Economic commentary

- *Slower economic growth among the industrial countries in early 1986 partly reflected a fall in exports, especially to oil producers.*
- *Growth should strengthen in the second half as consumers have yet to respond fully to the increase in their real incomes, brought about by the fall in inflation.*
- *The stance of policy in the major countries remains cautious. Some risks to growth remain, including the persistence of large current account imbalances and protectionist pressures.*
- *In the United Kingdom the growth of output remained weak in the first half of the year. The growth of employment slowed and unemployment increased.*
- *Consumer demand strengthened in the second quarter and is likely to be the main source of growth in the second half of the year.*
- *The strength of mortgage borrowing has contributed to a rise in the personal sector's ratio of debt to income.*
- *The United Kingdom's current account surplus was a little under £1 billion in the first half, as the oil surplus fell and the growth of manufactured exports remained weak. But the depreciation of sterling should improve competitiveness.*

Since September of last year the price of oil has fallen by half and the dollar's effective rate by a fifth, movements which should ultimately prove beneficial for the non-oil-producing sectors of the world economy. But the results so far have been mixed. Despite the fall in inflation and the continued growth of consumer spending among the major industrial economies, the growth of industrial production has been weak and that of GNP sluggish. These developments are partly a consequence of the fact that oil producers reacted more quickly than oil consumers to the fall in oil prices. In particular, consumers in the main industrial countries have yet to respond fully to the rise in their real incomes induced by the fall in inflation, nor have companies fully responded to improved profitability as a result of the fall in raw material costs. The fall in the dollar appears to have had little impact on the US trade balance, partly because of the initial J-curve effects, and large current account imbalances persist. Indications of low growth in the US economy during the second quarter contributed to the recent cuts in the US discount rate and lie behind the clear desire on the part of the US authorities for more rapid growth of domestic demand elsewhere, especially in Germany and Japan. More specifically, their concern is that unless demand for US exports increases, protectionist pressures in the United States could intensify.

Growth *has slowed in the industrial economies . . .*

There was a sharp deceleration in activity in the major economies[1] in the first quarter of 1986. The growth of GNP

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

GNP growth in the major economies

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

	1983	1984	1985			1986
			Year	H1	H2	Q1(b)
Canada	3.1	5.5	4.0	3.4	3.8	2.1
France	0.7	1.5	1.3	0.4	3.2	—
Germany	1.5	3.0	2.4	0.8	5.0	-4.2
Italy(a)	-0.2	2.8	2.3	2.5	1.4	6.3
Japan	3.2	5.0	4.5	4.5	4.2	-2.1
United Kingdom(a)	3.5	3.0	3.5	4.9	1.5	3.7
United States	3.6	6.4	2.7	2.5	3.2	3.8
Total	**2.7**	**4.7**	**2.9**	**2.6**	**3.4**	**1.4**

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

Components of GNP(a) growth in the major economies

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

	1984	1985			1986
		Year	H1	H2	Q1
Private consumption	3.1	3.0	3.2	3.6	3.5
Private fixed investment	8.5	6.2	4.5	8.4	-4.2
Public expenditure	2.6	3.0	1.0	6.2	-5.4
Stockbuilding(b)	1.1	-0.6	-0.3	-0.2	0.7
Domestic demand	**5.1**	**3.0**	**2.2**	**4.5**	**1.9**
Net trade(b)	-0.3	-0.1	0.4	-1.1	-0.5
GNP	**4.7**	**2.9**	**2.6**	**3.4**	**1.4**

(a) Or GDP.
(b) Contribution to growth as a percentage of GNP (or GDP).

slowed from 3½% at an annual rate in the second half of last year to 1½%. The slowdown was particularly pronounced in Germany and Japan, and was also evident in some of the smaller European economies. However, growth strengthened in the second quarter in Germany, France and Japan although in the United States GNP is estimated to have grown at an annual rate of only 0.6% in the second quarter after 3.8% in the first.

Industrial production in the major countries has been less buoyant than GDP, reflecting the weakness of manufacturing output, and rose by only ½% in the year to June. There was a sufficient increase in output from the service sector to reduce unemployment in the United States, Canada and Germany, but not in some other countries, including Japan and the United Kingdom, leaving the average standardised unemployment rate for the OECD as a whole at around 8%.

Much of the growth in GNP that occurred in the first quarter reflected a further rise in consumer spending, whereas business investment was weak in several major economies in the early months of 1986. In Japan a small increase in business investment followed large (though declining) increases in the three previous quarters. The apparent weakness of public expenditure in the first quarter mainly reflected cutbacks in farm support schemes in the United States, but public spending also fell in Germany and France. The contribution to growth of net trade was only a little less adverse than in the second half of last year. Japanese export volumes fell in the year to June and German export volumes fell in the year to May. Weak export performance in these two countries is thought to reflect lower import demand by oil producers, a loss in competitiveness outside North America following rapid exchange rate appreciation and, in the case of Japan, a cutback in the growth of imports by China. Import volumes in the major overseas economies are estimated to have risen by some 8% in the year to the first quarter.

. . . and **lower oil and commodity prices** *have necessitated adjustment by oil producers and developing countries*

The major oil exporters had already experienced a decline in the real value of their export revenues as the dollar depreciated after March 1985. The collapse in the free market price of oil from $28 per barrel in early December 1985 to below $10 per barrel this summer intensified financial pressures, although prices subsequently firmed following OPEC's agreement in early August to limit production to some 16.7 million barrels a day in both September and October. It is estimated that the OPEC countries reduced their import volumes by some 15% in 1985, and a sharper fall is expected this year. A number of oil exporters outside the OPEC group, such as Mexico, have also cut back their imports.

In contrast, developing countries which rely on imported oil benefit from lower oil prices, but the weakness of commodity prices has depressed the export revenues of several countries in this group.[1] In August the Economist all-items index of spot commodity prices was 14% lower than in December

(1) Further discussion of the diverse pressures and prospects facing the developing countries may be found in the note on page 355.

1985.[1] Food prices were particularly weak, falling by nearly 20% over this period. Worldwide agricultural overproduction may have been exacerbated by the attempts of indebted developing countries to increase export revenues by expanding production of cash crops, as well as by the agricultural support policies of many developed economies. Although sluggish activity in the industrial countries is partly responsible for depressing prices of many industrial raw materials, various structural factors are also thought to be at work.[2] Despite the lower dollar and the decline in US interest rates, many developing countries continue to face severe financial pressures. Import volumes of non-OPEC developing countries are estimated to have risen by about 4% last year and may grow even more slowly this year.

Growth *among industrial countries should increase in the second half*

The weakness in the growth of output in industrial economies in the first quarter appears to reflect the fast response of countries and sectors adversely affected by the fall in oil prices. There is some evidence that exports from the industrial countries to the oil exporting countries have fallen sharply; for example, exports from Germany to the OPEC countries in the first half of 1986 may be down by as much as 30% in deutschemark terms compared with the same period in 1985. Some of the weakness in investment, especially in the United States, is attributable to lower activity in the oil industry.

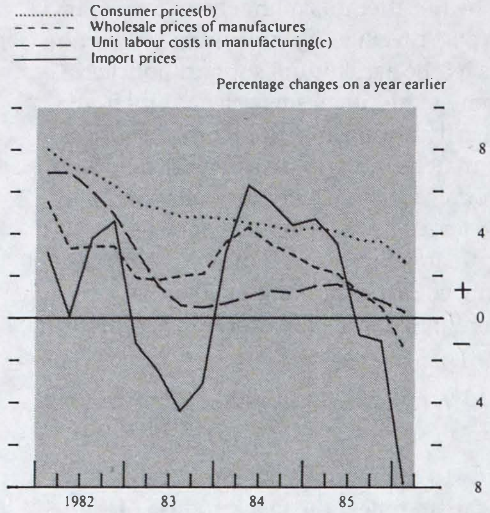
In many economies, the decline in consumer price inflation implies that real incomes have grown rapidly. There is, however, some evidence that consumer spending patterns have not yet fully responded. In the first quarter real personal disposable income in the major economies rose by over 5% at an annual rate, whereas consumer spending rose by only 3½%. Thus a significant part of the extra increase in real incomes appears to have been saved in the first instance. In Germany the saving ratio increased from 12.9% in the fourth quarter of 1985 to 14.1% in the first quarter of 1986; in the United States the ratio rose from 4.4% in the fourth quarter of 1985 to an estimated 5.1% in the second quarter of this year. However, the increase in saving ratios is not expected to be permanent, and the Bank's earlier forecast of GNP growth in the region of 3.0% in both 1986 and 1987 in the major industrial economies was based on the expectation of higher consumer spending in response to faster growth of real incomes.[3] Already there is some evidence of an increase in retail sales in the second quarter in France and Germany; a recovery in retail demand was also under way in Japan by March, and in the United States by June.

