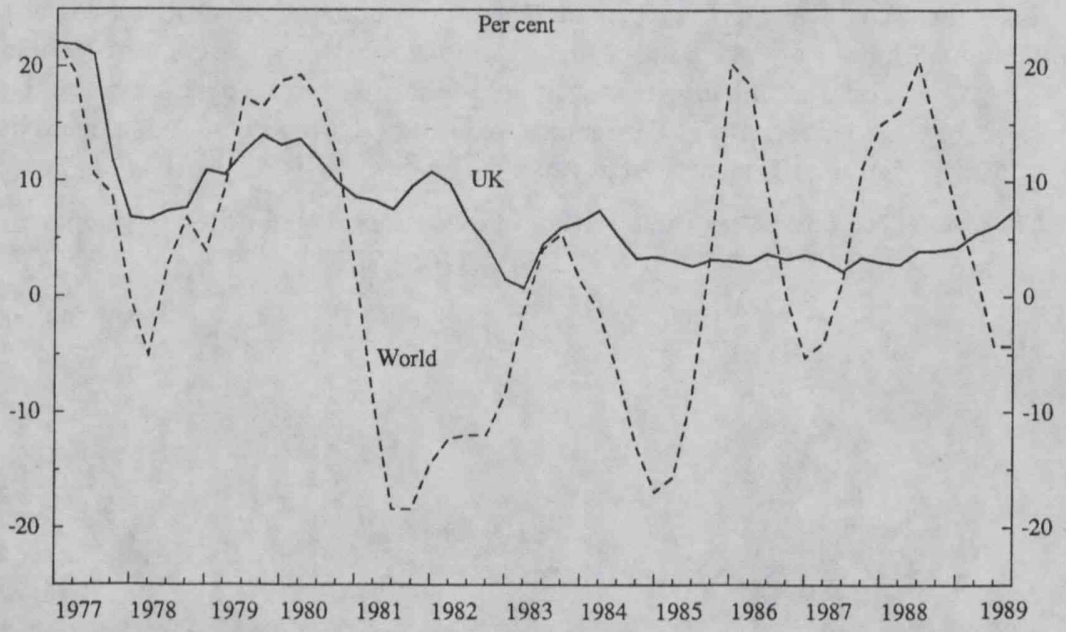


Table A1 Food price inflation in the EC in 1989

	Per cent					
	UK	W Germany	France	Italy	Spain	EC
January	4.4	1.6	3.2	4.9	6.9	3.6
February	4.0	1.6	3.2	5.5	6.5	3.8
March	4.2	1.7	3.5	6.1	6.5	4.0
April	5.0	1.9	3.8	6.4	7.9	4.4
May	5.3	2.2	4.1	6.7	8.2	4.6
June	5.6	2.1	4.2	6.7	9.0	4.7
July	5.9	2.4	4.5	6.6	9.2	5.1
August	5.9	2.4	4.8	6.5	6.5	5.0
September	6.2	2.8	4.9	6.3	7.2	5.1
October	7.1	3.1	5.1	-	7.9	5.5
November	7.4	2.7	5.2	-	8.6	5.5
December	7.5	-	-	-	-	-

A.6 There are, however, a number of products that are not covered by the CAP, including, in particular, **coffee** and **cocoa.** While, for example, world coffee prices fell by almost 40 per cent in the second half of 1989, UK retail coffee prices in December were 5½ per cent higher than a year earlier.

A.7 The UK market for coffee is dominated by two large manufacturers, Nestle and Maxwell House (General Foods). Together they account for about three quarters of the retail market. Nestle - the market leaders - currently face very high interest payments following their expensive takeover of Rowntree Mackintosh. They may therefore have been prepared to accept some loss of market share to their competitors rather than cut their prices and risk a 'price war'. Nestle's position in the confectionery market may also explain why falling cocoa prices have not been reflected in the price of chocolates etc. But the recent rises in sugar prices may have been an important factor as well.

A.8 The operation of the CAP and the uncompetitive behaviour of coffee and confectionery manufacturers together may largely explain why falling world food prices have not been reflected in falling UK retail food prices. However, they are not sufficient to explain the increase in prices through 1989. And neither can it be explained by rapidly rising real demand for food. Real consumers' expenditure on food in 1989 is provisionally estimated to have been less than 1 per cent up on 1988, against an increase in total consumers' expenditure of 4¼ per cent.

