Economic commentary

- *The growth of output in the major industrial countries strengthened, and inflation fell, in the second half of last year.*
- *The sharp fall in oil prices will improve the prospects for maintaining the growth of output and lowering inflation in industrial countries.*
- *The dollar weakened during the first quarter of 1986; there was downward pressure on interest rates accompanied by cuts in official rates in most major centres in March. Yields on long-term bonds also fell, reflecting an improvement in inflation expectations.*
- *The UK economy continued to grow during 1985, and GDP(A), adjusted for the miners' dispute, was 2½% higher than in 1984. But growth slowed in the second half of the year.*
- *The annual increase of retail prices fell to around 5% in early 1986, reflecting lower commodity prices and the appreciation of sterling during much of 1985.*
- *The rate of growth of earnings in manufacturing remains well in excess of inflation, and, although growth of productivity was maintained, unit labour costs rose faster than those of competitors.*
- *Although real interest rates remained strongly positive during 1985, they appeared to have little marked effect on the growth of credit; both consumer credit and mortgage lending strengthened in the second half.*
- *The March Budget provides for a net tax reduction of £1 billion in 1986/87; the target for £M3 is reinstated and the PSBR is projected to fall to 1¾% of GDP in 1986/87.*

Oil prices *have fallen sharply . . .*

Spot oil prices fell from $28 per barrel at the beginning of December to below $13 per barrel by end-March. Although there had been an excess supply of oil on the world market for some time, oil prices did not fall sharply until after the OPEC ministerial meeting in December when Ministers decided to 'secure and defend a fair share of the world oil market for OPEC producers'. This decision reflected the increasing reluctance of several OPEC countries to restrain their oil production. Most importantly, Saudi Arabia was no longer willing to produce oil at a level below its agreed quota while other members exceeded theirs. The failure of OPEC Ministers, at a further meeting in March, to agree on a strategy of production restraint pushed spot prices below $13 per barrel towards the end of March. OPEC Ministers plan to meet again in mid-April.

Lower oil prices should benefit the world economy apart from countries that depend heavily on oil exports. The precise effects on aggregate demand are uncertain, as the stimulus to demand in oil importing countries will be offset to some extent by reduced demand from oil exporters. Most countries should also benefit from lower inflation: for example, if oil prices

The world oil market: a longer-term perspective

World oil consumption, other than in centrally planned economies (CPEs), fell sharply between 1979 and 1983 and under the cumulative influence of increased real oil prices has since remained sluggish despite the recovery in world economic activity. In OECD countries, oil demand in 1985 was nearly 20% lower than in 1979 and 16% lower than in 1973. Oil consumption per unit of OECD output has declined nearly 40% since 1973 and the share of oil in total energy demand in the OECD fell from 52% in 1973 to 43% in 1985. However non-OECD oil demand has risen overall by about 40% since the early seventies. Most of the rise is attributable to OPEC countries; oil demand among other developing countries has declined since 1979.

World[a] oil demand and supply

Million barrels per day

	1973	1979	1985
Demand(b)			
OECD	40.5	41.6	34.0
Developing countries	7.3	8.5	8.2
OPEC	1.0	2.3	3.4
Total	**48.8**	**52.4**	**45.6**
Supply(c)			
OECD	13.9	14.7	17.2
of which, North Sea	—	*2.1*	*3.6*
Developing countries	2.7	5.3	8.5
CPE net exports	0.7	1.1	1.6
Total non-OPEC	17.3	21.1	27.3
OPEC	31.3	31.6	17.2
of which, Saudi Arabia(d)	*7.6*	*9.5*	*3.4*
Total	**48.6**	**52.7**	**44.5**
Balance(e)	-0.2	0.3	-1.1

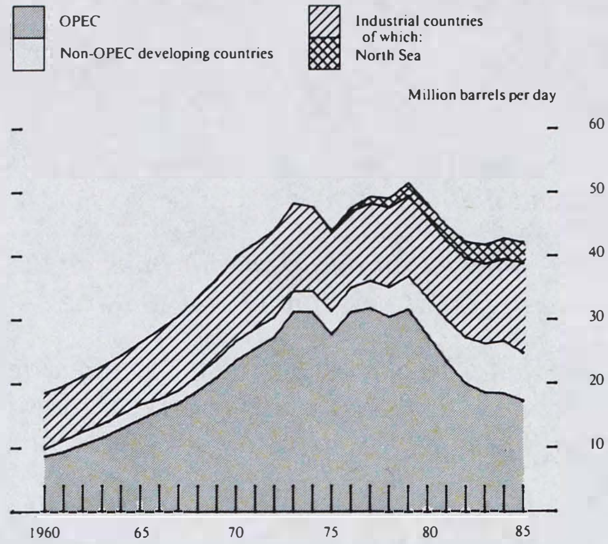
Source: International Energy Agency.

(a) Excluding CPEs.
(b) Including marine bunkers.
(c) Including crude oil, natural gas liquids and unconventional oils.
(d) Crude oil only, includes one half share of Neutral Zone.
(e) Supply less demand. Change in stocks and statistical and reporting errors, and processing gains.

Since 1973, non-OPEC oil production (excluding CPEs) has increased by more than 50%. Most of the non-OPEC sources of oil are produced at much higher cost than OPEC oil. The exploration and exploitation of non-OPEC oil was encouraged by the price hikes in the 1970s. Of this increase in non-OPEC production, a little under two thirds is attributable to developing countries, with substantial increases being recorded by Mexico, Egypt and Malaysia. OECD oil production rose by 24% over this period, with most of the increase attributable to production from the North Sea. But without the oil price shocks of the 1970s, it is unlikely that non-OPEC oil production would have increased so strongly.

Lower world demand and higher non-OPEC supply have severely squeezed OPEC production. Between the early 1950s and the time of the first oil price shock in 1973-74, OPEC's share of a rapidly expanding world total (excluding CPEs) had risen from a third to nearly two thirds. Since then, OPEC's share has fallen at an accelerating rate and was only 40% in 1985. Within

World[a] oil production

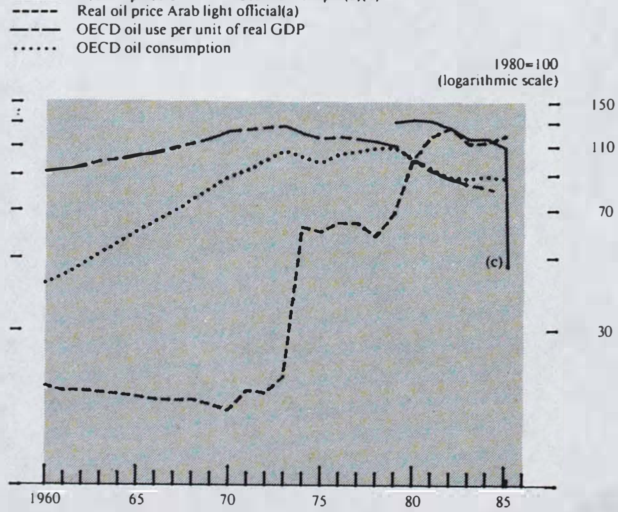


(a) Excluding CPEs.

OPEC, Saudi Arabia absorbed the brunt of the decline in demand: its crude oil production fell from 9.9 million barrels per day (mbd) in 1980 to 3.4 mbd in 1985, and to only 2.6 mbd in the third quarter of 1985.

Saudi Arabia's attempt to regain share (its crude oil output rose to around the level of its notional OPEC quota of 4.35 mbd in the fourth quarter of 1985 and in early 1986), together with the announcement by OPEC in December that it was seeking a 'fair share' of the market, has precipitated a sharp fall in oil prices. By end-March the spot market price of North Sea crude had fallen to below $13 per barrel. In real terms oil prices have fallen to levels below those prior to the Iranian revolution in late 1978, although they remain more than twice as high as in 1973.

Real oil prices and oil demand



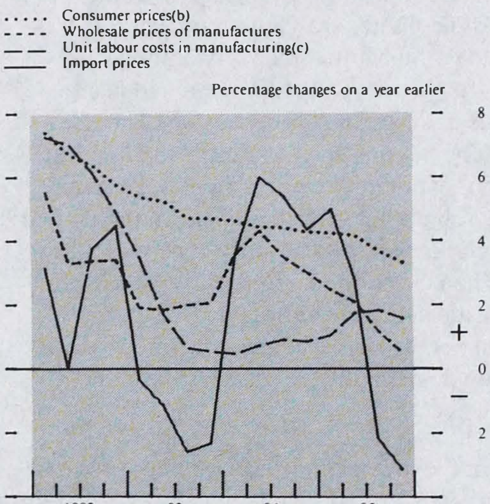
(a) Deflated by industrial countries' export prices.
(b) With the Arab light official price becoming unrepresentative from 1985 Q3, the North Sea spot price is used here as a proxy for the general level of oil prices since that date. It is expressed relative to the average Arab light price in 1980.
(c) Based on UK North Sea marker spot price of $13.50 on 14 March 1986.

stabilised at around $15 per barrel, then, compared with an oil price of around $30 per barrel, OECD consumer prices should eventually be lower on this account by up to 3%. Some of this gain may ultimately be eroded as the effects of faster growth, including higher demand for primary products, add to cost pressures. Nevertheless, in the first two years or so, lower oil prices will reduce inflationary forces. The extent of the gains to both prices and output depends on the policy response. Some governments may take the opportunity to raise indirect taxes on oil products to consolidate their fiscal position. Some fall in market interest rates has already occurred, accompanied by cuts in official interest rates in most major industrial countries. Cheaper oil and lower interest rates should, in general, ease the debt burden of oil importing developing countries. On the other hand lower oil prices will have adverse implications for certain oil exporting countries and for banks with a high exposure to them.