Inflation *in the major economies has fallen further*

Consumer prices in the major overseas economies were unchanged on average between the first and second quarters, reducing the rate of inflation in the twelve months to July to 1½%. These low rates of inflation are in part attributable to a combination of favourable external circumstances. In the first

(1) Commodity price figures are given in special drawing rights (SDRs) throughout. The weakness of the dollar in this period means that price increases in dollars were larger, and decreases smaller, than in SDRs.
(2) For a more detailed discussion see the June 1986 *Bulletin* page 172.
(3) The latest Bank forecast for the main industrialised economies is summarised on page 170 of the June 1986 *Bulletin*.

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



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

Manufacturing unit labour costs in the major economies

Percentage changes over same period a year earlier

	1983	1984	1985 Year	1985 H1	1985 H2	1986 Q1
Canada	0.9	−4.5	2.3	2.1	2.6	1.9
France	7.6	3.5	2.3	3.1	1.3	−0.7
Germany	−0.4	−1.0	0.4	−0.7	1.4	2.9
Italy	13.4	2.8	3.8	3.9	3.9	2.8
Japan	−2.2	−4.2	0.6	−0.8	2.0	2.1
United Kingdom	0.2	3.6	6.0	5.8	6.4	8.2
United States	−2.8	−1.3	1.6	1.5	1.7	0.2
Total	**—**	**−0.7**	**2.0**	**1.7**	**2.4**	**1.6**

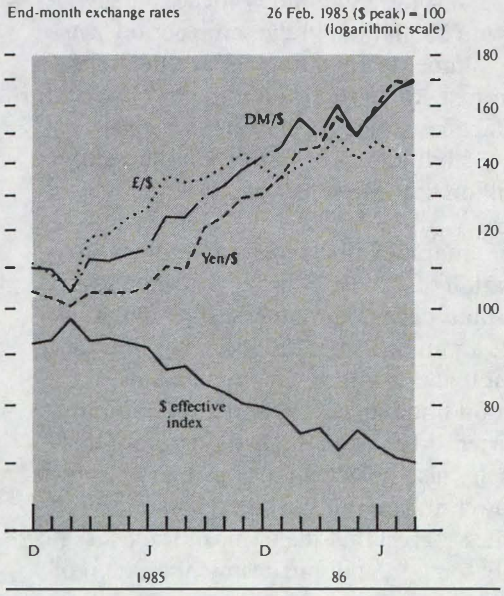
half of 1986 the fall in the prices of oil and many other primary products coincided with continued weakness in the US dollar. These factors resulted in a substantial reduction in import prices outside the United States. It is particularly striking that US wholesale (output) prices in July were still some 2½% lower than twelve months earlier, despite the effective depreciation of the dollar of over 20% in the same period.

There is some evidence of continuing wage moderation in several countries. This may reflect the low inflationary environment, and the anti-inflationary policy stance in many countries, although improved profitability may have led to some upward pressures on wages. Hourly earnings rose by only 2% at an annual rate in the United States in the three months to June, while in Italy a revision to the *scala mobile* mechanism for indexing wages also seems to have been associated with a reduction in wage inflation. However, the rise in whole economy earnings in Germany and Japan of 3% and 4¾% respectively in the year to the first quarter was above that in the year to the previous quarter. Manufacturing earnings in the major overseas economies have risen at an annual rate of nearly 5% in the first quarter of the year, well below the underlying increase in UK manufacturing earnings, which averaged 8¼% during the first quarter. The weakness of manufacturing output meanwhile resulted in a slower growth in productivity. Despite this, the increase in labour costs per unit of output in manufacturing in the major seven slowed from 2½% over a year earlier in the second half of last year to 1½% in the first quarter of 1986. In the United Kingdom, the corresponding figures were 6½% and 8¼%.

Fiscal policy *continues to be cautious . . .*

Among the major economies there has been little change in the stance of fiscal policy, which remains cautious with the general aim of reducing the size of central government deficits. In the United States slower growth has resulted in an upward revision to the official estimates of the budget deficit for the 1985/86 financial year to some $220–$230 billion. If the Gramm-Rudman-Hollings targets for reducing the size of the deficit in the financial year 1986/87 are to be met, some $20 billion of further cuts will be required, followed by more retrenchment the following year. The tax reform package recently agreed by the Joint Congressional Committee will, if enacted, reduce personal taxes and raise the tax burden of the corporate sector. Over a five-year period it is intended that the package should be revenue-neutral, although the changes may result in some $10 billion of additional revenue in the first year. In both Germany and Japan the authorities are holding to their intention to achieve further reductions in targeted fiscal imbalances as a proportion of GNP by 1990. The draft Federal budget in Germany implies only modest real expenditure growth over the next two years and Japan's budget guidelines for 1987/88 would increase discretionary central government spending by just 1% in nominal terms from this year's expected outturn. Although several smaller OECD countries have taken advantage of lower oil prices to raise energy taxes to consolidate their fiscal position, these have had little impact on the overall fiscal stance in the OECD.

The dollar *has fallen 30% since its peak in February 1985*



Official lending rates to market in the major overseas economies[(a)]

Percent per annum

Week beginning	United States (Discount rate)	Japan (Discount rate)	Germany (Discount/ Lombard rate)	France (First category paper(b))	Italy (Discount rate)	*United Kingdom (Base rates)*
1985						
16 Sept.	7.50	5.00	4.00/5.50	9.63	15.50	*11.5*
1986						
20 Jan.				8.75	15.00	*12.5*
3 Feb.		4.50				
10 Mar.	7.00	4.00	3.50	8.50		
24 Mar.				8.25	14.00	*11.5*
14 Apr.				7.75		*11.0*
21 Apr.	6.50	3.50				*10.5*
26 May				7.25	13.00	*10.0*
14 July	6.00			7.00	12.00	
25 Aug.	5.50					

(a) Official interest rates on selected dates. For the United Kingdom the level of base rates (not an official rate) is included as a memorandum item. US prime rates were two percentage points above the discount rate on the dates shown.

(b) Rate at which first category paper is purchased by the authorities.

. . . and the latest cuts in the US discount rate *were not followed elsewhere*

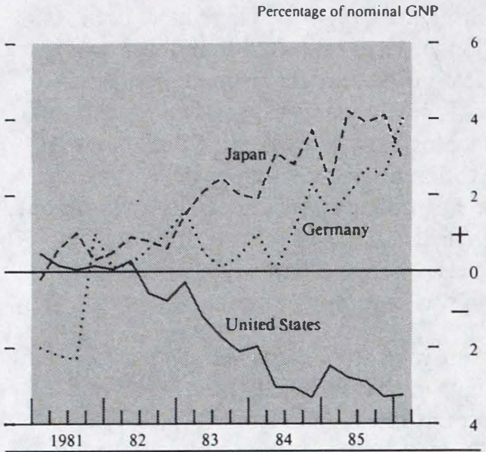
Short-term market interest rates moved lower in the United States during the second quarter, partly in response to weaker activity. By early September the rate on three-month Treasury bills had fallen to 5¼%. Market rates in France and Italy also fell during the second quarter, as a result of lower inflation and a reduction in exchange rate pressures following the April EMS realignment. However, short-term rates in Germany and Japan now seem to have stabilised at about 4½%. There have been diverse movements in longer-term rates in different centres. In the United States the yield on 10-year government bonds continued to drift down, to just under 7% by early September. There are, however, concerns that the weakening dollar and narrowing interest rate differentials may reduce the willingness of Japanese investors to buy dollar assets, especially government securities. Long rates have also fallen in France and Italy, but have tended to stabilise elsewhere, perhaps influenced by a perception that inflation was bottoming out.

The cuts in official lending rates to markets included a co-ordinated round of cuts in March. The United States and Japan also cut their discount rates in tandem in April. The Federal Reserve Board's decision to cut the discount rate again in both July and August (from 6½% to 5½%) appears to have been a response to slow economic growth. The cuts occurred during a period when the growth rates of the broader monetary aggregates were tending to rise, although they remained within their target bands, and the growth of M1 remained well above its target range. (The Federal Reserve has recently de-emphasised the M1 monetary target this year on the grounds that much of the growth in the interest-bearing component of this aggregate relates to liquid savings balances.) These recent cuts in the US discount rate have not yet been followed by other major countries. The freedom of the German authorities to reduce rates further may have been constrained by rapid growth in central bank money which in the year to July rose 7%—above the target range of 3½%–5½%—and by the position of the deutschemark in the EMS during the early summer. In Japan, rapid growth in liquidity has reportedly reinforced resistance to a further discount rate cut by the Bank of Japan. With inflation expectations thought to be relatively low, real interest rates, both in the short and long term, remain fairly high in most countries (see the note on real interest rates on page 359).

The dollar's continued fall *has so far had little impact on trade balances*

By the time of the Plaza agreement last September, the dollar's effective rate had fallen by around 10% from its peak during the first quarter of 1985. One of the main objectives of the agreement was to achieve some further orderly depreciation of the dollar. By early September this year the dollar had fallen by a further 20%, in part reflecting weaker US activity and lower US interest rates. The fall in the dollar against the yen and the deutschemark has been greater—the dollar is now some 29% lower against the yen than a year ago. But the dollar has remained fairly stable or even appreciated slightly against the currencies of other countries, including some of the newly industrialised countries in Asia.

