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Commentary on the economic situation

What is the underlying inflation rate?

"Underlying" inflation can be measured in several ways

It seems such an obvious question. Surely, with Mr. Major saying that the future course of interest rates depends on the answer, its meaning should also be clear-cut. In fact, however, there is room for debate not only about how the underlying inflation rate will change in future, but also about what it is at present. With general agreement that the headline inflation rate is misleading, the Government has allowed two alternative interpretations to circulate. The first is that the "underlying inflation rate" is measured by the annual increase in the retail price index excluding housing costs; the second, apparently endorsed in the latest *Bank of England Quarterly Bulletin*, is that "manufacturers' output prices" (i.e., the output-based producer price index) need to be watched. Comfortingly, both approaches seem to give more or less the same figure. In the twelve months to April, the RPI ex-housing was up by 6.3% and the PPI on an output basis by 6.1%. The consensus view - which is easy enough to substantiate by listing a number of well-known special factors affecting the indices - is that the increase in the RPI ex-housing will peak in August. This implies that the evidence of a fall in the underlying inflation rate will begin to become persuasive in October, after the publication of the September inflation figures. That would give scope for the first interest-rate cut at about the same time.

Growth of unit labour costs to remain high throughout 1990

The argument is coherent, plausible and quite possibly correct. But there are some difficulties. Perhaps the most important is that both the RPI and PPI are being held down at present by a squeeze on profit margins. Wage costs per unit of output - which some economists might argue give a particularly reliable guide to inflation pressures - are rising significantly faster than the Government's two favoured measures. For example, the economy-wide increase in wages and salaries per unit of output in the year to the third quarter was 10.2% and in the year to the fourth quarter 9.0%. With wage settlements higher now than in late 1989, it is unlikely that the figures will be much better at any point in 1990.

Interest rate cuts should be justified by other developments

In fact, one or two months' better RPI and PPI figures in the autumn will not provide a solid justification for interest rate cuts. There may be a very strong case for interest rate cuts this autumn, but it will rest on two other features of the economy. The first is the slowdown in domestic demand, which will be even more obvious then than it is today. (The accompanying research paper highlights the severity of the financial squeeze on the corporate sector.) The second is the decline in credit growth now under way. The April lending figure of £4.6b. was a change in the right direction. It should be set in the encouraging context of lower building society mortgage commitments and a collapse in the value of new syndicated credits (according to figures in *Euromoney*).

Professor Tim Congdon 29th May, 1990

Summary of paper on

'How will companies cope with the liquidity crisis of 1990'

Purpose of the paper A minor debate has emerged about the outlook for economic activity in 1990, with some commentators apparently believing that recent retail sales figures show that demand is resilient (or even "buoyant" in some versions). In fact, the economy is slowing down sharply. The deflationary pressures from high interest rates are particularly acute in the corporate sector. This issue of the *Gerrard & National Monthly Economic Review* therefore considers how large companies' cutbacks in stockbuilding and investment will need to be.

Main points

* **Companies today face financial pressures similar to those in the "liquidity crises" of 1969, 1974 and 1980. The pressures can be measured both by companies' liquidity ratio (i.e., ratio of deposits to loans) and by their financial deficit. (Their liquidity ratio fell as much in the first three quarters of 1989 as in the three previous crises and the financial deficit in 1989 was an all-time record.)**

* **To bring their liquidity ratio back to normal, companies will have to trim their financial deficit and/or to finance their deficit to a greater degree from non-bank sources. Companies' behaviour is strongly influenced by the quantity of bank deposits (i.e., money) they hold, contrary to the impression given in a recent article in the May issue of the *Bank of England Quarterly Bulletin.***

* **Since companies' undistributed income is almost certain to fall again this year to a level two-thirds of that in 1988, they will have great difficulty reducing their deficit unless they cut stocks and investment. Stockbuilding and investment together need to be reduced by £7b. or £8b. (i.e., 1 1/2% of GDP) in 1990 to bring the deficit under £20b.**

* **Even after such cuts, company liquidity will remain weak at the end of the year. Lower interest rates will be essential to ease companies' financial strains and avoid a deep recession.**

This paper was written by Professor Tim Congdon and Giorgio Radaelli.

How will companies cope with the liquidity crisis of 1990?

