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US Tax Reform

& The US Dollar

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When it comes to the fight for tax reform in the United States, Princeton has a front row seat. I have personally had the opportunity to meet with both sides in Washington (Flat vs Retail Sales Tax) and can say with confidence that some sort of tax reform **WILL** become reality. The question of what type of reform remains to be seen but the impact of tax reform on the US dollar will undoubtedly be significant.

Our computer models appear to have correctly forecast that there would be a major 62 year high in the Japanese yen and a substantial record high for many European currencies against the dollar during 1995/1996. We do see that a risk of one more new high for the DM, Swiss and French franc against the dollar is possible either during March or as late as May of 1996. However, following May of 1996, we see a significant change in trend for the dollar to the tune of about 40% to 60% as we move into 1998. This change in trend will certainly be aided by the tax reform movement now underway in Washington.

I had the opportunity to question Dick Armey directly a few months ago as well as Bill Archer, Chairman of the House Ways and Means Committee. I found Armey had his feet cemented into the floor. When I asked him if there was any room for a compromise his simply replied **NO!** It is amazing to sit in Bill Archer's office and hear the Chairman of the most powerful committee in Washington tell you he wants to **"pull the IRS out by its roots."** You must suddenly send a signal from your brain to your lungs just to insure that you don't forget to start breathing again followed by a quick slap across your face to make sure you are not dreaming. After you manage to recover, it suddenly dawns on you that there are two camps within the Republican party. One that wants to pretend there is change while enjoying the perks, privilege and power of Washington and the other who honestly want to make a change.

I also testified before the Kemp commission charged by Congress to investigate and return a reasonable recommendation as to what course of direction tax reform should take. Unfortunately, the response at the Kemp commission was anything but an honest investigation. Kemp is openly biased in favor of the flat tax and criticizes anyone who dares to challenge his vision of the future no matter how flawed it might be. In my personal opinion, Kemp, someone who I once supported for a run at the Presidency, has been in Washington far too long. His commission is nothing more than a typical Washington PR stunt designed to promote the flat tax. After 15 minutes of testimony, in which debate is discouraged, the morning session is taken up by a about 20 people testifying to various points. Then the commission concludes with Kemp meeting the press to state how wonderful the flat tax will be and then he moves on to the next city. This is nothing more than a road show without any honest intent at seeking solutions for the future. Instead, the road show is designed purely as a PR stunt where the conclusion has been arrived at long before the first testimony was given. This exercise in Washington's vision of a democracy amounts to being able to stand up with a straight face while telling the world **"these are our conclusion after listening to the American public nationwide."** *(A copy of our letter to Kemp is available on request.)*

Despite the charade of the Kemp commission, we should not lose hope about tax reform. The flat tax of 17% is now being pushed by Steve Forbes while the retail sales tax is being promoted by Dick Lugar, both candidates for President in 1996. One of these plans will eventually be installed by Washington, but the strategy appears to be agreed upon by all sides.

While the retail sales tax proposal will be introduced as a bill sometime around April of 1996, there doesn't appear to be any rush to get tax reform to a voting stage. The general thinking in Washington views that the tax reform plan will be picked by the Republican Presidential candidate. The actual enactment of the tax reform will then be carried out in 1997.

FLAT TAX

The flat tax plan essentially gives no deductions and allows you to fill your taxes out on a postcard. Sounds nice, particularly when you consider estate, gift and capital gains taxes will disappear. However, what is not being told to the people in a completely honest manner is the fact that you will also be taxed on all your benefits, including health care. This could result in higher taxes being paid by the middle class who do not have 4 kids and particularly if you are single. It will do nothing to address the growing trend of capital taking flight into offshore markets - one of our great concerns for long-term economic stability. The flat tax, in reality, is merely a continuation of the current tax reform trend that has been in motion since 1986 - the steady elimination of deductions in combination with a rate reduction. There is **NO** safeguard against future tax hikes that would leave the American public paying a lot more in taxes than they do now when total deductions are eliminated. This reform, in our opinion, is not reform at all. Some would think that the lobbyists would hate the flat tax. What is interesting, lobbyists see the flat tax as putting everything back to **ZERO** where they get to start all over again. In reality, the flat tax merely shifts taxes around from one group to another and makes no effort whatsoever to actually increase the tax base itself.

RETAIL SALES TAX

The retail sales tax proposals seem to be coming in around 17%. Essentially, everything on the business side becomes tax free and there are no estate, gift, capital gains or even a postcard to fill out. This plan **"rips the IRS out by its roots"** and certainly represents much more visible tax reform than the flat tax scheme. It also eliminates the lobbyists in Washington since there will be little they can do to get special tax breaks for one group over another. Of course the retail sales tax will end the discrimination against legal Americans and those who operate either in a cash environment or are outright illegal aliens. Everyone will be taxed, including visitors, on whatever they purchase in the US. This plan addresses the taxation of necessities by simply rebating $5,000 to every taxpayer with a social security number. While the retail sales tax appears to be a much more honest approach at taxation, there are some problems this plan presents to business on an international perspective. Many nations impose taxation on worldwide income that is earned in a tax-free zone. This plan would put at risk American business who could find their US income subject to tax in other countries who would look at the US as a tax-free shelter like the Cayman Islands. Nevertheless, the benefit to the average American is far greater under the retail sales tax vs the flat tax. According to the IRS, 17% of the economy is underground. California, Texas, Florida and many other states are being burdened by the vast growing illegal populations that receive all the benefits of an American without having to pay income tax. Only a retail sales tax will actually broaden the tax base to ensure tax fairness.

