Economic commentary

- *Economic growth among the industrial countries rose in the second quarter, led by consumer spending.*
- *Consumer price inflation remains at a low level; the prospects are for a period of steady growth combined with low inflation.*
- *The stance of policy in the major countries remain cautious, although in Japan the discount rate was lowered to 3% at the end of October.*
- *Current account imbalances persist. US trade flows have been slow to respond to the fall in the dollar; the trade surpluses (in dollar terms) of Japan and Germany have widened, reflecting gains in their terms of trade.*
- *In the United Kingdom the growth of output strengthened in the third quarter.*
- *Consumer demand has continued to grow strongly, reflecting the growth of real incomes.*
- *The visible trade deficit widened in the third quarter, as the volume of non-oil imports rose. Sterling weakened and base rates were raised to 11% in October.*
- *The growth of unit wage costs in manufacturing slowed in the third quarter as productivity rose. But there was little change in the growth of underlying earnings.*
- *The Chancellor reaffirmed the PSBR forecast for both fiscal 1986/87 and 1987/88 at $1\frac{3}{4}$% of GDP.*

During the early months of the year the world economy experienced a sharp fall in oil prices, a renewed decline in other commodity prices, and a steady depreciation of the dollar. Among the major industrial countries, the twelve-month rate of consumer price inflation halved, market interest rates fell and there was a large rise in real personal disposable incomes. Activity in the major seven economies did not immediately respond to these potentially favourable developments. Indeed, activity was sluggish in the first quarter, reflecting in part weak demand for imports from non-oil developing countries as well as retrenchment by those countries heavily dependent on oil exports. In more recent months the growth of GNP among the main industrial countries has strengthened somewhat. Consumer price inflation and interest rates may now have passed their trough (at least for the time being), but the net effect of the developments over the past year has been an improvement in the prospects for steady and broadly-based growth, combined with low inflation, among the major economies. Persistent trade imbalances between the United States, Japan and Germany remain a principal area of concern. In response to the appreciation of their exchange rates, changes in net trade volumes in both Japan and Germany are now putting downward pressure on their trade surpluses, but large terms of trade gains have meant that their surpluses, measured in dollars, have continued to rise. In the United States, both import and export volumes have been slow to respond to the depreciation of the

GNP growth in the major economies

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

	1984	1985		1986
		Year	H2	H1
Canada	5.5	4.0	3.8	3.6
France(a)	1.5	1.3	3.2	1.3
Germany	3.0	2.5	4.5	0.6
Italy(a)	2.8	2.3	1.4	4.4
Japan	5.0	4.5	4.2	1.3
United Kingdom(a)	3.0	3.5	1.6	2.5
United States	6.4	2.7	3.2	2.5
Total	**4.7**	**2.9**	**3.4**	**2.1**

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

Components of GNP(a) growth in the major economies

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

	1984	1985		1986
		Year	H2	H1
Private consumption	3.2	3.0	3.7	3.6
Private fixed investment	8.6	6.2	8.5	0.9
Public expenditure	2.6	3.0	6.2	0.4
Stockbuilding(b)	1.0	−0.6	−0.3	0.5
Domestic demand	**5.1**	**3.0**	**4.4**	**3.5**
Net trade(b)	−0.4	−0.1	1.0	−1.4
GNP	**4.7**	**2.9**	**3.4**	**2.1**

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

World trade and UK markets

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

	1984	1985			1986
		Year	H1	H2	H1(c)
Import volumes(a)					
Major seven economies(b)	12.8	5.3	4.9	5.2	11.1
of which:					
North America	23.1	8.1	8.0	8.4	13.4
Japan	10.7	0.4	0.5	− 1.5	21.0
Europe	6.9	4.7	3.5	4.3	6.9
Other OECD	7.6	5.9	4.8	7.4	5.2
Oil exporting countries	−8.6	−15.4	−16.3	−19.7	−19.8
Other developing countries	7.0	3.6	1.7	− 3.7	6.6
Total	**8.8**	**3.6**	**2.7**	**2.4**	**7.0**
UK markets(d)	**7.0**	**3.1**	**1.7**	**4.2**	**7.3**

(a) Imports of goods only.
(b) Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
(c) Includes Bank estimates.
(d) UK trade-weighted index.

dollar. Trade protection and the possible intensification of debt servicing problems of several oil exporting developing countries remain major threats to a continuation of economic growth.

Activity *has picked up in the major industrial economies . . .*

After sluggish growth in the first quarter, the GNP of the major seven industrial countries grew more strongly in the second, despite slower growth in the United States. Private consumption, private investment and government expenditure all grew by around 6% at an annual rate, but net trade with the rest of the world continued to exert a significant drag on GNP growth. The strength of consumption and investment in the second quarter was probably a lagged response to events earlier in the year. Much of the large unanticipated rise in real personal disposable incomes had been saved in the first quarter (resulting in an increase in the majors' average savings ratio). The buoyancy of consumption in the second quarter was associated with a fall in savings ratios in most of the major countries as consumers began to adjust their spending patterns to the increase in real incomes. Investment fell in the first quarter, but picked up in the second, which may partly reflect a lagged response to both the fall in interest rates and the strong increase in profits, the latter in part the result of the fall in oil and commodity prices. Despite the upturn in activity in the second quarter, the unemployment rate rose slightly in all of the major economies except Canada and Germany. In the first half of 1986 domestic demand in the major countries grew by around 3½% at an annual rate, whereas GNP increased by little over 2%, reflecting a large spillover into net imports, especially in Japan, France and Germany; only in Canada did trade contribute positively to growth.

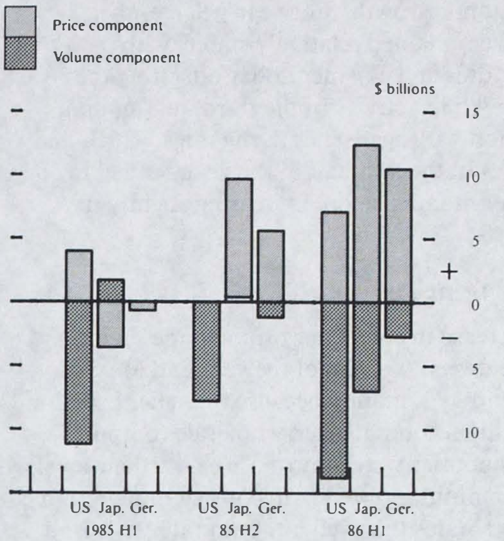
In the United States, GNP rose in the third quarter at an annual rate of nearly 3%, mainly reflecting higher consumer spending. Among the European economies retail sales remained fairly buoyant. Industrial production has continued its modest recovery in some countries, although in Japan industrial production fell in the third quarter to a level 1¼% below that of a year earlier, reflecting the impact on the Japanese manufacturing sector of the yen's appreciation over the past eighteen months.