A.9 It would appear that food price inflation in the UK (and in the EC in general) has risen because of a number of special factors. For example in the UK :

- The supply of many seasonal food products has been reduced by last year's **dry weather**, especially fresh fruits and vegetables. In December, seasonal food prices were 9.5 per cent higher than a year earlier, with potatoes over 24 per cent up and fresh vegetables 13¾ per cent up.
- Two devaluations in the **green pound** - one in January last year and another in the late summer - will have raised market prices, although MAFF do not estimate their effect to have been large.
- Changes in the **support regime** for beef led farmers to market their stock early and switch some to export markets, reducing domestic supplies of beef.

Prospects

A.10 The outlook for food price inflation is very uncertain. **World food prices** are expected to remain fairly flat through 1990 and 1991. Dramatic falls in prices, such as occurred to coffee and cocoa in 1989, are unlikely. However, stocks of coffee remain high and it will be several years before the required adjustment of supply begins to allow a return to more normal prices for these key commodities. In the absence of further climatic disorders, slowing but still rapid world growth is unlikely to provide any significant impetus to prices of other foods in either direction.

A.11 In the very short term, we expect **UK food price inflation** to rise to 7.6 per cent in 1990Q1. Thereafter, some of the factors which pushed up food prices in 1989 are likely to unwind quickly. There is already also some evidence that pork and bacon prices may

have peaked and that the "hog-cycle" is moving into a downswing again. And coffee manufacturers have just announced cuts of over 10 per cent in their prices.

A.12 However, these effects will probably be partly offset by a further devaluation of the green pound, phased in from the start of the second quarter, which could well be larger than recent devaluations. Moreover, though the effects of the changes in the support regime for beef can be expected to have worked themselves out quite soon, similar changes to the support regime for sheep meat are likely to push up lamb prices from 1 January. And retail tea prices may have not yet fully adjusted to the recent increases in the world price of tea.

A.13 But overall, with the growth of consumer demand forecast to be weak over the next two years and, in particular, the supply of seasonal fruit and vegetables likely to recover from the spring (assuming more normal weather than in 1989), we expect UK food price inflation to fall sharply this year, to 5 per cent in 1990Q4. It is expected to moderate further thereafter, to 4 per cent by 1991Q4.

Table A2 Prospects for food prices

	Percentage changes on a year earlier					
			Forecast			
	1989 Q2	1989 Q4	1990 Q2	1990 Q4	1991 Q2	1991 Q4
World	2.3	-4.3	-1.1	2.2	3.2	2.1
UK	5.4	7.4	6.8	5.0	4.4	4.0

ANNEX B: RECENT NATIONAL ACCOUNTS DATA

B.1 The forecast was based on the third quarter GDP numbers, published on 20 December. They included a radical re-evaluation of the statistical adjustments to the components of the expenditure measure of GDP, **GDP(E)**. **Table B1** sets out the latest adjustments, and compares them with those included in the second quarter GDP figures published in September. In the first three quarters of 1989, the new adjustments amount to over 2½ per cent of GDP.

Table B1 National accounts statistical adjustments

	£million at 1985 prices					
	Latest			Published in September press notice		
	1987	1988	1989 Q1-Q3	1987	1988	1989H1
Consumers expenditure	1500	3080	3750	0	1318	681
GDFCF	0	850	1470	0	850	440
Stockbuilding	0	1240	2410	0	1230	2316
Net exports	0	520	430	0	520	280
GDP (E)	**1500**	**5690**	**8060**	**0**	**3918**	**3717**
Adjustments to GDP(E) as per cent of GDP (market prices)	0.4	1.4	2.6	0	1.0	1.8

B.2 The latest figures put much more of the statistical adjustment on consumer spending than in the September press notice, when proportionately the largest adjustment in 1989 was allocated to stockbuilding. However given the size of the required adjustment it looked increasingly implausible to load so much on to stockbuilding. It was not supported by evidence from the CBI's surveys of manufacturers, distributors and retailers, and implied an unbelievable rise in stock-output ratios. The CSO give no particular rationale for allocating the adjustment to consumers' expenditure, other than that as the largest single component of GDP(E) it is more readily able to absorb such a large adjustment.

B.3 By themselves, the new adjustments have worsened the sectoral balancing items. The increase in consumers' expenditure has made the personal sector balancing item even larger, whilst the reduction in stockbuilding has made the industrial and commercial companies' balancing item even more negative.