IMPLEMENTATION OF TAX REFORM

The states themselves are not happy about tax reform. At the Kemp hearing that I attended, testimony from a lobby group representing the states argued that they needed 5 years lead time to prepare for a flat tax. Some states merely piggyback on the federal returns and some argued that they would require state changes in tax code. What was interesting was the fact that the sales tax could be implemented in 2 years or less. In fact, even that admission is a bit conservative. There is hardly a state who cannot raise a sales tax in less than 6 months when they need revenue.

The retail sales tax appears to be a much cleaner and honest way of implementing tax reform. We see the collection process as being very simple. The sales tax would be added by the merchants on top of what they are currently collecting and that revenue would be gathered by the state and then remitted to the federal government. The flat tax keeps the IRS intact and as a result allows the federal government to raise the flat tax at anytime. With respect to a sales tax, the evidence shows that such a tax is much more difficult for the government to raise. In New Jersey, when Democrat Jim Florio was elected, he raised every tax he could get his hands on. The one tax he had to back-off of was the sales tax and the income taxes remained in effect until Whitman was elected with a promise to cut income taxes by 30%.

THE COMPROMISE

We believe that a compromise will eventually be necessary within either plan. We have submitted our own plan that merges the best of both worlds while keeping an eye on international considerations.

(Princeton Economic Institute Proposal for Economic Growth and Tax Reform) Essentially, the PEI plan is a 10% retail sales tax, 2% sales tax on real estate and a 15% corporate, self-employed business tax. The only areas that are tax exempt are food, healthcare and housing rent. The business tax matches the lowest tax rate in the world - that of Hong Kong. All taxes on interest and dividends are eliminated. The corporate deductions are charity and research and development along with a $1,000 credit per employee. This will help reduce the cost of labor to small business. In addition, all net take home wages will be increased by 15% simultaneously. This PEI proposal will essentially remove all distinctions between offshore and onshore investment income. If this is enacted, a large portion of offshore tax-free shelters will then move back onshore helping to drive down interest rates. America will become the Cayman Islands of the world.

TAX REFORM & SOCIAL SECURITY

Neither the flat tax or the retail sales tax proposals touch Social Security. Both plans leave intact the ability of government to continue raising the tax rate in this area while confiscating the revenue for other special projects. The SS fund is commingled with the general budget. This means that any cut in benefits can be argued to be a spending cut to provide a tax cut for the rich. This slogan is used by the Democrats very freely. While there is some truth to this point, what is being overlooked here is that the rules were established by the Democrats under Johnson when everything was put in one pot to hide the cost of the Vietnam war. Now the Republicans don't seem to be smart enough to realize that they cannot win by the corrupt democratic rules. What has to take place is that all the associated trust funds have to be put off-budget and act as true independent trust funds. This means that if the SS fund were actually run like a mutual fund, there would be some profit that could be accumulated for the long-term. This would mean that the future expenses of the SS fund will be reduced if there is some actual capital accumulation allowed to take place instead of the excess funds being used for welfare or some other social program. **If the Republicans were smart, instead of holding hearings on White Water, they should hold hearings on how the Democrats have raided the various trust funds for the past 40 years to fund their socialist state behind the back of all Americans while jeopardizing social security recipients for generations to come.** Any tax reform **MUST** address this issue or it too will be doomed to failure in the future.

TAX REFORM & THE DOLLAR

There is little doubt that the dollar will benefit enormously from a positive tax reform movement. So will the stock market and even the US bond market. Interest rates would decline as a mere function of net capital movement into the United States. As I visit our clients around the world, the reaction to our PEI plan has been staggering. In Europe, **EVERY** client I met with, either industrial corporation or institutional investor, immediately saw a change in trend for the future. The Europeans were very optimistic since they saw how the Reagan tax cuts forced some tax cuts in Europe. The consensus was that a similar trend would be forced upon Europe and those who responded last would suffer the most.

In Japan, a survey of 40 of our top industrial clients in Tokyo revealed that 100% responded that they would shift sizable business including manufacture to the United States. This was not surprising since Japan is doing this already due to the high levels of taxation. But what was surprising was that 22% responded by saying that they would consider moving their **LEGAL** headquarters to the United States! Already several first section listed Japanese companies have moved their **LEGAL** headquarters to Hong Kong because of the 15% tax rate. It would appear that if the US were to adopt the PEI proposal, the next boom will not be in Asia, it will shift to the United States where the infrastructure already exists.

CONCLUSION

Tax reform is coming. The exact shape is hard to say. We naturally hope that our compromise plan would be implemented for this would insure long-term growth. The flat tax will provide a similar benefit for the short-term, which might last but 2 years and peak by 1998. The pure retail sales tax has a lot of stiff resistance in Washington from the old-boys who fear losing too much power. Their arguments will be exaggerated to scare people away from the retail sales tax approach. This is **NOT** based on economics, but the loss of power and the loss of lobbyist perks. In any event, the dollar and US shares will have a very nice ride to the upside and this will be just one of the key issues that drive the trend in that direction.

UNITED STATES

PRODUCER PRICES: Producer prices slipped 0.1% in August, the third consecutive month without a rise, providing more evidence that inflation pressures have eased. The Labor Department said food prices were unchanged in August as prices of fresh and dried vegetables plunged 12.7%. Energy prices fell 0.9%, the third decline in 3 months. Excluding the volatile energy and food sectors, prices paid by wholesalers rose just 0.1% down from a 0.2% increase in each of the preceding months.