Some aspects of the transmission mechanism of monetary policy

Growing evidence of financial crisis in industry

Evidence is mounting of a severe financial squeeze on the corporate sector, similar to the "liquidity crises" of 1974 and 1980. The recent spate of corporate bankruptcies and staff lay-offs, particularly in the building industry, has reflected the pressures and aroused understandable fears of rising unemployment in the second half of 1990. These signs of intensifying financial problems for companies are important. They contrast with the recent resilience of retail spending by the personal sector and lend substance to the view that the next move in interest rates is down. The purpose of this *Gerrard & National Monthly Economic Review* is to consider how companies will react to the hostile financial environment and so help to assess how large the interest-rate reductions will need to be. (It should also be said that the much-reported "resilience" of retail spending is exaggerated. Retail sales volume in the first four months of 1990 was only 1.8% up on the same period a year earlier.)

Our analysis will also be intended to throw light on how interest rate changes impact on economic activity. The latest *Bank of England Quarterly Bulletin* includes an article on 'The interest rate transmission mechanism' which describes some of the key channels of influence from interest-rate changes to the economy. We will comment on the article, particularly on one rather remarkable feature. This is the absence of references to "the money supply", on any of its definitions, and a consequent failure to analyse important monetary aspects of the transmission mechanism. In fact, not only does the article ignore technical concepts of broad and narrow monetary aggregates, but also it does not once use the word "money", almost as if there were a taboo on it.

Need to explain how corporate liquidity strains can coincide with rapid growth of broad money

The silence on the money supply may due to the difficulty of finding good, reliable relationships between the quantity of money and the amount of spending. This difficulty seems particularly acute at present, when annualised broad money growth of almost 20% coincides with another corporate sector liquidity crisis. If the quantity of money matters, how is its rapid growth to be reconciled with widespread corporate financial difficulties? If high monetary growth is supposed to stimulate business activity and slow monetary growth to retard it, why are companies now cutting back on their expansion plans? These questions clearly need to be answered if we are to defend the macroeconomic significance of broad money.

One of the key concepts in our argument will be the corporate sector's liquidity ratio, which we define as the ratio of bank deposits held by industrial and commercial companies to their bank borrowings. This is only one of several measures of balance sheet strength, but other measures (e.g., the ratio of net liquidity - or deposits minus loans - to equity capital) typically move with it.

Experience over the last thirty years shows that capital spending plans are significantly influenced by this ratio. The logic behind the connection is obvious enough. If balance sheets are weak, companies retrench on investment in order to conserve cash; if balance sheets are strong, they step up investment because fixed capital ought to yield a higher rate of return than their liquid assets.

Pivotal role of companies' liquidity ratio

The accompanying chart shows the behaviour of the liquidity ratio since 1965. As can be seen, it has varied between 0.4 and 0.65 around an average value somewhat above 0.5. Clearly, there have been fluctuations, but these fluctuations have been against a background of long-run balance-sheet stability. (It is striking that industrial and commercial companies' holdings of bank deposits increased from £2.8b. at the first quarter 1965 to £61.9b. at the fourth quarter 1989, and their loans from £4.3b. to £122.4b. over the same period, but the ratio between them has mostly been quite steady.) There have been only four large, fairly continuous reductions (of more than 0.1) in the ratio in the 25-year period - from 0.65 in the second quarter 1968 to 0.47 in the third quarter 1970; from 0.64 in the first quarter 1973 to 0.39 in the fourth quarter 1974; from 0.54 in the first quarter 1978 to 0.39 in the first quarter 1980; and from 0.65 in the fourth quarter 1987 to 0.52 in the third quarter 1989. (The liquidity ratio actually went up to 0.55 in the first quarter 1990, but it remains to be seen if this is anything more than a temporary bounce.) The first three of these falls were followed by major cuts in company spending on stocks and investment, and by a more general weakening in economic activity. The fourth has already seen a marked change in companies' mood and behaviour.

Companies' liquidity ratio

Chart shows ratio of sterling bank deposits held by industrial and commercial companies to their sterling bank borrowings. Note that - despite enormous rises in the *absolute* amounts of deposits and loans - their *relative* size (mesured by the ratio) has stayed within a band from 0.4 to 0.65, suggesting underlying balance sheet stability.