Current account surpluses and deficits *have increased*



World trade and UK markets

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

	1984	1985 Year	H1	H2
Import volumes(a)				
Major seven(b)	12.8	5.5	4.6	5.6
of which:				
North America	23.1	8.1	7.8	9.8
Japan	11.0	0.1	− 1.4	1.1
Europe	6.9	4.8	3.7	4.6
Other OECD	7.0	7.0	6.4	5.9
Oil exporting countries	−8.6	−15.4	−16.3	−19.7
Other developing countries	7.1	3.8	2.1	− 4.1
Total	**8.9**	**3.6**	**2.5**	**2.8**
UK markets	**7.0**	**3.1**	**1.7**	**4.2**

(a) Imports of goods only.

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

These exchange rate movements have so far not been associated with any improvements in current account imbalances of the United States, Germany and Japan. In the United States the volume of exports fell by 3½% in the three months ended June compared with a year earlier, and import volumes were nearly 8% higher over the same period. The US trade deficit widened and in the first half of 1986 was provisionally estimated at some $84 billion (not seasonally adjusted), compared with $69 billion in the same period last year. In Japan export volumes fell by nearly 1½% in the three months ended June from a year earlier, and import volumes rose by 17%. But the Japanese trade surplus (not seasonally adjusted) widened to $38 billion in the first half of the year, compared with $23 billion in the first half of last year.

Some initial movement in trade imbalances was to be expected as a result of the operation of J-curve effects.[1] The increase in the Japanese trade surplus, despite the adverse movement in trade volumes, reflects an improvement in the terms of trade. Bank estimates suggest that this improvement may have increased Japan's non-oil trade surplus by some $10 billion between the third quarter of 1985 and the first quarter of this year, although the surplus also reflected lower primary product prices as well as the lower dollar. For the United States, however, Bank estimates suggest that the terms of trade loss may have amounted to only some $1½ billion, despite the extent of the fall in the dollar. In addition, many exporters to the US market have accepted substantial reductions in profit margins which had been inflated by the unsustainably high level of the dollar up to the first quarter of 1985.

Current account imbalances *persist*

The persistence of large external current account imbalances poses a continuing threat of volatility in financial markets if dollar assets become less attractive to investors. Furthermore, the US current account deficit and the large bilateral deficits with a few countries continue to generate pressures for increased protection of the US market. Given the likelihood of retaliation by other economies if such pressures prevailed, this could have a serious impact on world trade.

In addition, prospects for balanced growth continue to be clouded by the predicament of several heavily indebted developing countries (see the note on page 355). Some economies have achieved a considerable degree of adjustment, but there remains a risk that others may face further import retrenchment as a result of weak export prices. This may both limit the development process and constrain the export performance of industrial countries.

The prospects for inflation in the industrial countries are partly dependent on the future of oil prices. Despite OPEC's recent agreement to limit their oil production in September and October, the level at which oil prices will eventually stabilise remains uncertain. Although prices firmed immediately in response to the agreement, their current levels are not necessarily a good indication of prices over the medium term. If OPEC is

(1) The tendency of a country with a depreciating currency to experience an initial deterioration in its trade balance, owing to adverse terms of trade movements, before ultimately reaping the benefits of improved volume performance: the converse process applies to a country with an appreciating currency.

successful in withdrawing almost 4 mbd from the oil market, it could facilitate further quota negotiations and set the stage for a longer-term accord. Much depends on the willingness of OPEC members to adhere to individual production limits in the coming weeks. But it seems unlikely that oil prices will return in the medium term to their levels of $25–$30 per barrel a year ago.

At home, **output** *has remained subdued . . .*

In the United Kingdom GDP is provisionally estimated to have risen ½% between the first and second quarters, according to the output measure, to a level 1½% higher than a year earlier (after allowing for the effects of the coal dispute). The second quarter increase, which was slightly higher than that recorded in the first quarter, reflected the continued growth of output from the service sector, higher construction activity and a small increase in manufacturing output. North Sea output fell by 4% in the second quarter, partly because rig maintenance was carried out, and this was mainly responsible for the fall in industrial production during the quarter. If the fall in North Sea output is excluded, non-oil GDP is estimated to have risen by ¾% in the quarter to a level 1½% higher than a year ago (after allowing for the effects of the coal dispute). Although the slowdown in the growth of output is not in doubt, the series on manufacturing output has been subject to frequent revisions in recent months, and the alternative estimates of GDP continue to show differences in the rate of growth in the short run.

Manufacturing output, trade and employment

Percentage changes from second quarter 1985 to second quarter 1986

	1980 output weights	Output	Exports (a)	Imports (a)	Employ -ment
Metals and minerals	*90*	−1.8	6.9	6.9	−3.1
Chemicals and man-made fibres	*92*	−3.8	4.5	3.3	−0.6
Mechanical engineering	*144*	2.3	1.1	6.7	−1.1
Electrical engineering	*129*	−4.1	−7.6	−5.4	−0.4
Other engineering(b)	*168*	−5.6	1.3	−5.6	−1.8
Food, drink and tobacco	*135*	1.5	−2.5	7.1	−2.2
Textiles and clothing	*71*	1.9	−5.0	12.6	−2.3
Other	*171*	2.9	..	..	−0.6
Total	*1000*	**−1.0**	—(c)	**2.6**(c)	**−1.4**

.. not available.

(a) Data for trade volumes refer to the SITC breakdown whereas output and employment data refer to the SIC breakdown—the categories therefore do not correspond exactly.

(b) Includes metal goods not included elsewhere, motor vehicles and parts and other transport equipment.

(c) Totals for trade data exclude 'erratics'.

Manufacturing output rose slightly in the second quarter, following three consecutive quarterly declines, but remains 1% below its level a year earlier. The sectors that have been particularly weak within manufacturing are electrical engineering, chemicals, vehicles and metals, which have been affected by falls in export demand, combined in certain cases with lower domestic demand. Within electrical engineering, export sales have fallen sharply since the third quarter of last year and new orders for both home and export markets have fallen consistently since early last year; lower output of cars and commercial vehicles appears to reflect some reduction in domestic and export demand since the third quarter of 1985; the fall in output of chemicals, including organic chemicals and fertilisers, could be associated with the fall in oil prices as potential customers may have delayed purchases in anticipation of price reductions. By contrast, mechanical engineering has experienced an increase in sales since mid-1985. There has also been a modest growth in the output of textiles.

. . . but **consumer spending** *has strengthened . . .*

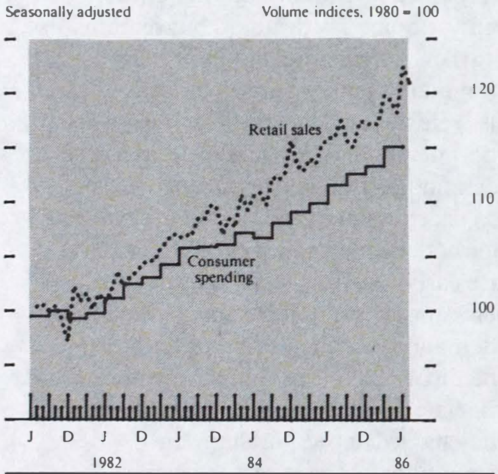
There is further evidence of a change in the composition of expenditure in recent quarters. In the first half of 1985 net exports and fixed investment made important contributions to growth, but investment faded thereafter and net exports made a negative contribution in the first quarter of 1986. Consumer spending has been the main source of growth this year, and is provisionally estimated to have strengthened in the second quarter to a level 4½% over that of a year earlier. In recent quarters initial estimates of consumer spending

Contributions to the growth of GDP

Changes in components (over the same period in previous year) as a percentage of GDP(E) at 1980 market prices; *seasonally adjusted*

	1984	1985				1986
	Year	Year	H1	Q3	Q4	Q1
Consumer spending	1.1	1.7	1.1	2.5	2.1	2.8
Government consumption	0.3	—	0.2	–0.2	–0.1	0.2
Gross fixed investment	1.2	0.2	0.4	–0.4	—	–0.5
Stockbuilding	–0.1	0.3	0.4	0.6	0.1	0.9
Domestic expenditure	**2.5**	**2.2**	**2.1**	**2.5**	**2.1**	**3.4**
Exports	2.0	1.8	2.6	1.3	0.5	–0.3
Imports	–2.5	–0.9	–1.7	–0.4	0.2	–0.2
GDP (E) (percentage change)	**2.0**	**3.1**	**3.0**	**3.4**	**2.8**	**2.9**
GDP (O) (percentage change)	*3.2*	*3.6*	*3.8*	*3.5*	*3.4*	*2.1*

Consumer spending and retail sales
strengthened in the second quarter



have tended to underestimate the growth rate. Recent revisions to the series show that consumption has increased by 4%–4½% per annum over each of the last four quarters. The retail sales index also points to reasonably strong growth in spending in the first half of this year. This growth continued into the second half as the volume of retail sales in the three months ended August was 4½% above its level a year earlier, according to provisional estimates.