Prices for intermediate goods - particularly processed items such as flour and lumber - were unchanged for the second consecutive month, while prices for crude materials, such as grains and coal dropped 1.4% after falling 0.8% in July. That's a significant change from earlier this year, when analysts predicted strong price increases for intermediate and raw materials would push up prices of finished goods.

RETAIL SALES: The Commerce Department said that a surge in car sales prompted a modest rebound of US retail spending in August. Retail sales rose 0.6% and by 5% in the year to August. However data for July were revised down to show to show sales falling 0.4% rather than 0.1% reported previously. The swing in sales was fully accounted for by changes in car sales, which rose 2.4% last month following a 1.5% decline in July. Excluding cars, retail sales were flat in both July and August.

Weak sectors included clothing and building materials, which saw sales declines of 1.5% and 0.8% from July. Restaurant sales fell 0.5%. Taking July and August together, the sales figures were weaker than most economists expected.

TRADE DEFICIT: The broadest measure of the trade deficit ballooned $4.59 billion in the second quarter, to a record $43.62 billion. The current-account trade figures covers merchandise, investment income, government payments such as travel and tourism.

The deficit was up 11.8% in the second quarter from the first quarter's $39.03 billion. While exports grew slightly to $239.56 billion from $232.44 billion, imports swelled even more - up 4.5% to $275.81 billion. The deficit in investment income rose to $2.87 billion. Also adding to the overall trade gap was the merchandise deficit, which widened 3.2% to $142.54 billion.

ECONOMIC GROWTH: The dip in US economic growth in the second quarter was less serious than first thought, according to the Commerce Department. Its final estimate showed gross domestic production expanding at an annualized rate of 1.3%. This was the slowest quarterly growth rate in two years, but an improvement on earlier estimates of 0.5% and 1.1%. The latest revision mainly reflected higher estimates for government spending and business inventories. Most economists believe the economy has gained momentum since the spring and is now growing at an annualized rate of 2-3%, in line with its long-term potential. The second quarter "inventory correction" is regarded as largely complete.

CONSUMER CONFIDENCE: The Conference Board, a New York business analysis group, said its confidence index fell in September to 97.4% against 102.4% in August. The index has hovered around 100 since the beginning of the year. Despite the fall, it remained at levels indicating a fairly strong economy.

However, elements of the latest survey pointed to some loss of economic momentum. Fewer than 24% of the respondents said business conditions were good, against nearly 27% in August. The proportion expecting fewer jobs in the months ahead rose to 19%, against less tan 16% last month.

HOUSE SALES: Low US mortgage rates pushed sales of previously owned homes up 3% in August to the highest level since May 1994. Sales rose to an annualized rate 4.11 million units in August, up from 3.99 million in July, according to the National Association of Realtors.

The August sales rate was up 5.1% fro a year earlier and was the highest since May 1994, when the rate was also 4.11 million, the group said. The national median sales price of existing single family homes rose to $117,600 in August, up from $115,900 in July and $113,000 a year earlier.

INVENTORIES: Inventories held by US companies grew for the 16th consecutive month in July, as a slump in business sales indicated that companies were having trouble working down their stocks of unsold goods. Total stocks of unsold goods held by manufacturers, wholesalers and retailers grew 0.3% to a seasonally adjusted $962.83 billion. That followed a revised June increase of 0.4% the department had previously estimated. Business sales dropped 1.2% in July to a seasonally adjusted $674.95 billion, after rising 0.7% in June.

As a result, the inventory-to-sales ratio - a measure of how long it would take to sell existing stocks at the July sales pace - climbed to 1.43 months' worth from 1.41 month's worth in June. Department officials said it was the highest level for the ratio in 18 months. The July inventory rise occurred at the manufacturing and wholesale levels, while retail inventories fell in June.

DURABLE GOODS ORDERS: New orders for US durable goods rose strongly in August, providing further evidence that the economy is rebounding after a weak second quarter. The Commerce Department said orders rose 4.9% in August and 6.8% in the year to August. It was the first increase since May and the largest since August 1994.

The gain in orders follows reports of a sharp increase in industrial production in August and stronger demand for cars, houses and other interest-rate sensitive goods.

The orders figures are highly volatile on a monthly basis. August's increased followed a 1.8% decline in July and a 0.3% drop in June. The swing reflected erratic changes in transport orders, which rose 15.7% in August, having fallen 7.7% in July. Excluding transport, orders were up 2%.

US RANKED MOST COMPETITIVE ECONOMY: The US was ranked as the world's most competitive economy in 1995 for the second year running, while Japan slipped further and differences in European economies broadened. Fourth-ranked Japan continued to lose ground after its eight-year reign as the world's most competitive economy. The report contended that Japan's protracted economic crisis cost it points in the domestic economic strength and finance categories.

The survey was conducted by the Geneva-based World Economic Forum and The International Institute for Management and Development in Lausanne, Switzerland. The rankings are base on an index that weighs eight factors that economists believe determine a country's competitive environment, including economic strength; participation in international trade; performance of the capital markets and management expertise.

The US owed its number 1 ranking to top marks in domestic economic strength, internationalization and management. The report said the aggressiveness of US industry has become particularly noticeable in new technologies ranging from computers to telecommunications. The low dollar added to the appeal of the US as a place for investment.