Source: Bank of England *Long Runs of Monetary Data 1963-88* and *Financial Statistics*

As we shall see, the liquidity ratio reflects the general stance of monetary policy and tends to decline at times of high interest rates. More surprisingly, we will show that the liquidity ratio can fall even when broad money growth is rapid and that it is therefore possible for fast growth of broad money to coincide with financial strains in the corporate sector. But, before we give detailed arithmetic on the liquidity ratio and its prospects over the next year or two, we need to analyse influences on, first, the size of companies' financial deficit and, secondly, on the financing of the deficit.

List of influences on companies' financial balance

Companies' financial balance (i.e., deficit or surplus) measures the difference between the acquisition of financial assets and the incurral of liabilities. It is the sum of the following influences,

> Companies' financial balance = Gross trading profits (excluding stock appreciation) + Other income (mainly interest) + Income from abroad - Payments of dividends and interest - Payments due abroad - Tax - Net capital transfers - Gross domestic fixed capital formation - Stockbuilding.

This may look long-winded, but it is easily abbreviated. The first six of the items on the right-hand side of the identity sum to companies' undistributed income, which is best regarded as the residue of profits after interest, dividends and tax have been paid. Undistributed income can be retained, used for the purchase of other companies' shares or otherwise saved, when it represents the acquisition of financial assets (i.e., a financial surplus), or it can be spent on tangible goods and services in the form of investment or stockbuilding, which erode the financial surplus. If investment and stockbuilding together exceed undistributed income, companies have a financial deficit. In summary, and ignoring capital transfers (which are usually small), and companies' payments to and from abroad (which are large),

> Companies' financial balance = Undistributed income - Gross domestic fixed capital formation - Stockbuilding.

(Note that, if stock appreciation is included in gross trading profits and undistributed income, the relevant concept of stocks change is the increase in the book value of stocks, not stockbuilding.)

A record deficit in 1989

Industrial and commercial companies' financial deficit last year was £23.4b., equivalent to 5.4% of gross domestic product. Both the figure itself, and its ratio to GDP, were all-time records. Over the 26 years from 1963 to 1989 companies on average had a small financial *surplus* of 0.2% of GDP.

To forecast the effect of higher interest rates on the financial deficit we need to look at the likely response of all three of these terms. It is clear that undistributed income - which reflects profits, less interest, dividends and tax - will almost certainly be reduced relative to what they would otherwise have been and could

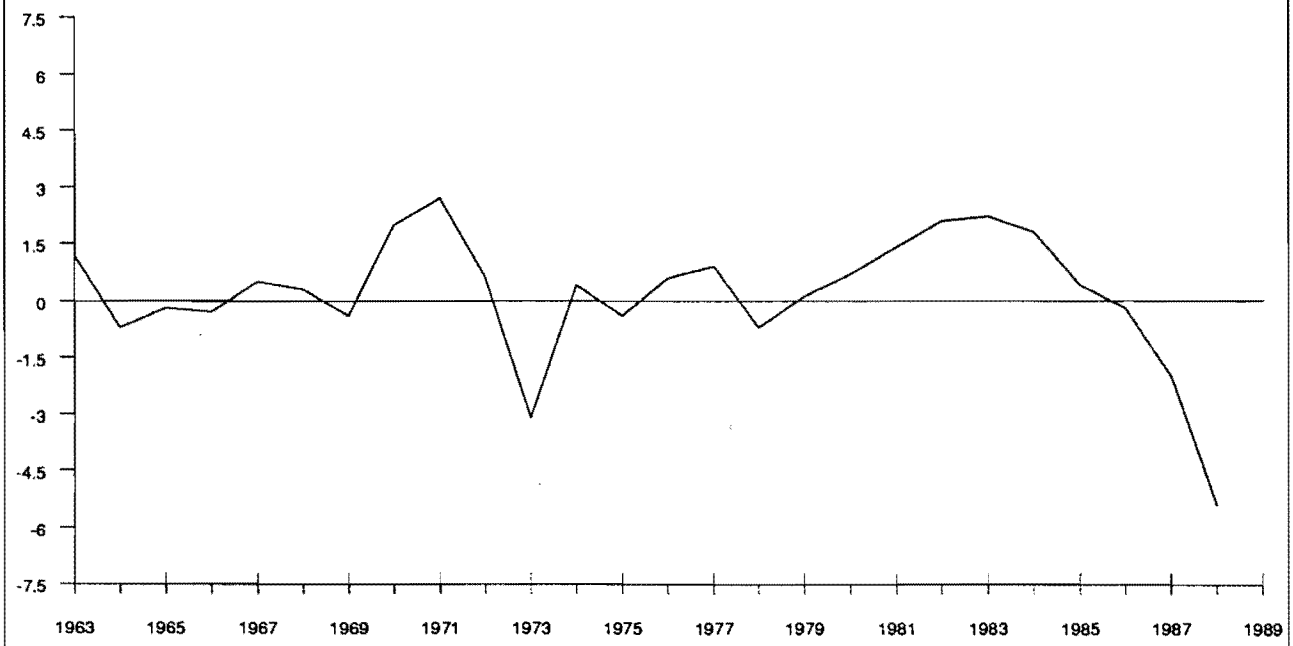
even fall in absolute terms. As interest rates go up, the personal sector's demand for credit - particularly for mortgages - is discouraged, consumption grows more slowly or falls, housebuilding weakens and the more hostile business environment squeezes profit margins. There will also be a rise in net interest payments, because the corporate sector is a substantial net debtor. (At the end of the first quarter 1990 industrial and commercial companies' borrowing from banks and building societies was £133.1b., whereas their holdings of bank and building society deposits amounted to £72.9b. It follows that every 1% rise in interest rates adds to about £600m. a year to the net interest bill.) The effect on dividend payments is less easy to predict, but in any case companies are reluctant to cut dividends unless their finances are in serious trouble.