Total personal income rose by 8½% in the year to the first quarter of 1986, slightly faster than in 1985 as a whole. In the year to the first quarter RPDI grew by 3½%, compared with an average annual growth rate close to 2½% in each of the previous three years. The indications for the second quarter are for continued strong growth as the underlying rate of increase of whole economy average earnings remained at 7½% per annum and the rate of inflation fell.

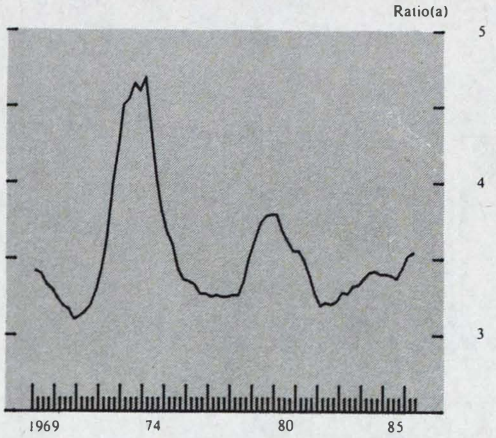
Fixed investment was affected by the final stage of phasing out of first-year capital allowances in April. As in 1985 this gave companies an incentive to bring forward capital spending into the first three months of the calendar year; but the resulting 4% rise in investment over the previous quarter among the manufacturing, construction, distribution and financial industries was less than occurred in the first quarter of last year. Capital spending in these industries in the second quarter fell back to the levels attained at the end of last year and was no higher in the first half of the year than the level attained in the first half of 1985. The growth of manufacturing investment could slacken in coming months, according to the most recent CBI quarterly industrial trends survey, completed in July. The latest DTI investment intentions survey suggests that manufacturing investment may rise by only 1¼% in 1986 over 1985, although investment in the manufacturing, distributive and service industries may increase by 3% over the same period. Non North Sea companies have experienced a steady increase in their real rates of return, which rose to 8½% in the first quarter, the highest level since 1973.

Stocks in the production and distribution industries increased by over £400 million (at 1980 prices) in the first quarter of 1986, following an increase of £700 million in 1985 as a whole. But there was a further fall in manufacturers' stocks, as well as a decline in stocks held by the energy sector. Provisional estimates show that after six months of heavy de-stocking, manufacturers' stocks were virtually unchanged in the second quarter. The small increase in production in the second quarter meant a further fall in the stock/output ratio to 90.5—the lowest since 1974. The CBI surveys suggest that stock levels are likely to continue to fall over the next few months.

. . . *and there has been a strong increase in* **mortgage lending . . .**

Private residential investment fell almost 5% in the first quarter, but was still nearly 4% higher than a year earlier. The fall was more than accounted for by reduced spending on home improvements, with investment in new dwellings nearly 5% higher than in the last quarter of 1985. Exceptionally adverse weather conditions reduced housing starts in the early part of the year, and there has been some recovery in recent months.

House prices *have risen faster than* **earnings**



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

Personal sector income, expenditure and financial transactions

£ billions

	1984	1985 Year	1985 Q3(a)	1985 Q4(a)	1986 Q1(a)
Personal disposable income	221.0	238.7	240.4	247.3	251.6
Less consumers' expenditure	194.2	210.2	212.3	218.0	221.1
Saving	26.8	28.5	28.1	29.3	29.5
Less capital expenditure	14.8	17.2	16.0	19.0	18.8
Financial surplus	**12.0**	**11.3**	**12.1**	**10.3**	**10.7**
Acquisition of financial assets					
Building society shares and deposits	13.2	12.9	13.1	13.0	16.8
Bank deposits	3.3	5.2	4.2	4.5	14.5
National savings	3.2	2.5	2.7	1.9	0.8
Life assurance and pension funds	17.2	18.1	19.2	18.6	15.8
Other	-1.0	0.8	3.6	-7.0	1.7
Total	**35.9**	**39.5**	**42.8**	**31.0**	**49.6**
Borrowing					
For house purchase	17.0	18.2	19.7	20.8	18.3
of which:					
from banks	*2.0*	*4.1*	*6.8*	*4.2*	*2.3*
from building societies	*14.6*	*14.3*	*13.1*	*16.8*	*16.4*
Bank borrowing for consumption	2.6	3.0	3.1	3.3	3.1
Other bank borrowing	2.6	2.9	3.3	2.7	1.4
Other borrowing	-0.9	1.3	0.1	4.6	0.7
Total	**21.3**	**25.4**	**26.2**	**31.4**	**23.5**
Net acquisition of financial assets	**14.6**	**14.1**	**16.6**	**-0.4**	**26.1**
Balancing item	2.6	2.8	4.5	-10.7	15.4

(a) Seasonally adjusted at annual rates.

The number of starts was 11% higher in the three months ended July than in the same period last year, with public sector starts continuing to fall and likely to account for less than a sixth of the total this year, compared with nearly half in 1977.

The recovery in starts is likely to continue given the signs of strong demand for housing and the strength of the growth of real income. In the first half of the year total mortgage lending (net of repayments and seasonally adjusted) rose to £10¾ billion according to provisional estimates, compared with £8¼ billion in the same period last year. There has been an exceptionally strong growth in new commitments by building societies, which were 50% higher than a year earlier, and grew by one third in the second quarter alone. Advances have also risen sharply in recent months, with the societies making net advances of £4¾ billion in the second quarter compared with £4 billion in the first. Provisional estimates suggest that bank mortgage lending increased in the second quarter, following a fall in the first. Nevertheless it appears that the building societies are maintaining their dominance of the housing market.

The increase in societies' net advances has not, however, been matched by a comparable increase in net retail inflows, which were almost £¾ billion lower in the second quarter than in the first. Although the societies made greater use of the wholesale markets, the increase in their mortgage lending was associated with a decline in their liquidity ratio to below 16% (not seasonally adjusted) at the end of the second quarter, compared with 18% at the end of last year.

House prices rose by 12.7% in the year to the end of the second quarter, compared with 12.3% at the end of the first, according to the Department of the Environment's mix-adjusted average index of prices based on completions. The rate of increase of house prices has exceeded that of nominal personal incomes, with the result that there has been a marked rise in the house price/earnings ratio, although it remains below the peaks of the 1970s. This surge in house prices is mainly due to the fast growth of real incomes, although lower nominal interest rates and the greater availability of mortgage finance, owing to competition between building societies, banks and other institutions, may also have played a part. The general effect of financial liberalisation in the housing market has meant that building societies no longer seek to ration customers by using mortgage queues, but rather seek to meet the demand for mortgage funds. This suggests that mortgage lending may have become more sensitive to changes in real incomes and interest rates in recent years.

. . . which accounts for much of the growth in **household sector debt**

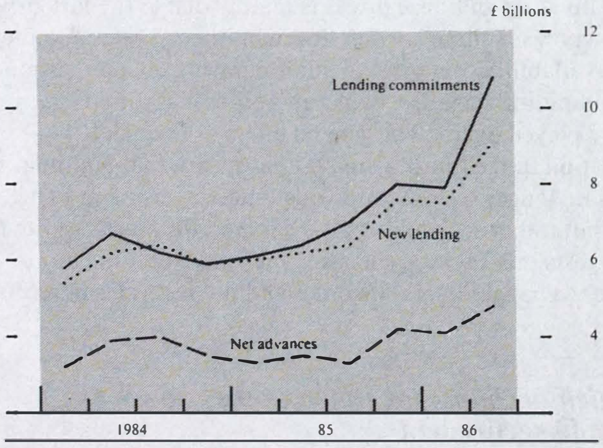
In 1985 the personal sector increased its stock of borrowing for house purchase by almost 17%, equivalent to a real rate of increase of more than 10%. The strength of mortgage borrowing has been an important factor in accounting for the rise in household sector debt. There was a further increase in borrowing by the personal sector in the first quarter of 1986—total net new borrowing rose to £23½ billion at an annual rate. This was however a smaller rate of increase than recorded in the fourth quarter when mortgage and other borrowing rose

Recent building society behaviour

The total stock of mortgages outstanding to building societies, banks and other institutions, which rose by 17% in 1985, increased at much the same rate in the first half of 1986 and has probably risen more rapidly in the third quarter. The building societies continue to hold the dominant share of mortgages outstanding at around 75% but their share of net advances (ie new lending less repayment of principal) has varied recently in the wake of promotional initiatives from the banks. In the second half of 1985, the banks took a 27% share of net mortgage advances after intense marketing efforts. Their net mortgage advances then fell in the first quarter of this year but increased to £1.2 billion (seasonally adjusted) in the second, compared with £4.8 billion by the societies.