. . . despite **adjustment** *in the rest of the world*

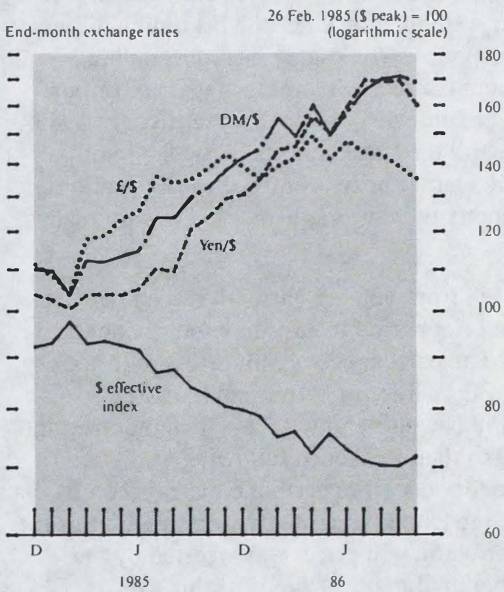
It is not only the Japanese export sector that has been somewhat subdued in recent months. Export volumes of the major seven countries were static in the first half of the year, mainly because of import retrenchment by OPEC and several developing countries. Lower import demand by OPEC countries reflected their continued adjustment to lower oil revenues. Their import volumes fell by some 15% in 1985, according to Bank estimates, and continued falling in the first half of this year. The growth of import volumes by other developing countries as a group slowed in 1985, reflecting limitations on the availability of foreign exchange owing to the weakness of commodity prices and slow growth of export volumes. Import growth remained weak during the early months of this year, and would have been even weaker save for an exceptional rise in Taiwanese imports.

The adjustment of US trade flows to a lower dollar has been slow. Although the US dollar has depreciated against most of the major

Increases in the **visible surpluses** *of Japan and Germany in the last year reflect improvements in the* **terms of trade**



The decline in **the dollar** *has slowed*



Interest rates[(a)]

Monthly averages

	1985		1986		
	Mar.	Dec.	May	Sept.	Oct.
Canada					
Short-term interest rate	11.3	9.3	8.6	8.4	8.4
Long-term interest rate	12.2	10.1	9.4	9.4	9.6
France					
Short-term interest rate	10.7	9.0	7.2	7.1	7.4
Long-term interest rate	12.3	11.3	8.6	8.5	9.0
Germany					
Short-term interest rate	6.4	4.9	4.6	4.5	4.6
Long-term interest rate	7.7	6.6	6.1	6.1	6.3
Italy					
Short-term interest rate	16.1	14.9	13.5	11.7	11.9(a)
Long-term interest rate	13.5	13.7	10.9	10.4	10.3
Japan					
Short-term interest rate	6.3	7.4	4.6	4.7	4.8(a)
Long-term interest rate	6.6	5.8	5.1	5.0	5.3(a)
United Kingdom					
Short-term interest rate	13.6	11.7	10.2	10.1	11.1
Long-term interest rate	10.9	10.5	9.0	10.0	10.6
United States					
Short-term interest rate	9.0	7.8	6.7	5.7	5.7
Long-term interest rate	11.8	9.6	8.0	8.1	8.0

(a) Interest rates for October 1986 include estimates.

currencies since February 1985, it has remained fairly stable in real terms against the currencies of some other countries, including Canada, South Korea and Taiwan (which account for over a quarter of US imports). Industry in these countries has suffered little loss of competitiveness relative to the US traded goods sector. The expected downward adjustment of US import volumes to the fall in the dollar against the major currencies may also have been delayed by the short-run influence of non-price factors. In addition, many exporters to the United States raised profit margins when the dollar appreciated and appear to have been content to accept a reduction in margins, rather than raise prices, as the dollar weakened. The delay in the response of US export volumes, which fell by 1% at an annual rate in the first half of this year, reflects the lags involved in re-establishing export markets as well as competition from the newly industrialising countries, especially in the Pacific market.

The US trade deficit deteriorated in the third quarter as a whole when compared with the second quarter. In the first nine months of the year the deficit was provisionally estimated at some $128 billion (not seasonally adjusted), compared with $108 billion in the same period last year. In Japan and Germany, the twelve-month growth of import volumes has exceeded that of exports for some months now, but their trade surpluses continue to rise in dollar terms. In the first three quarters of the year, the Japanese and German surpluses were estimated at around $65 billion and $36 billion respectively, compared with $39 billion and $16 billion for the same period in 1985. According to Bank estimates, improvements in the terms of trade widened the Japanese and German trade surpluses by some $40 billion and $25 billion respectively in the first nine months of the year compared with the same period last year, more than sufficient to offset the adverse movements in trade volumes.

The dollar *has fallen less in recent months*

The persistence of trade imbalances, the accommodating stance of US monetary policy and indications of slower growth of US output during the second quarter contributed to further downward pressure on the dollar in the summer. Subsequently, however, these factors were offset somewhat by more favourable US economic indicators and statements by US officials to the effect that the fall in the dollar had gone far enough. At the end of October the US and Japanese authorities issued a joint statement affirming their willingness to co-operate on exchange rate issues, stressing their desire for greater exchange rate stability—at that time the yen/dollar rate was around ¥162. By mid-November, the dollar was only some 2% lower in effective terms than six months earlier. Over the same period there had been a steady rise of around 5% in the effective rate for the deutschemark; the fall in the yen from end-September resulted in a net decline in its effective rate over this six-month period of about 1%.

Interest rates *have stabilised . . .*

Market interest rates in most countries outside the United States have also remained fairly stable in recent months. In both Germany and Japan this may have reflected the authorities' reluctance, in view of the rapid growth of central bank money and liquidity, to lower official rates following the cuts in the US discount rate in July and August. In the United States, short-term market rates were about 80 basis points lower by mid-November than six months previously. They had fallen fairly steadily between June and early September, mainly in response to the evidence of weak economic growth. Since early September, however, US rates have remained relatively stable, with improved US trade figures and a firmer dollar offsetting the impact of stronger growth in activity in the third quarter and faster growth of the monetary aggregates. Long rates, which had fallen in most countries in the first half of the year, tended to stabilise in the summer months before increasing slightly in October.

