Economic commentary

- *The fall in oil prices has strengthened the downward pressures on inflation among the major industrial countries.*

- *Lower oil prices have improved the prospects for a resumption of economic growth, although there was a slowdown in the growth of industrial production among industrial countries in the first quarter.*

- *The prospects for a more sustained period of growth have also been enhanced by the fall in the dollar and in interest rates in early 1986. But some risks remain, including protectionist pressures.*

- *In the United Kingdom there has been a slowdown in the growth of output since the second quarter of 1985 and there has been a further rise in unemployment since the end of the year. But domestic spending continues to rise.*

- *The growth of manufacturing productivity has slowed, reflecting slower growth of output. Unit wage costs continue to rise faster than those of our competitors.*

- *There is likely to be a strong increase in real earnings this year, with the increase in retail prices falling to 2¾% at an annual rate in May and underlying earnings continuing to rise at 7½%.*

- *The growth of liquidity remains strong, as the private sector continues to adjust to the improved availability of credit following the liberalisation of the financial system.*

Prospects for a continuation of **economic growth** *have improved . . .*

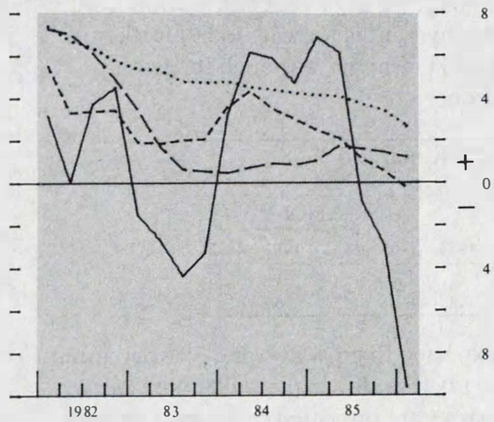
Developments in the world economy in recent months have resulted in an improvement in the prospects for growth in 1986 and 1987. The most favourable development has been the continued fall in rates of inflation. The steady progress made in lowering inflation in the major countries reflects a number of factors, including the firm stance of monetary and fiscal policy in most economies, lower commodity prices and the continued moderate growth of wages in a number of countries. The sharp fall in oil prices since last December has strengthened the downward pressures on inflation, and consumer prices in the major economies rose by only 1% at an annual rate in the first quarter.

The stimulus to output from the large fall in oil prices is not expected to have an immediate impact, in view of the time taken by consumers in particular to adjust to higher real incomes. In fact, in the first quarter of the year industrial production in the major economies was weaker than expected. But the immediate effects of the fall in oil prices have already had a visible impact in financial markets. Bond yields have fallen further as inflation expectations responded to lower oil prices; short-term interest rates have also fallen in most major centres since the Plaza accord last September. However, some doubts

Inflation in the major overseas economies[a]
continues to fall, mainly because of lower import prices

.... Consumer prices(b)
- - - - - Wholesale prices of manufactures
— — — Unit labour costs in manufacturing(c)
——— Import prices

Percentage changes on a year earlier



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

Inflation in the major economies
Percentage changes over previous period at annual rates(a)

	1983	1984	1985 Year	1985 H1	1985 H2	Latest three months on previous three months(b)
Consumer prices						
Canada	5.8	4.3	3.9	4.2	3.8	4.3
France	9.5	7.7	5.8	6.1	4.4	0.4
Germany	3.3	2.4	2.2	3.6	0.4	-1.2
Italy	15.0	10.6	8.6	10.2	6.9	6.6
Japan	1.9	2.3	2.1	2.2	1.9	-1.4
United Kingdom	4.7	5.0	6.1	7.5	4.4	3.9
United States	3.1	3.4	3.5	3.0	3.3	-1.5
Total	**4.6**	**4.2**	**3.9**	**4.1**	**3.1**	**-0.2**
Memorandum items						
Wholesale prices in manufacturing (total)	*2.2*	*3.7*	*1.9*	*2.8*	*- 0.2*	*-7.2*
Import prices (total)	*- 2.0*	*5.4*	*2.5*	*7.4*	*-10.4*	

.. not available.
(a) Not seasonally adjusted.
(b) Latest consumer price figures are for April 1986. Wholesale price data are available to April for Japan, United Kingdom and United States; March for Canada and Italy; February for Germany and December for France.

and uncertainties remain. The US budget deficit remains large; current account imbalances persist; developing countries are continuing to experience debt servicing problems; and in developed countries certain sectors, such as agriculture and energy, remain especially vulnerable. Nevertheless, on balance the risks to a continuation of economic growth combined with low inflation have probably receded.

. . . as **inflation** *continues to fall*

Consumer price inflation in the major overseas economies[1] in aggregate fell below 4% in 1985, maintaining the downward trend established since 1981. In the three months to April consumer prices fell in Japan, Germany and the United States and were virtually static in France.

The sharp fall in spot oil prices, from around \$28 per barrel in December last year to \$12 per barrel in early June, has resulted in strong downward pressure on inflation. The average traded price of oil lags behind the fall in spot prices, so there could be a further favourable short-term impact on inflation from this source. The longer-term impact of lower oil prices on inflation, as well as on the growth of output and trade, depends very much on the duration of lower oil prices, on the wage response to lower inflation, and on official policy reactions. It remains possible that restraints on production by OPEC producers, coupled with firmer demand following the fall in prices to date, could result in some recovery of oil prices later in the year. The OPEC ministerial meeting in April reached an agreement to set production ceilings for the third and fourth quarters of 1986. But the agreement was not unanimous and there was no consensus on the allocation of individual country quotas within the new ceilings. The latest Bank forecasts of the world economy (summarised on page 170) have assumed that OPEC will agree on a measure of production restraint, yielding an oil price of \$20 per barrel from the second half of 1986 until the end of 1987. But if oil prices were instead to stabilise at around \$10 per barrel, consumer prices in the major seven economies might be some $2\frac{1}{2}$% lower and GNP $1\frac{1}{2}$%–2% higher after two years compared with the base case. These results are sensitive to the growth of earnings: the benefits of lower oil prices could be dissipated if wages were to rise strongly in response to improved activity and profitability. In addition, the short-term impact of the fall in oil prices is dependent on the policy responses. To date the Danish and Italian governments have raised taxes on petrol in an attempt to consolidate their fiscal positions, thus diminishing the direct benefit to consumers of lower oil prices, whereas in Germany the government has stated it will pass on all the benefits of the fall in oil prices to the consumer.

Among other factors, anti-inflationary policies which have been in force for several years in most of the major countries have played an important role in dampening inflation expectations, thus helping to restrain growth in nominal earnings and unit labour costs in most economies. Even so there was a pause in the slowdown of average earnings growth in manufacturing in the first half of last year and as a result the rise in 1985, at 5%, was as much as in 1984. But the increase

(1) Canada, France, Germany, Italy, Japan, and the United States.

World economic prospects—latest Bank forecasts

The outlook for the main industrialised countries has improved in a number of respects since the autumn (see December 1985 *Bulletin* page 506), and some of the previous risks to continued economic progress may have receded. The falls in both oil and non-oil primary product prices should lower inflation and promote activity, while the exchange rate changes since the Plaza accord should help to reduce external imbalances between the major economies.

Demand and output in the seven major economies[a]

Percentage changes

	1984	1985	Forecasts 1986	1987	1988
Domestic demand	**5.1**	**2.7**	3.7	**3.1**	**2.6**
of which:					
Private consumption	3.0	2.8	3.6	3.3	2.6
Private investment	9.0	6.1	6.6	5.0	3.9
Public expenditure	2.5	2.6	1.1	1.1	1.2
Stockbuilding(b)	1.1	−0.6	0.1	0.0	0.0
Net trade(b)	−0.3	—	−0.5	−0.3	−0.1
GNP(c)	**4.8**	**2.7**	3.3	**2.9**	**2.6**

(a) Canada, France, Germany, Italy, Japan, United Kingdom and the United States.

(b) Percentage contribution to GNP or GDP.