Country rankings from the International Institute of Management Development:

1. USA

2. SINGAPORE

3. HONG KONG

4. JAPAN

5. SWITZERLAND

6. GERMANY

7. NETHERLANDS

8. NEW ZEALAND1

9. DENMARK

10. NORWAY

11. TAIWAN

12. CANADA

13. AUSTRIA

14. AUSTRALIA

15. SWEDEN

16. FINLAND

17. FRANCE

18. UNITED KINGDOM

19 . BELGIUM/LUXEMBOURG

20. CHILE

JAPAN

UNEMPLOYMENT: The Japanese unemployment rate hit a record 3.23% in August, up from 3.16% in July, as the country's hard pressed manufacturers continued to reduce their labor costs. August was the sixth month in a row in which the jobless rate remained over 3%.

According to the Economic Planning Agency, the social taboo against heavy redundancies remains so strong that companies are saddled with surplus employees equal to another 3% of the workforce. Analysts say that the burden of surplus staff will continue to freeze recruitment, thus ensuring that youth unemployment will grow quickly. The jobless rate among 15 to 24- year olds is 6.9%, 1.5 percentage points higher than August of last year.

Another sign of the weak labor market in August was the 61 job offers for every 100 applicants, the third month that the rate has been stuck at this relative low level. Overall, the number of people in work stagnated in August, as a 2% rise in service sector jobs compensated for a 3.3% fall in manufacturing employment.

ECONOMIC GROWTH: Gross Domestic Product by an annualized 3.1% in real terms in the second quarter, after falling fractionally in the first, according to preliminary figures fro the government's Economic Planning Agency.

It rose by 0.8% compared with the first three months of the year, the first quarter-on-quarter growth for 9 months. Private consumption, up by 0.8% on the quarter, accounted for the bulk of the improvement, while net exports contributed nothing, the EPA said.

In nominal terms, the Japanese economy shrank 0.6% on year in the second quarter, for the second consecutive period, but grew by 0.2% from the first three months of the year.

Overall, the biggest surprise was a 2.5% rise in capital investment from the first ton the second quarter, a sharp improvement on 0.5% growth in the previous period.

MERCHANDISE TRADE SURPLUS: Japan's global merchandise trade surplus fell 1.3% in August, thanks mainly to a surprising plunge in automobile exports to the US. The drop in vehicle exports caused Japan's troublesome trade surplus with the US to narrow by 15% to $2.94 billion in August.

INFLATION: The second quarter GDP deflator, a comprehensive indicator of the level of prices in

Japan, fell by 1.2% from the same quarter in the previous year. This is the fourth quarter running in which prices have fallen and is evidence of the continuing weakness of domestic demand.

INDUSTRIAL PRODUCTION: The Trade Ministry announced July industrial production fell 2.7%, not the 2.4% as it had initially estimated. Production has been falling since April because low demand has left Japanese companies with big inventories and excess capacity.

LENDING RATE CUT: Japan's 11 leading commercial banks said they would cut their prime lending rates below 2%, a record low. The reductions were triggered by the Bank of Japan's decision to halve the official discount rate , at which the central bank lends to commercial banks, to 0.5%.

GERMANY

INDUSTRIAL PRODUCTION: German industrial production rose sharply in July after two months of stagnation. But analysts said the seasonally-adjusted figures could be misleading because of changes in the dates of school holidays compared with last year and the restructuring of production indices at the start of the year.

The economics ministry reported that industrial production for the whole of Germany increased in volume terms by an adjusted 3.3% in July compared with June after remaining unchanged in June and increasing by only 0.1% in May. Output in western Germany rose 4%, while in eastern Germany it fell 3.8%, reflecting the concentration of holidays in the new Lander in July. All German figures pointed to above average 3.9% growth of manufacturing production in July, with output of investment goods and consumer durables rising by an especially strong 6.1% compared with June. The building industry increased its output by 2.7% in July while energy production fell 1.2% in the month.

EAST GERMANY GROWTH: The Bonn government warned that the process of creating a modern, self-sustaining economy in the former communist east Germany is only half finished. The Berlin-based DIW economic research institute warned that the east would depend on large financial transfers for at least another 10 years.

The economics minister, Mr. Gunter Rexrodt said the eastern Lander remained a central priority of government. While declaring that the government aimed to reduce its subsidies in the east, he pledged this would happen step by step and only as economic conditions allowed. A report approved by the Bonn cabinet put the level of financial support for eastern Germany from federal, state and local authorities, as well as the European Union, at DM 475 billion ($329 billion) between 1991 and 1994.

But serious problems still exist, including too narrow an industrial base and low productivity, which resulted in eastern unit labor costs averaging some 37% more than in western Germany. Because capital resources of many east German companies remain unsatisfactory, the government had set up a special fund which would start operating in November and channel some DM500 million in long-term capital to medium-sized companies in the next three years.

West German sales to the east last year amounted to DM277.7 billion compared with east German sales to west Germany of DM66.9 billion. Financial transfers to the east this year will total DM195.5 billion against DM165.6 billion in 1994.

M3 MONEY SUPPLY: Germany's M3 measure of money supply resumed growing in August after a surprise fall in July. But expansion of the Bundesbank's most important monetary aggregate was still well below the growth target of an annualized 4-6%. The Bundesbank announced that M3, which includes cash, sight deposits with less than four years notice and regular savings accounts, grew by a seasonally adjusted, annualized 0.3% in August compared with its average level in the final quarter of last year. This compared with a fall of 0.4% in July and 0.4% rise in June.