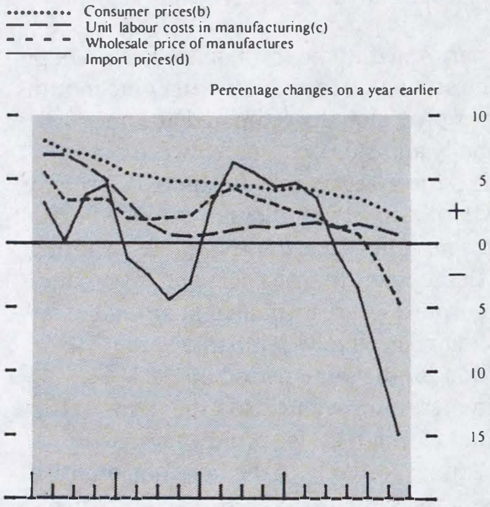
. . . in part reflecting **price** *trends*

The twelve-month increase in consumer prices in the major seven, which halved between the turn of the year and May, has now stabilised at around 1½%, mainly because of higher inflation in North America. In the second quarter, wholesale (output) prices in the major economies were almost 5% below their level a year earlier. In recent months, however, no consistent pattern has emerged. In the United States the twelve-month rate has edged up slightly from −2½% in July to −1½% in October; in Canada the wholesale price index has firmed since May; in Italy the rises in August and September were the first since the beginning of the year. By contrast, the Japanese wholesale price index fell in October for the twentieth consecutive month. Japanese import prices are expected to be some 40% lower this year than in 1985, reflecting the high yen and the lagged effects of the fall in oil prices. Nevertheless, consumer prices continue to rise year on year in Japan. In Germany there was a further fall in wholesale prices in October.

Spot oil prices, which fell from $28 per barrel in December last year to below $10 for a brief period in July, have subsequently firmed to around $15. The partial recovery in prices reflected the market's reaction to OPEC's interim agreement to restrict production to 17 million barrels per day or less in September and October. However, prices then weakened following OPEC's failure to reach agreement on a more permanent arrangement, although it was decided to extend the interim agreement until the end of the year. This weakening in prices was arrested by the sudden dismissal of Sheikh Yamani as Saudi Arabia's Oil Minister, and the call by his successor for an early meeting of OPEC's Pricing Committee. The committee subsequently recommended a prompt return to a system of fixed official prices using $18 per barrel as the reference price. The maintenance of prices at this level would almost certainly require some further restrictions in OPEC production, but at present it remains uncertain whether or how this might be brought about.

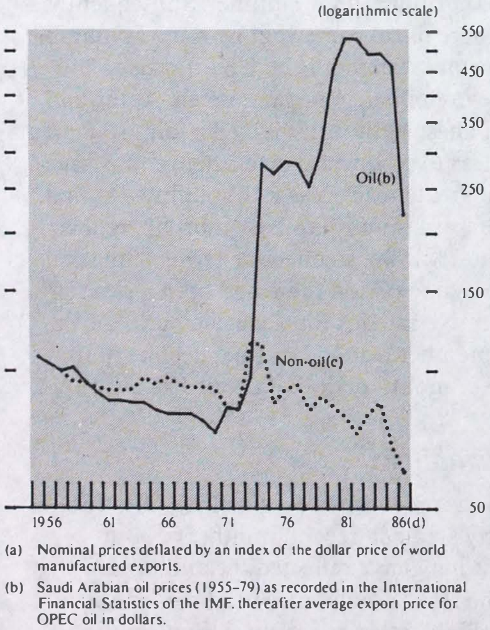
After falling in the first half of the year, spot non-oil commodity prices (in SDRs) have picked up slightly since the beginning of July, due to steady gains in the prices of industrial raw materials and, more recently, a rally in some food prices. It is, however, unlikely that this signals the beginning of a sustained recovery in real commodity prices. Among agricultural products, the general supply outlook remains healthy but shortages of immediate supplies have produced rallies in several markets. Upward price movements in metal markets also reflect the effect of certain short-run factors, including strikes. Structural influences, however, continue to depress the prospects of any long-term recovery in real metal prices.

Inflation *has fallen in the major overseas economies*[a]



(a) Canada, France, Germany, Italy, Japan and the United States.
(b) Consumers' expenditure deflator.
(c) Adjusted for the state of the economic cycle.
(d) Average of national figures, thus including imports from other major economies.

Real oil *and non-oil* **commodity prices** *continued to fall in 1986*[a]



(a) Nominal prices deflated by an index of the dollar price of world manufactured exports.
(b) Saudi Arabian oil prices (1955–79) as recorded in the International Financial Statistics of the IMF, thereafter average export price for OPEC oil in dollars.
(c) Derived from IMF non-oil primary product dollar price index.
(d) Estimated.

Earnings in the seven major economies are estimated to have risen by 4¼% on average in the first half over a year earlier, following growth of 5% in the second half of last year. But there is some evidence that the fall in wage settlements may have ended. In the United States, the twelve-month increase in wages has remained at just over 2% since April, after falling from 3% at the end of last year; in Germany, whole-economy wage inflation has accelerated this year, from under 3% in the first quarter to over 3½% in more recent months. One possible explanation is that the fall in import prices has enabled employers to agree to higher wage settlements, while still increasing profit margins. Although the growth of productivity has slowed recently, owing to the relative weakness of output, the increase in whole-economy labour costs per unit of output in the major seven fell from 3½% over a year earlier in the second half of last year to 3% in the first half of 1986. (A comparison of overseas and UK manufacturing and whole-economy unit labour costs is presented in the note on page 468.)

Monetary aggregates *have grown faster in a number of countries . . .*

In the United States, both M2 and M3 have breached the upper range of their target cones at various times in the last few weeks; M1 has been above its target cone since March. In Germany, central bank money has, since August, been rising by more than 7% at an annual rate over the 1985 fourth quarter target base, well above its target range of 3½%–5½%. In Japan, the main aggregate rose by nearly 9% on a twelve-month basis in the third quarter, at the upper end of the Bank of Japan's projection. These developments do not necessarily imply any increase in inflationary pressures. Deregulation and innovation in financial systems have made it increasingly difficult to interpret any given monetary aggregate.

Nevertheless, the behaviour of monetary aggregates in Germany and Japan was of sufficient concern for the authorities in those countries to resist pressure to cut their official interest rates. The Bundesbank discount rate has not fallen since March. In Japan, however, worries over the growth of liquidity were eventually overridden by the concern about the effects on domestic industry of the strong appreciation of the yen, which by end-October had appreciated by some 61% against the dollar from its low in February 1985. At the end of October the Bank of Japan cut its discount rate to 3%—the first cut in the rate since April.