(c) Or GDP.

Inflation in the major seven industrial countries is expected to fall to 2% on average in 1986, with local currency import prices falling almost 10%. Lower inflation reflects falls in oil and commodity prices and the maintenance of non-accommodating monetary and fiscal policies in the major countries. There is still uncertainty about the level at which oil prices will stabilise. The forecast assumes that OPEC will agree on a measure of production restraint, resulting in an average price (OPEC production-weighted fob price) of \$16 per barrel in the first half of 1986, rising to \$20 per barrel in the second half and remaining at that level through 1987. Unit labour costs are projected to rise at about 2% per annum on average throughout the forecast period and this, with the absence of further falls in import prices, implies a gradual pickup in inflation, perhaps to over 3% in 1988.

Output in the major seven is forecast to grow around 3% per annum in 1986–87, but to slow somewhat in 1988. During 1986 lower oil prices increase real incomes, leading to a forecast of faster growth of consumer spending and in turn to higher investment. By the end of the forecast period, however, the rise in inflation implies some slowdown in activity.

In the United States the growth of domestic demand is projected to fall steadily from around 3½% in 1986 to 1½% in 1988. Domestic demand is restrained as it is assumed fiscal policy tightens and the growth of investment slows. The rise in US inflation lowers real personal income growth, resulting in slower growth of consumption. But net trade is predicted to make a positive contribution to GNP growth in 1987–88 as the effects of improved competitiveness (owing to the fall in the dollar) come through. The growth of GNP is expected to fall from 3¼% this year to 2¼% in 1988.

Elsewhere, low inflation and lower interest rates should boost activity, particularly in Germany where strong growth of private consumption is expected throughout the forecast period, reflecting weak import prices and direct tax cuts in 1986 and 1988. Higher profits this year are expected to lead to strong growth of business investment throughout the forecast period, especially in Germany and Japan. However, GNP growth in Japan is constrained by a negative contribution from net trade. Unemployment is forecast to fall further in North America and Germany, although it edges up elsewhere in Europe.

World trade and UK markets

Percentage changes

	1983	1984	1985	Forecasts 1986	1987	1988
World trade	2.6	8.7	3.7	5.3	5.7	4.0
UK markets	0.4	8.0	2.9	5.3	6.2	5.6

World trade is expected to grow at some 5½% per annum this year and next before slowing in 1988. Non-oil developing countries are projected to increase import volumes at around 6% per annum. Despite lower interest rates and the lower dollar, certain countries dependent on exports of oil and other primary products are likely to have to adjust their growth of imports, with some OPEC countries in particular forced to retrench heavily. This may restrain the growth of UK export markets, especially in 1986, but buoyant trade forecasts for most European countries more than offset this, and hence UK markets look set to grow more strongly than world trade in general.

An alternative scenario with a \$10 per barrel oil price was also considered. Compared with the central forecast, consumer prices in the major seven might be some 2½% lower and GNP 1½%–2% higher after two years. There are a number of risks to these estimates. These include the uncertainty over the response of earnings in the industrial countries to lower inflation and improved activity, and the extent to which the main oil exporting countries can implement adjustment measures following the sharp fall in their revenues from oil exports.

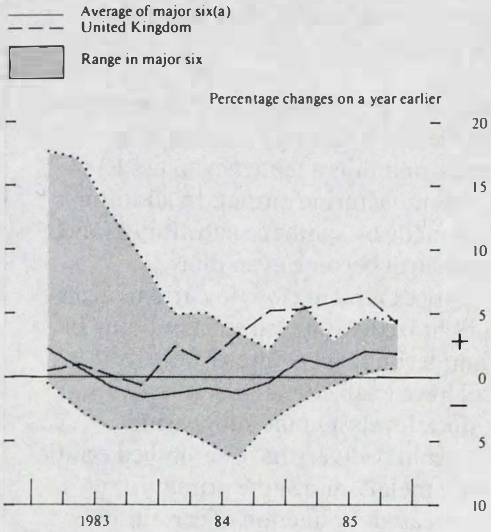
Effects of \$10 per barrel oil price: output and prices in the major seven economies

Percentage differences from central forecast

	1986	1987	1988
GNP	+0.5	+1.3	+1.7
Consumer prices(a)	−1.4	−2.6	−2.6

(a) Consumers' expenditure deflators

Manufacturers' labour costs *are rising faster in the United Kingdom than elsewhere*



(a) Canada, France, Germany, Italy, Japan, and the United States.

ranged from less than 4½% in North America, Japan, Germany, the Netherlands and Belgium to around 9% in the United Kingdom, a rate exceeded only in Italy among the major industrial economies. These developments were mirrored in the behaviour of labour costs in manufacturing. As the increase in earnings slowed during the year, labour costs per unit of output in the major overseas countries rose by just ½% at an annual rate in the second half of 1985. Again this rate was exceeded only in Italy and the United Kingdom, where labour costs rose at annual rates of 3¾% and 5¼% respectively.

A number of short-term factors have also influenced consumer price inflation, largely reflecting external developments, as import prices have fallen more rapidly than unit labour costs. The fall in the US dollar since early 1985 has resulted in lower domestic prices for goods the prices of which are normally fixed in dollars, such as oil, certain other key commodities and US exports of manufactures. This will have been of most benefit to those economies where imports of such goods represent a relatively large share of GNP. In the United States there had been some concern over the impact of the fall in the dollar on the rate of inflation. Since the spring of last year the dollar's effective exchange rate has fallen by 26%, but there has been only a very modest rise in US import prices. Importers into the US market must therefore have lowered their margins, although lower oil and commodity prices would also have been a factor. Imports of goods and services represent only some 11%–12% of GNP in the United States, even though the proportion has been rising.

With one or two interruptions, real commodity prices have been on a declining trend since the mid-1970s (see the note on page 172) but a number of specific factors resulted in further weakness in the second half of 1985. Prices of agricultural products were reduced by widespread good harvests, and metal prices were affected in part by the uncertainty surrounding the breakdown of the International Tin Agreement. Overall, dollar prices of industrial materials fell by 8% at an annual rate in the second half of 1985; over the same period, food prices rose, but were 3% lower than in the second half of 1984. Since the turn of the year metal prices have stabilised and food prices have picked up slightly, reflecting gains in coffee and sugar. However, much of the rise in dollar spot prices may be attributable simply to the weakness of the dollar. There is little sign of sustained recovery in commodity prices relative to the prices of exports of manufactures: and for the future the fall in oil prices will lower production costs of various industrial materials and some foods over the medium term.

The **growth of output** *strengthened in the second half of 1985*

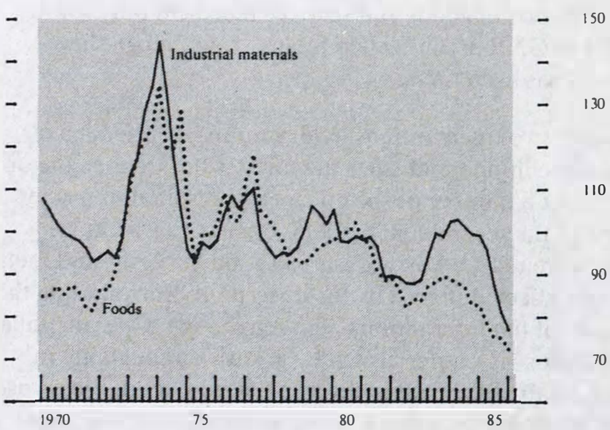
Output growth in the industrial economies in the second half of 1985 was stronger on the whole than in the first, especially among the continental European countries and in Canada. Private consumption did not grow as rapidly, but private investment strengthened, in part reflecting exceptional growth (15% at an annual rate) in Japan in the fourth quarter. Business investment in Japan has been strong throughout the current recovery, with the pace of output growth and buoyant profitability both contributory factors. More recently, business

Recent trends in primary product prices and developing countries' terms of trade

Non-oil primary product prices, which rose throughout 1983, turned around early in 1984 and have fallen significantly since then. The fall has been of importance because it has led to lower input costs for manufactures, thus contributing to the fall in the rate of inflation in industrial countries. But lower commodity prices, leading to an adverse shift in the terms of trade for many developing country producers of primary commodities, have depressed the growth of their export earnings, thus limiting their capacity to import.