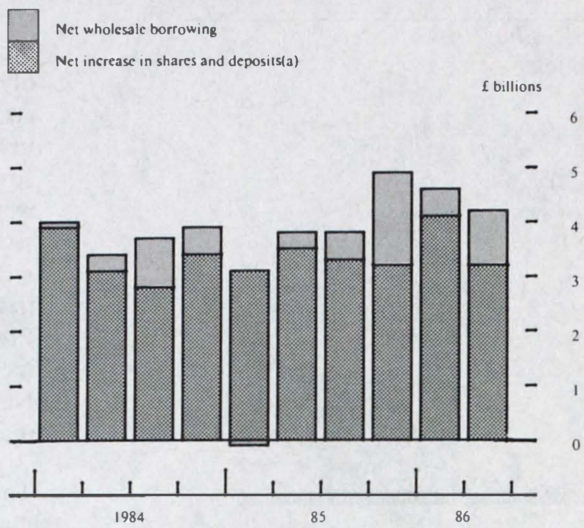
In recent months building societies' lending commitments have increased sharply, suggesting that higher new lending may still be in the pipeline, possibly with a two-to-three month lag. The relationship between lending commitments and new lending has remained fairly stable but, in recent years, new lending has not been a reliable indicator of net advances. For the societies, the ratio of net advances to new lending has been falling since 1984, and may be partly related to customers' refinancing with competitors. The ratio fell sharply in 1981 and 1982 and again in the third quarter of 1985 and the second quarter of 1986, all periods during which net mortgage advances by banks surged and the societies' share of net advances fell.

Chart 1
Building society mortgage lending



The building societies finance mortgage lending by retail and wholesale borrowing, or in the short run by drawing down liquid assets. Net inflows of principal into retail shares and deposits were lower in 1985 than in 1984, but the total increase in shares and deposits outstanding was sustained by the high interest rates paid. In addition societies have made greater use of

Chart 2
Building society funding



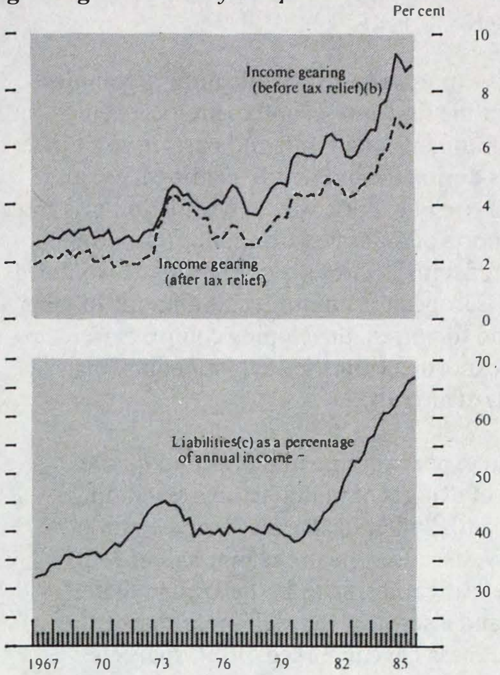
(a) Shares and deposits are seasonally adjusted.

wholesale borrowing, especially since the last quarter of 1985 when they made their first eurosterling issues. Their ability (particularly since 1983) to tap a variety of wholesale sources of funds has given societies greater flexibility in funding: there is some evidence that they make greatest use of the wholesale markets when retail inflows are subdued, but the pattern is not yet fully established.

The recent increase in societies' net advances has coincided with a fall in the rate of additions to shares and deposits outstanding which has not been fully matched by a rise in wholesale borrowing. Together with heavy tax payments, this caused the societies' liquidity ratio (not including holdings of other societies' CDs and not seasonally adjusted) to fall to 15.7% by the end of the second quarter of this year—its lowest level since 1974. The most recent fall in the liquidity ratio is an acceleration of a downward trend seen since early 1984, which may have been encouraged by the reduced net-of-tax return on societies' liquid assets relative to the rates earned on their mortgage lending. This may in part reflect a change in the tax treatment of societies' profits on gilts, which took effect in February 1984, and a movement in yields in favour of short-term bank deposits.

At the same time the pattern of societies' liquid asset holdings has changed, away from gilts and towards bank deposits. Between end-1984 and end-1985 the proportion of liquidity held in assets included in £M3 increased from 27% to 37% (though it had fallen back to 34% by mid-1986) and was an important influence on the growth of the £M3 aggregate, accounting for some of its faster growth in relation to PSL2.

Household sector[a] debt and income gearing *rose in the first quarter*



(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.

Growth of bank deposits and lending

£ billions: seasonally adjusted at quarterly rates; *figures for sterling only in italics*

	1984	1985 Year	1985 H2	1986 Q1	1986 Q2
Domestic deposits					
Personal sector	0.8	1.3	1.1	3.6	3.1
Companies	0.2	1.1	1.2	1.6	3.4
Other financial institutions	1.5	1.9	2.3	3.3	1.5
Public sector	0.2	0.2	0.3	0.3	1.5
Total deposits	**2.7**	**4.4**	**5.0**	**8.8**	**9.6**
	2.5	*3.8*	*4.4*	*8.0*	*7.1*
Domestic lending					
Personal sector	1.6	2.7	3.2	2.0	3.8
Companies(a)	1.8	2.0	2.1	2.0	−1.4
Other financial institutions	2.0	1.7	−0.3	5.2	5.5
Public sector	0.2	−0.4	1.5	−0.2	−0.9
Total lending	**5.6**	**6.0**	**6.4**	**9.0**	**7.0**
	4.3	*4.7*	*6.2*	*6.7*	*5.3*
Overseas sector: deposits net of lending					
Sterling	−0.1	0.5	−0.6	3.7	−3.2
Foreign currency	0.5	−1.4	−1.8	−0.2	0.6

(a) Including Issue Department transactions in commercial bills.

Current balance of payments

£ billions; balance of payments basis; *seasonally adjusted*

	Visible trade				Net invisibles	Current account
	Oil	Manufactures	Other	Visible balance		
1984	6.9	−3.9	−7.4	−4.4	5.6	**1.2**
1985	8.2	−3.0	−7.2	−2.1	5.7	**3.6**
1985 H1	4.4	−1.8	−4.0	−1.4	2.9	**1.5**
Q3	1.9	−0.7	−1.6	−0.4	1.9	**1.4**
Q4	1.9	−0.6	−1.6	−0.3	0.9	**0.6**
1986 Q1	1.9	−1.4	−2.0	−1.5	2.1	**0.6**
Q2	0.7	−0.6	−1.7	−1.6	2.0	**0.3**

strongly. Borrowing by the personal sector is expected to have risen further in the second quarter.

Bank lending to the personal sector rose strongly in the second quarter, maintaining the strength of recent quarters. Much of the increase reflected higher lending to unincorporated businesses, but mortgage lending and consumer credit also rose. Although the amount borrowed in the form of hire purchase and other instalment debt represents only a small proportion of the total borrowing of the personal sector, it continued to grow at an annual rate of some £3 billion in the first quarter. This highlights the sharp rate of increase of consumption-related borrowing—total consumer credit advanced to the personal sector increased from £22 billion at the end of 1984 to more than £26½ billion at the end of the first quarter of 1986. In addition, there is likely to have been some leakage of funds from the housing market, through equity extraction. This flow probably continued to rise in the first half of this year, although it is difficult to predict what proportion of net cash withdrawal may actually affect consumption.

The rise in the personal sector's stock of liabilities has been more than counterbalanced by the increase in its holdings of financial assets. In recent years the strength of the stock market has meant that the sector's holdings of equities and gilts through life assurance and pension funds has been the strongest growing component. But in 1986 bank deposits have grown rapidly, reflecting competitive rates on high-interest retail accounts, partly at the expense of building society retail inflows, (which helps to explain the high growth of £M3, both absolutely and in relation to growth of PSL2).

The strong growth in borrowing, especially for mortgages, has resulted in a steady rise in the ratio of the household sector's stock of gross liabilities to income since the early 1980s. By the first quarter of 1986 this ratio was close to two thirds. The rise in the debt/income ratio has meant that income gearing (the ratio of gross interest payments to household incomes) reached record levels in the first half of 1985, although some of the rise in this ratio reflects higher interest rates. Provisional estimates suggest that gearing remained high in the first quarter of 1986, with interest payments (before tax relief) accounting for nearly 9% of household income. Although the growth in household debt has been matched by a growth in financial assets, some mortgage borrowers who are already highly geared could face problems in servicing their debt if interest rates were to rise. Although the number of arrears and defaults on first mortgages remains low, it appears to be on an upward trend. The number of properties repossessed as a proportion of loans advanced by building societies rose from 0.17% in 1984 to 0.25% in 1985.

The **trade balance** *reflects a lower oil surplus and sluggish manufactured exports*

A further decline in oil prices and a reduction in the volume of net oil exports led to a fall of £1.2 billion in the oil surplus in the second quarter to a level less than a third of that recorded a year earlier. Nevertheless, the visible balance deteriorated only minimally as the non-oil balance benefited from a favourable movement in both the terms of trade and relative trade volumes.