. . . but **fiscal** *policy remains cautious*

Prior to their decision to cut interest rates, the Japanese authorities responded to international pressure to boost domestic demand (with a view to helping reduce trade imbalances and staving off calls in the United States for protectionist measures) by announcing a ¥3.6 trillion package. The Economic Planning Agency in Japan has estimated that the package will add 1.5% to domestic demand over the next year, enabling the economy to come close to the 4% growth projection for the current fiscal year. (Japanese private sector projections are much less optimistic.) The package consists mainly of additional public works expenditure by both central government and local authorities, but also includes increased availability of loans for construction and aid for those industries worst affected by the yen's appreciation. The doubts about the impact of the package on growth prospects reflect the belief that some of the measures represent the bringing forward of expenditure originally scheduled for 1987, and uncertainty over the private sector's response to the loan provisions.

The Japanese Tax Advisory Council has proposed a tax-reform plan, designed to be revenue neutral, which involves reductions in both income and corporate taxes, offset by a number of provisions including the introduction of a value added tax on sales of goods and the elimination of tax breaks for small savers. The ruling Liberal Democratic Party's own tax research committee is also due to report on tax reform by the end of the year.

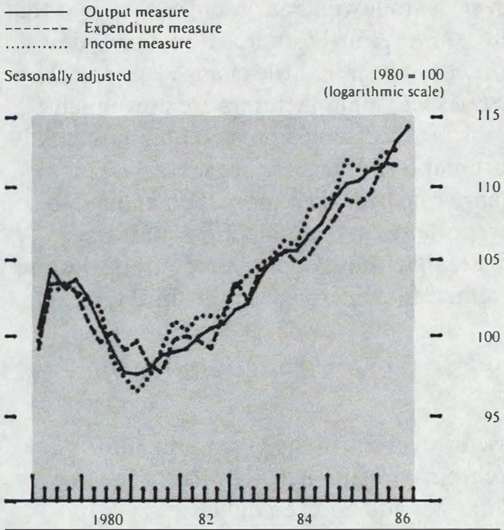
Earlier in the year the German government implemented the first part of a two stage cut in direct taxes, with the second part to follow in 1988. The authorities have also indicated their intention of introducing tax reforms which would reduce taxes by DM 40 billion (gross). It is estimated that the plan will entail a DM 20 billion net reduction in revenues. The plan will probably be implemented in two stages some time in the next legislative period (1987–90), and, as in Japan, is likely to involve some shift away from personal direct taxation towards indirect taxation. German fiscal policy is currently restrictive, but the authorities have indicated they would be prepared to re-examine the fiscal stance if growth slowed significantly in 1987.

In the United States, following the Supreme Court ruling that the automatic sequestration clauses of the Gramm-Rudman-Hollings (GRH) balanced budget legislation are illegal, GRH's fallback procedures are now being followed. Under these, both Houses of Congress must vote on the cuts necessary to meet the GRH targets, and only if these are passed, and then agreed by the President, can they be implemented. The 'automatic' cuts for fiscal 1986 of $12 billion were reauthorised by Congress following the Supreme Court's ruling, but, in spite of these, the deficit for fiscal 1986 was $221 billion, compared with a GRH target of $172 billion. For the 1987 fiscal year, the official estimate of the deficit, following the outcome of Congressional negotiations, is now within the permissible range of the GRH target of $144 billion. But the risk remains that, if economic performance proves to be less buoyant than assumed in the official projections which underlie the deficit forecast, the target will be missed. The major tax reform bill was signed into law in October and its implementation is expected to result in additional revenue of some $10 billion in fiscal 1987, although it is expected to entail a net loss of revenue in the following financial year.

The US and Japanese current account imbalance *is likely to persist through 1987 and 1988*

Domestic demand is likely to grow at around 4½% per annum in 1987 and 1988 on average in both Germany and Japan, according to the Bank's latest forecast (summarised on pages 472–3). This would be sufficient to reduce the German current account surplus to around half its present level by the end of 1988, but the Japanese surplus could even remain around $100 billion, buoyed up by very favourable terms of trade movements and a gradual fall in the invisibles deficit. Moreover, the US current account deficit is expected to remain close to current levels, despite the expectation of a slightly contractionary stance of fiscal policy, moderate growth of domestic demand, static imports and fairly rapid growth of export volumes in 1987–88. The concerns over the sustainability of large external and fiscal deficits in the United States have led to predictions in the past that there could be a change of sentiment against dollar assets, thereby precipitating further falls in the dollar and upward pressure on US interest rates. This risk remains. Over the past year, however, a number of factors have contributed to lower US interest rates, including the easing of US monetary policy since mid-1985, lower oil prices and increased expectations of action to reduce the US fiscal deficit. In addition, it also appears that a number of institutional factors have helped to sustain capital flows from Japan to the United States in the face of a depreciating dollar, including the continuing liberalisation of rules governing the overseas exposure of Japanese institutional investors.

GDP(O) *strengthened in the third quarter*

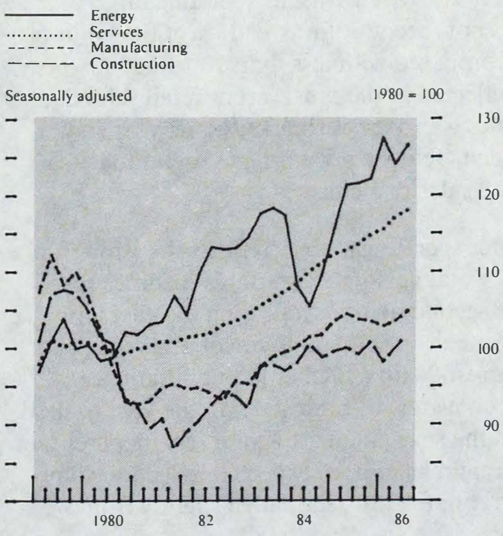


At home the growth of output *strengthened in the third quarter*

GDP is estimated to have risen 1% in the third quarter to a level 3% higher than a year earlier, according to the provisional output measure. There was further strong growth of output in the service sector and higher output from the manufacturing sector as well as from the energy sector following the completion of substantial maintenance work on North Sea installations, which reduced oil production in the second quarter. The strength of the rebound in oil production in the third quarter meant that non-oil GDP(O) rose by slightly less—by little over ½%, although it was 2¾% higher than a year earlier.

The different measures of GDP continue to produce different rates of growth—in the second quarter it was about 1½% higher than a year earlier, according to the average measure. The output measure of GDP is regarded as the most reliable indicator of short-term movements in the economy. Upward revisions to the second quarter estimate of GDP(O), as well as the buoyant third quarter figure, indicate that output has grown steadily during 1986. The slowdown in the economy now appears to have been largely concentrated in the second half of last year, and reflected the increasing degree of import retrenchment by OPEC, weak demand in certain developing countries and possibly the lagged effects of sterling's appreciation in the first half of 1985.