. . . and will add to the progress made in lowering **inflation**

Inflation fell further in the major seven OECD economies in the second half of last year. Consumer prices rose by 3% at an annual rate during the second half of 1985, and by 3¾% in the year as a whole, compared with an average rise of 4¼% in 1984. A number of factors are thought to be responsible for the success in lowering inflation, including cautious monetary policies, reinforced by tighter fiscal policies in most countries. The progress towards lower inflation has been helped by slower growth of unit labour costs in manufacturing in most major countries. Adjusted for the state of the cycle, such costs rose by only 1¼% in aggregate in 1984, and by less than 2% last year, assisted by modest wage settlements (most notably in the United States where earnings continued to rise by only 4% per annum, facilitating further gains in employment) and by trend productivity growth averaging around 2¾%.

Inflation *continues to fall in the major overseas economies*[(a)]



(a) Canada, France, Germany, Italy, Japan and United States.
(b) Consumer expenditure deflator.
(c) Adjusted for the state of the economic cycle.

Falling commodity prices have also aided the disinflationary process. Both food and industrial material prices have fallen by around 20% in real terms (ie relative to world manufactured export prices) over the past two years. Good harvests have contributed to a plentiful supply of agricultural products, especially grains, over much of this period. The longer-term demand for metals has been affected by the trend towards smaller, lighter goods which require less metal per unit, and by competition from alternative materials such as plastics. In the short term, stockbuilding of metals has also been discouraged by high real interest rates and uncertainty over movements in dollar-denominated commodity prices during a period of expected dollar decline. At the same time, supply has tended to rise, reflecting the need of many producing countries to maintain a flow of foreign exchange earnings to meet debt service payments and satisfy import requirements. The failure of the International Tin Agreement in October 1985 served to illustrate the difficulty of stabilising prices via a buffer stock agreement, particularly over a prolonged period of weak demand and excess supply. This development has inevitably affected other metal contracts, although since mid-December spot prices of certain metals have levelled off in response to some rise in demand.

A further decline in inflation rates in most industrial countries seems likely. In the year to the fourth quarter of 1985, local currency import prices fell by 2½% in the major industrial countries in aggregate, and further falls may be expected this year, especially in countries that are relatively large importers of oil, such as Japan. The extent of the fall will depend upon movements in exchange rates. In Japan, for example, the appreciation of the yen will contribute to lower inflation, whereas in the United States some of the benefits of lower oil prices are likely to be offset as a result of the recent dollar depreciation. With wage settlements continuing at moderate levels in most countries, manufacturing wholesale prices in the major countries rose at progressively lower rates in the course of last year, from an aggregate year-on-year rate of 2¾% in the first quarter to only 1% in the fourth quarter. These factors are likely to result in an increase in consumer prices among the major countries of below 3% in 1986, with the prospect of near zero inflation in both Germany and Japan.

Output in the major industrial countries *grew more strongly in the second half of last year*

GNP growth in the major economies

Percentage changes over preceding period at annual rates; at constant prices; *seasonally adjusted*

	1983	1984	1985(a) Year	H1	H2(a)
Canada	3.3	5.0	4.5	3.6	5.6
France	0.7	1.6	1.3	0.4	2.8
Germany	1.6	2.7	2.3	−0.2	6.3
Italy(b)	−0.4	2.6	2.4	2.1	3.2
Japan	3.2	5.0	4.6	4.4	4.7
United Kingdom(b)	3.1	2.6	3.2	3.9	2.1
United States	3.4	6.7	2.3	2.1	2.4
Total	**2.6**	**4.8**	**2.8**	**2.3**	**3.6**

(a) Estimates.
(b) GDP: figures for the United Kingdom relate to the average estimate.

Output in the major industrial countries increased at an annual rate of 3½% in the second half of 1985, giving a growth rate of 2¾% for the year as a whole. Faster growth in the second half of the year mainly reflected a substantial recovery among European economies after growth in the first half had been depressed by the effects of exceptionally severe weather on construction activity. The bounce-back was most marked in Germany, where GNP is estimated to have risen by 6% at an annual rate, following a slight fall in the first half. In the United States and Japan, activity expanded at a fairly even rate throughout the year. The US economy grew at 2¼% in 1985, as steady growth in domestic demand continued to be partially offset by a faster rise in net imports. In Japan, the most recent figures suggest that growth strengthened towards the end of the year.

Components of GNP(a) growth in the major industrialised economies

Percentage changes at annual rates; at constant prices, *seasonally adjusted*

	1983	1984	1985 Year	H1	H2
Private consumption	3.1	3.0	2.8	3.1	3.1
Private fixed investment	2.9	9.1	6.1	3.9	8.2
Public expenditure	1.2	2.5	2.6	—	6.4
Stockbuilding(b)	0.3	1.1	−0.5	−0.9	−0.1
Domestic demand	**3.0**	**5.2**	**2.8**	**1.7**	**4.5**
Net trade(b)	−0.4	−0.4	—	0.6	−0.9
GNP(a)	**2.6**	**4.8**	**2.8**	**2.3**	**3.6**

(a) Or GDP.
(b) Contribution to GNP (or GDP).

Private consumption in the major industrialised countries rose by 2¾% in real terms in 1985, not far below the rate recorded in the previous two years. The growth of consumption was sustained by declining saving ratios, associated with further falls in inflation. Private fixed investment strengthened in the second half of 1985, and rose by 6% in real terms in the year as a whole. But much of this growth in investment was concentrated in Japan and North America. Investment rose by only 1¾% during 1985 in the main European economies, reflecting the more muted nature of the recovery, although capital spending strengthened in the second half of the year. Stockbuilding, which contributed more than 1% to growth in the major economies in 1984, made a ½% negative contribution in 1985.

The volume of public expenditure on goods and services increased by about 2½% overall in the major industrial countries last year, similar to the rate of increase in 1984. But this figure masks a considerable variation between countries. In the United States, underlying public expenditure continued to grow rapidly, rising by about 4½% in real terms. The more restrictive fiscal policies pursued in Japan and Europe resulted in much lower growth rates of expenditure there. In Japan, real public spending fell by as much as 2% last year after zero growth in 1984; in Europe, increases of 2%–2¾% per annum in Italy and Germany and of less than ½% per annum in France have been recorded over the past two years.

But the **growth of world trade** *slowed . . .*

The growth of world trade fell in the course of last year to 4%, well below that recorded in 1984. Slower GDP growth in the United States and Japan restricted the rate of growth of imports, and an improvement in the latter's relative price competitiveness up to early 1985 was also a factor in limiting the growth of imports into Japan. Lower oil production and weaker oil prices led oil exporting countries to reduce their demand for imports by an estimated 15% in 1985 following declines of 10% in both 1983 and 1984. There is also some tentative evidence that the growth of import volumes in the non-oil developing countries slowed in the second half of last year, and prospects for several of these countries, especially those heavily dependent on exports of primary products, remain uncertain.

. . . and large **internal and external imbalances** *persist*

Forecasts of continued growth in the world economy in 1986 have been strengthened by the fall in oil prices. However, the persistent internal and external imbalances in some of the largest industrial countries remain a cause for concern, particularly in view of the strength of protectionist pressure in the United States. The US federal budget deficit remains at around $200 billion, or 5% of GDP. The Gramm-Rudman legislation, designed to eliminate the deficit by 1991, represents an important step in the appropriate direction. Doubts remain as to the likelihood of the stipulated deficit ceilings being met and, aside from the legal challenge to the constitutionality of the legislation, it may be difficult to secure political agreement on the federal spending cuts and/or revenue increases needed to achieve these ceilings. But the legislation represents a clear commitment by the Administration and Congress to tackle the deficit.

The US external current account deficit increased further in the second half of 1985, to an annual rate of over $140 billion (3½% of GNP). The rise was accompanied by increases in the Japanese and German current account surpluses, to annual rates of $60 billion (4% of GNP) and $17 billion (2½% of GNP) respectively. The recent fall in oil prices should act to reduce the US current account deficit, but it will also augment the Japanese and German surpluses proportionately more. Recent Bank estimates suggest that the direct effect of a $10 per barrel fall in crude oil prices would be, *ceteris paribus,* to improve the US current account by about $30 billion in each of the next two years, although this effect would diminish in later years as the improvement in US growth resulting from the associated gain in the terms of trade feeds through to higher import volumes. In Japan and Germany, the direct effect on the current account surpluses could be a rise of perhaps $20 billion and $10 billion a year respectively over the first two years. Indirect effects will however be important and, in particular, exchange rate changes would be expected to moderate the rise in the surpluses of Japan and Germany and to improve the US current account.