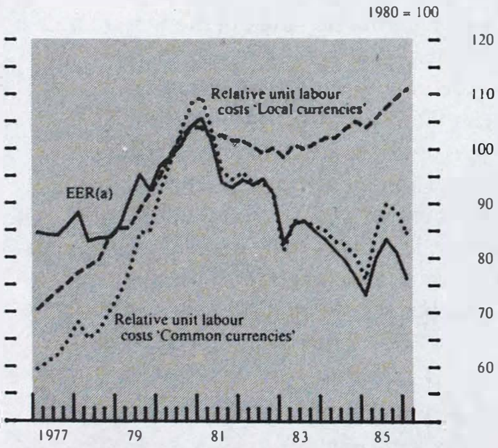
UK exports of manufactures

UK exports of manufactures to:	Share in total UK exports of manufactures in 1985 (per cent)	Percentage change in value 1986 H1 on 1985 H1
Developed countries	75	+ 1.3
of which:		
Western Europe	51	+ 3.8
North America	18	− 1.9
Other(a)	6	−10.2
Developing countries	22	− 7.1
	21(b)	−*10.1*(b)
of which:		
Oil exporters	10	− 4.5
	9(b)	−*13.7*(b)
Other developing countries	13	− 9.2
Centrally planned economies	2	+17.1
Total	100	− 0.3
Total excluding erratics	92	− 1.7

(a) Japan, Australia, New Zealand and South Africa.

(b) Figures in *italics* exclude exports to oil exporting countries of 'other transport equipment' (SITC 79) a category including, *inter alia*, aircraft.

Export competitiveness *improved following the fall in sterling from the fourth quarter of 1985*



(a) Weighted by 13 countries.

There was a small fall in the estimated balance on invisibles and the overall current surplus at £0.3 billion was somewhat below first quarter levels.

The volume of non-oil exports rose 6½% while import volumes fell marginally between the first and second quarters. There were, however, large shipments of aircraft and parts to some oil exporting countries during the quarter. Excluding these and other erratic items, the rise in exports was 3¼% while imports rose ½%. The volume of exports of manufactured goods (excluding erratics) rose by 4½%, reflecting a strong recovery of sales to the United States and the European Community. Shipments to other industrial countries and to non-oil developing countries were flat while those to oil-exporting countries fell (after allowing for exceptional exports of aircraft).

Despite the recovery in export volume in the second quarter, the volume and value of exports of manufactures (excluding erratics) have been essentially flat for the past eighteen months. The value of sales to Western Europe in the first half of 1986 was 3¾% higher than a year earlier; sales to the United States were only 1½% higher and elsewhere they fell more sharply. Particular areas of weakness have included OPEC markets (excluding aircraft), newly industrialising countries in the Far East and other developed countries.

The flatness of manufactured exports in the first half of 1986 may account for the less optimistic views expressed by UK exporters in the most recent CBI quarterly survey (which was, however, carried out before the depreciation of sterling in July and August). Although there was only a small rise in the volume of imports of manufactures in the second quarter, their composition pointed to both a revival in consumer expenditure and a slowdown in capital spending. Imports of consumer goods other than cars rose about 6% between the first and second quarters and were up more than 12% over a year earlier. In contrast, imports of capital goods were down 4% and 8¾% respectively.

The ability of UK producers to increase exports continues to be hampered by poor cost performance. In terms of local currencies, UK unit labour costs in manufacturing have continued to rise much faster than those of competitors. However, after taking into account sterling's depreciation since last autumn, the United Kingdom's relative unit labour costs resumed the fall that began around 1981, and in the first quarter were 7¾% below the temporary peak reached in the third quarter of last year. The further fall in sterling's effective rate since the first quarter should result in some additional improvement in competitiveness, at least in the short run.

Although the balance on invisibles fell in the second quarter, it included an increase in the balance on services, as the recovery in the surplus on civil aviation and increased earnings from financial services offset a deterioration in earnings on the travel account. There was a small increase in the surplus on interest, profits and dividends, but a larger deficit on transfers. In the first half of the year, the surplus on invisibles amounted to £4 billion compared with a surplus of £2.9 billion in the first half of last year.

Weak output growth has been reflected in the **labour market . . .**

Unemployment (seasonally adjusted and excluding school leavers) rose in July by 4,000, the eighth consecutive monthly increase, to reach 11.7% of the working population using the new base for the calculation (unemployment as a percentage of unemployed plus employees in employment, armed forces and the self-employed), or 13.1% on the earlier narrower definition (unemployment as a percentage of the unemployed and employees in employment alone). Unemployment has increased by an average of 13,000 a month since the end of last year, the sharpest upward trend since early 1983. The aggregates conceal marked regional differences: for example, the unemployment rate in the South East (8.6%), is less than half that in Northern Ireland. The number of unfilled vacancies reported to Job Centres is continuing to rise slowly. Simultaneous increases in unemployment and vacancies would seem to indicate mismatches between the skills available and those required. The July figures for recorded vacancies, excluding the Community Programme, show that the South East accounts for over a third of vacancies in Great Britain, but only about a quarter of those unemployed.

The employed labour force in Great Britain rose by 29,000 in the first quarter. Although employment has now increased for twelve successive quarters, the first quarter rise was the smallest since early 1983. The slowdown reflected a large fall in manufacturing employment of some 36,000. Service employment rose by 55,000 and self-employment is estimated to have grown by 31,000, on the assumption that the average rate of increase observed between the 1981 and 1985 labour force surveys has continued subsequently. Although the number of female part-time workers rose during the first quarter, it was insufficient to offset the fall in those in full-time employment, with the result that the number of employees in employment fell for the first time in three years. In the second quarter there was a further large fall in manufacturing employment. The number of hours of overtime worked has continued to decline slowly from the peak of June last year, and the number of hours lost through short-time working in June has hardly changed compared with a year earlier.

The growth of labour productivity remains sluggish. Output per head in manufacturing in the second quarter was little different from that of a year earlier and in the economy as a whole it rose by 1.1% in the year to the first quarter of 1986. Much of the slowdown in productivity may be cyclical in character, having coincided with the slowdown in output since mid-1985.

. . . but **pay** *continues to rise faster than* **productivity**

Wage settlements remain well above the rate of inflation and the growth of productivity, despite the continued rise in unemployment. The CBI estimates that settlements in manufacturing have averaged 6.2% in the past twelve months, little changed from the increases recorded in the previous year. Within the services sector, the rate of settlements was estimated at 6.6% in the year to the second quarter. The apparent stickiness of wage settlements, despite the fall in the rate of inflation, may

Changes in employment in Great Britain

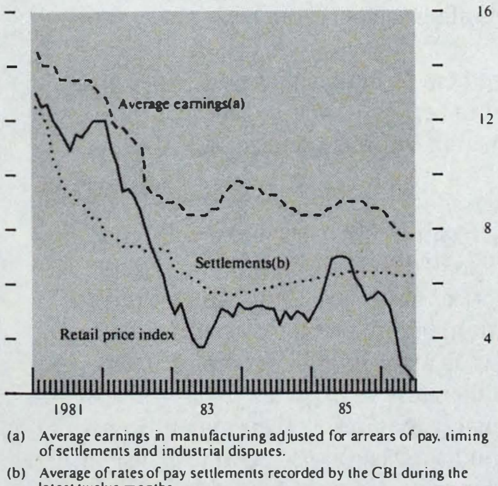
Thousands; *seasonally adjusted*

	Employees in employment: Total	*of which:* Female part-time workers	Full-time equivalent (a)	Self-employed (b)	Employed labour force
Level at March 1983	20,545	3,866	18,614	2,147	23,015
Quarter on quarter change					
1983 June	+30	+74	− 7	+13	+ 44
Sept.	+62	+69	+27	+69	+134
Dec.	+75	+73	+38	+69	+144
1984 Mar.	+31	+43	+10	+69	+101
June	+20	+36	+ 2	+68	+ 89
Sept.	+51	+32	+35	+27	+ 80
Dec.	+93	+63	+61	+27	+119
1985 Mar.	+44	+35	+26	+27	+ 69
June.	+37	+44	+15	+27	+ 64
Sept.	+18	+41	− 2	+31	+ 48
Dec.	+73	+35	+57	+30	+101
1986 Mar.	− 2	+47	−25	+31	+ 29
Level at March 1986	21,077	4,458	18,851	2,635	24,035

(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*.

Pay settlements *remain above the* **rate of inflation**

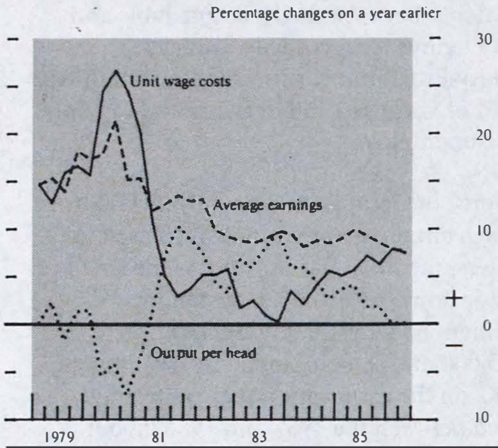


(a) Average earnings in manufacturing adjusted for arrears of pay, timing of settlements and industrial disputes.