In real terms[1] non-oil commodity prices have not returned to their exceptional levels of the commodity price boom in 1973–74—the highest since the Korean War. In the early 1970s, industrial raw material prices rose rapidly in the face of strong demand as oil prices quadrupled, raising production costs (eg metal smelting) and the prices of oil-based synthetic substitutes (eg polyester fabrics). At the same time, poor crops for several major agricultural commodities, such as grains and sugar, boosted food and other agricultural product prices. By comparison, the rise in primary product prices in 1979–80 following the second oil shock was more subdued.

Real commodity prices[a]



(a) Derived from UN data: 1985 Q4 and 1986 QI are provisional figures. For definition, see footnote (1) below.

There was some recovery in industrial raw material prices in 1983–84, although in real terms they remained below the level of the two preceding peaks; the recovery in real food prices was even more muted. Since May 1984 prices for all commodity groups have fallen in real terms and are now well below the trough reached in 1982. This weakness has given rise to the view that there are structural factors at work which may act to depress prices in the longer term, with severe consequences for countries heavily dependent on exports of primary products.

Demand for industrial raw materials, and in particular metals, has been affected by a trend towards more sophisticated goods, and thus a tendency to use less metal per unit of manufacturing output. In addition inroads have been made by synthetic substitutes (and oil based substitutes will become even more competitive if oil prices remain close to current levels). High interest rates have discouraged stockbuilding in the short term, and technological improvements in inventory control have enabled manufacturers to maintain lower stock levels. On the supply side, improvements in scrap recovery have smoothed erratic supplies of primary metals; and some primary producers have increased production of certain commodities, even in the face of falling prices, in an attempt to boost total export revenue.

These structural factors are tending to reduce the prospect of substantial price rises for commodities, except in the event of major supply shocks such as widespread crop failures. The effect on individual exporting countries will depend on the commodities they produce and the share of these products in total exports.

Taken as a bloc, developing countries[2] increased the proportion of their export revenue derived from exports of fuel and manufactures over the period from 1970 to 1983 while dependence on exports of non-oil primary products, especially agricultural commodities, declined. For example, the share of food products in the value of developing country exports declined from over 30% to less than 20% over this period, whereas the share of oil increased from about 8% to 23% and of manufactures from about 27% to 45%.

Nevertheless, many countries continue to depend on revenue from exports of primary products for a substantial portion of total export earnings. A number of countries rely on agricultural commodities for over half of their export earnings and a few countries are heavily dependent on exports of a single metal for a substantial proportion of their export earnings. Thus, although developing countries as a group have become less dependent on primary product exports, trade in commodities remains extremely important to many individual countries, and they have experienced a deterioration in their terms of trade which shows little sign of reversal.

(1) Defined as the dollar primary product price index deflated by an index of world prices in dollars of manufactured exports.
(2) Using the UN definition of developing market economies, but excluding OPEC and with the addition of China.

GNP growth in the major economies

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

	1983	1984	1985	1985	
			Year	H1	H2
Canada	3.3	5.0	4.5	3.7	5.6
France	0.7	1.6	1.3	0.4	2.8
Germany	1.5	3.0	2.4	0.8	5.0
Italy(a)	-0.4	2.6	2.4	2.1	3.1
Japan	3.2	5.0	4.6	4.5	4.7
United Kingdom(a)	3.3	2.7	3.2	3.9	2.2
United States	3.4	6.7	2.2	2.1	2.0
Total	**2.6**	**4.8**	**2.7**	**2.4**	**3.1**

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

Components of GNP(a) growth in the major economies

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

	1983	1984	1985		
			Year	H1	H2
Private consumption	3.2	3.0	2.8	3.3	2.9
Private fixed investment	2.9	9.0	6.1	3.9	8.1
Public expenditure	1.1	2.5	2.6	-0.1	6.4
Stockbuilding(b)	0.3	1.1	-0.6	-0.8	-0.2
Domestic demand	**3.0**	**5.1**	**2.7**	**1.8**	**4.3**
Net trade(b)	-0.4	-0.3	0.0	0.6	-1.2
GNP(a)	**2.6**	**4.8**	**2.7**	**2.4**	**3.1**

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

investment in the United States and Canada may have been adversely affected by the cancellation of projects in the energy sector. But it is likely that higher profitability and stronger demand in energy-using sectors will result in further growth in investment among the major industrial economies as a group.

But elements of weakness *persist*

Nevertheless, questions remain about the strength of the recovery over the short term. Public expenditure on goods and services in the major six overseas countries grew at 6½% (annual rate) in the second half of 1985 after declining in the first, but much slower growth is expected in 1986. Stockbuilding made a negative contribution to growth in 1985 as a whole, but less so later in the year. Stockbuilding was strong in France and Japan in the second half and also accounted for the whole of the estimated 2.9% growth of GNP (at an annual rate) in the United States in the first quarter of 1986. The strength of stockbuilding could imply slower output growth in subsequent quarters.

The growth of world trade slowed from an annual rate of about 3% in the first half of 1985 to around 1¼% in the second. The decline in the real price of oil during 1985 intensified financial pressures on several leading oil producers. OPEC import volumes declined by about 14% in 1985 after falling by 18% between 1982 and 1984. The recent fall in the oil price may necessitate even more severe retrenchment by oil producers in 1986, with consequential effects on exports from industrial economies. The decline in real non-oil commodity prices during 1985 tended to tighten financial constraints on the non-oil developing countries and their imports appear to have fallen sharply in the third quarter. Consistent with this, net trade exerted a negative impact on growth in the major industrial countries in the second half of the year. However, for the United States the fall in the dollar during 1985 should begin to reduce the negative contribution to growth which the external sector has made in recent years. For other major economies, especially those which have benefited from strong export growth to the US market over the last three years, the appreciation of their currencies against the dollar may require a combination of stronger domestic demand and improved domestic supply conditions to maintain their recovery.

The growth of industrial production in the major economies in recent months has also been weaker than expected and by March was less than 1½% above the level of a year earlier in the major overseas economies as a group. After eighteen months of steady growth in Germany, production fell in the first quarter and by March was only 2¼% higher than a year earlier. Industrial production fell in Japan during the first quarter, so that by March it was also only 2¼% higher than in March 1985. The slow growth of production in the United States persisted into the first quarter to a level 1½% higher than a year ago. The reasons are uncertain, but weak export growth, reflecting import constraints among OPEC and other non-industrial countries, seems to have been an important factor.

The prospects for sustained growth in world trade continue to be threatened by large payments imbalances and the threat of protectionist pressures. In 1985, the US external current account deficit was $118 billion (3% of GNP), while Japan had a surplus of $49 billion (4% of GNP) and Germany a surplus of $14 billion (2% of GNP). Developments in the past twelve months have helped to reduce these imbalances. In particular the exchange rate changes given impetus by the Plaza accord have improved the competitiveness of US goods and services and already appear to have slowed the growth of Japan's exports.

The dollar continued to weaken during the first quarter, especially against the yen, against which it had by early June depreciated by about one third from its February 1985 level. The full effect on trade volumes is likely to take some time to come through. In the short term, recent exchange rate changes have contributed to an improvement in the terms of trade of most industrial countries, other than the United States and oil exporters such as the United Kingdom. In the first quarter, Japan's current account surplus rose to nearly $16 billion (seasonally adjusted) partly reflecting the lower cost of oil imports; the US current account deficit is estimated at $34 billion (seasonally adjusted). Some further movement in exchange rates or faster growth of domestic demand in the surplus countries is likely to be required if these large imbalances are to be reduced significantly.