Output of the **service sector** *has grown steadily*



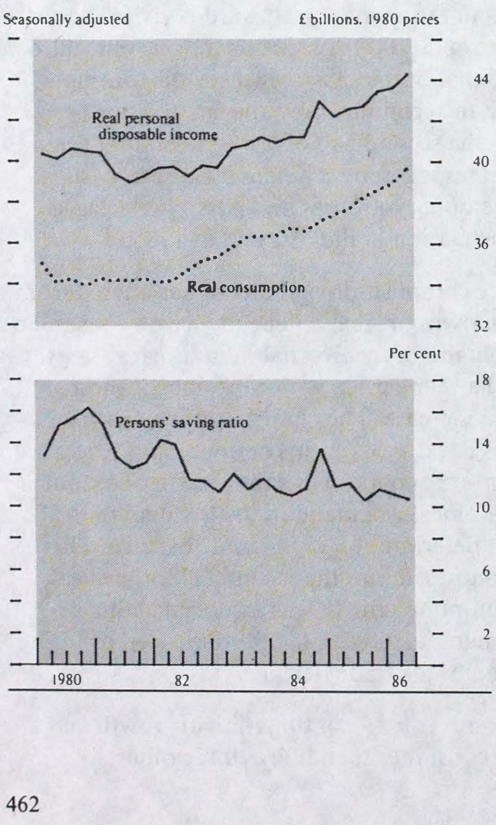
During the past year the composition of demand has altered from one of fairly balanced growth to greater dependence on consumer spending. Domestic demand in the first half of the year rose by some 2¾% over its level a year earlier, with consumer spending accounting for all of the increase. The contribution to growth from external trade was negative over this period, mainly because of weaker growth of non-oil exports. Thus the growth of output was lower than that of domestic demand in the first half of the year, with a consequent deterioration in the trade balance. This pattern has probably continued into the second half of the year, as the strength of consumption growth was associated with an increase in imports of manufactures in the third quarter, resulting in a further deterioration of the trade balance.

There are, however, prospects for a continuation of growth and a better balance between consumer spending and the other components of expenditure. This reflects the gains in competitiveness resulting from the fall in sterling during the year and the expectation of stronger growth in export markets in 1986 and 1987 as a whole compared with 1985. There are already some positive signs. These include the strong increase in manufacturing output in September; in the third quarter as a whole it rose by 1¼%. The increase was broadly based, including a 4% rise in the output of electrical engineering, a sector which had been particularly weak in the year to mid-1986, and a 3% increase in output from the chemical industry. The only sectors in which output fell were metals and other mineral products. Following revisions to the series, manufacturing output is now shown to have grown steadily in both the second and third quarters after the fall in output around the turn of the year. The increase in output is supported by the rather more buoyant picture that has emerged from some of the recent labour market indicators.

A more positive outlook is also portrayed by the Confederation of British Industry's industrial trends surveys for October and November. A larger balance of manufacturing companies, especially those in the consumer goods sector, expected to increase their output over the following four months than was the case in the July quarterly survey. Furthermore, after a period of several months when order books were little changed, and both export orders and deliveries fell, manufacturers are now much more optimistic about the prospects for orders, in both home and, especially, in export markets. But there are several risks to this outlook. The exchange rate has fallen more than enough to offset the impact of lower oil prices; manufacturers' unit wage costs continue to rise faster than those of our competitors, despite a welcome slowdown in their rate of growth in the third quarter.

Consumer spending *has grown strongly in recent quarters . . .*

Consumer spending *has grown strongly as income has risen*



Consumer spending rose by over 5% in the year to the third quarter according to preliminary estimates—similar to the rate recorded in the second quarter and appreciably faster than its growth in recent years. The estimate is subject to revision, although this is unlikely to alter the picture of stronger growth in consumer spending this year. Much of the growth in recent quarters reflects higher spending on durable goods, although the third quarter rise also included an unusually fast increase in spending on food. In the year to the third quarter, real spending on durables rose by over 9%, twice as fast as spending on non-durables. Durables now account for over 12% of the volume of total consumption, compared with less than 10% in 1980. These trends are also reflected in the most recent retail sales data. The volume of retail sales was over 6% higher than a year earlier in the three months ended October, according to preliminary estimates, with non-food sales rising fastest.

The strength of consumer spending mainly reflects the strong growth of real incomes. Total personal disposable incomes rose by 8% in the year to the second quarter, reflecting increases in wages and salaries, income from self-employment and receipts of rent, dividends and interest. With a further fall in inflation, real personal disposable income grew by almost 4% in the year to the second quarter. Despite the strength of growth of real incomes in recent quarters, which might have been expected to lead to some increase in the savings ratio, the ratio has fallen slightly from

10¾% in the second half of last year to little over 10½% in the first half of 1986.

. . . *and has been supported by an increase in* **borrowing**

The strength of consumer spending reflects not only the growth of real incomes, but also the rise in consumer credit. In the first half of the year net increases in consumer credit (increases in credit less repayments) were 5½% (seasonally adjusted) above their level a year earlier, with most of the increase reflecting further growth in bank lending. In 1985 as a whole there was a net increase in consumer credit outstanding of almost £4 billion, and by the end of the year the total stock of consumer credit outstanding was £26 billion, almost double the amount outstanding at the end of 1981.

The increase in housing activity in 1986 has also resulted in higher spending on durables. The greater activity in the housing market has also been accompanied by higher mortgage lending as well as an increase in net cash extraction from the housing market. In the first nine months of the year, total mortgage lending (net of repayments and seasonally adjusted) rose to £18½ billion, compared with £13½ billion in the same period a year earlier. In the third quarter, building society advances rose by £5½ billion compared with an average of £4¾ billion a quarter in the first half. Bank mortgage lending also rose in the quarter, pushing up the banks' share of the mortgage market to some 25%. More recently however there is some evidence that the growth of building society lending may have levelled off as net advances fell in October and there was a further fall in new lending commitments.