B.4 Despite some improvements to the measurement of certain categories of expenditure, such as the supply-side estimates of investment, growth in GDP(E) as measured by the raw data continues to fall well short of growth in the output measure, GDP(O) - see **Table B2.**

Table B2 Expenditure and output estimates of GDP

percentage changes on a year earlier

		GDP(E)		GDP(O)	Difference between GDP(O) and measured GDP(E) (% points)
		Published	Measured[1]		
1988	Q1	5.3	3.6	5.7	1.9
	Q2	4.1	4.7	4.7	0.0
	Q3	3.7	0.6	4.1	3.5
	Q4	3.2	2.3	3.5	1.2
1989	Q1	2.9	0.8	3.0	2.2
	Q2	2.7	-0.2	2.7	2.9
	Q3	2.0	1.4	1.9	0.5

[1] *ie before statistical adjustments*

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BACKGROUND

Present Position

1. Indicators since the Autumn Statement confirm a weak outlook for personal and business sector demand: -

- retail sales have been sluggish (despite the high figure for December);

- consumer confidence declined sharply in October, and stayed low until January when it recovered much of the previous loss;

- the housing market - which made a major contribution to the overheating - is now very weak with falling prices and housing starts;

- the emergence of a huge company sector financial deficit - previously only matched in 1974 and 1980 when they were followed by large reductions of stocks and investment;

- investment intentions have weakened - one possible indicator is commercial vehicle registration which are well down on earlier levels.

2. Surprisingly, however, monetary indicators have been slow to adjust:-

- MO growth has been stuck a little above its target range for the past 6 months. We have yet to see the full effects of the tightening of monetary policy on MO, but in the past MO growth has been 3 to 4 per cent less than money GDP growth. There are no obvious reasons why the gap should have narrowed;

- M4 growth continues at 16-20 per cent; bank lending remains very buoyant;

6

- the exchange rate has fallen by 10 per cent over the past year and is 5 per cent below its 1986-88 average level (although it has bounced back in recent weeks from its low point).

3. Inflation has been disappointing in recent months - the inflation rate ex-MIPS, at 6.1 per cent, is higher than its mid summer level. One important feature has been the rapid growth of food prices - also evident in other EC countries.

4. At last there are clear signs of some improvement in the trade figures - often a precursor of lower inflationary pressure:-

- exports continue to grow rapidly;

- import growth has slowed and the level of imports is relatively unchanged over the past 6 months.

The invisible surplus has fallen sharply over the past two years reflecting an adverse travel balance, a growing deficit on transfers and high interest payments on overseas investment in the UK - but it should improve as consumer demand weakens and interest rates (eventually) fall back.

5. The large Public Sector Debt Repayment in recent years has been heavily influenced by the cycle. In 1987 and 1988 rapid growth meant buoyant taxes - particularly corporation tax - and a declining public expenditure ratio. This year it appears that the PSDR may be down to £8 billion from £14 billion last year. We believe this largely reflects some big one-off items - the lower privatisation proceeds (£3 billion), a high take-up of private pensions (£2½ billion) and a surge in local authority capital expenditure (£2 billion) before the change of regime.

The Outlook

6. The main features of the forecast are as follows:

- slow growth in 1990. GDP may grow by less than 1 per cent - with non oil GDP about flat;

- a marked reduction in the current account deficit with exports holding their share of world trade and import growth declining in line with domestic demand;

- a vanishing PSDR; as the beneficial cyclical effects unwind the surplus may be down from about £8 billion this year to £5 billion next in the absence of budget measures. Excluding privatisation proceeds, general Government Expenditure may rise from 39 per cent of GDP this year to 39¾ per cent next year;

- not much progress on inflation in 1990 which will be adversely affected by special factors: local authorities setting the community charge at a high level compared to previous rate levels; high mortgage rates; rapid growth of nationalised industry prices; the depreciation of sterling during 1989.

- there should be a sharp improvement in the headline RPI figure next year as some of these factors fall out of the 12 month comparison. The underlying rate may not improve much during this year but should decline from the end of this year onwards.

7. The forecast is highly uncertain. The big question is the speed at which private sector expenditure adjusts to its deficit and higher interest rates:

- consumption has risen very rapidly in recent years. With high debt/income ratio and debt service burdens will be pressures to reduce spending. But consumers always resistant to efforts to curb spending;

- big uncertainty about response by companies to company sector deficit.

We have underestimated strength of demand in recent years. This may continue - or it may be reversed faster than we expect.

QUESTIONS FOR POLICY

8. Is the prospect for inflation acceptable? Some points to note:

- there is a substantial lag between policy action and inflation coming down;

- there is a lot of uncertainty about the timing of lower inflation;

- in the short run inflation is affected by a number of non-monetary factors eg mortgage rates, public sector prices, food prices;

- getting inflation down probably means a period of slow output growth.