(b) Average of rates of pay settlements recorded by the CBI during the latest twelve months.

be partly because those settlements completed earlier in the year reflected higher rates of inflation. In addition, buoyant profits may also have enabled firms to afford pay rises in excess of productivity growth. Underlying average earnings for the economy as a whole rose by 7½% in the year to June—virtually unchanged from the previous two years. In manufacturing, the underlying annual increase in average earnings edged down to 7¾% in June from a peak of 9% in the third quarter of 1985, a decline which mainly reflects the fall in overtime working. The growth of public sector earnings may have firmed following recent pay awards. With the retail price index currently around 2½% above its level a year ago, real average earnings in the economy have grown by 4%–5% during the last twelve months.

Unit wage costs, average earnings and productivity in manufacturing



In manufacturing, wage costs per unit of output rose by 7½% in the year to the second quarter, compared with over 7¾% in the year to the first. For the economy as a whole unit labour costs rose by 6¾% in the year to the first quarter. However, these initial estimates of unit labour costs are subject to revision, partly reflecting the revisions to the manufacturing output series.

The rate of **inflation** *has continued to fall*

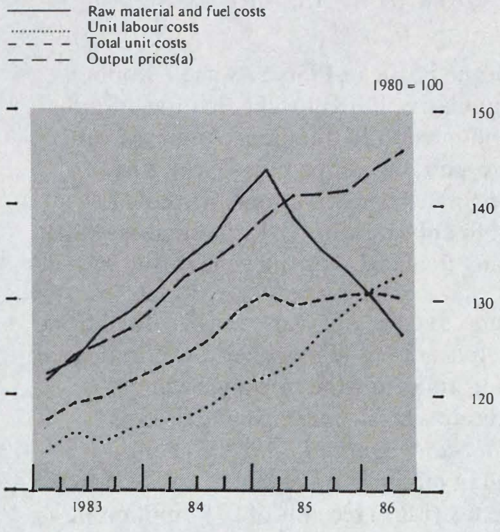
Retail price inflation fell to 2.4% in the year to August, compared with its most recent peak of 7% in May last year. Much of the deceleration reflects lower petrol prices and mortgage interest rates. Excluding the mortgage interest element, the twelve-month increase in the RPI fell from 5.3% in May of 1985 to 3.3% in August this year. On the RPI measure, inflation is at its lowest since November 1967, although it remains higher than in a number of other industrial countries. The immediate prospects are for a continuation of low inflation.

Inflation has been, and will continue to be, affected by movements in oil prices and the exchange rate. Bank estimates suggest that, for a given percentage fall in sterling oil prices from a given date, a fall in sterling's effective rate of one quarter as much would leave retail price inflation unaffected after about three years. During much of 1986 sterling was comparatively resilient in the face of the steep fall in oil prices. The weakness of sterling since July has, however, contributed to a 13% fall in the ERI since the third quarter of 1985 as against a 50% fall in sterling oil prices—a combination which, if it persists, should result in little change in inflation compared with what would have been expected if there had been no change in oil prices nor the associated movement in the exchange rate since last autumn. (The relationship between oil prices and the exchange rate is examined in the note on page 331.)

In the year to August manufacturers' domestic selling prices rose by 4¼%, while falls in commodity and fuel prices resulted in a decline in input prices of 9¾%. Thus in recent quarters manufacturing output prices have increased relative to costs, implying widening profit margins. The steady rise in margins is in one sense surprising as many companies report strong competition and might therefore be expected to pass on cost reductions relatively quickly to improve their market stance. Some price cutting might have been expected in response to this, but so far most companies appear to have taken advantage of the fall in input prices to increase margins, even at the expense of market share.

Profits of non North Sea companies *have risen strongly*

Manufacturers' profit margins *continue to widen*



(a) Weighted average of home (65%) and export (35%) prices.

Company profitability in the non North Sea sector has consequently benefited from falling costs over the last year. In the first quarter of 1986 non North Sea ICCs' profits (net of stock appreciation) were some 16% higher than a year earlier, helping to increase the pre-tax rate of return to 8½%. However, the slower growth of output, especially in the manufacturing sector, may now result in weaker growth of profits. Even if there is a pick-up in output growth in the second half of the year, steadier input costs and the possibility of slower rises in output prices suggest that profits may henceforth grow at a slower rate than in recent quarters.

The prospect of weaker profits, continued high real rates of interest, and companies' concern over the strength of demand, as reported in successive CBI surveys, suggest a less attractive climate for investment than for some time. The incentives for companies to invest may also have been significantly influenced by the 1984 Budget. This will have provided incentives to reschedule investment expenditures so as to be able to claim allowances before they were phased out. Whether there is a longer-term effect on the overall level of investment is less clear, although for tax-paying firms it is likely that the cost of capital has risen as a result of the abolition of the first-year allowance.

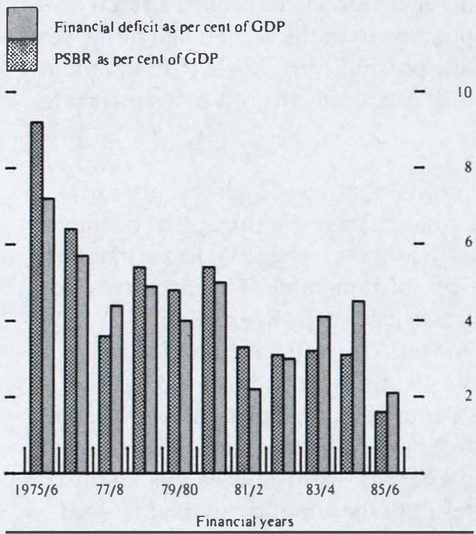
New bank borrowing by industrial and commercial companies rose by almost £3 billion in the first quarter, although it fell back in the second. The strength of borrowing in the first quarter was partly associated with the surge in capital spending as firms brought forward investment before first-year capital allowances were phased out. Borrowing was slightly lower than in the corresponding quarter of 1985 when there was a larger surge in investment spending and more was financed by way of leasing. For the company sector as a whole there was a sharp fall in the financial surplus in the first quarter, reflecting higher capital spending and a fall in undistributed income. Despite this, companies continued to build up their liquid assets, including bank deposits. The combination of a fall in bank borrowing and a rise in the accumulation of liquid assets between the first and second quarters has been accompanied by an increase in capital issues (amounting to about £1 billion) over this period. It is too soon to tell whether this reflects a shift in the perceived attractiveness of equity finance relative to debt finance in the wake of the changes in company tax rates which, for tax-paying companies, have reduced the relative advantages of using bank borrowing to finance expenditure.

The growth of broad money *continues to exceed that of nominal GDP*

Although the twelve-month growth of nominal GNP slowed from 10½% at the end of last year to 8½% by the first quarter of 1986, that of £M3 rose faster, and increased to 18½% in the second quarter, well above its new target range of 11%–15%. Thus the velocity of circulation of £M3, which fell by 2% last year, fell by over 7% in the first half of 1986. These trends are also reflected in movements of private sector liquidity, as measured by PSL2. By contrast the twelve-month growth rate of M0 has been relatively stable at around 3%–3½%, well within the 2%–6% target band set for 1986/87. These developments are considered in more detail in 'Operation of monetary policy' on page 333.

The **PSBR** *has benefited from the buoyancy of non-oil revenues*

Both the **PSBR** *and the* **financial deficit** *have fallen as a proportion of GDP*



The Budget forecast for the PSBR in 1986/87 was £7.1 billion, or 1¾% of GDP. The cumulative PSBR for the first five months of the financial year amounted to £3.8 billion, compared with £4.3 billion for the corresponding period of last year. The outturn for the 1985/86 financial year was unexpectedly low at £5.8 billion, equivalent to only 1.6% of GDP, the smallest PSBR as a share of GDP for any financial year since the early 1970s.

The public sector's finances so far this year have benefited from continued buoyant receipts of non-oil revenues. Corporation tax receipts have been strong, reflecting the recent growth of company profits, and receipts of income tax have risen as forecast in the *Financial Statement and Budget Report.* But the full effects of the fall in oil prices on revenues have yet to be felt. Petroleum revenue tax (PRT) receipts of £714 million in March reflected only the fall in sterling oil prices that occurred up to the end of 1985. The further sharp fall in the oil price since then will not affect PRT receipts until September, when a refund is expected, in contrast to receipts of £1½ billion in September 1985. Total supply expenditure in the five months to August was 2¾% higher than in the same period a year earlier.