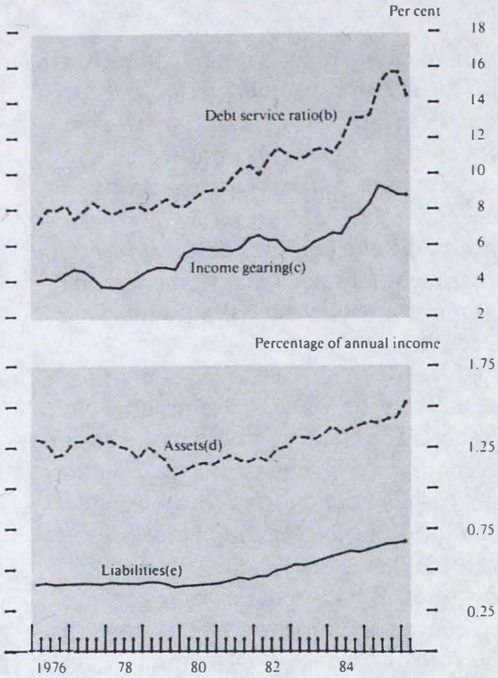
The buoyancy of mortgage lending in the first nine months of the year is mainly a reflection of the strong growth of real incomes, the fall in interest rates earlier in the year and the associated increase in the demand for housing. Housing starts increased by 8% in the year to the third quarter. House prices rose strongly up to July, but have tended to stabilise since then at a level in the third quarter just over 13¼% higher than a year earlier, according to the Halifax mix-adjusted house price index. The gap between prices in the North and South continues to widen. The twelve-month increase of house prices in the third quarter was more than 25% in Greater London, 20% in the South-East, less than 7% in the North and only 4% in Scotland. The recent increase in mortgage rates may reduce demand to some extent, so that the rise in house prices may slow in coming months.

The strength of mortgage borrowing, combined with the increase in consumer credit, contributed to a further rise in personal sector debt in the first half of the year. Total net new borrowing rose to £34 billion at an annual rate in the second quarter, following a rise of £24 billion in the first. By mid-1986 it is estimated the personal sector's stock of liabilities was some £218 billion, compared with £90 billion at end-1980.

. . . *accompanied by a rise in the* **personal sector's stock of assets**

The accumulation of debt by the personal sector since 1980 largely reflects the improvement in the sector's access to credit as

The household sector's[a] **debt** *and* **assets** *have risen*



(a) Personal sector, excluding net receipts of LAPFs.
(b) Gross interest payments, plus repayments of principal as a percentage of household income.
(c) Gross interest payments as a percentage of household income before tax relief.
(d) The stock of personal sector assets, minus holdings of LAPFs.
(e) The stock of mortgages, bank borrowing and retail trade credit owed by households.

a result of the end of credit rationing. Much of the increase in borrowing has been at longer-term, principally on mortgages. This increase has, however, been more than matched in absolute terms by a rise in the personal sector's stock of financial assets in response to the fall in inflation and to higher rates of return.

In the decade prior to 1980 the constraints on borrowing resulted in a rundown in personal holdings of liquid assets to finance expenditure, a process accentuated by higher rates of inflation which eroded the real value of assets. Since 1980, however, financial assets have grown rapidly in relation to income, as the personal sector has sought to rebuild its stock of assets. Part of the increase includes a growth in holdings of liquid assets, such as building society deposits. In addition, the strength of the stock market had led to large revaluations of the sector's holdings of shares and their holdings in life assurance and pension funds (LAPFs). Holdings in LAPFs have accounted for most of the increase in the sector's acquisition of assets in both 1984 and 1985. During the first half of 1986, the LAPFs' net receipts continued to grow strongly and, when coupled with further revaluations in the first quarter, LAPF holdings accounted for some 45% of total personal sector assets, compared with 26% in 1975.

The average annual rate of growth of the sector's stock of assets since 1980 (16½% per annum) has been slightly less than the growth of debt (17½% per annum). Because the stock of assets is some three times that of liabilities, the absolute increase in assets between 1980 and 1985 was much larger than the increase in liabilities. Whereas this comparison suggests the financial position of the personal sector as a whole is satisfactory, little is known about the distribution of assets and liabilities. The rapid growth of borrowing has, moreover, resulted in strong growth in both the personal sector's income gearing ratio (defined as the proportion of gross interest payments to income) and its debt service ratio (defined as the proportion of payments of both capital and interest on mortgages to income). Although the continued growth of borrowing can be seen as part of the adjustment to the easing of credit restraints, which does not yet appear to have been completed, there must be some question about the sector's ability to go on accumulating debt without some households becoming overextended.

Capital spending by business *was flat in the third quarter . . .*

Capital expenditure by business was little changed in the third quarter, according to provisional estimates, although it was some 1½% lower than a year earlier. Investment by companies in construction, distribution and financial services rose 1¼% higher than a year earlier, but manufacturing investment, including leased assets, fell for the second successive quarter to a level more than 6% below that of a year earlier. Manufacturing investment has so far not reflected either the recent increases in output or the high level of profitability, even allowing for the historically high cost of capital at present. The continuing strength of company profitability and the rather more optimistic prospects for the growth in output in 1987 are expected to lead to higher investment in plant and machinery, according to the CBI's

October industrial trends survey. The CBI forecasts that the growth of private fixed investment will increase from less than 1% this year to 4¾% in 1987, including a strengthening of investment in the manufacturing sector.

The volume of assets financed by leasing fell by 8½% in the third quarter and, as a proportion of total manufacturing investment, leasing fell to 9%, the lowest share for several years. The reduced reliance on leasing largely reflects the previously announced abolition of first-year allowances from April.

. . . *and* **import volumes** *rose sharply*

The current account is provisionally estimated to have been in deficit by £0.8 billion in the third quarter. With the oil surplus only slightly lower than in the second quarter, the deterioration in the current account was largely attributable to the £1.4 billion widening of the deficit on non-oil trade, accounted for almost entirely by trade in manufactures. While some of the deterioration was the result of lower sales of erratic items (in particular, aircraft), the underlying deficit in manufactures also rose sharply from £1.2 billion in the second quarter to £2.2 billion in the third. Provisional estimates suggest that earnings on invisible trade continued to rise in the third quarter and, following upward revisions, the surplus on invisibles was estimated at £2.3 billion. In October the deficit on visible trade amounted to £0.8 billion, but this was more than offset by the estimated surplus on invisibles. The cumulative current account surplus in the first ten months of the year amounted to little over £0.1 billion, which reflected a £10.4 billion deficit on non-oil trade and an estimated surplus on invisibles of £7.0 billion.