Undistributed income very weak in 1989

How much impact have the rises in interest rates since mid-1988 had on companies' undistributed income? The answer is that the effect has been dramatic. Since the rise in interest rates began in mid-1988 the growth of the economy has slowed down, with the usual adverse effects on profits. In 1989 gross trading profits went up by 5% to £69.0b., a rate of increase notably less than that in nominal GDP. Meanwhile interest payments soared by 69% from £13.9b. to £23.5b. Indeed, interest payments last year were more than double the level of £11.9b. recorded in 1987. In view of the pressures on their finances, it might have been expected that companies would trim their dividend payments. But - on the contrary - dividends have been growing quickly in the last two years, perhaps because companies have been worried about the threat of takeovers and have been trying to maintain shareholder loyalty. Dividend

Companies' financial deficit

Chart shows ratio of industrial and commercial companies' financial deficit to gross domestic product, as a %, since 1963.



Source: *Economic Trends* and CSO press release

payments last year were £19.4b., 31.7% up on 1988's £14.7b. and more than treble the figure of £6.4b. as recently as 1985. Tax payments were also up sharply, reflecting good profits growth in previous years. As a result of these developments in profits, interest and dividend payments, and tax, undistributed income slumped from £42.2b. in 1988 to £34.4b. in 1989.

What are the prospects for 1990? In view of sharply rising pay settlements and unit labour costs, and the obvious market pressures against price increases, profits made in the UK are unlikely to do better than remain stable in money terms. There could be some increase in the value of profits from abroad, but it will be offset by the rising profitability of foreign-owned North Sea operations. Undistributed income can therefore improve only if interest and dividend payments decline.

However, it is certain that instead they will go up quite substantially. Dividend payments were increasing steadily in the course of 1989, reaching £5.2b. in the fourth quarter compared to £4.8b. in the first. They could be 8% or so higher in 1990 than last year. Meanwhile interest payments will be larger for two reasons. First, companies' net indebtedness is higher than it was, with the £60.0b. excess of sterling loans over deposits at end-1990 compared with £43.6b. at end-1989. Secondly, it seems quite likely that the average level of base rate in 1990 will be higher than 1989's 13.85%. A reasonable projection is that net sterling interest payments will amount to £9 1/2b. - £10b., compared to perhaps £7 1/2b. last year. Tax payments are substantially determined by past profitability. The 1990/91 *Financial Statement and Budget Report* has an estimate of corporation tax receipts this financial year of £20.7b. compared to £21.4b. in 1989/90. It seems that companies will be paying about the same amount of tax in 1990 as in 1989.