Effective exchange rates[a] and short-term interest rates[b]

Monthly averages

	1985				1986	
	Mar.	Sept.	Oct.	Dec.	Jan.	Feb.(c)
Canada						
ERI	88.5	85.8	84.0	81.2	80.0	78.8
Interest rate	11.3	9.1	8.7	9.3	10.2	11.7
France						
ERI	63.2	67.1	68.6	69.7	70.4	71.1
Interest rate	10.7	9.6	9.3	9.0	9.0	8.8
Germany						
ERI	119.1	125.6	127.9	130.2	132.0	133.1
Interest rate	6.4	4.7	4.8	4.8	4.7	4.5
Italy						
ERI	45.0	44.2	44.6	44.9	45.5	46.0
Interest rate	16.1	14.5	14.4	14.9	15.2	16.1
Japan						
ERI	155.4	159.0	170.3	177.1	177.7	189.2
Interest rate	6.3	6.3	6.5	7.4	6.5	6.0
United Kingdom						
ERI	73.4	81.4	80.4	79.1	76.6	74.2
Interest rate	13.6	11.5	11.6	11.7	12.8	12.7
United States						
ERI	152.4	138.4	130.8	127.0	125.3	120.5
Interest rate	9.0	7.9	7.9	7.8	7.8	7.7

(a) Exchange rate index (ERI) 1975 = 100.
(b) Interest rates are three-month market-determined interest rates.
(c) Includes estimates.

Between the Plaza meeting of the G5 countries last September and mid-March, the dollar fell by some 15% in effective terms, and by 24% against the yen. Since its peak in late February 1985 the effective rate for the dollar has fallen by some 25%. The continued weakness of the dollar in early 1986 reflected the market response to indications of slower US economic growth and statements by Japanese and US officials suggesting that further depreciation of the dollar would not be unwelcome. The Japanese yen rose to its highest level against the dollar for seven years and by mid-March was ¥177 against the dollar, while the Continental European currencies have also strengthened. Meanwhile, sterling and the Canadian dollar have weakened recently, mainly because of the fall in oil prices. The fall in the Canadian dollar also reflects market concerns over prospects for reducing the large Canadian federal budget deficit.

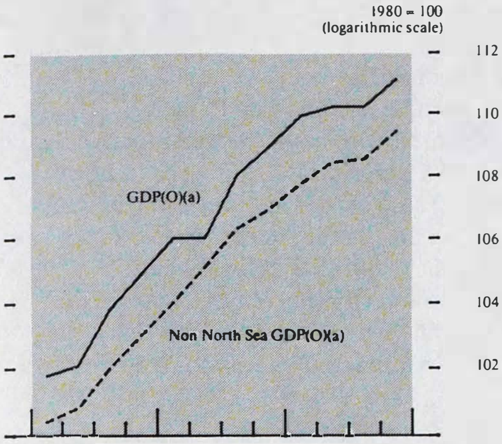
Interest rates *in some major countries have fallen recently*

The depreciation of the dollar since the Plaza meeting and improved inflation prospects, aided by lower oil prices, have led to further downward pressures on interest rates. During March most major industrial countries responded by lowering official interest rates. In Germany the discount rate was lowered to 3½% in early March (although the Lombard rate remained unchanged)—a move which was quickly followed by France, Japan and the Netherlands. In Japan the recent downward movements in interest rates appear to be intended to stimulate the growth of domestic demand. The fall in rates has more than reversed the temporary increase in interest rates of last October and November. In the United States, rates on 3-month Treasury bills fell below 7% in early March and the Federal Reserve cut its discount rate by ½% to 7%. The reduction followed rather than preceded the fall in German and Japanese rates, thus limiting the possibility of a sharp fall in the dollar. The reduction in the discount rate was the first since May 1985 and, until early March, there had been little change in US short-term rates. In the United Kingdom, bank base rates were lowered by one percentage point immediately after the Budget in mid-March, thus reversing the increase of one percentage point which had occurred in early January when sterling weakened as oil prices fell. There also appears to have been some improvement in inflation expectations, reflected in the fall in longer-term rates in most major countries. In the United States for example, the yields on government bonds fell towards the end of 1985 in association with the passage of the Gramm-Rudman legislation and the fall in oil prices, and by mid-March yields had fallen below 8%.

In the United Kingdom **the growth of GDP** *slowed in the second half of 1985 . . .*

The UK economy continued to grow during the second half of 1985, although at a slower rate than in the earlier part of the year. The economy grew by over 3¼% in 1985 according to provisional estimates, or by 2½% when allowance is made for the effects of the miners' dispute. Thus the United Kingdom is now well into its fifth successive year of economic growth. By the fourth quarter of 1985, GDP was nearly 7% higher than its previous peak in the second quarter of 1979. The prospects are that the economy will continue to grow throughout 1986. Lower oil prices (by the end of March, sterling oil prices had fallen 60% since the third quarter) are expected to have a mildly beneficial effect on growth, as domestic demand responds to higher real domestic incomes and exports respond to the 7% fall in the exchange rate over the same period. But real national disposable income will be adversely affected by the impact of falling oil prices on the terms of trade.

The UK economy *continued to grow during 1985, but at a slower rate in the second half*



(a) Adjusted for the effects of the miners' dispute.

Following strong growth in the twelve months to mid-1985, when GDP(O) (adjusted for the miners' dispute) was up by more than 3½% over the first half of 1984, the growth of output slowed in the second half of 1985. Most of the second half growth occurred in the fourth quarter, when GDP(O) rose by ¾% over the third quarter, reflecting higher output in the construction and service industries, but only a modest increase in output among the production industries. By the fourth quarter, the strike-adjusted measure of GDP(O) was only 2% higher than in the fourth quarter of 1984. For 1985 as a whole, the alternative measures of GDP indicate growth of some 3%–3½% over 1984, or 2¼%–2¾% after adjusting for the effects of the miners' dispute.

Both manufacturing output and industrial production are estimated to have been 3% higher in 1985 than in 1984, after allowing for the effects of the miners' dispute. The latest estimates of manufacturing output have been revised to allow for the previous persistent tendency of the initial estimates to understate the growth of the series. The revisions include information on the expected changes in the level of output contained in the Confederation of British Industries' monthly survey . The revised series is therefore more consistent with the picture of continuing growth of manufacturing output in the second half of 1985 contained in the CBI surveys.

Manufacturing output rose by ¼% in the fourth quarter, reflecting continued growth in the engineering industry. The index of industrial production also rose by ¼% in the fourth quarter and a further rise in January this year brought the index back up to its level of the second quarter of 1979. But much of this recovery is due to increased North Sea output, without which industrial production would still be below the levels of early 1979.

Contributions to the change in UK GDP

Changes in components as a percentage of GDP: at 1980 prices

	1983	1984	1985			
			Year	H1	Q3	Q4
Consumer spending	2.7	1.3	1.9	0.9	0.7	0.4
Government consumption	0.4	0.3	0.1	−0.2	0.2	—
Fixed investment	1.0	1.6	0.2	0.4	0.7	—
Stockbuilding	0.9	−0.4	0.5	0.1	−0.7	1.0
Domestic demand	**5.1**	**2.8**	**2.7**	**1.2**	**1.0**	**1.5**
Exports	0.8	2.3	2.0	1.4	−1.0	0.7
Imports(a)	−1.7	−2.8	−1.0	−0.1	0.2	−1.0
Factor cost adjustment	−0.5	−0.6	−0.4	−0.2	−0.2	−0.3
GDP(E)	**3.7**	**1.7**	**3.3**	**2.5**	**−0.1**	**0.9**
Memorandum item: GDP(O)	*3.0*	*3.2*	*3.5*	*2.2*	*0.3*	*0.7*

(a) Increase in volume −

. . . *although* domestic demand *strengthened*

The composition of demand altered during 1985. In the previous year much of the growth reflected the strength of investment, partly offset by a negative contribution from the trade sector as imports of goods and services rose strongly. In 1985 trade made a positive contribution overall, and accounted for much of the growth in the first half of the year. Exports continued to rise in response to the depreciation of sterling during the previous two years, and imports fell, partly reflecting lower oil imports as the miners' dispute ended. In the second half of 1985 domestic demand strengthened, increasing by 1½% over first half levels, mainly because of higher consumer spending and a large increase in stockbuilding in the fourth quarter. The higher contribution from domestic demand was partly offset by faster growth of imports in the final quarter.

Consumer spending rose by 1% in the third quarter and by more than ½% in the fourth. The growth of consumption reflected the rise in real personal disposable income which by the fourth quarter was over 2% higher than in the first quarter. Expenditure on durable goods accounted for much of the third quarter growth in spending, whereas services accounted for all the growth in the fourth. By the fourth quarter, consumer spending was over 3¼% above its level a year earlier. Further increases in real personal disposable income are expected to result in a 4% growth in consumer spending in 1986, according to the Budget forecast. In January and February the volume of retail sales was little changed, but retail sales cover only a portion of goods and services included in consumer spending, and the harsh weather conditions in February may have depressed sales.

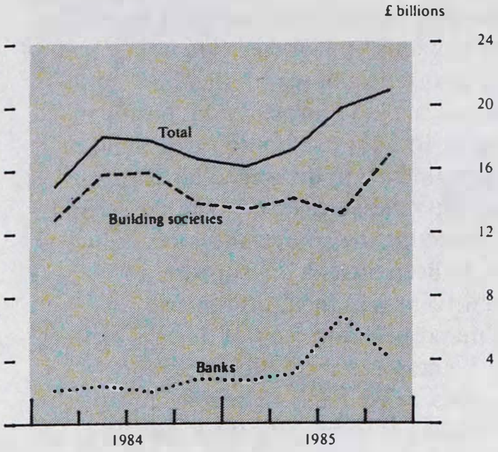
The volume of capital spending by business in the manufacturing, construction, distribution and financial industries in the fourth quarter was only moderately above that recorded in the third. In 1985 as a whole, capital spending by business (as defined above) rose by 7½%, although much of this growth was concentrated in the first quarter as firms brought forward expenditure into the 1984/85 fiscal year before the reduction in the value of capital allowances from 1 April. In the manufacturing sector, where investment rose by 6½% over 1984, the proportion of assets financed by leasing rose from 13% to over 16½%.