UK current account

£ billions; *seasonally adjusted*

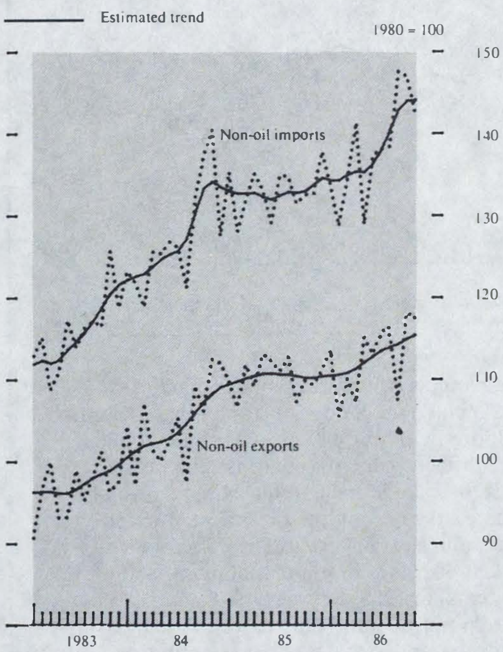
	1985	1986 Q1	Q2	Q3
Visible trade				
Non-oil balance				
of which:				
Manufactures				
Erratics(a)	0.7	0.1	0.6	0.2
Other	− 3.8	−1.6	−1.2	−2.2
Total manufactures	− 3.0	−1.5	−0.6	−2.0
Non-manufactures	− 7.3	−2.0	−1.7	−1.8
Total non-oil	−10.3	−3.4	−2.3	−3.7
Oil balance	8.2	1.9	0.8	0.7
Total visible trade	− 2.1	−1.4	−1.6	−3.0
Invisibles (net)	5.7	2.0	1.9	2.3(b)
Current balance	**3.5**	**0.5**	**0.3**	**−0.8**(b)

(a) Ships, aircraft, North Sea installations, precious stones and silver. Components may not add to totals because of rounding.

(b) Projection.

In volume terms, non-oil exports (excluding erratics) continued to recover from their depressed level at the beginning of the year, rising 6% between the first and third quarters, when they were 2¼% up on a year earlier. However, much of the rise in the third quarter was in non-manufactured goods; manufactured export volumes (excluding erratics) rose by less than 1%. Latest estimates suggest that UK export markets for manufactures grew rapidly in the second quarter after falling in the first. Such developments may help explain the erratic pattern of exports of manufactures since the end of 1985, although an upward trend is now discernible. Volumes should also be beginning to benefit from sterling's depreciation—some 14% in effective terms in the year to the end of the third quarter and a further 2% by mid-November. Recent survey evidence certainly shows greater optimism amongst UK exporters.

The trend in **non-oil trade volumes**(a) *has risen recently*



(a) Including erratics.

The most notable development in the third quarter was, however, a surge in non-oil import volumes. This followed a period since early 1985 when the rise in import volumes had been subdued by the standards of recent years, especially in view of the increase in consumer spending. More recently, imports of manufactures, and in particular finished goods, have risen sharply. The volume of finished manufactures (excluding erratics) rose 9% in the third quarter when, reflecting the strong growth in personal disposable income and borrowing, imports of consumer goods including cars were 18% higher than a year earlier. However, not all of the third quarter increase in imports of finished manufactures was of consumer goods: imports of intermediate and capital goods also rose strongly, and this growth continued in October.

Recent trends in import penetration

The volume of non-fuel imports rose by over 7% in the third quarter to a level some 9% higher than a year earlier. All categories except basic materials rose rapidly, with the sharpest increases over the past year occurring in imports of finished manufactured goods, particularly cars and other consumer goods (see table). From late-1983 to late-1985 imports of consumer goods had been growing only slowly but have since risen strongly. In contrast, the volume of imports of capital goods, which had grown at an average annual rate of 16% between 1981 and 1985, fell sharply in the first half of this year before bouncing back in the third quarter.

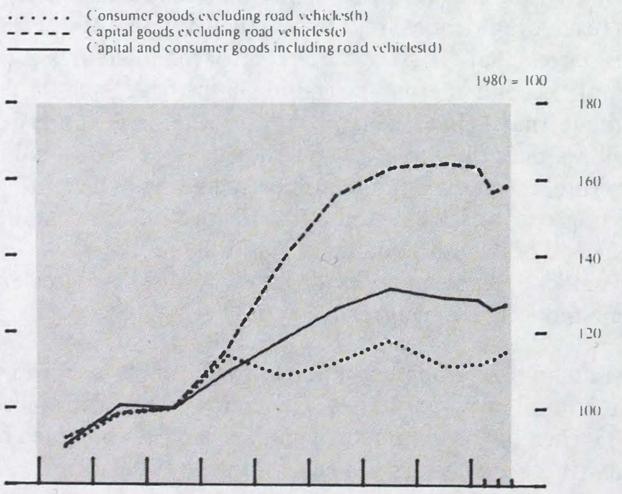
Growth in the volume of imports of finished manufactures[a]
Percentage changes

	Total	Passenger motor cars	Consumer goods other than cars	Intermediate goods(b)	Capital goods
Weight (1980)	*100*	*13*	*29*	*29*	*29*
1986 Q3 on 1986 Q2	9¾	14¼	7¾	6	10¾
1986 Q3 on 1985 Q3	11¼	15¼	19½	12¾	1

(a) Excluding ships, aircraft and North Sea installations.
(b) Mainly parts and accessories for a wide range of capital and consumer goods.

The implications of these trends in the volume of imports of finished manufactures for the degree of import penetration in roughly comparable categories of consumers' expenditure and gross domestic fixed capital formation are shown in Chart 1. From 1980, import penetration grew most rapidly in the capital goods category but stabilised in 1984–85 and then fell back in early 1986. The upward trend in the share of imports of consumer goods (excluding cars) slowed appreciably after 1981 but appears to have resumed from late last year. If cars (which are recorded partly in consumer spending and partly in investment) are included as well as other road vehicles, there was a steady rise in import penetration from 1980 until 1984 which was partly reversed in the following 18 months. In the third quarter of this year the share of imports appears to have risen.

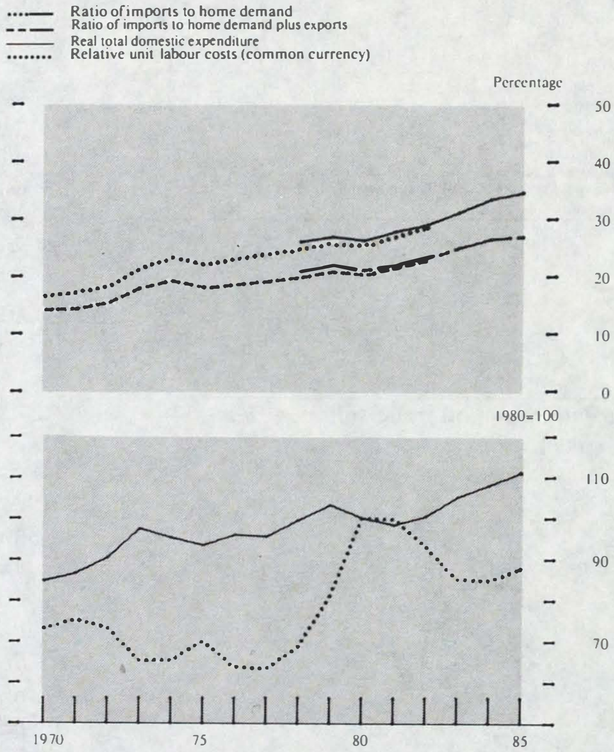
Chart 1
Proxies for import penetration in finished manufactures[a]