Undistributed income will fall further in 1990,

With profits more or less unchanged, dividend and interest payments together up by £4b. - £5b., and tax receipts a little more, the conclusion has to be that undistributed income will drop this year, perhaps to less than £30b. If the figure were to be £28. or £29b. it would be not much more than two-thirds of 1988's peak level.

implying that the financial deficit can be reduced only by cuts in stocks and investment

How, then, is the financial deficit to be reduced? As we have seen, the only way is to curtail spending on investment and stocks. Our analysis suggests that, if companies are to cut their financial deficit in 1990 to under £20b., they will have to cut back on these two items by about £7b. or £8b. (The financial deficit in 1990 was more than £3b. higher than £20b., while - if nothing were done - the deterioration in undistributed income would push the deficit up by £4b. - £5b. more.) If companies do react on these lines, they will trim domestic demand and gross domestic product by about 1 1/2%, which, by itself, would be enough to cause a recession. The upshot of the analysis so far is therefore very unwelcome. Action to bring the financial deficit down from the unprecedented

level of £23 1/2b. to a barely tolerable figure just under £20b. tips the economy into recession. If companies were yet more determined to correct their deficit and tried to cut it to under £15b., the fall in domestic demand would exceed 2% of GDP and would begin to resemble that in 1980. (In practice, of course, other things would happen which would offset the cutbacks by the corporate sector. Thus, imports would fall because of the collapse in demand and the drop in GDP would be less than that in domestic demand.)

Alternative ways of financing the deficit

But that is not the end of the corporate gloom and doom. We have also to consider how the persisting large deficit is to be financed. It can be done in three ways - by bank borrowing; by incurring liabilities outside the banking system (e.g., by issuing equity, making bond issues); or by selling assets. (It is important to note that selling assets to other companies does not help the *aggregate* finances of the corporate sector as a whole, however much it may relieve the position of an *individual* company.) In practice, of course, there is a mixture of all three. The particular combination chosen will depend partly on the state of balance sheets at the time. Companies are more likely to borrow from the banks if they have strong balance sheets than if they have weak balance sheets. Clearly, the behaviour of the liquidity ratio is determined by the relative size of bank and non-bank borrowing.

- reliance on equity issues would hit share prices

It is possible to imagine an extreme case in which the corporate sector incurs a massive financial deficit, but still strengthens its balance sheet. For example, if companies issue £25b. of new equity in 1990, this would be in excess of their likely financial deficit and they would have some funds free to repay bank loans. However, there are obvious constraints on this option, not least the implications for share prices. (It is particularly difficult to imagine financial markets making net purchases of this scale at present, when the high interest rates available in the money markets offer such an attractive alternative use for funds. We see here another way that high interest rates can squeeze companies.) In recent years industrial and commercial companies' capital issues have usually been higher than transactions taking cash out of their hands (predominantly takeovers), but not by a wide margin. The figures since 1980 have been as follows:

Industrial and commercial companies' transactions in company securities (£m.):

	Capital issues	Other transactions	Net issue ('minus' sign indicates net issue)
1980	-1,385	247	-1,138
1981	-2,364	444	-1,920
1982	-1,235	1,659	424
1983	-2,434	1,109	-1,325
1984	-1,674	3,510	1,836
1985	-4,993	3,008	-1,985
1986	-7,409	1,935	-5,474
1987	-17,678	2,255	-15,423
1988	-8,872	9,424	552
1989	-10,356	11,759	1,403

Source: *Financial Statistics*

The one year of heavy net issue - 1987 - also saw a collapse in share prices. Perhaps that was not altogether coincidental.

- reliance on bank borrowing would damage the corporate liquidity ratio

It is also possible to imagine another extreme case where companies' financial deficit is covered entirely by sterling bank borrowing. If this were to happen in 1990, loans would rise to £140b. - £145b. at the end of the year. With deposits unchanged, the liquidity ratio would fall to 0.43 - 0.45, which would match depths plumbed in late 1974/early 1975 and 1980. (Companies could also reduce their bank deposits. But, if these fell by £20b., the liquidity ratio would slump to under 0.35, the lowest ever recorded, and so this response seems unlikely. When their balance sheets are stretched, companies try to preserve cash in the bank.)