Interest rates *have fallen*

Lower inflation and greater confidence that action would be taken to lower the US budget deficit have resulted in a fall in longer-term interest rates. Bond yields in the United States fell sharply last year, and long-term yields have fallen in other centres, especially in recent months. The decline in US bond yields continued into the first quarter, but was arrested in May primarily because of foreign investors' concern at the continued fall in the dollar. The factors leading to the fall in longer rates have also contributed to a general, although more modest, reduction in short-term interest rates. In the United States short rates had fallen from around 9% in March 1985 to 6¼% in April this year. The Japanese authorities first increased their interest rates to reinforce the Plaza accord, but interest rates fell in most other centres. In the United States the Federal Reserve lowered the discount rate in March from 7½% to 7%, a move which may have been primarily determined by the prospects for US growth and inflation. In April the Board announced a further cut from 7% to 6½% which it stated was 'consistent with international interest rate considerations'. But by the end of May US short rates had firmed to over 6½% partly in response to further weakness in the dollar in late April.

There is some uncertaintly over the resulting movements in real interest rates. There is, of course, no single measure of the real interest rate, as rates differ between maturities and inflation expections cannot be measured precisely. At the long end, movements in yields on government bonds suggest that real rates have fallen or levelled off. At the short end (defined as three-month rates), the fall in nominal rates does not, however, appear to have resulted in any marked fall in real interest rates. Indeed, in some cases real rates may have risen as the fall in nominal rates has lagged behind the fall in inflation. In recent years short-term real rates (pre-tax) have been in excess of 4% in most centres, sometimes by a considerable

Effective exchange rates[a] and interest rates[b]

Monthly averages

	1985		1986	
	Mar.	Sept.	Jan.	Apr.[b]
Canada				
ERI	88.5	85.8	80.0	79.0
Short-term interest rate	11.3	9.1	10.2	9.6
Long-term interest rate	12.2	11.0	10.4	9.3
France				
ERI	63.2	67.1	70.4	69.1
Short-term interest rate	10.7	9.6	9.0	7.6
Long-term interest rate	12.3	12.0	10.8	8.6
Germany				
ERI	119.1	125.6	132.0	134.2
Short-term interest rate	6.4	4.7	4.7	4.5
Long-term interest rate	7.7	6.5	6.5	5.7
Italy				
ERI	45.0	44.2	45.5	46.0
Short-term interest rate	16.1	14.5	15.2	13.8
Long-term interest rate	13.5	13.8	13.5	12.3
Japan				
ERI	155.4	159.0	177.7	197.4
Short-term interest rate	6.3	6.3	6.5	4.9
Long-term interest rate	6.6	5.9	5.8	4.7
United Kingdom				
ERI	73.4	81.4	76.6	76.3
Short-term interest rate	13.6	11.5	12.8	10.6
Long-term interest rate	10.9	10.4	10.8	8.8
United States				
ERI	152.4	138.4	125.3	117.4
Short-term interest rate	9.0	7.9	7.8	6.6
Long-term interest rate	11.8	10.7	9.5	7.6

(a) Exchange rate index (ERI) 1975 = 100.
(b) Interest rates for April 1986 include estimates.

margin. So far, rates at these levels do not appear to have had a major adverse effect on levels of activity in industrial economies.

In the United Kingdom, the **growth of output** *has slowed . . .*

GDP rose by almost ½% in the first quarter, according to the provisional output measure, to a level 1½% higher than a year earlier (after allowing for the effects of the coal dispute in 1984 and 1985). Growth in the first quarter reflected higher output by the energy sector and service industries, partly offset by a fall in manufacturing output. There was little change in total output excluding oil and gas extraction. The estimates of GDP(O) in the first quarter are consistent with a picture of a slowdown in the growth of underlying economic activity which started in the first half of 1985. By the first quarter of 1986, manufacturing output was 1½% lower than its temporary peak in the second quarter of last year. The growth of industrial production reflects higher production of coal and coke following the end of the coal dispute. However, the underlying level of industrial production is little changed from that of early 1985. Thus, much of the growth in output since mid-1985 reflects further growth in the service industries, where first quarter output was over 1½% above second quarter 1985 levels.

The fall in manufacturing output reflects falls in output in the hitherto more buoyant sectors, particularly electrical engineering and chemicals, since the second quarter of 1985. Other sectors, such as mechanical engineering, food, and printing and publishing have continued to grow. Overall, the index of manufacturing output is almost 7% below its previous peak in the first half of 1979.

It is unclear why the growth of manufacturing output has been so weak in recent quarters. As noted earlier, the weakness of industrial production in the United Kingdom appears to have been paralleled in several other countries, despite a continuation of economic growth, and slower growth of world trade may be one explanation. In the electrical engineering industry, for example, there appears to have been a sharp fall in export volumes in the first quarter over a year earlier, reflected in the fall in output. Although the volume of manufactured exports as a whole (excluding erratics) was 8% higher in 1985 than in the previous year, there was little change in volumes during the year; and the volume of exports of manufactures fell 4¾% in the first quarter of 1986. The Confederation of British Industry's survey results on export orders were consistent with the sluggishness of the volume of exports of manufactures since the second half of last year. Export order books were reported to be below normal on balance throughout the second half of 1985, compared with above normal in the first half, and export orders remained relatively weak up to March this year, although the result of the May survey suggests an improved prospect.

There is some evidence to suggest the failure of manufacturing output to grow in recent quarters is simply a pause. As outlined below, some components of spending have continued to grow, although not as strongly as in the previous twelve months. Further falls in inflation should ensure a steady growth of consumer spending during 1986. There was some

Growth of output

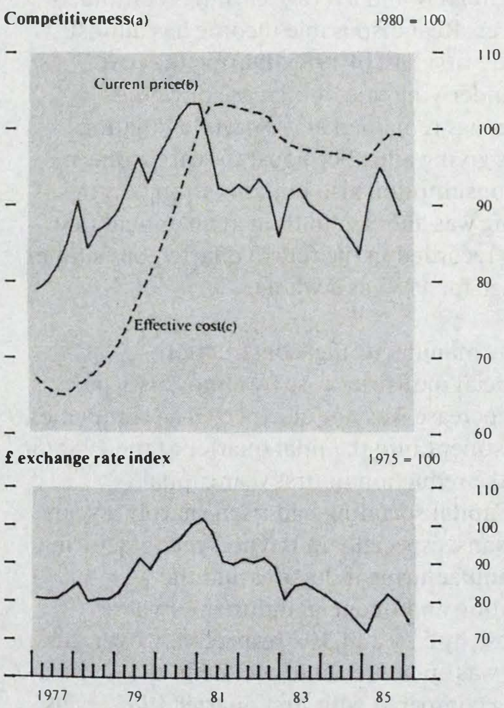
Percentage changes on previous period at annual rates; at constant prices: *seasonally adjusted*

	GDP(O)(a)	Production and construction: Total	*of which:* Manufacturing	Services
Weights in GDP(O)	*1,000*	*424*	*266*	*554*
1983	+3.0	+ 3.6	+2.9	+2.9
1984	+3.2	+ 1.6	+3.9	+3.8
1985	+3.4	+ 4.2	+2.9	+3.1
1985 Q1	+4.5	+10.5	+6.9	+1.1
Q2	+4.5	+ 7.0	+3.1	+3.3
Q3	+0.7	− 1.1	−0.8	+1.4
Q4	+3.3	+ 1.1	−0.8	+3.6
1986 Q1	+1.4	..	−4.9	+1.8

.. not available.

(a) Includes agriculture, forestry and fishing as well as production, construction and services.

Export competitiveness *improved from the fourth quarter as sterling fell*



(a) An increase in the indices as defined below represents a deterioration in competitiveness.

(b) Unit value export prices relative to UK trade-weighted sterling overseas wholesale prices.