The August increase reflected strong credit expansion, inflows from abroad and somewhat weaker investment in bonds. The M3 figures were consistent with expressed in the latest Bundesbank monthly report published that the German economy should continue to grow with low inflation.

INDUSTRIAL ORDERS: The inflow of new orders for Germany's manufacturing industry increased sharply in July, marking the third consecutive month of swings in what has become the country's most volatile indicators. The economics ministry reported that pan-German orders, when measured on a seasonally adjusted volume basis, jumped by 4.1% in July from June, following a sharp fall of 3.4% in June and a 3% rise in May. However the order inflow was far less erratic when viewed two months at a time. The ministry said new orders for June and July together were unchanged compared with April and May and only 0.1% lower than in June and July of last year. The ministry ascribed a 5.5% drop in orders for eastern German industry in July to the incidence of school holidays in that month. By contrast, orders booked by western German companies rose by 4.6% in July.

PRODUCER PRICES: The German producer price index remained unchanged in August against July, at a level of 1.8% above the same month last year. The figures are the latest in a series of German price indices which suggest Germany is enjoying a period of relative price stability. Under new pan-German inflation is now below 2%. In the western German states, the producer price index rose by

1.8% on an annual basis, while eastern Germany, excluding west Berlin, the rise was only 1.2%. Compared with July, the main price increases in west Germany were recorded for copper products, especially electrolytic copper (12%), newsprint (4.5%) and light heating oil (2.3%. Pan-German producer prices for chemical products fell 0.4%. Eastern prices showed significantly less variation.

WHOLESALE PRICES: Wholesale prices in west Germany fell by 0.5% between July and August, strengthening hopes that consumer price inflation will continue to stay below 2% for some months to come. The Federal Statistics Office said wholesale prices rose only 1% in August compared with same month last year, after year-on-year increases of 1.7% in July and 2.0% in June. Seasonal factors were the main factor behind August's fall in the index (based on 1985=100) to 98.7 from 99.2 in July.

However, in September Germany's inflation appears to have picked up, according to provisional figures for western Germany from the Federal Statistics Office. On the strength of returns from four federal states, the office estimated that the cost of living in western Germany increased by 1.8% in the 12 months to September after falling to an annual rate of 1.5% in August, from 1.9% in July. The cost of living increased by 0.1% between August and September.

The office also reported a sharp 0.6% increase in import prices between July and August with the result that they were 0.5% higher last month than in August 1994. Export prices rose 0.2% between July and August and were 2.1% up on August last year.

PRODUCTION EXPECTATIONS: Western German industry expects production to stagnate in the near future, a survey by the IFO Institute for Economic Research showed. Western German companies said they were skeptical about future developments, but most were optimistic about exports.

EAST GERMAN INVESTMENT: More than DM64 billion ($43 million) has been invested in enterprises sold by the Treuhan privatization agency between 1992 and 1994, twice the amount expected over the period, according to the BvS, the successor to the agency.. The sum represents nearly 60% of the total amount investors had pledged to invest when they took over enterprises from Treuhand. In all, a total of DM217 billion has been earmarked by the Treuhand for its enterprises, which includes costs for restructuring and investment guarantees.

The investment level per capita in eastern Germany has almost doubled from DM5,800 to DM13,340 between 1991 and 1994, surpassing investment in west Germany which last year was DM9,100 per capita. But despite the high level of investments, Mr. Heinrich Hornef, head of the BvS, said the privatized sector, with the exception of the construction and food processing industries, still faced difficulties, particularly the availability of capital resources.

UNITED KINGDOM

INFLATION: The Central Statistical Office said inflation rose from 3.5% in July to 3.6% in August, with the increase more than accounted for by higher seasonal food prices. These rocketed 13.1% between July and August, the biggest increase since 1979. Hot weather fueled demand while at the same time hitting supplies.

The government's target measure of underlying inflation - which excludes mortgage interest payments - picked up from 2.8% in July to a near 2-year high of 2.9% in August. Underlying inflation has been above the government's long-term target of 2.5% or below throughout this year. The average household needed a 4.1 pay rise over the year to August to maintain living standards by offsetting higher prices and taxes - the biggest figure for four years. This outstrips the 3.25% rise in average earnings in the year to July, leaving the typical household worse off ad helping to explain the continued absence of the "feel good factor".

The CSO also announced that the volume of goods bought in the shops fell 0.8% in August, after adjusting for seasonal effects.

HOUSING: UK homebuyers lured into the housing market in the 1980s by the prospect of quick profit suffered acute pain during the transition to a low inflation economy. Mr. Eddie George, the governor of the Bank of England said house prices in the UK rose in real terms by 2.5% a year from 1970 to 1992 and by more than 9% a year between 1985 and 1990 - one of the highest rates in the western world.

Addressing the International Union of Housing and Finance Institutions' World Congress, Mr. Eddie George said that the demand was boosted by rising wage packets and by tax breaks on home loans and a wide range of new mortgage products. He said that the demand for housing as a financial asset - as a hedge against inflation - should decline, so that then overall real house prices may tend to rise more slowly over time.