Fixed investment by the manufacturing, construction, distribution and service industries may rise by 1% in 1986 following two years of strong growth, according to the latest survey of investment intentions by the Department of Trade and Industry. The quarterly pattern is expected to be distorted as in 1985, since there was an incentive to bring capital expenditure forward into the 1985/86 fiscal year as first year capital allowances were abolished in April. The latest CBI quarterly trends survey suggests that manufacturing investment will grow this year, although at a slower rate than in 1985. A balance of respondents indicated there could be a small increase in the volume of investment, primarily on plant and machinery, to improve efficiency. Within the manufacturing sector, the CBI expect investment to rise by 6½% in the first three quarters of 1986 over the corresponding period last year.

Stockbuilding made a substantial contribution to growth in the fourth quarter of 1985, with large increases in stocks in the energy sector and at the retail level. It is uncertain how much of this rise was involuntary. For the year as a whole stockbuilding made a positive contribution to growth, after its negative contribution in 1984.

Residential fixed investment was unchanged in the fourth quarter, and in 1985 as a whole was little changed from 1984. There was a marked decline in construction activity during the first quarter of the year owing to harsh weather conditions, but activity recovered throughout the remainder of the year. For the year as a whole private sector housing starts were 161,600, nearly 5% higher than in 1984. Although public sector housing starts rose to 8,900 in the fourth quarter, total starts in 1985

Mortgage lending[(a)] *rose in the second half of 1985*



(a) Net new mortgage advances by banks and building societies: seasonally adjusted at an annual rate.

were some 15% below those recorded in 1984. House prices rose by 8¾% in the year to the fourth quarter of 1985, a rate similar to that recorded in the first half of 1985.

Net new mortgage advances by banks and building societies were particularly buoyant in the fourth quarter, contributing to a rise of 11% in net new advances between 1984 and 1985. A notable feature of the mortgage market during 1985 was the increased lending by the banks. Competitive mortgage rates charged by banks, especially in the third quarter, enabled them to make net mortgage advances of just over £4 billion in 1985, compared with £2.3 billion in 1984, and to increase their market share. The building societies responded towards the end of the year as some societies abolished the premium on large mortgages; in the fourth quarter mortgage lending by the societies reached near record levels as they greatly increased their take-up of wholesale funds, partly through issues of sterling floating-rate notes. In early 1986, the largest societies removed the differential rates of interest on endowment mortgages, and then lowered the mortgage rate to 12% following the cut in base rates in mid-March.

Non-oil **import volumes** *rose in the fourth quarter*

The current account surplus, at £0.9 billion, was slightly lower than in the third quarter, according to preliminary estimates. The visible trade deficit narrowed, reflecting a further improvement in the non-oil terms of trade which more than offset an adverse movement in trade volumes. The surplus on trade in oil was virtually unchanged at £1.9 billion. The invisibles surplus fell to £1.1 billion, mainly because of a decline in net investment earnings, as income from direct investment abroad was depressed exceptionally by a large write-off by BP's main US subsidiary, Sohio.

For 1985 as a whole the current account surplus was estimated at nearly £3 billion, much as forecast in the Autumn Statement. The position in 1985 was affected both by the miners' dispute (a probable cost of £1¼ billion), and by an irregular pattern of net payments to European Community institutions, which were £1.2 billion higher than in 1984. Nevertheless, both the oil and the non-oil trade balances improved. There were favourable movements in non-oil trade during the year, although both import and export volumes grew at a markedly slower rate than in 1984. Overall, the non-oil terms of trade improved by 2%. The invisibles surplus was £5.0 billion in 1985 according to preliminary estimates. The surplus on services rose more than £2 billion, with significantly higher net receipts from financial services and travel. By contrast, the surplus on interest, profits and dividends fell by more than £1 billion. A decline in net direct investment income and a fall in banks' net interest earnings more than offset a rise in net receipts from non-bank portfolio investment.

There have been fluctuations in trade volumes in recent months, but there is some evidence that the underlying trends in trade in the non-oil trade account are again deteriorating. In the fourth quarter of 1985, non-oil export volumes, excluding the normally erratic items, fell by 1%, while non-oil import volumes rose by 1¾%. Offsetting movements in the erratic items and the terms of trade resulted in only a small decline in the

UK manufacturing: competitiveness and market growth

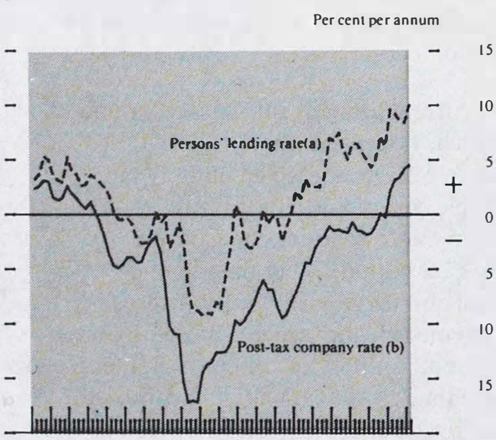
Percentage changes on previous period

	1984 Year	1985 Year	Q1	Q2	Q3	Q4(a)
Competiveness(b)						
Price competitiveness in foreign markets	-2.7	3.8	-1.7	8.6	3.9	-3.0
Price competitiveness in the UK market	-2.3	1.6	-1.2	3.2	4.1	2.4
Cost competitiveness:						
Total	-2.9	3.3	-5.3	11.9	6.0	-2.8
Against United States	-9.3	0.8	-8.8	14.8	10.8	4.5
Against Europe	2.2	5.4	-2.7	9.6	3.3	-4.7
Sterling exchange rate index	-5.4	-0.1	-4.0	9.4	4.1	-2.7
Demand for UK manufactured goods						
UK export markets	8.4	4.5	-1.6	0.4	1.9	0.5
Domestic market	6.3	4.5	3.5	-1.4	1.3	2.9

(a) Estimate.

(b) An *increase* in these indices implies a *loss* of competitiveness.

Real interest rates *remained strongly positive in 1985*



(a) Banks' base rate *plus* one per cent, *minus* a measure of expected consumer price inflation.

(b) Banks' base rate *plus* one per cent, adjusted to allow for the deductability of interest payments for corporation tax purposes *minus* a measure of expected wholesale price inflation.

deficit on non-oil trade during the quarter. These trends appear to have continued into early 1986.

Part of the deterioration in non-oil trade in the fourth quarter reflects differences in demand conditions in the United Kingdom and elsewhere. UK export markets grew more slowly during 1985 than in the previous year, and growth in the fourth quarter was little changed from that in the third. Provisional Bank estimates suggest a similarly flat profile in the first quarter of the year. By contrast, domestic demand in the United Kingdom strengthened in the final quarter. In addition, effective competitiveness worsened from the second quarter of 1985, partly reflecting the appreciation in sterling. Some of this loss will have been offset by the apparent improvement in competitiveness in the fourth quarter, especially in European markets. But in view of the lags between movements in competitiveness and their effect on trade volumes, trade flows at present are likely to be reflecting the deterioration in competitiveness from early 1985. The latest CBI quarterly trends survey presents a mixed view on export prospects. Export orders received over the previous four months declined but, with order books below normal, a majority of firms expected some increase in orders over the next four months. A majority of firms also identified prices as the chief restraint on new export orders.

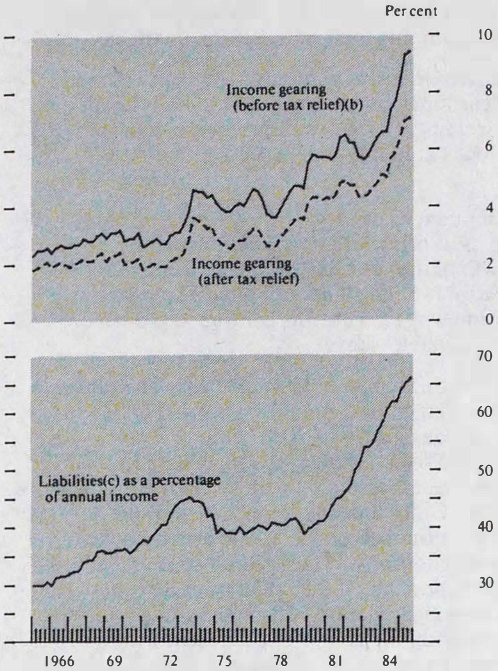
Real interest rates *have risen, without retarding the growth of credit*

The success in lowering inflation has been accompanied by a rise in real interest rates, which are generally thought to be important determinants of saving and investment. There is of course no single ideal measure of the real interest rate, because inflation expectations are hard to pin down. Not only are these expectations difficult to measure, but the real interest rate may vary as between different maturities. In addition, the real rate appropriate to private saving and investment decisions is often one which takes account of the tax treatment of interest, and the appropriate marginal tax rates will vary. In recent years real interest rates are estimated to have risen to positive levels from the negative levels of the 1970s. This development has, however, been accompanied by a large increase in borrowing by companies and households.