In practice, the outcome in 1990 will be a compromise between the two extremes of 100% capital issues and 100% bank borrowing. But there are obvious problems with increased reliance on bank borrowing. The liquidity ratio will fall, even if not quite to the nadir seen in the crises of 1974 and 1980, and interest payments in 1991 and later years will be higher. Unless there is a radical change in the macroeconomic environment, almost any conceivable pattern of financing their deficit this year will leave companies still facing balance-sheet strain - and the need for continuing caution towards stocks and investment - at the beginning of next year.

How investment and stocks dominate changes in GDP

Figures below show changes in investment, stockbuilding and GDP, all in £m., 1985 prices, from previous year's level. It is clear that - in simple accounting terms - change in investment and stockbuilding dominate the business cyucle.

	Change in investment	Change in stockbuilding	Sum of changes in investment and stockbuilding	Charge in GDP
1973	3,417	6,602	10,019	19,090
1974	-1,353	-3,615	-4,968	-1,538
1975	-1,082	-6,382	-7,464	-1,850
1976	894	5,024	5,918	9,303
1977	-970	1,794	824	3,080
1978	1,607	-549	1,058	7,843
1979	1,536	461	1,997	6,142
1980	-3,034	-6,699	-9,733	-5,106
1981	-5,118	171	-4,947	-2,451
1982	2,617	1,919	4,536	3,580
1983	2,561	2,638	5,199	10,423
1984	4,582	-245	4,337	4,049
1985	2,285	-497	1,788	11,830
1986	1,238	137	1,375	10,170
1987	5,309	426	5,735	14,289
1988	9,152	2,738	11,890	13,321
1989	3,660	-701	2,959	7,154

Source: *Economic Trends*

Large private sector projects will prolong the adjustment problem

A further consideration reinforces this argument. Previous *Gerrard & National Monthly Economic Reviews* (notably the December 1989 issue, with its paper on 'How the economy's structure has changed under Mrs. Thatcher') have highlighted the huge backlog of large private sector capital projects and programmes now outstanding. These include a vast investment programme in improving the water supply by the newly-privatized water authorities, the Channel Tunnel rail link and a range of London office developments, all due to be started while work on the Channel Tunnel and Canary Wharf is proceeding. Much of the extra investment will involve bank financing. For example, the water authorities arranged £8,250m. of syndicated loans in December and January to finance their capital spending programme.

If the various investment plans do go ahead, there are obvious adverse implications for the corporate sector's financial position. Instead of the financial deficit falling and the liquidity ratio rising, as would normally happen after companies adjust their spending in the aftermath of an unsustainable boom, these two measures of corporate financial strength could remain under pressure in 1991 and 1992. (There is the objection that some of the recently-privatized industries, notably water, have stable cash flows which should enable them to have higher gearing levels than most companies now in the private sector. But that hardly applies to property companies which are still active in looking for new office projects.)

Only escape-route lies in radical change in macroeconomic environment, with lower interest rates

So, how are companies to escape the hostile forces we have identified? Will their finances remain weak throughout the early 1990s? Note that - in reaching our unhappy conclusion about the continuing financial pressures - we added the qualification "unless there is a radical change in the macroeconomic environment". The key variable here is the level of interest rates. If interest rates were to fall sharply - say, by 3% or more - the macroeconomic environment would indeed change radically and our numbers would have to be re-worked. Undoubtedly, companies' finances would be stronger and the need for cutbacks in stockbuilding and investment would be less compelling. Our analysis therefore identifies good reasons for expecting interest rate cuts later in 1990 and early 1991. It certainly implies that, if interest rates are not reduced, a recession is in prospect.

The argument in this *Review* has not appealed to any particular measure of the "money supply" and may, in this respect, seem similar to that in the May *Bank of England Quarterly Bulletin.* In fact, however, our approach is very different. The focus has been on companies' liquidity ratio as a vital motivating influence on their behaviour. Bank deposits are both the numerator in this ratio and the dominant element in broad money. By adding this monetary dimension, some important mechanisms linking interest rates and company spending can be identified.