9. Is policy tight enough to satisfy objectives? Or is there a concern that policy may be too tight?

- Forecast suggests policy may be tight enough to get inflation below 5 per cent by mid 1991; meanwhile we face a prolonged period before then of inflation at a higher level; and, of course, the forecast is subject to a margin of error;

- biggest worry is the unsatisfactory growth of money supply on various definitions. MO growth is too high. And broad money growth is showing few signs of falling;

- the inflation outlook could be undermined by exchange rate depreciation in face of continuing current account deficit;

- there is no way of avoiding the risk of policy being too tight. If we want to make sure of getting inflation down there has to be an equal chance of undershooting and overshooting objectives;

- if activity does weaken more rapidly than expected then we are always in a position to reduce interest rates.

10. What can we do to make the MTFS more credible?

- the record on sticking to the MTFS has been poor. Instead of reducing the growth of money GDP it has gone up. We have a target for MO but hardly ever let it trigger interest rate changes. We say we believe in a firm exchange rate but it has fallen by 10 per cent over the past year;

- this suggests our best chance of achieving credibility is to set realistic objectives; stick to the monetary indicators we have chosen; and do not look for excuses for unpalatable figures;

- the biggest weakness in monetary control procedures is the interaction of bank and building society lending with the housing market. Rising house prices interact with lending to create bubbles of feast and famine;

- there may be a case for setting an explicit inflation objective for the medium term - say 1993-4. It would commit the Government to achieving it which could increase credibility. Inflation is the ultimate target of monetary policy; it is easily understood and it would be seen as an important commitment. The dangers are that it would risk pressure to manipulate prices by subsidy, etc; it could be missed because of shocks

outside our control; and it would be difficult to choose a target that was simultaneously challenging and realistic.

11. Should we change approach to monetary policy?

- no case for dropping MO target. Problem, if anything, has been failure to take sufficient notice;

- dangerous to set M4 target; no way of controlling it; and cannot tell if reflects desire to spend or distress borrowing. But need to continue to take into account;

- continue to take account of what the exchange rate seems to be telling us about monetary conditions and future inflation;

- case for monitoring money GDP more closely to check against message from MO and other monetary indicators.

12. Should we change approach to fiscal policy?

- continue medium term perspective;

- must continue to support monetary policy;

- cannot target PSDR in individual years as fluctuates so much with output;

- continue to aim for budget balance over the medium term. In year of rapid growth expect a surplus; and a smaller surplus or deficit in year of weak growth.

13. What is the case for tightening fiscal policy?

- there is already some easing of fiscal policy built into the system via the introduction of independent taxation and the full year affects of changes in National Insurance announced in the last Budget;

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- medium term prospect is for elimination of PSDR;

- it would help confidence in the market (which may see the declining PSDR as a fiscal weakening) and may improve prospect for lower interest rates;

- would speed up reduction in current account;

- would spread counter-inflationary pressures more widely.

14. Is there a case for a repeat of 1981?

- Then we were happy (even eager) to see a lower exchange rate. No longer the case;

- danger now that sharp tightening would look as if determined to reduce interest rates which might weaken sterling;

- would be set back to ambitions for lower taxes with adverse supply side consequences.

15. How do we deal with the commitment to join ERM?

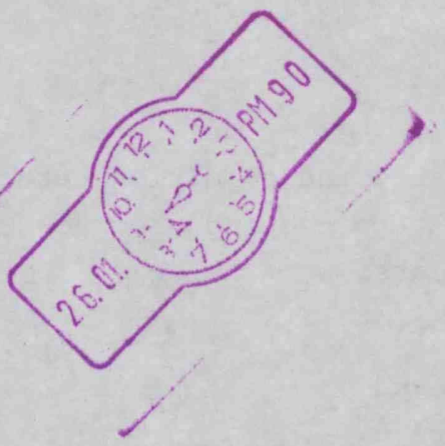
- Economically, we need to be satisfied that the exchange rate is at a level that can be sustained for some time to come; at a reasonable interest rate.

- that requires us to be satisfied that the economy has adjusted sufficiently to permit a reduction in interest rates without undermining domestic monetary conditions as credible membership of ERM will produce pressures to narrow differential;

- political considerations include the timing of entry in relation to the IGC and the next election.

Clearly the conditions are not satisfied at the moment. When they will be depends on how rapidly the policies in place have their effects.

26 January 1990


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