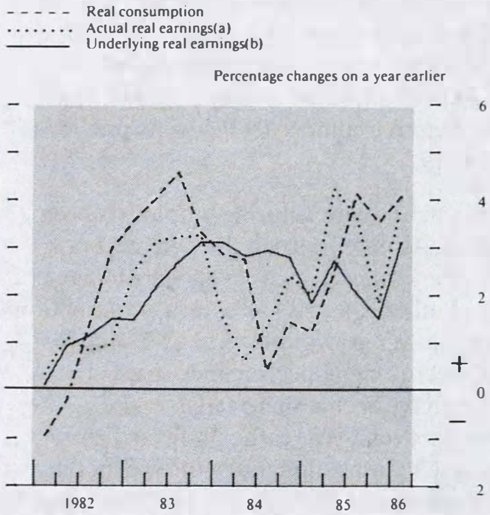
(c) A weighted average of relative normalised unit labour costs (local currencies).

improvement in competitiveness in the fourth quarter of 1985 and in the first quarter of this year. The improvement has partly reversed the loss in competitiveness during much of 1985 as sterling appreciated, which affected the growth of non-oil export volumes. The April CBI survey reports a general improvement in the business outlook for orders, output and exports, but a shortage of orders continues to be the main constraint on higher output, and the survey results may reflect seasonal optimism. Although it is clear that the growth of output has slowed, analysis of the main components of demand using the Bank's model of the economy suggests that the supply of manufactured goods (domestic production and imports taken together) has satisfied an unusually small proportion of the increase in total demand. This suggests that the figures for domestic manufacturing output in the last two quarters could overstate the weakness in output. Relationships between labour demand and productivity in manufacturing tend to support this.

. . . *but* **domestic expenditure** *has continued to grow*

Although provisional estimates for the first quarter suggest there was only a modest increase in consumers' expenditure compared with the fourth quarter of last year, it was still more than 4% higher than a year earlier. In recent years the pattern of quarterly movements in spending has been somewhat irregular and there is no firm evidence of any reduction in the growth of spending. Estimates of the volume of retail sales in April show sales rose over $1\frac{1}{2}$% in the three months ended April to a level $4\frac{1}{2}$% higher than a year earlier. In 1985, real consumer spending grew by 3%, while real disposable income rose by over 2% as employment grew and average earnings continued to rise faster than prices. Real disposable income has almost certainly risen since the first half of 1985. During the first quarter of 1986, the underlying rate of increase of whole economy average earnings remained at $7\frac{1}{2}$%, while inflation continued to fall, thus giving a further boost to real incomes. Bank borrowing for consumption also remains strong. In the first quarter, borrowing was about £3 billion at an annual rate, below the £3.3 billion recorded in the fourth quarter, but similar to the quarterly average for 1985 as a whole.

Real consumption *has risen with real earnings*



(a) Average earnings in the whole economy deflated by the consumers expenditure deflator.

(b) The term underlying earnings is used by the Department of Employment to mean actual weekly earnings adjusted for temporary factors such as timing of settlements, back-pay and strikes. It includes overtime earnings.

Capital expenditure by manufacturing, construction, distribution and financial industries rose by almost $4\frac{1}{2}$% in the first quarter. The increase was not unexpected as companies brought forward investment into the final quarter of the 1985/86 financial year before the reduction in first year capital allowances in April. Capital spending had risen sharply a year earlier for similar reasons, especially in the non-manufacturing sector. In both the manufacturing industries and the construction, distribution and financial industries (where capital expenditure rose by $5\frac{1}{2}$% and $3\frac{3}{4}$% respectively over the fourth quarter), there was an appreciable decline in the dependence on leasing compared with first quarter 1985 levels. The reduced reliance on leasing may be partly explained by a combination of earlier reductions in capital allowances and the buoyancy of profits, enabling companies to obtain tax benefits on investment financed directly. Nevertheless the volume of leasing to all industries in the first quarter, at £0.9 billion, was the second highest on record.

According to the latest survey of investment intentions by the DTI, fixed investment by the manufacturing, construction, distribution and selected service industries will grow by 3% in 1986, compared with 8% in 1985. As in 1985, fixed investment is expected to show the strongest growth outside manufacturing, although this is largely because the volume of leasing by manufacturing companies is expected to fall by 15%; manufacturers' direct investment, on the other hand, is expected to grow by 6¼%. This latest survey is more optimistic than the previous survey, published at the end of last year, which projected a rise in fixed investment of 1% in 1986, including a small decline in total investment in the manufacturing sector.

The factors which contributed to the growth of manufacturing investment in 1984 and 1985 were the expansion of output and the associated increase in profits—the real rate of return on capital employed by non North Sea industrial and commercial companies (ICCs) rose to 8% last year, above the peak of the previous profits cycle in 1977–78. The strength of the stock market may also have had some effect on investment, as the market valuation of firms increased at a faster rate than the replacement cost of their capital stock, lowering the cost of capital. Finally, the phased reduction in capital allowances and corporation tax rates provided a fiscal climate that was conducive to investment. Some of these factors should continue to influence manufacturing investment this year, especially as profitability is expected to remain strong as inflation falls. The doubts relate to the strength of overall demand limiting the return on investment, the persistence of high real interest rates, and the extent to which investment expenditure has been brought forward to take advantage of the higher capital allowances which were available up to April this year.

Manufacturers' and distributors' stocks are estimated to have risen by £230 million (at 1980 prices) in the first quarter. The increase included a large rise in stocks at the wholesale level and a further rise in retailers' stocks, partially offset by a fall in manufacturers' stocks, suggesting that some of the increase in stocks may have been involuntary as sales weakened in January and February. Stock-output ratios in both the maufacturing and distribution and service sectors are estimated to have fallen in 1985, maintaining the downward trend that commenced in the late 1970s. The downward trend in the overall stock/output ratio is dominated by the shift in the composition of output from manufacturing, where stock/output ratios are higher, to services. But in the manufacturing sector the stock/output ratio rose in the first quarter, as the fall in production exceeded the rate of de-stocking.

Housing starts in the three months to April (seasonally adjusted) were 9% below those of the previous three months having been affected by unusually severe weather in February But private housing starts were 2% higher than a year earlier, when weather conditions were also unfavourable.

Following the steady increase in mortgage lending during 1985, loans for house purchase fell back to an annual rate of £18.8 billion in the first quarter. Building societies made net new mortgage advances of £16.4 billion, little changed from the previous quarter. Their sources of funds for lending were widened again in March when some societies made fixed-rate eurosterling issues—the first such issues by building societies to take advantage of the swaps market. Mortgage lending by banks declined to £2.4 billion in the first quarter, compared with the high levels seen in the second half of 1985. However, competition in the mortgage market is increasing. Other financial institutions such as insurance companies have announced their intention to become large-scale mortgage lenders. Several institutions specialising in mortgage lending and intending to create markets in mortgage-backed securities have also been established. Following the cuts in base rates during April, most building societies reduced their mortgage interest rates to 11% at the beginning of June, but borrowers are also being offered fixed and LIBOR-related mortgage rates by some banks.

The **visible trade deficit** *rose to over £1 billion in the first quarter*

The current account is provisionally estimated to have been £0.5 billion in surplus during the first quarter. The visible trade deficit rose to £1.4 billion, reflecting a large increase in the deficit on non-oil trade. The oil surplus increased modestly, as larger volumes of net crude oil exports outweighed the effects of lower prices. The price of traded oil has fallen steadily, and by April was around $13.3 per barrel, half that prevailing at the end of last year. As a result the oil surplus had fallen to £337 million by April.