COMPANY LIQUIDITY: The level of liquidity in large British companies rose in the second quarter of this year. The seasonally adjusted liquidity ratio for all large companies was 134, according to CSO. This was higher than the previous six months, but slightly below the levels seen at the start of last year. However, most of the recent increase was due to greater levels of liquidity in non-manufacturing companies. The liquidity level in large manufacturing companies, by contrast, was lower in the second quarter of the year than at any point during last year. The liquidity ratio is calculated as a proportion of the total current financial assets compared with the total current financial liabilities.

CURRENT ACCOUNT: Britain recorded its biggest deficit for a year- and-a- half. The currant account deficit was in the red a total of 2.4 billion Sterling ($3.7 billion) in the second quarter according to the CSO. The CSO has more than trebled its estimate of the first quarter deficit to 1.3 billion Sterling. Having recorded a surplus as recently as autumn last year, the current account balance has since worsened sharply.

The deterioration in the balance of payments so far this year has come mainly from trade in invisibles, which include services, flows of investment income and inter-governmental transfers. Britain recorded an invisible trade surplus of 1.6 billion Sterling in the first half of the year, compared with more than 5 billion Sterling in the second half of 1994. The rise in the current account deficit between the first and second quarters reflects an increase in the visible trade deficit from 2 billion to 3.2 billion Sterling. But comparing the first half of this year with the second half of 1994, the visible trade position has barely changed.

TRADE GAP WITH NON-EU STATES: Britain's trade deficit with countries outside the European Union reached its highest level for nearly three years in August as imports rose nine times faster than exports.

The visible trade gap rose to 996 million Sterling ($1.54 billion) in August from 872 million Sterling in July, according to the CSO. The deficit has been widening since the spring, before which it was running at 200 million to 400 million Sterling a month.

In the three months to August, imports from outside the EU were up 5.2% on three months to May, while exports were down 1.3%. Excluding oil and erratic items such as ships and aircraft, exports have risen over the period but lagged behind imports.

The trade figures have been hit by maintenance work in the North Sea, which has pushed Britain's trade balance in oil into the red over the last four months. Excluding oil and erratics, the deficit widened from 665 million to 762 million Sterling. August's 412 million Sterling trade deficit with North America was the biggest since 1991.

INDUSTRY OPTIMISM: Reported shortages in manufacturing capacity are not a serious threat to recovery, according to a study published by the Foundation for Manufacturing and Industry. The report says recent strong growth in manufacturing output had led to a sharp rise in capacity utilization and increased reports of plant capacity constraining output. This, in turn, had aroused concern that the constraints might inhibit the recovery of manufacturing output and become a source of inflationary pressure.

The study points out that, unlike the recession of the early 1980s, that of the early 1990s did not cause reductions in total UK manufacturing capacity. More effective management and changes in working practices allowed manufacturers to raise their output by 2.8% a year without any increase in their stock of capital or labor force. The strong productivity trend gave grounds for optimism about future capacity growth.

DROP IN CAR DEMAND: Weaker than expected car sales in the UK are starting to affect the production. August's output for the domestic market was 36,919 - down 11.8% on the 41,833 in August 1994. However, a 17% year-on-year rise in production for export markets, to 34,185 from 29,213, kept total car output 2.9% higher than in August last year, at 73,104 compared with 71,046.

Recovery in other European markets are showing signs of faltering, and the industry is growing increasingly uncertain about production prospects in the rest of the year.

For the first eight months of the year, car output was 9.4% higher than the 949,863 achieved in the same period of last year. Within this, the export output of 491,223 was 35.3% higher than a year before.

FRANCE

TAX REFORM: France's tax reform is intended to lower the top marginal rate from 56.8% to 40%, while applying a basic rate to more categories of income. The overall aim is to increase the tax base in order to support some FFr400 billion ($81 billion) of annual welfare payments that are presently levied on company payrolls. Mr. Jean Arthuis, France's finance minister, said the reforms would be contained in a new 5-year law to be presented to parliament in early 1996. By giving some details of its tax plans now, the government hopes to blunt criticism by Mr. Alain Madelin, the former finance minister, and by financial markets that it is moving too slowly to in reforming public finances.

GROWTH FORECAST: The French government has cautiously scaled down its forecast for growth next year in the French economy to 2.8% and is making new plans to freeze some public spending this year to match a dip in tax revenue. Last spring the Finance Ministry was banking on economic expansion next year of 3.3%, but most forecasting institutes have since downgraded their 1996 growth estimates to around 3% or a bit below.

Mr. Arthuis, the finance minister, said that he planned to freeze some departments' spending credits this year, in a move to offset lower-than-expected advance corporation tax payments being made this year by French companies and to meet the government target of holding the budget deficit to FFr322 billion ($63 billion). In 1996 government planned to keep overall spending increases to 2%, below an expected inflation average of 2.2%.

TRADE SURPLUS: France's merchandise trade surplus fell from FFr9.73 billion ($1.98 billion) in June to FFr5.3 billion in July, according to the customs service. The decline was chiefly due to lower aircraft and industrial sales rather to any boycott by anti-nuclear protesters of French goods.

But the July figure brought the seasonally-corrected trade surplus to FFr64.63 billion for the first seven months of the year, compared with FFr41.41 billion in the same period of 1994. The government is targeting a FFr100 billion trade surplus for the year. The single biggest reason for the export decline was that France sold only three Airbus (FFr1.3 billion) in July compared to 11 (worth FFr4.6billion) a month earlier. By contrast, exports to countries like Japan, Sweden and Australia where antinuclear groups have threatened to boycott French products stayed stable in July, the first full month after President Chirac's announcement that he would resume nuclear testing in the Pacific.