So far the rise in real rates has not discouraged the growth of borrowing. Personal borrowing has increased rapidly since the early 1980s, because of the removal of constraints in credit markets following deregulation and greater competition between banks and building societies. Both mortgage lending and consumer credit strengthened during the second half of 1985. The household sector has therefore substantially increased its ratio of debt to income, and income gearing (the ratio of debt payments to disposable income) has risen to record levels, although much of the rise since 1984 reflects higher interest rates.

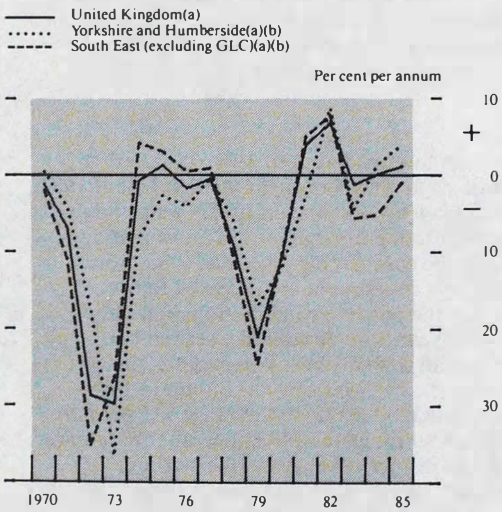
The significance of these developments for the growth of consumption in 1985 is more difficult to assess. As the value of assets held by the personal sector as a whole exceeds the value of its liabilities, its income will have risen as a result of higher interest rates, and this might reasonably have been expected to

Household sector[a] income gearing and debt
continued to rise during 1985



(a) Personal sector, excluding net contributions to life and pension funds.
(b) Household sector interest payments as a percentage of household income.
(c) Stock of mortgages, bank borrowing and retail trade credit outstanding with the household sector.

Post-tax building society mortgage rates
now exceed the annual rate of house price inflation



(a) Nominal post-tax building society mortgage rate *less* rate of change of Department of Employment mix-adjusted house price index.
(b) Partly estimated for 1985.

stimulate consumption. These trends may also account for some of the decline in the saving ratio, which fell from 13.3% in 1981 to 11% by the fourth quarter of 1985. But there are some uncertainties about the impact of higher real rates on consumer spending. Existing borrowers have experienced high levels of income gearing in 1985. If net borrowers' spending were more sensitive to changes in disposable income than that of net savers, these households might have postponed inessential consumer spending as they met higher debt service payments. It is not known to what extent net savers might have deferred consumption to take advantage of the spread between building society deposit and lending rates, which tended to widen during 1985, although the resulting increase in assets will ultimately boost income.

Higher interest rates have meant that from the first quarter of 1985 the post-tax mortgage interest rate (for basic rate tax payers) exceeded the average rate of house price increase. In the United Kingdom as a whole this has occurred in only three of the previous fourteen years. Even so, there is little firm evidence that the demand for mortgages has slackened significantly. But wide regional disparities have emerged in the rise in house prices since mid-1984. In Yorkshire and Humberside, for example, the post-tax interest rate paid on a mortgage exceeded the rate of increase of house prices in 1985 by about 4%. In the South-East, where the housing market has been more buoyant, the opposite has held and house prices exceeded the post-tax mortgage rate by about 1%, although the margin narrowed during 1985.

For tax-paying companies able to borrow on the finest terms, the real post-tax cost of borrowing is estimated to have risen to nearly 5% in early 1986. This is high in relation to the negative real interest rates of the 1970s, though not much out of line with the cost of borrowing in the mid-1960s. Fixed capital spending by companies has grown strongly from a low base over the last two years, rising nearly 15% in 1984 and 7½% last year. Some of this growth reflected a cyclical recovery in investment, but it was also reinforced by the 1984 Budget when pre-announced reductions in corporate tax rates and capital allowances provided an incentive to bring forward investment expenditure.

Unemployment *has begun to rise again, after remaining broadly flat in the second half of 1985*

The employed labour force in the United Kingdom is estimated to have risen by 28,000 in the third quarter of 1985, a slightly lower increase than in the previous two quarters and less than half the increase in the same period last year. The growth in employment was entirely accounted for by the estimated rise in the number of self-employed, as had been the case in the first half of the year. During the first nine months of 1985 there was a small increase in the numbers of employees in employment. Within Great Britain, the number of employees in the service industries rose by 34,000 in the third quarter, but there was a more than offsetting fall in employment in the production and construction industries, over a third of which was in the manufacturing sector. The decline in manufacturing employment has continued, with employment falling by more

The Budget

The Budget provides for a net reduction in taxation, compared to an indexed base, of £1 billion. This is despite lower North Sea tax revenues in 1986/87, projected at only £6 billion compared with £11½ billion expected at the time of the 1985 Budget. This fall is only partially offset by more buoyant non North Sea revenues, which are forecast to be about £3½ billion higher on an indexed base leaving a net shortfall of £2 billion. This reduces the fiscal adjustment of £3½ billion, foreseen for 1986/87 in the 1985 Budget—to £1½ billion. £1 billion was used for tax reductions; the remaining £½ to reduce the PSBR to £7 billion (1¾% of GDP).

Direct effects of Budget measures on the Exchequer—changes from an indexed base

£ millions at current prices:

	Effect in 1986/87
Income tax basic rate	−950
Petrol/derv duties	+135
Vehicle excise duties	−135
Tobacco duty	+175
Alcoholic drink duties	−175
Other tax measures	− 35
Total tax measures	**−985**

The main proposals

The *basic rate of income tax* is reduced from 30% to 29%. All personal allowances and the upper limit for basic rate tax are indexed, but the widths of the bands for higher rate tax are unchanged, bringing in a little extra revenue compared with indexation.

The *duties on petrol and derv* are raised by a little more than inflation, but there was no increase in vehicle excise duty on cars and most other vehicles. The increase in specific duties on cigarettes is offset as there is no increase in duties on alcoholic drinks. *Charities* will benefit from a broadening of the tax reliefs available to both persons and companies on charitable donations, and from a significant extension of VAT reliefs.

Stamp duty on share transfers will be reduced from 1% to ½%, from the autumn but this loss to the Exchequer is offset by a widening of the range of securities transactions on which such tax is charged from Budget day. A new scheme, known as the *Personal Equity Plan*, is being introduced to encourage individual share ownership; further measures are being taken to promote schemes relating employees' remuneration to companies' profits, and the government is undertaking preliminary discussions on the possible introduction of temporary tax relief on profit sharing schemes.

The Business Expansion Scheme (previously due to end next year) is being extended indefinitely and is being more closely targeted. *Capital transfer tax* on lifetime gifts between individuals is being abolished. Clearer rules are being introduced to deal with excessive pension fund surpluses.

Further steps are being taken to help the unemployed, at an expenditure cost of £195 million in 1986/87 which is expected to be offset by savings of £95 million on social security. The cost of these measures is deducted from the reserve and the public expenditure planning total is, therefore, unaffected.

The Green Paper, *The Reform of Personal Taxation* (Cmnd 9756), sets out ideas for equal tax treatment of individuals with provision for transfer of allowances between husband and wife. It also looks at longer-term issues.

The medium-term financial strategy

The aim of policy is to bring inflation down further by reducing the growth of money GDP gradually from about 9% in 1985/86 to 5½% by 1989/90. This will put downward pressure on inflation while permitting continued growth of real output at a sustainable rate.

Targets are set for both M0 and £M3 in 1986/87. The range for M0 of 2%–6% is that envisaged in last year's MTFS, with illustrative ranges through to 1989/90. The range for £M3 has been raised to 11%–15% for 1986/87, to reflect the rapid fall in velocity in recent years associated with structural changes in financial markets. Other indicators, in particular the exchange rate, will continue to be taken into account when assessing monetary conditions. If these conditions are judged to be unsatisfactory, especially if the underlying growth of M0 or £M3 were to move significantly outside their target ranges, action would be taken on interest rates consistent with the Government's aims for money GDP and inflation. Changes in short-term interest rates clearly affect the tightness of monetary conditions, and, although the growth of £M3 may not be altered significantly during the target period, such action would be likely to be reflected in the behaviour of M0 and the exchange rate.

The PSBR is projected to be £7 billion in each of the next four years, falling from 2% of GDP in 1985/86 to 1½% by 1988/89. The planning totals for public expenditure as set out in the *Public Expenditure White Paper* (Cmnd 9702) have not been revised. Fiscal adjustments of £2–£4 billion could be available in each of the next three years, although these projections remain subject to considerable uncertainty.

Economic prospects

The rate of inflation is forecast to fall to 3½% by the end of this year and remain at that level through the first half of 1987. GDP is expected to grow by 3% on average this year, and by slightly less in the year to the first half of 1987, but non-oil growth is expected to be comparable to that of 1985. Both consumer spending and investment are expected to rise strongly this year, but the positive contribution of net trade in the first half of this year is reversed in the second half. Despite this, and the fall in the value of oil exports, the current account is expected to be in surplus by £3½ billion in 1986. The forecast assumes that oil prices will average $15 per barrel for the rest of 1986 and throughout 1987, thereafter remaining broadly unchanged in real terms, and that the sterling exchange rate will not change much either in dollar or effective terms.