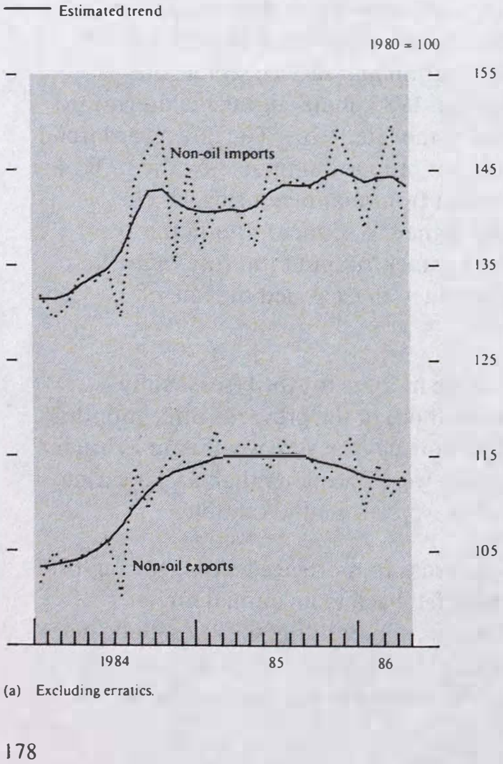
Trade in crude oil

Balance of payments basis: *seasonally adjusted*

	Exports			Imports		
	£ millions fob	Million tonnes	Average traded value $ per barrel	£ millions fob	Million tonnes	Average traded value $ per barrel
1983	10.1	68.3	29.9	3.2	22.8	28.5
1984	12.2	75.9	28.6	3.8	25.0	26.8
1985	12.9	79.0	28.3	4.2	26.1	27.5
1985 HI	7.4	41.6	28.2	2.3	13.4	27.1
1985 Q3	2.6	17.5	27.2	0.8	5.6	26.7
Q4	2.9	19.9	27.9	1.1	7.2	28.1
1986 QI	2.5	22.8	21.3	0.7	6.2	20.9
1986 Jan.	1.1	8.2	26.3	0.2	1.8	25.8
Feb.	0.9	8.2	19.9	0.2	2.2	19.3
Mar.	0.5	6.4	16.3	0.2	2.2	18.3
Apr.	0.5	6.8	13.3	0.2	2.2	13.9

Adverse movements in both volumes and the terms of trade were responsible for the rise in the non-oil trade deficit to £3.4 billion in the first quarter from £2.1 billion in the fourth. Much of the deterioration was reflected in a rise in the deficit on manufactures to £1.6 billion, although the deficit in March was unusually large. Having been little changed in 1985, the volume of exports of manufactured goods (excluding erratics) fell 4¼% between the fourth and first quarters. The volume of imports of manufactures (excluding erratics) rose strongly in February and March, although in the quarter as a whole it was 3¾% below that of the fourth quarter. After rising during 1985, the non-oil terms of trade fell by over ¾% in the first quarter.

The trend in **non-oil trade volumes**[(a)] *appears to have flattened recently*



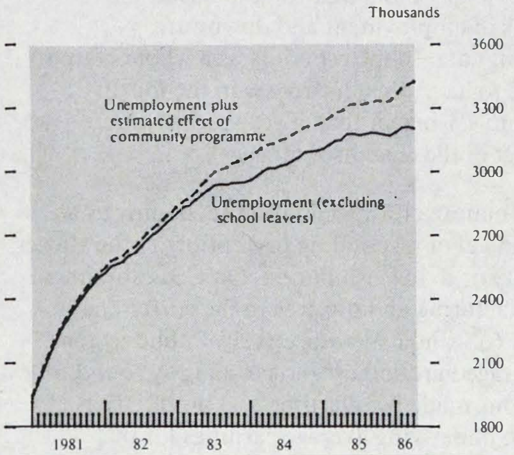
(a) Excluding erratics.

The April trade figures presented a more favourable picture as the visible trade deficit narrowed to £0.2 billion (from £1.2 billion in March), with a small surplus on manufactures. Manufacturing export volumes recovered the ground lost in the first quarter, and imports of both semi-finished and finished manufactures fell sharply. Estimates of the underlying trend of non-oil export volumes suggest that it may have flattened in recent months, having fallen steadily since the middle of 1985. Import volumes have fluctuated considerably in recent months, but the underlying level shows little change since last summer.

Unemployment *has risen since December . . .*

The weaker growth of output has been accompanied by a rise in unemployment since the end of last year. By May, unemployment (seasonally adjusted and excluding school leavers) had risen for six consecutive months, and the unemployment rate was 13.3%. Were it not for the continued

Unemployment *has continued to rise since the end of 1985*



Changes in employment in Great Britain

Thousands: *seasonally adjusted*

	Employees in employment: Total	*of which:* Female part-time workers	Full-time equivalent(a)	Self-employed persons(b)	Employed labour force
Level at March 1983	20,547	3,866	18,614	2,208	23,015
Quarter on quarter change					
1983 June	+ 27	+ 73	− 9	+ 13	+ 42
Sept.	+ 58	+ 70	+ 23	+ 69	+ 129
Dec.	+ 84	+ 72	+ 48	+ 69	+ 153
1984 Mar.	+ 29	+ 45	+ 6	+ 69	+ 99
June	+ 17	+ 34	—	+ 68	+ 85
Sept.	+ 47	+ 32	+ 31	+ 27	+ 76
Dec.	+ 105	+ 64	+ 73	+ 27	+ 132
1985 Mar.	+ 38	+ 35	+ 21	+ 27	+ 63
June	+ 33	+ 42	+ 12	+ 27	+ 61
Sept.	+ 19	+ 42	− 2	+ 31	+ 49
Dec.	+ 79	+ 32	+ 64	+ 30	+ 105
Level at December 1985	21,083	4,407	18,881	2,665	24,010

(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*.

beneficial impact of special employment measures, such as the Community Programme, the upward trend in unemployment would have been higher than the average monthly increase of 15,000 experienced over the last six months.

The employed labour force (defined as employees in employment, the self-employed and the armed forces) rose by 106,000, seasonally adjusted, in the fourth quarter of 1985, approximately twice the average increase recorded during the first three quarters of the year. As in recent quarters, the growth of the employed labour force is more than accounted for by the service industries and the continuation of an assumed quarterly increase of 30,000 in the numbers of self-employed (the average quarterly increase recorded between 1981 and 1984).

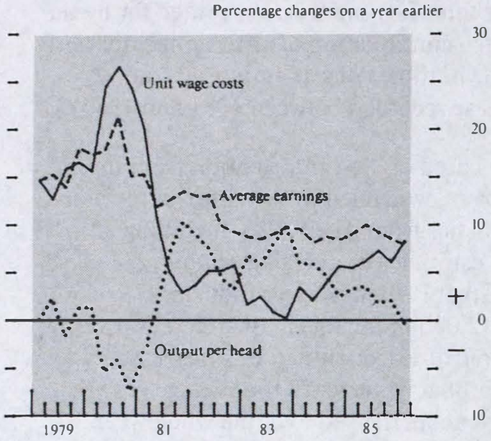
These latest figures are based on new information from the 1985 *Labour Force Survey*, which led to a number of revisions in the employment statistics from April 1983, including an upward revision to the estimates of overall growth in employment. Within Great Britain, service industry employment rose by 112,000 in the fourth quarter. However, there is probably a degree of seasonality in this figure, so the underlying increase is probably nearer to the average growth rate of 65,000 per quarter experienced over the whole year. Nevertheless, the number of employees in employment has continued to rise, with the growth of part-time employment in the service industries more than offsetting falls in employment in the production and construction industries. But after six months of relative stability in manufacturing employment, weaker growth of output may have contributed to the faster rate of decline in manufacturing employment, a trend which continued into the first quarter as employment fell by 36,000.

The growth in the employed labour force is dominated by the inflow of married women, principally into part-time service industry jobs. In the year to December 1985, the number of female employees in employment rose by over 158,000 (of which 151,000 were part-time), accounting for virtually all the increase in employees in employment over this period. The revisions show, however, that the contribution of males to employment levels in the past may have been underestimated. Rather than falling, the number of male employees in employment is now estimated to have remained broadly static over the past year. As a result, the full-time equivalent employees in employment series is now estimated to have shown a further increase throughout 1985. The latest available estimates of activity rates (the proportion of the population in or actively seeking work) suggest the labour force (defined as those employed and those unemployed who are actively seeking work) may grow by 440,000 between 1985 and 1988, two thirds of which is expected to come from increased female participation. Over the previous three year period the labour force grew by almost 600,000, most of which reflected population growth.