INFLATION: The French inflation rate rose from 1.5% a year in July to 1.9% in August, reflecting the rise in the value added tax from 18.6% to 20.6%. The rise would have been greater, but for a fall in food prices which kept the monthly increase to 0.4%, the national statistics bureau INSEE said. Prices of manufactured

goods in the private sector rose 0.7% from July and 0.9% from a year earlier. Energy prices rose 1.1% on a monthly basis.

UNEMPLOYED: The number of unemployed in France, seasonally adjusted, rose in August by 27,000 to 2,939,100 from July. The jobless rate, based on International Labor Organization Criteria, which exclude jobseekers who did any work, was unchanged at 11.4% in August from July, according to the Labor Ministry. But the ministry's former non-headline figure, which includes jobseekers who worked more than 72 hours last month, showed a decline of 0.2% to 3,208,000. The ministry said the data should be interpreted with "prudence" because August was subject to "strong seasonal variations". Before August's rise, the number out of work had fallen in 10 months from 3,100,100 million in September to 2,911,700 million in July.

AUSTRALIA

TRADE GAP: Australia's current account deficit fell sharply in August to A$1.526 billion (US$1.16 billion) seasonally adjusted, from a revised figure of A$2.008 billion in the previous month. This is the third consecutive month in which the deficit has fallen, and the lowest result since March 1994.

The improved trade balance was due to the decline in merchandise imports, down by 7.6% - a fall exacerbated by the recent appreciation of the Australian dollar. Merchandise exports also posted a fall, although much smaller, of 1.5%, with rural exports falling by 2.6%, and non-rural exports by 1.1%. Mr. Ralph Willis, Australia's treasurer, said the latest set of numbers gave the government "real confidence for believing that we will produce a better outcome for the current account this year than was forecast in the budget".

BUILDING APPROVALS: Australian building approvals in August fell 7.7% from July, according to the Bureau of Statistics. Approvals in the month totalled 10,373, compared with 11,237 approvals in July. In the year they were down 41%.

JOB VACANCIES: Australian job vacancies in August fell and the amount of overtime worked by employees dropped for a fourth successive survey reported the Bureau of Statistics. The bureau said the trend estimate of job vacancies fell 1.6% to 56,800 in August. In the year, job vacancies declined 8.4%. Job vacancies are now 10.7% lower than the most recent high of 63,600 vacancies recorded last November. A record vacancy level of 71,200 was reached in February 1989.

In August, the number of new jobs created in Australia rose by a smaller-than-expected 700 jobs to 8.27 million. The jobless rate rose to 8.3% from 8.2%

NEW VEHICLE REGISTRATIONS: Australian new motor vehicle registrations in August fell 5.1% from July. Registrations were up 1.6% on the year. The monthly decline followed a 2.6% drop in July. The Bureau of Statistics said registrations for all vehicles in August fell to 50,249 from 52,938 in July. The bureau reported that passenger vehicle registrations fell 4.3% in the month to 42,060. They were up 1.7% on the year. Registrations of other vehicles, including commercial vans decreased 9.1% in August to 8,189. That was a gain of 1.2% on the year.

WESTPAC LEADING INDEX: The most widely watched leading indicator of the Australian economy rose 0.6% in July, signalling the 50-month isn't losing steam yet.

The Westpac-Melbourne Institute monthly index measures where the economy is likely to be in six months. Westpac Bank and the institute said the latest figures show the economy remains "inflation-prone" but not to the same degree as the runaway price years of the 1970s and 1980s.

INFLATION: Australian expectations for annual inflation fell to a one-year low of 4.3% in September, according to a survey by Westpac Bank and the Melbourne Institute Centre for Business Cycle Analysis. The index fell from 5.2% in August to record its lowest level since August 1994. Its the first time since April the reading has diverged from a 4.9% to 5.2% range.

The measure is a median rate of price rises expected by consumers in the next 12 months. Consumer price inflation in Australia was running at 4.5% in the year to June 30, up from 3.9% the previous year. Core inflation, which the central bank watches when adjusting interest rates, was at an annual rate of 2.5% in the June quarter, the highest since the June quarter of 1992.

HOUSING INDUSTRY: Australia's central bank said the decline in new housing starts may continue, though rising levels of commercial building may offset the impact of the housing slump on the construction sector generally.

There has been a concern that low inflation is keeping housing prices stagnant, while rising interest rates are pushing up mortgage repayments. The bank said the asset price of homes is not increasing at the same rate as in previous economic recoveries because inflation is comparatively lower.

MANUFACTURING INPUT PRICES: The prices of materials used by Australian manufacturing industry fell 1.0% in July from June, according to the Bureau of Statistics. In the year , prices were up 7.1%. The seasonally adjusted monthly rise compares with a 1% rise in June.

The prices of imported materials used by manufacturing industry were unchanged in July from June. They rose 12.2% on the year.. The prices of locally produced materials used by industry fell 1.6% in July from June. They rose 4.3% on the year.

BARRIERS TO ASIAN-PACIFIC MARKETS: Australian companies still face an extraordinary variety of tariff and non-tariff barriers as they try to penetrate Asia-Pacific markets. This is despite political overtures to Asian neighbors and the much vaunted Asia- Pacific Economic Cooperation (Apec) forum initiative, according to a survey of industry organizations by the Committee for the Development of Australia (CEDA), which comprises private sector industrialists.