Money GDP, monetary growth and the PSBR

	1985/86	1986/87	1987/88	1988/89	1989/90
Money GDP(a)	9½	6¾	6½	6	5½
M0(b)	3½	2–6	2–6	1–5	1–5
£M3(b)	14¾	11–15			
PSBR (£ billions)(c)	7	7	7	7	7
as percentage of GDP	*2*	*1¾*	*1¾*	*1½*	*1½*

(a) Percentage changes on previous financial year. The figure for 1986/87 is a forecast; for subsequent years, the figures describe the Government's broad medium-term objective.

(b) Percentage change from mid-February for 1985/86; target ranges for 1986/87; and illustrative range (for M0) for 1987/88 onwards.

(c) Figures after 1986/87 are illustrative.

Projected contributions to the change in GDP

Percentages of GDP at annual rates

	1985 H2–1986 H1	1986 H1–1986 H2	1986 H2–1987 H1
Consumer spending	+2¼	+3	+2¼
Government consumption	—	+ ¼	+ ¼
Fixed investment	+2½	− ¼	+ ¼
Stockbuilding	−1	+ ¾	+ ¼
Exports	+3	+1	+ 1
Imports	−2½	−2	−1¼
GDP(a)	**+4**	**+2½**	**+2¼**

Source: *Financial Statement and Budget Report 1986–87.*

(a) Average measure at 1980 factor cost. Adjustments needed to derive this measure from the expenditure figures are omitted from the table.

than 20,000 in the fourth quarter and by a further 7,000 in January.

Changes in employment in Great Britain

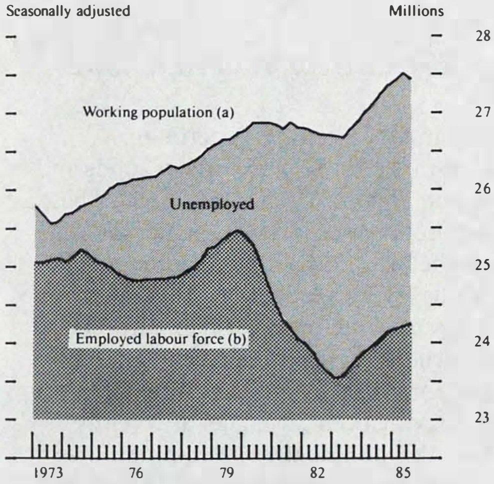
Thousands: *seasonally adjusted*

	Employees in employment: Total	Employees in employment: *of which:* Female part-time workers	Full-time equivalent(a)	Self-employed persons(b)
Level at March 1983	20,547	3,867	18,615	2,208
Quarter on quarter change				
1983 June	+ 17	+ 71	− 18	+ 13
Sept.	+ 42	+ 69	+ 7	+ 68
Dec.	+ 58	+ 58	+ 29	+ 69
1984 Mar.	+ 19	+ 43	− 2	+ 68
June	—	+ 36	− 18	+ 68
Sept.	+ 31	+ 37	+ 12	+ 32
Dec.	+ 84	+ 67	+ 51	+ 31
1985 Mar.	+ 7	+ 39	− 13	+ 31
June	+ 12	+ 41	− 12	+ 32
Sept.	− 3	+ 34	− 20	+ 31

(a) Assumes two part-time jobs to be equivalent to one full-time: adjustment has been made to female employment only (data are not available for males). The 1985 New Earnings Survey suggests average weekly hours worked by full-time employees is 38.4 and by part-timers is 19.5.

(b) Change in self-employed persons (for the United Kingdom) from projections of the estimates published in the *Employment Gazette*.

The rise in **unemployment** *slowed in the second and third quarters of 1985*



(a) Unemployed plus employed labour force.
(b) Employees in employment, HM Forces and self-employed.

Most of the growth among employees in employment represents an increase in part-time working by women, mainly in the service industries. In the first three quarters of 1985, female employment in Great Britain rose by 115,000, most of which can be attributed to an increase in part-time workers. Since male employment has continued to fall at an average rate of some 26,000 per quarter over the last year, this implies that the number of full-time equivalent employees has fallen steadily since the fourth quarter of 1984, and by September 1985 their total was only slightly above that estimated in March 1983. But these calculations exclude the growth in self employment. Estimates of the increase in the number of self-employed (for the United Kingdom) show a rise of over 440,000 between March 1983 and September 1985.

Unemployment (seasonally adjusted and excluding school leavers) rose to 13.3% in February, following sharp increases in both December and January. The increase in unemployment follows a period since April 1985 when the upward trend appeared to flatten, as unemployment fell by some 6,000 per month for three successive months in the autumn. This relative improvement reflected in part the continued effect of special employment and training measures. The most recent unemployment figures suggest that the trend in unemployment discounting the effects of special measures is still upward.

One reason why unemployment has remained high, despite the growth of employment, has been the large increase in the labour force. In 1985 the population of working age is estimated to have grown by around 100,000. The female activity rate (ie the proportion of women in work or actively seeking work) is believed to have continued its slow rise, chiefly because married women have been attracted into the labour market by an increased number of part-time job opportunities. Male activity rates are thought to have stabilised after recent falls. The combined effect is estimated to have boosted the civilian labour force in 1985 by around 225,000. Over the next three years (1986–89), the labour force is expected to rise more slowly—by an average of 113,000 a year.

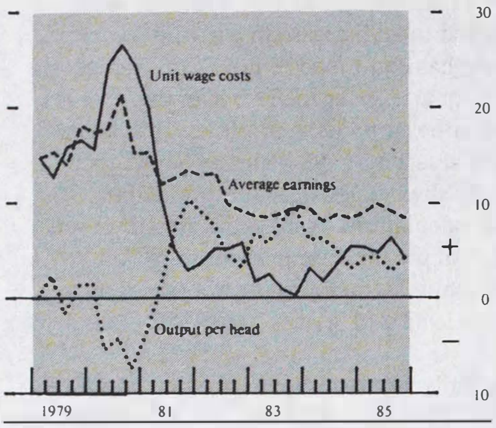
The increase in **average earnings** *continues to exceed the rate of* **productivity growth**

In the fourth quarter, productivity in the manufacturing sector, as measured by output per head, rose 0.6% to a level 3¾% higher than a year earlier. The growth of productivity had slowed in the third quarter, partly reflecting the slowdown in the economy at that time. Productivity growth last year was thus below the fast rates of growth of the three previous years, which partly reflected the cyclical boost during the earlier stages of the recovery. For the whole economy, output per head was little changed in the third quarter of 1985 compared with the second, and was then 2¼% above its level a year earlier.

Average wage settlements remain well above the rate of growth of productivity. Evidence from the early stages of the pay round suggests that rates of settlement are much the same as at the

The growth of **average earnings in manufacturing** *continues to exceed the growth of productivity*

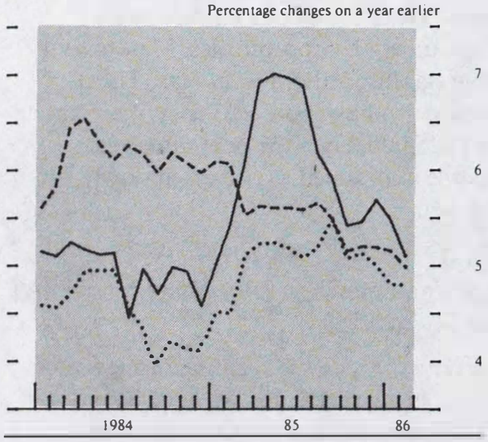
Percentage changes on a year earlier



The increase in **retail prices** *has slowed since mid-1985*

- - - - Manufacturers' output prices
..... RPI excluding mortgages
—— RPI all items

Percentage changes on a year earlier



equivalent stage a year ago. Some 390 settlements relating to the current pay round had been notified to the CBI by March and these settlements averaged 6½%, compared with 6¼% at the same point last year. Over 75% of settlements in manufacturing were in the range of 4½%–7½%; settlements in private services seem to have been at a slightly higher level than in manufacturing. These conclusions are necessarily tentative since, according to the CBI, only 31% of companies have so far settled in the current pay round. There have been few major public sector settlements so far, since most come towards the end of the round. Furthermore, unlike last year, pay negotiations are taking place with the prospect of lower inflation during 1986, and it is uncertain what impact this will have on settlements.

Underlying earnings in the economy as a whole rose by 7½% in the year to January, having shown little change for nearly two years. Since the beginning of 1982 the twelve-month increase in average earnings has been greater than the equivalent rise in prices. Further, the slower growth of productivity in the manufacturing sector during 1985 contributed to a faster rise in unit wage costs. Although the upward revisions to the manufacturing output series have meant that the increase in unit wage costs is less than previously thought, by the fourth quarter unit wage costs in manufacturing were 4½% above their level a year earlier. This increase is above the average of most other major industrial countries, thus contributing to a loss in competitiveness.