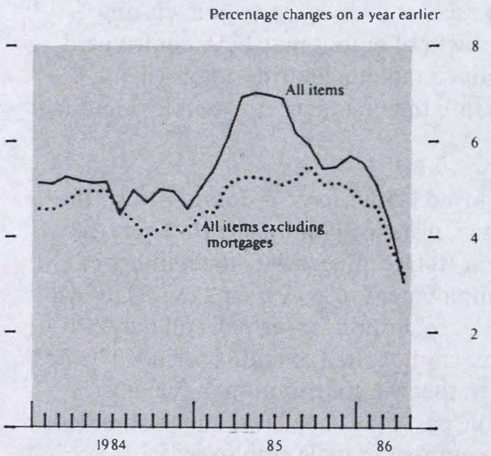
. . . and the growth of **productivity** *has slowed*

The growth of productivity has slowed in recent quarters, as is usual when the growth of output slows. The slowdown is most marked in the manufacturing sector where output per head

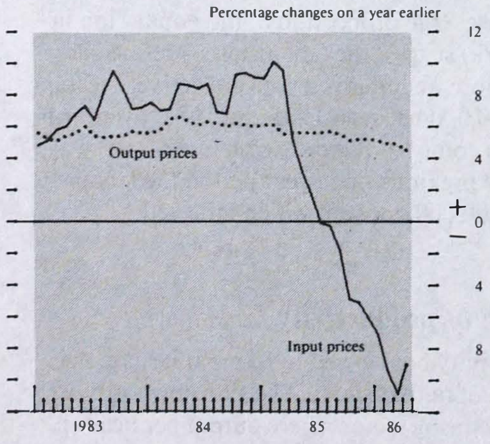
The growth of **productivity** *has slowed while* **unit wage costs** *have continued to rise*



The annual rate of inflation, as measured by the **retail price index,** *has fallen steadily this year*



Manufacturers input prices *have fallen sharply;* **output prices** *continue to rise, but at a slower rate*



appears to have peaked in the second quarter of last year, and fallen in succeeding quarters. In the first quarter of 1986 output per head fell by $\frac{3}{4}$% to a level $\frac{1}{4}$% below that of a year earlier. The slowdown in the growth of productivity is also more pronounced than previously thought, owing to upward revisions to estimates of employment and downward revisions to the output data. In the economy as a whole, output per head is estimated to have risen nearly $\frac{1}{4}$% in the fourth quarter to a level about 1% higher than a year earlier (after adjusting for the effect of the coal dispute).

Wage settlements, in manufacturing and in the economy as a whole, show little sign yet of responding perceptibly to the slower growth of productivity or to lower inflation. On CBI estimates, settlements in manufacturing and services in the current pay round have averaged $6\frac{1}{4}$% and $6\frac{3}{4}$% respectively. Public sector settlements have averaged around $6\frac{1}{2}$% so far this pay round. When the contributions made by overtime and productivity bonuses are included, underlying average earnings for the economy as a whole rose by $7\frac{1}{2}$% in the year to April, close to the increase in each of the past three years. The underlying annual increase in average earnings in manufacturing has edged down from $8\frac{3}{4}$% in the fourth quarter of 1985 to 8% in April, which probably reflects the reduction in manufacturing overtime. Thus real earnings (in relation to the RPI measure of inflation) are rising at between 4% and 5% a year.

The combination of slower growth in productivity and the still rapid increase in earnings has resulted in an acceleration of unit wage and salary costs within the manufacturing sector. In the first quarter, unit wage and salary costs are estimated to have been $8\frac{1}{4}$% above their level a year earlier, compared with a rise of 6% in the fourth quarter of last year. Much of this acceleration can be attributed to the fall in output per head, and to the extent that manufacturing output is expected to rise during the second half of the year probably overstates the current trend. Nevertheless the fast growth of wage costs remains a major concern. Although the growth in labour costs has slowed from the high rates of the early 1980s, the difference between the growth of UK and competitors' labour costs remains large. According to IMF estimates, normalised UK unit labour costs in manufacturing (after removing cyclical effects) rose about $7\frac{1}{2}$% in 1985, whereas the average increase in the major OECD economies as a whole was about 2%.

The rate of **inflation** *has slackened*

Retail price inflation in the year to May fell to $2\frac{3}{4}$% compared with 7% in the year to May 1985. Much of the reduction reflects lower petrol prices and falls in mortgage interest rates. The RPI includes the mortgage interest rate and is affected by changes in interest rates. Excluding mortgage rates, the twelve-month increase in the RPI fell to less than $3\frac{1}{4}$%, from $5\frac{1}{4}$% in May last year.

Manufacturers' input prices have fallen sharply and by May were $8\frac{1}{2}$% below their level a year earlier. Much of the decline in recent months is attributable to the fall in oil prices: by May, manufacturers' fuel costs were 11% below their level a year earlier. Despite the sharp fall in input prices, the fall in the twelve-month increase of manufacturers' output prices has been only gradual, from 5½% in mid-1985 to 4½% by May this year. One implication is that profit margins have widened. Bank estimates suggest that although unit labour costs rose during 1985, this increase was more than offset by declines in fuel and raw material prices, implying a substantial growth of manufacturers' margins throughout the year.

Lower oil prices are contributing directly to lower inflation in the United Kingdom as elsewhere. But they also affected sterling's effective exchange rate which fell at the end of last year in response to the expected decline in the value of net oil exports and an initial deterioration in the balance of trade. Bank estimates suggest that, from third quarter levels, for a given percentage fall in sterling oil prices a fall in sterling's effective rate of one quarter as much would leave retail price inflation unaffected. Sterling's effective rate has been very stable since March, a combination of a strengthening against the dollar and a slight fall against some other currencies. Compared with the level in the autumn of 1985, by early June sterling had fallen by less than 5%, as against a 60% fall in sterling spot oil prices, suggesting that inflation may be slightly lower than might have been expected.

Although the rise in the retail price index has fallen to low levels, there has been less of an improvement in the underlying rate of inflation. One measure of the latter is the GDP deflator which represents the price of domestic value added. The GDP deflator rose nearly 7% between the fourth quarters of 1984 and 1985, compared with 4% in the previous year. The acceleration reflected increases in both unit labour costs (about two thirds of total costs) and profits per unit of output. However, falls in import prices, mainly the result of sterling's appreciation and weak commodity prices, offset much of the acceleration, so that the deflator for total final expenditure rose just 4¼% in the year to the fourth quarter of 1985, compared with over 5½% in the previous year. The rise in the GDP deflator is officially forecast to fall to 3¾% in the financial year 1986–87 and will be greatly influenced over this period by changes in the oil price, which cannot be expected to continue to fall at the same rate. An alternative measure of underlying inflation, which is both timely and less influenced by changes in oil prices, is unit labour costs in the whole economy. In the fourth quarter of last year these costs were estimated at 5% above their level a year earlier, and are expected to rise by a similar amount in 1986 as a whole.

. . . although the growth of **liquidity** *remains strong . . .*

Although the growth of real GDP has slowed in recent quarters, some nominal magnitudes have maintained their faster growth. In the year to the fourth quarter of 1985, nominal GDP (at market prices) rose by 10½%, and total final expenditure by 6¾%. In addition, the relatively fast growth of liquidity in relation to nominal GNP, evident since 1980, has continued. The velocity of circulation of £M3 has continued to fall so far during 1986 (as has that of other broader aggregates, which fell in 1985, as in every year since 1980). The twelve-month rate of growth of the broad monetary aggregate, £M3, rose to 19½% in banking May—in excess of its new target range of 11%–15%. The growth of private sector liquidity, as measured by PSL2 (now redefined — see page 186) has also remained above that of money incomes, and by May its twelve-month growth rate was $14\frac{3}{4}\%$. But the growth of narrow money, M0, remains well within its 2%–6% target range.