Some monetary aspects of the transmission mechanism from interest rates to the economy, neglected in recent article in *Bank of England Quarterly Bulletin*

First, when interest rates increase, the personal sector and financial institutions want to hold more bank deposits because the return on these deposits has become more attractive relative to other assets. (Nowadays the overwhelming majority of deposits are interest-bearing.) If the total quantity of deposits in the economy is fixed, fewer deposits are left for industrial and commercial companies, their liquidity ratio is lower and the pressure to trim investment and stockbuilding is harsher. Secondly, higher interest rates reduce the total quantity of deposits (relative to what it would otherwise have been) because certain forms of private sector credit are discouraged. (If bank lending is less, the growth rate of banks' assets - and, hence, their deposit liabilities - is lower.) The evidence is that the earliest kinds of credit to weaken after an interest rate rise are mortgages and consumer credit, both the responsibility of the personal sector. With persons cutting back on their borrowing, and capturing a higher proportion of the more slowly-growing total of deposits, companies' balance sheets are hurt twice. (It is indeed striking that companies' liquidity ratio is much more volatile than, for example, the ratio of the personal sector's bank deposits to personal disposable income. The personal sector's monetary behaviour is more stable than companies'.)

The omission of money from the *Bulletin* article is remarkable. Economists have traditionally seen the attempts made by people and companies to adjust their spending to excess or deficient money holdings as the central transmission mechanism of monetary policy. These adjustment attempts are known technically as the "real balance effect", a phrase which had a certain vogue in Treasury and Bank circles in the early 1980s. But the role of excess or deficient money holdings, and the real balance effect, are not mentioned in the *Bulletin* article. To analyse the link between interest rates and economic activity without any comment on money or the real balance effect, as the *Bulletin* article has done, is very incomplete and rather surprising. It is rather like the Met Office issuing a weather forecast without checking the barometer or a doctor carrying out a medical examination on someone without taking his pulse. By contrast, the analysis in this *Review* pivots on companies' attitudes towards their money holdings. In particular, we have shown that the corporate liquidity ratio (i.e., *company deposits* divided by company borrowings) can weaken even if there is fast growth of broad money (i.e., the total of *all deposits* held by companies, persons and financial institutions, plus notes and coin).

Cutbacks in stocks and investment point to weak economy in rest of 1990

But the main purpose of this *Review* has not been to score debating points. Instead our aim has been to carry out some nitty-gritty figure-work on the corporate sector's finances, in order to assess the scale of the cutbacks necessary if a satisfactory financial position is to be restored. Our conclusion is disturbing. We have seen that companies' undistributed income is almost certain to fall in 1990 and that their financial deficit can therefore be reduced only by significant reductions to stockbuilding and investment. But, even assuming that these reductions together amount to £7b. to £8b. (i.e., about 1 1/2% of GDP), the

financial deficit comes down only to a little under £20b. When we consider the various alternatives in financing this deficit, it emerges that the liquidity ratio is likely to remain under strain for the foreseeable future.

Of course, there are many other influences on GDP here and our remarks about stockbuilding and investment are not validated by a fully-articulated econometric model. (But they are similar to the forecasts produced by Lombard Street Research, Gerrard & National's economic research subsidiary, which does use a large econometric model.) If we consider other important influences on GDP to complete the picture, it is difficult to rescue the economy from a continuing, rather severe downturn in the second half of 1990. Consumer spending on non-durables and public expenditure (notably on the infrastructure) are growing at present, but spending on durables is weak and housing starts are very depressed.

Economic weakness will be reinforced by housing slump

The housing slump is important. Since investment in dwellings is conducted mostly by the personal sector, not by the corporate sector, its behaviour is altogether separate from the analysis in this *Review*. We know, from official data on construction orders, that private housing orders in the first quarter 1990 were running about 35% lower than a year earlier. With personal sector investment in dwellings amounting to about 3% of GDP, the contraction in housing will - by itself - take 1% or so off GDP in the next few quarters. Taken together with the large cutbacks in stockbuilding and investment we have argued are probable in the corporate sector, it is clear that domestic demand will be falling, perhaps quite heavily, in the second half of 1990.

Need for lower interest rates to avert recession

It follows that, if the Government is to stop the economy sliding into a recession as severe in early 1990 as that in late 1980 and early 1981, interest rates - as measured by clearing bank base rates - will have to be reduced by 2% - 3% over the next six to twelve months. This conclusion does not depend on British participation in the exchange rate mechanism of the EMS, although that may provide a politically convenient context for the interest rate cuts.