Weak **commodity prices** *have contributed to lower inflation*

Lower commodity prices and the strength of sterling contributed to a sharp fall in the price of imports of goods and services between the second and third quarters of 1985. These trends were also reflected in the price index for materials and fuels purchased by manufacturing industry. In February 1986 the index was 9½% below its level a year earlier. This reflects the continued weakness in raw material prices, which were 9% below their level a year earlier, and the more recent fall in oil prices—the prices of fuel purchased by industry were 10½% below their level a year earlier (having been 5% higher as recently as September 1985). Despite this decline the twelve-month rise in manufacturers' output prices was little changed at 5%. Only part of this difference reflects higher unit labour costs. The result has been that manufacturers' domestic profit margins improved during 1985 and may have widened further in early 1986. But pressure on margins may increase in 1986 owing to the fall in sterling from the fourth quarter and because commodity prices may now have stopped falling.

The annual increase in the index of total home costs (the GDP deflator) rose by some 6¾% in the year to the fourth quarter of 1985, rather faster than in the corresponding period of 1984. The index is, however, projected to rise by less than 4% during 1986/87 in the latest official forecast. The retail price index (RPI) rose by 5.1% in the twelve months to February. Its twelve-month growth rate has fallen steadily from the 7% recorded in mid-1985 and should fall further in coming months. Indeed, after excluding the effect of the mortgage rate increases in 1985, the underlying rate of increase of the RPI has been very stable at about 5% per annum for almost a year.

Industrial and commercial companies' income and capital accounts

£ billions in current prices; quarterly averages, *seasonally adjusted*

	1984	1985 Year	1985 H1	1985 Q3	1985 Q4
Total income(a)	**15.8**	**18.8**	**19.1**	**18.4**	**18.5**
of which:					
Gross trading profits (b):					
North Sea	4.8	4.6	5.1	4.0	4.3
non North Sea	7.9	10.2	9.7	10.5	10.7
Total allocations	**9.2**	**11.1**	**11.1**	**10.6**	**11.4**
Undistributed income (net of stock appreciation)	6.6	7.9	7.3	7.3	6.5
Less: fixed investment	4.7	5.6	5.5	5.7	5.7
other	−0.1	0.7	−0.1	−0.3	0.4
Financial balance (surplus +)	**1.9**	**1.6**	**1.9**	**2.0**	**0.4**
Financial transactions (outflow/ acquisition of assets −)					
Identified transactions	**− 0.9**	..	**0.4**	**−4.2**	..
of which:					
Investment in UK company securities	−1.0	−1.2	−1.3	−1.1	−0.9
Investment abroad	−1.1	..	−1.2	−1.1	..
Liquid assets	−0.6	..	−1.2	−2.4	..
Other financial assets	−0.5	..	0.4	−1.4	..
Trade credit, etc(d)	—	0.2	−0.1	—	1.6
Borrowing from banks(e)	1.8	1.6	2.0	0.7	1.8
Other borrowing	0.5	..	1.7	1.0	..
Unidentified transactions (balancing item)	−1.0	..	−2.3	2.3	..

(a) Including interest, other property income and income from abroad.

(b) Net of stock appreciation.

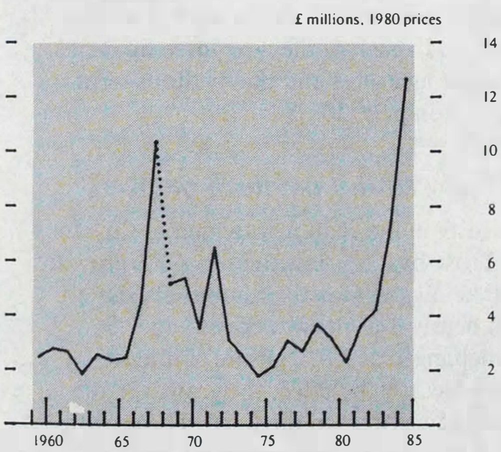
(c) A major component (deposits with borrowing from banks in the BIS reporting area) is not available for the most recent quarter.

(d) Accruals adjustment, net unremitted profits and net trade credit.

(e) Including Issue Department holdings of commercial bills.

The average expenditure[(a)] *on* **company mergers** *rose sharply in 1985*

...... Break in series



(a) Total expenditure on acquisitions and mergers within the United Kingdom, as recorded by the DTI, deflated by the GDP deflator and divided by the number of acquisitions and mergers.

Profitability *of non North Sea companies rose in the third and fourth quarter*

Industrial and commercial company profits rose to £14.9 billion in the fourth quarter of 1985 having fallen to £14.5 billion in the third quarter. The fall in the third quarter was entirely attributable to lower profits in the North Sea sector, as output was flat in the second and third quarters and prices weakened. The fall in oil prices from December will lower North Sea profits further in 1986. Profits in the non North Sea sector continued to rise in both the third and fourth quarters. In 1985 as a whole, profits of non North Sea companies were 21% higher than in 1984 (if the profits of British Telecom are removed from the figures). The real rate of return among non North Sea companies rose to 8.9% in the fourth quarter and nearly 8½% for the year as a whole, which compares favourably with the 7¼% recorded during the previous cyclical peak in 1978 and with the 3½% recorded during the trough of the recession in 1981.

Industrial and commercial companies' (ICCs) recorded financial surplus averaged nearly £1.6 billion per quarter in 1985, slightly below the average in 1984. (Comparison of the pattern of financial transactions continues to be hampered by the size and variability of the balancing item in the accounts.) The rate of borrowing from banks[(1)] declined over the second and third quarters of 1985 following a large increase around the turn of the year. Companies were estimated to have been net providers of funds to the banking system in the third quarter. But in the fourth quarter borrowing by ICCs from banks is estimated to have risen to over £1¾ billion. Although it is not clear what lay behind this path of bank borrowing during 1985, some of the borrowing throughout the year may have been associated with investment brought forward in response to the tax changes; and some may have been associated with merger activity.

In 1985 there was a considerable increase in the amount of equity issues by companies. A total of £5.2 billion (net) was raised compared with £2.3 billion in 1984; these figures exclude shares issued directly in exchange for another company's shares in a takeover, and shares sold by owners when going public or on privatisation. There was a sharp rise in the value of mergers and takeovers during 1985. After adjusting for inflation the level of expenditure on acquisitions was the highest since the levels recorded in 1968 and 1972. This was mainly because of a relatively small number of big mergers; the average size of merger was larger than in 1972 and (after allowing for differing statistical coverage) also larger than in 1968. Both the boom in merger activity and the increase in capital issues have occurred alongside a continuing rise in the stock market.

Both the **public expenditure and PSBR targets** *for 1985/86 are likely to be met*

In the first eleven months of the current financial year the public sector borrowing requirement (PSBR) amounted to £2.8 billion, compared with £7.7 billion in the same period last year. The public sector accounts normally move into surplus in January with higher tax payments, but the £4.5 billion surplus

(1) Figures have recently been revised to take account of the reclassification of certain transactions of securities dealers—see the note on page 30.

January with higher tax payments, but the £4.5 billion surplus in January 1986 was appreciably higher than expected. This improvement was sustained into February when there was a further surplus of £0.4 billion. The 1986 Budget forecast of £6¾ billion for the PSBR in 1985/86 as a whole compares with the 1985 forecast of £7 billion, which was revised up to £8 billion in the Autumn Statement on account of lower than expected oil revenues, largely because of a higher sterling exchange rate. The recent fall in dollar oil prices will have little further effect on revenues in the 1985/86 financial year because of lags in payments. These adverse developments on oil revenues have, however, been partially offset by higher than expected tax revenues from other sources, especially VAT.

Public expenditure planning total in 1986 White Paper

£ billions; *figures in italics are percentage changes on previous year*

	1985/86	1986/87	1987/88	1988/89
In current prices:				
Planning total	134.2	139.1	143.9	148.7
	+3.5	*+3.6*	*+3.5*	*+3.3*
Excluding privatisation proceeds	136.8	143.8	148.6	153.4
	+3.9	*+5.1*	*+3.4*	*+3.2*
In real terms (1984/85 prices):				
Planning total	127.8	126.7	126.7	127.1
	−1.4	*−0.8*	—	*+0.3*
Excluding privatisation proceeds	130.3	131.1	130.9	131.2
	−1.1	*+0.6*	*−0.1*	*+0.2*

The 1985/86 Budget expenditure plans, with a planning total of £134 billion, equivalent to 44½% of GDP, are likely to be met. There have been a number of overruns on individual programmes, all of which are expected to be met from the reserve, which is likely to be fully spent. General government expenditure is planned to remain roughly constant in real terms between 1986/87 and 1988/89 and to fall as a share of GDP to 41% by 1988/89. Detailed expenditure plans for 1986/87 and beyond were published in the *Public Expenditure White Paper* (Cmnd 9702) in January. Compared with 1985/86, the public expenditure planning total, in which privatisation proceeds are counted as negative expenditure, falls by just over ¾% in real terms in 1986/87. If privatisation proceeds are excluded, this represents a rise of about ½%. Although the planning totals for this year and next are unchanged from the 1985 Budget, higher expenditure on certain programmes is planned, in particular on social security, nationalised industries' external finance and special employment and training measures, offset by higher privatisation proceeds. The privatisation programme is now expected to raise £4¾ billion in each of the next three financial years. Details of the Budget measures and the medium-term financial strategy are given on page 20.