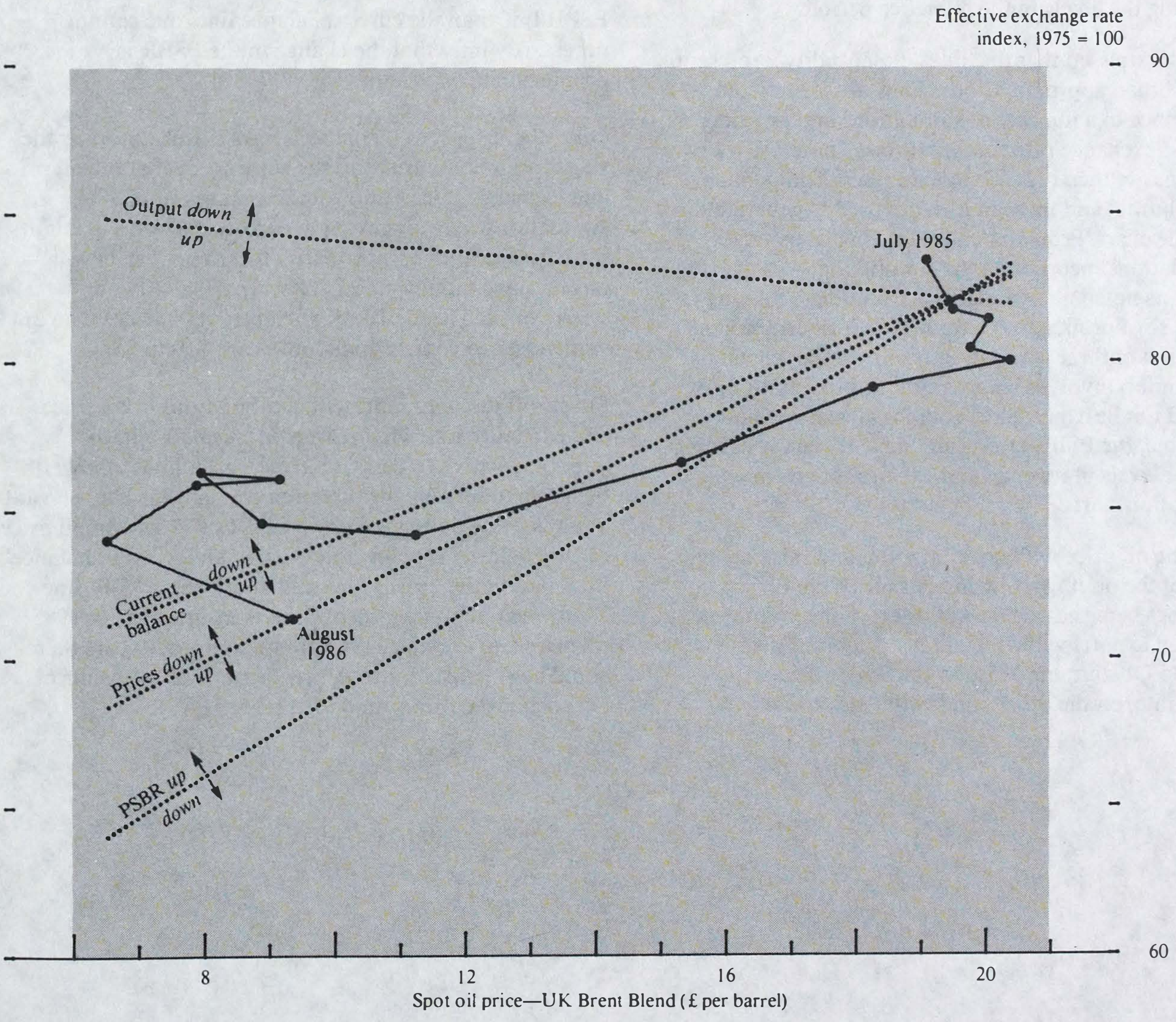
The fall in the proportion of the PSBR to GDP in recent years also reflects the increase in receipts from privatisation. These receipts, which are counted as negative expenditure, were estimated at £2¾ billion in 1985/86 and have led to a PSBR lower than the public sector financial deficit in recent years. Nonetheless even excluding privatisation receipts, the PSBR as a proportion of GDP was some 2¼% in 1985/86, well below the level of most previous years.

The impact of changing oil prices

Over the past year the price of crude oil has changed considerably. The Brent spot price, for example, fell from over $30 per barrel in November of last year to below $9 per barrel in July. Although it has recovered in the past month, it remains around 50% lower than in the third quarter of 1985. Furthermore, in the last year sterling has strengthened against the dollar, accentuating the fall in sterling oil prices. As the United Kingdom is currently a net exporter of oil, its real national disposable income (gross national product adjusted for changes in the terms of trade) would, other things being equal, fall as a consequence of the deterioration in its terms of trade. However, the economy might benefit from any eventual stimulus to exports or domestic demand and from the beneficial impact of lower oil prices on inflation.

The effects of the fall in oil prices are, however, complicated by movements in the UK exchange rate. This note attempts to assess the potential macroeconomic impact of the particular combinations of oil price and exchange rate changes that have actually been observed. It uses a number of simulations performed on the Bank's quarterly model of the economy. The simulations are similar to those described in a Treasury working paper on the impact of lower oil prices:[1] they were the basis of some of the Bank's earlier analysis of oil price changes.[2] There are a number of simplifying assumptions: *wages and interest rates, for example, are assumed not to react; tax rates and other instruments of fiscal policy are also assumed to remain invariant to changes in the oil price and the exchange rate.* The results do not represent

The sterling oil price and the exchange rate



(1) 'The Economic Effects of Lower Oil Prices', G Horton and S Powell, April 1985, GES Working Paper No 76.
(2) See for example the March 1986 *Bulletin*, page 25.

the exact outcome of any oil price change: rather they provide an indication of some of the pressures any such change might generate.

The reference period from which the changes are measured is also somewhat arbitrary. The third quarter of 1985 was chosen—a period when the oil price had reached something of a plateau and the effective exchange rate had fallen from temporarily higher levels.

The simulations focus on four key variables: output, the current account of the balance of payments, prices and the PSBR. The results are summarised in the chart. The solid line plots the actual levels of the oil price and the effective exchange rate since the third quarter of 1985 (monthly averages); the four broken lines each correspond to one of the four variables of interest, and may be regarded as lines of 'neutrality'. They are 'neutral' in the sense that they show those combinations of the effective exchange rate and the oil price (in sterling) which imply no change (over a three-year horizon) in the prospects for the relevant variable relative to those implied by the effective exchange rate and oil price remaining unchanged at the third quarter 1985 levels. The lines thus intersect at a point representing the levels in the reference period.

It should be stressed that the 'lines of neutrality' represent only very broad approximations. They are formulated with reference to a number of simulations and a variety of oil price/exchange rate combinations. These simulations are then reduced to a number of convenient 'rules-of-thumb' and these in turn are used to generate the lines on the chart. Problems can arise at various stages. The simulations incorporate the simplifying assumptions noted above, together with others relating to the response of profits, world trade etc. Furthermore, the transcription of these simulation results to the relevant rules-of-thumb involves considerable approximation and would not be expected to hold for all starting points. For example, the PSBR effects are likely to vary according to the base levels of revenue and expenditure from which the simulation starts.

A fall in the oil price will lower inflation and raise the real incomes of the oil importing industrialised countries. Other things being equal, world trade and the volume of UK non-oil exports will rise, thereby providing a stimulus to UK output. A rise in sterling's effective exchange rate, on the other hand, will tend to worsen competitiveness, counteracting the increase in output. Hence the 'output' line slopes downward from left to right.

A fall in the oil price will depress the external oil balance. A fall in the exchange rate boosts competitiveness and net non-oil exports while at the same time raising the sterling value of UK net overseas investment income. Hence the 'current balance' line slopes up from left to right.

The 'prices' and 'PSBR' lines also slope upwards from left to right. A fall in the oil price will reduce UK prices. This fall in the price level may be offset by a fall in the exchange rate which will raise the sterling price of internationally tradable goods and services. A fall in oil prices (and hence a reduction in oil tax revenues) will increase the PSBR. Other things being equal, a depreciation of the exchange rate will stimulate higher non-oil direct and indirect tax revenues through higher non-oil output and prices.

The slopes of each of the lines reflect the relative strength of the impact of oil prices and the exchange rate on the variable in question. However, one cannot deduce the absolute strength of any change from the chart. In particular, if, for example, a point is further from the PSBR line than the current balance line, one cannot necessarily infer that the change to the PSBR is proportionately greater.

One other aspect of the neutral lines is worth noting: the slopes are not invariant to the starting level of the oil price and exchange rate. Although the changes in the simulations were expressed in percentage terms, a fall in the oil price from \$30 per barrel to \$15 per barrel will have a substantially greater effect (particularly on variables such as the PSBR and current balance) than an equivalent percentage reduction from \$10 to \$5.

Points off the lines represent combinations of oil price and exchange rate which imply some change in the variable relative to the base. Hence each line is flanked by labels indicating the direction of change in the relevant variable. The point given by an EER of 71 and an oil price of £9 per barrel is below the 'output' and 'current balance' lines but on the 'prices' line and above the 'PSBR' line. Thus, relative to the prospects at the third quarter 1985 oil price and exchange rate, after about three years there could be (1) higher output; (2) a better current balance; (3) unchanged prices; and (4) a higher PSBR.