The trend decline in velocity in recent years reflects a number of structural changes in the financial sector and the persistence of high real interest rates. These changes include the removal of official restraints on the growth of banks' business and the ending of building society rate-fixing arrangements, resulting in intensified competition. There has accordingly been a substantial improvement in the personal sector's access to credit markets, especially to sources of long-term finance such as mortgages. The personal sector's ratio of debt to income rose steadily until the end of last year and has probably continued to do so (see March 1986 *Bulletin* page 19). In 1985 as a whole the stock of personal sector borrowing rose by over £25 billion, compared with £21 billion in 1984. Mortgage borrowing accounted for over 70% of total personal sector borrowing and the banks increased their share of mortgage lending, especially in the second half of the year. Some—perhaps more than a third—of total mortgage borrowing represented a net cash withdrawal from the housing market, which may ultimately be used for purposes other than house purchase. On Bank estimates, this is a smaller proportion than in 1984. Bank borrowing for consumption also rose throughout the year, although its share in total borrowing (almost 12%) was little changed over 1984.

Personal sector income, expenditure and financial transactions

£ billions

	1984	1985			
		Year	H1(a)	Q3(a)	Q4(a)
Personal disposable income	220.9	237.9	233.5	239.8	244.7
Less consumers' expenditure	193.9	210.1	205.2	12.4	217.7
Saving	27.0	27.8	28.3	27.4	27.0
Less capital expenditure	14.8	17.3	16.3	16.4	20.1
Financial surplus	**12.2**	**10.5**	**11.6**	**11.2**	**7.6**
Acquisition of financial assets					
Building society shares and deposits	13.2	12.9	12.8	13.1	13.0
Bank deposits	3.3	5.2	6.0	4.2	4.5
National savings	3.2	2.5	2.8	2.7	1.9
Life assurance and pension funds	17.1	17.7	17.2	18.5	18.1
Other	–1.4	0.7	2.5	3.4	–6.2
Total	**35.4**	**39.0**	**41.3**	**41.9**	**31.3**
Borrowing					
For house purchase	17.0	18.4	16.3	19.9	21.1
of which:					
from banks	*2.3*	*4.1*	*2.7*	*6.8*	*4.2*
from building societies	*14.6*	*14.3*	*13.7*	*13.1*	*16.8*
Bank borrowing for consumption	2.6	3.0	2.8	3.2	3.3
Other bank borrowing	1.6	3.2	3.3	3.4	2.7
Other borrowing	–0.1	0.7	–0.5	—	3.7
Total	**21.1**	**25.3**	**21.9**	**26.5**	**30.8**
Net acquisition of financial assets	**14.3**	**13.7**	**19.4**	**15.4**	**0.5**
Balancing item	2.1	3.2	7.8	4.2	7.1

(a) Seasonally adjusted at annual rates.

In 1985 the personal sector increased its holdings of financial assets by £39 billion. The rate of increase slowed during the year as growth in building society shares and deposits and life assurance and pension funds was partly offset by slower growth of holdings of company and government securities (shown as 'other' in the table). But for the year as a whole the personal sector again acquired financial assets at a faster rate than it increased its borrowing, although the resulting net acquisition was less than in 1984.

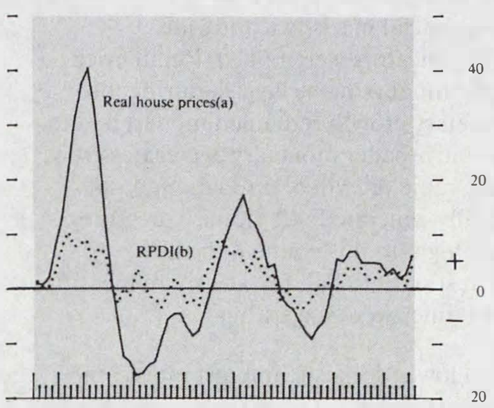
Industrial and commercial companies' gross liquidity has also risen in recent years, much of the increase being accompanied by a substantial rise in borrowing from banks. Bank borrowing by these companies amounted to £8.2 billion in 1985, compared with £7.2 billion in 1984. Data for the first quarter of this year show bank borrowing in the region of £3 billion, accompanied by a further increase in liquid assets. Part of the surge of bank borrowing in the first quarter may have been used to finance higher investment expenditure as companies brought forward investment into the first quarter, for the reasons outlined earlier. Overall, companies' net liquidity continued to improve, but remains below its levels in 1983–84.

Other financial institutions (OFIs) added £42 billion to their holdings of financial assets, of which some £7.4 billion took the form of bank deposits. But only about half of this increase in bank deposits can be attributed to any particular group of OFIs as there is a difference between what is reported as deposits received by the monetary sector and what the OFIs themselves report. However, this apparently large buildup of liquid funds may not reflect any major change in OFI behaviour. The rise in their bank deposits remains in line with the rapid growth of total OFI assets. As a percentage of their balance sheets, bank deposits have only risen from around 4¼% to 5½% during the past five years, and while this ratio did rise rather more rapidly during 1985 than in earlier years this reflects building society switching of liquid funds between gilts and bank deposits rather than a net buildup of liquidity: the societies accounted for nearly 40% of the rise in OFI bank deposits.

Much of the faster growth of liquidity is thought to reflect decisions by persons to increase their liquidity and credit on a permanent basis. Clearly the growth of liquidity on this scale could have inflationary implications if a significant portion were spent on goods and services or on assets overseas. But so far there is no evidence that this adjustment in response to the opportunities following liberalisation is complete or that the private sector has yet attained some 'desired' level of liquidity.

Changes in **real house prices** *have tended to follow changes in* **real personal disposable income**

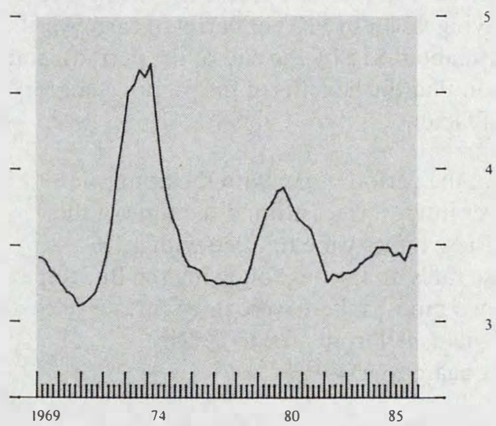
Percentage changes on a year earlier



(a) The Department of the Environment's mix-adjusted house price index, seasonally adjusted, relative to the consumers' expenditure deflator.
(b) Real personal disposable income.

The house price to annual earnings ratio[(a)] *has remained stable in recent quarters*

Ratio



(a) The ratio uses the Department of the Environment's mix-adjusted house price index, and the Department of Employment's index of whole economy average earnings.

. . . *and some* asset prices *have risen*

House prices have continued to rise. The twelve-month increase in the Department of the Environment's mix-adjusted index in the first quarter averaged 12.3%, with large and increasing regional variations in the rates of increase. An important factor determining the rate of increase in house prices tends to be the growth of real personal disposable incomes (RPDI): there was a clear link between the rapid growth of RPDI in 1972–73 and 1978–79 and the sharp rise in house prices in those years. Continued growth in RPDI is therefore likely to have contributed to the faster increase in house prices in the year to date. The increased availability of mortgage finance and the more recent fall in mortgage rates may also have played some part. The ratio of house prices to average earnings has, however, remained fairly stable in recent quarters.

Equity prices rose rapidly in the first quarter, and the FT 500 share index rose over 9% to a level 19% higher than a year earlier. The rise was sustained by the buoyancy of profits and the market confidence in UK economic prospects, especially following the fall in oil prices. A continuing high level of takeover activity may also have boosted equity prices. But the rise in prices was not maintained into the second quarter, as profit taking and some disappointing economic indicators contributed to a weaker market from mid-April.

The PSBR *in 1985/86 fell to a low level*

The public sector borrowing requirement (PSBR) for 1985/86 was just under £5.9 billion, almost £1 billion lower than estimated at the time of the 1986 Budget, and equivalent to only 1.6% of GDP. This was the smallest PSBR as a share of GDP for any financial year since the early 1970s.