Counterparts to changes in money stock

	1983 Year	1984 Year	1985 Year	H1	Q3	Q4
	£ billions, quarterly averages seasonally adjusted					
PSBR	2.9	2.5	1.9	1.8	2.9	1.1
Debt sales to UK non-bank private sector	− 2.7	− 2.8	− 1.9	− 3.0	− 0.8	− 0.9
External and foreign currency finance of the public sector	− 0.4	− 0.4	− 0.8	− 1.0	− 0.4	− 1.0
Public sector contribution to £M3	− 0.2	− 0.6	− 0.8	− 2.2	− 1.7	− 0.8
Sterling lending to private sector	3.2	4.1	5.2	5.7	4.2	5.3
External and foreign currency finance of the monetary sector(a)	− 0.2	− 0.5	0.1	0.8	0.1	− 1.4
Net non-deposit liabilities in sterling(a)	− 0.5	− 0.5	− 0.7	− 1.2	− 0.4	—
£M3	**2.4**	**2.5**	**3.8**	**3.2**	**5.7**	**3.1**
PSL2	4.6	6.2	6.7	5.5	7.8	0.8
	Percentage changes (b)					
£M3	10.4	9.7	13.4	11.6	20.5	10.3
PSL2	12.3	14.7	13.8	11.6	16.2	16.0

(a) On new definitions, see June 1985 *Bulletin*, page 185.
(b) From end of previous period, at an annual rate.

The growth of £M3 *slowed in the fourth quarter*

Broad measures of liquidity in the economy tended to slow in the fourth quarter. £M3 rose by 2.5%, less than its 4.8% growth in the third quarter and below the growth of nominal GDP in the fourth, estimated at nearly 3%. Growth of the wider aggregate, PSL2, was unchanged at 3.8%, although if term shares with building societies are included, the growth in the fourth quarter was a little lower than in the third. The growth of £M3 in early 1986 has so far been more subdued than in the second half of last year. In his Budget speech, the Chancellor reinstated the target range for £M3, but at a higher level of 11%–15%, reflecting the fall in income velocity of £M3 in recent years.

Among the counterparts to £M3, the total public sector contribution (including external finance) was contractionary following the large expansionary influence in the third quarter. The main factors contributing to this decline were a large rise in funding and a steep fall in the PSBR, which was overfunded by £790 million. These developments are discussed in greater detail on pages 27–37.

The economic effects on the United Kingdom of lower oil prices[1]

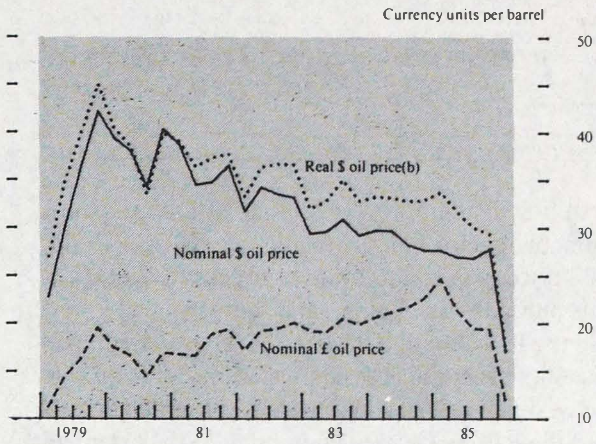
Between the third quarter of 1985 and mid-March 1986 nominal oil prices fell by around 45% in dollar terms. Over the same period, sterling's effective exchange rate index fell by about 9% and sterling rose by 6% against the dollar, so that sterling crude oil prices virtually halved. This note considers the implications for the UK economy of these changes in oil prices and the exchange rate.

In addition to direct effects, the United Kingdom will be affected indirectly by the impact of the oil price cut on other countries. For the major industrial countries, which together are net oil importers, the price fall improves the terms of trade and should lower inflation and raise demand and output. Consumer price inflation in 1986 may be 1% lower than it would otherwise have been (though the effect in individual countries will vary according to exchange rate movements). In 1987 inflation may also be 1% lower, although much depends on the extent and speed of any wage reaction. Lower prices in these countries will raise real incomes, profits, and the real value of financial wealth, thereby increasing domestic expenditure. If the targets for money supply and public expenditure framed in nominal terms are not fully adjusted to the lower price level, they will have more expansionary effects on real activity . As a result, GNP growth in the major economies may benefit from the price cut by up to one percentage point this year and perhaps another percentage point in 1987.

Stronger activity in the developed economies should have a beneficial effect on the United Kingdom's export prospects in these markets. There is likely to be some offset from a contraction in demand from OPEC, so that UK export market growth may be little changed on account of the fall in oil prices. Although the United Kingdom's export markets may not expand, the UK share of these markets should increase as a result of the better competitive positon that has resulted from sterling's depreciation. Some of these benefits should occur in 1986, although the full effects are likely to take two years or so to come through.

The fall in oil prices makes the United Kingdom worse off by reducing the average price of something we sell abroad relative to the price of what we buy. North Sea oil production accounted for 6% of real GDP in 1985, but about half of production is consumed in the United Kingdom. For this portion of output there is no loss to the nation as a whole resulting from the price cut, rather a transfer of income within the United Kingdom from producers and government to oil users. For the remainder

Oil price[a]



(a) Latest figure is based on average of North Sea marker spot prices in 1986 Q1 to 14 March.
(b) Deflated by industrial countries' export prices.

of oil output which is exported, however, consumers abroad gain at the expense of the United Kingdom. Real net oil exports comprise 2¾% of GDP, so that the recent fall in price directly reduces net national disposable income (GNP adjusted for the terms of trade) by about 1%. This loss shows up in the current account of the balance of payments, with a direct loss of up to £3 billion per annum at likely 1986 levels of production. However, the overall reduction in the current account is likely to be smaller than this as there will be some offset from lower remittances abroad of oil company profits (though the overseas earnings of UK-based oil companies may also decline). The major factor limiting the impact on the balance of payments will be the decline in the exchange rate that has accompanied the fall in oil prices. There will be some worsening of the terms of trade in 1986 as a result of the depreciation, but improvements in real net trade will increasingly have a more dominant effect. Simulations on the Bank of England economic model suggest that a 9% fall in the effective exchange rate should be sufficient to offset the effect of lower oil receipts on the current account after about four years. The improvement in the non-oil current account will follow from the beneficial effects of improved competitiveness which depends on there being no offset to the effects of exchange rate depreciation from higher wage settlements.[2]

For retail price inflation to remain unaffected from a given percentage fall in the sterling oil price from its level last autumn, the effective exchange rate would need to depreciate by about one quarter as much. In fact, the depreciation since the third quarter has been less than

(1) The oil price and the effective rate for sterling averaged $26.8 per barrel and ERI 82.1 respectively in the third quarter. Oil prices refer to Brent oil prices, which have moved closely with the average of the prices of UK oil imports and exports.
(2) The results are based on the assumption of no change in tax rates, real government expenditure, wages, or UK interest rates.

Effect on the United Kingdom of the recent fall in oil prices[a] and the exchange rate

Changes relative to base

	1986	1987	1988
Oil price: (dollars per barrel)	−11.80		
Effective exchange rate (per cent)	− 9		
Dollar/sterling rate (per cent)	+ 6		
Oil trade balance (£ billions)	− 3	− 3	− 2¾
Current balance (£ billions)	− 2½	− 1½	− ½
PSBR (£ billions)	+ 3½	+ 2½	+ 1½
Consumer price inflation (percentage points per annum)	− ¼ to ½	− ¼ to ½	—
GDP growth (percentage points per annum)	+ ½	+ 1	+ ¼
Unemployment (thousands)	−25	−150	−275

Source: Bank estimates.

(a) Assuming no difference in tax rates, government expenditure, interest rates or wages as a result of the price fall.

this, resulting in an improvement in inflation prospects. The immediate effects on the retail price index (RPI) of lower oil prices will result from lower petrol prices. In 1985 the pump prices of petrol and motor oil had a weight of 5% in the RPI. About a third of that comprises the cost of crude oil, so that the 50% fall in sterling crude oil prices on its own reduces petroleum product prices by about 15% and the RPI by ¾%, though in practice the extent and speed of the fall will depend on competition and movements in refining and distribution costs and margins. Thereafter, despite weaker world inflation, prices of imported goods can be expected to rise in response to the fall in the exchange rate so that on balance prices in 1986 as a whole may be ¼%–½% lower than otherwise. In 1987 the RPI should benefit again by the same amount, with the reduction in UK manufacturers' costs resulting from the oil price cut being only partly offset by higher sterling costs of other imports. There will also be indirect effects of lower oil prices on the RPI, including the effects of lower world inflation.

Given the inertia of wages and salaries, lower UK inflation will tend to raise real incomes, thereby increasing consumption. This will help to reinforce the effects on activity of the improved real net trade outlook. Investment too should be strengthened owing to stronger demand and an improvement in competitiveness and profitability. Stronger demand should result in a faster growth of output and a fall in unemployment. In total, GDP may rise half a percentage point faster this year and by one percentage point faster next year than would otherwise have been the case, and unemployment could fall by over a quarter of a million by 1988.

In the absence of any adjustments to policy, the fall in the oil price transfers income between the various sectors of the domestic economy. The personal sector and the non-oil company sector benefit from lower prices and higher activity, while North Sea companies and the government will lose revenue. The bulk of the loss falls on tax receipts—on average taxes absorb about three quarters of the effect of price changes on the value of North Sea oil production. But the loss in oil revenue should increasingly be offset by the effects of higher activity on tax receipts and of lower unemployment on social security outlays. The net cost to the PSBR should fall from £3½ billion in calendar 1986 to about half that in 1988.