The restrictions affect all sectors, ranging from primary products to services, and are being compounded by sub-regional arrangements such as NAFTA (North America Free Trade Area) and AFTA (Asean Free Trade Area) The survey suggests that regional tariff and non-tariff barriers are a major obstacle to exports of processed foods and dairy products - a sector specifically by the Australian government as having substantial growth potential.

The survey is the first comprehensive look at the barriers to expanding trade in the region - which now accounts for 75% of Australia's trade and comes in conjunction with a conference in Sydney at which industrialists and trade officials will discuss what APEC can offer the business community.

Mr. Paul Keating, Australia's prime minister, said his country would be looking for commitments on free trade from fellow members of the Asia-Pacific Economic Cooperation forum when leaders met in Osaka. He wants APEC members to table individual country plans showing how and when they will meet the Boger free trade commitments before 1996. The APEC agreement reached at Bogor last year committed the 18 member countries to free trade in the region by 2020, with more developed countries meeting the target more quickly.

Mr. Keating stressed Australia's belief that liberalization must be comprehensive ad cover all sectors, but argued that potentially damaging splits within APEC over liberalization of agricultural trade could be averted if tariff and quota reductions in this area were phased more gradually.

WORLD BANK RATING: A new World Bank study has found that, on a per capita basis, Australia is the world's richest nation, followed by Canada because of their large natural wealth and sparse populations. The bank estimates about 70% of their wealth is held in natural resources.

The bank reaches this startling conclusion because it ranks countries not on the basis of their flow of income and gross national product data, but according to their stock of assets. Bank economists believe that wealth, properly measured, should include the following categories of assets:

1)Natural capital: the value of land, water, timber, gold and other minerals.
2)Produced assets: the value of machinery, factories, roads and railways.
3)Human resources: the value represented by people's productive capacity as measured by levels of education and nutrition.
4)Social capital: the value of human organizations and institutions. (The bank staff has not worked out how to measure "social capital", so the rankings are based on the first three components.

Japan was ranked number five, the UK number 22 and the US was ranked number 12.

CANADA:

GROSS DOMESTIC PRODUCT: Canada's GDP increased 0.1% in July from June thanks to higher manufacturing and mining output, according to StatsCan. Real gross domestic product rose to seasonally adjusted C$541.2 billion (US$402.4 billion) in July from a revised C$540.5 billion in June. Economists expected GDP to drop 0.2% for the month and stemmed largely from a 1% jump in mining output and a 0.7% increase in manufacturing, StatsCan said. Production rose in seven industry groups and fell in seven.

RETAIL SALES: Retail sales reversed two monthly gains by slipping 0.2% in July, mostly because of lower motor vehicle and clothing sales according to StatsCan.

WHOLESALE SALES: Wholesale sales declined 0.3% in July, the fifth monthly decline since the start of the year. Sales of lumber, building materials and hardware products accounted for most of the loss.

INDUSTRIAL PRICES: The industrial product price index was unchanged in August from July as lower gasoline prices offset higher pulp and paper prices, according to StatsCan. August's report bettered economists' expectations of a 0.1% increase. The index stood at 129.2 in August, showing prices were up 7.1% from the year earlier month. The index stood at 100 in 1986. Excluding petroleum and coal products, the producer price index was unchanged in August at 131.5 and was up 7.6% from the year-earlier month.

Canada's 7.1% annual gain in industrial prices puts it second behind Italy among the Group of Seven nations. Italy leads the group with an annual 9.2% increase.

RAW MATERIALS PRICE INDEX: Canada's raw materials price index fell 0.3% in August from July because of lower wood prices. The monthly decline was greater than economist's expectations of a 0.2% decrease. August's index was 130.3, up 4.3% from the year earlier month. The index was 100 in 1986.

JOBLESS CLAIMS: StatsCan said the number of people receiving unemployment insurance in Canada rose 0.1% in July from June. About 716,000 Canadians received benefits in July, which followed a June increase of 0.5%. The two months mark the first climb in jobless benefits since October 1992.

TRADE SURPLUS: Canada's trade surplus narrowed to C$1.21 billion US$881 million. Exports fell for the third consecutive month, dropping 7.1% to C19 billion. Economists had expected exports to rise .4%. It was the largest month-to-month decline in Canadian exports since June 1989. Last month StatsCan reported economic growth in the second quarter contracted at a 1% annualized rate, the first such decline in three years. Technically defined, two falling quarters of GDP constitute a recession.

Imports also posted their third monthly decline, falling 4.4% to C$17.7 billion compared with economists' expectations of a 0.1% decline. The figures were seasonally adjusted.

Canada's trade surplus with the US - its largest trading partner - slipped C$997 million to C$2.208 billion , according to StatsCan. US-bound exports fell 6.1% to C$15.497 billion in July, while imports slipped 0.1% to C$13.289 billion.

Exports to the 15-member European Union fell 9.4% to C$963 million, while imports tumbled 17.4% to C$1.77 billion, leaving Canada with a net trade gap of C$807 million. With Japan, Canada's trade surplus rose to C$1.01 billion from

C$359 million, as exports fell 2.5% to C$1.01 billion and imports declined 6.5% to C$631 million.

RETAIL SALES: Canada's retail sales fell 0.3% from June, the first decline in four months, as Canadians spent less on cars and clothing, according to StatsCan. July sales totalled C$17.663 billion (US$12.97 billion) down from June's C$17.716 billion. The decline was worse than economists expectations of a 0.3% monthly gain.

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