(a) Ratio of imports to domestic final demand (1980 prices) excluding ships, aircraft and North Sea installations. Quarterly data for 1986 are moving averages of current and preceding three quarters.
(b) Ratio of imports of consumer goods (excluding cars) to consumer expenditure on durable goods (excluding vehicles), clothing and footwear, and 'other' goods, less approximate adjustments in respect of categories which are not classified as finished manufactures in the trade figures.
(c) Ratio of imports of machinery and miscellaneous capital goods to domestic investment in plant and machinery.
(d) Ratio of sum of categories included in (b) and (c) together with cars and other road vehicles.

In the past, increases in import penetration have been strongest during periods of rapid growth of domestic demand, and are likely to have been associated with deteriorating cost competitiveness on occasions (see Chart 2). Although domestic demand has risen in recent quarters, and there was some loss of competitiveness in 1985, there was little change in the overall trend of import penetration in manufacturing until the third quarter of this year, when it appears import penetration did increase. However, by the third quarter the level of cost competitiveness was estimated at some 5½% below the average for 1985, which should help to moderate any rise in import penetration in coming quarters.

Chart 2
Import penetration in manufacturing 1970–85[a]

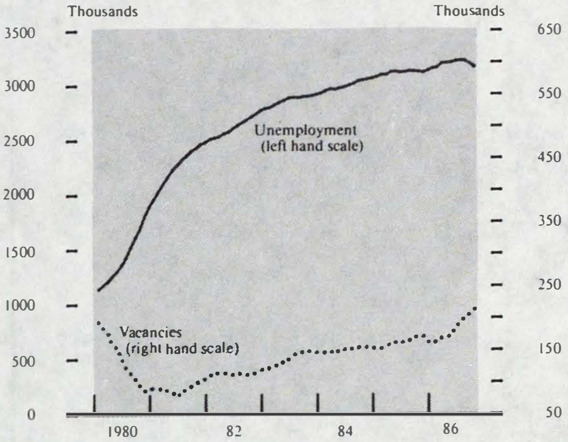


(a) Based on Standard Industrial Classification (SIC). Data on a 1980 SIC basis are not available prior to 1978. Earlier data shown are based on the 1968 SIC.

The two ratios for import penetration in manufacturing shown in Chart 2 include the food, drink and tobacco sector where, overall, domestic producers have maintained their share over the last fifteen years. In other manufacturing sectors the biggest losses of home market share incurred by domestic producers have been in the car industry and in electrical and mechanical engineering. These sectors accounted for about one third of imports of manufactures (excluding food items) in 1985. Between 1978 and 1985 the ratio of imports to home demand plus exports rose by over half in the car industry and in electrical engineering, and by over 30% in mechanical engineering. In contrast, import penetration has grown least in domestic markets for computers and other office equipment (by 2% on the measure indicated above), instrument engineering, and paper, printing and publishing (about 12%).

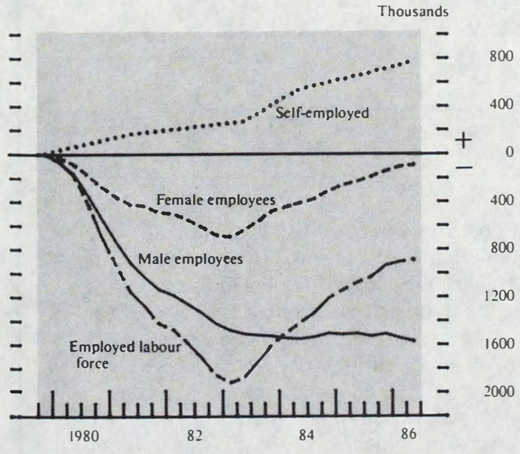
As measured by unit values, the UK terms of trade rose slightly in the third quarter and were then 3% above their level of a year earlier. However, with sterling's effective index falling over 7% during the quarter, there were latterly signs that import prices were accelerating, with prices of finished imported goods rising by 5½% in the year to the third quarter, almost as much as those of finished manufactured exports (excluding erratics) over the same period. The movement in the terms of trade based on unit value indices is, however, not an accurate indicator of the impact of the changes in import and export prices either on the trade balance or on real national disposable income. The unit value indices are based on the 1980 composition of trade and do not reflect changes in composition since then, in particular the changed pattern of trade in oil. In the year to the third quarter, the *average* value terms of trade in goods fell by 8%, mainly reflecting the fall in oil prices. This fall in the average value terms of trade contributed nearly £1½ billion to the £2½ billion deterioration in the visible trade balance over this period. This fall in the terms of trade for goods is estimated to have contributed to a reduction in real national disposable income of about 1¾% between the third quarters of 1985 and 1986.

Unemployment[(a)] *has fallen and* **vacancies**[(b)] *have risen in recent months*



(a) Seasonally adjusted, excluding school leavers.
(b) Seasonally adjusted, excluding the Community Programme.

In the United Kingdom **the employed labour force** *has continued to grow*[(a)]



(a) Cumulative change since the end of 1979.

Unemployment *has fallen since July*

Recent indicators of the labour market provide a somewhat more buoyant view of the economy, with lower unemployment, a further rise in vacancies and a slowing in the rate of decline of manufacturing employment. After a continued rise from December 1985 to July this year, unemployment has fallen for three successive months, and the unemployment rate was 11.5% in October (seasonally adjusted and excluding school leavers). It is probable that some of the fall in unemployment reflects the impact of the Restart scheme for the longer-term unemployed (those out of work for more than a year). The scheme was extended nationwide in July after its introduction on a pilot basis. It is difficult to estimate the effects of the programme on the unemployment count, but there will have been some impact, reflected in the fall in long-term unemployment in the third quarter.

The growth of employment was relatively modest in the first half of 1986. During the second quarter the employed labour force rose by 21,000, the assumed rise of 30,000 in the numbers self-employed more than offsetting a decline in employees in employment. Manufacturing employment, which had fallen by some 76,000 in the first half of the year, fell by a further 20,000 in the third quarter. This represents an appreciable slowing of the rate of decline, and may reflect the recovery in manufacturing output since the first quarter of the year.

. . . *but* **underlying average earnings** *continue to rise at over 7% per annum . . .*

Wage settlements in the 1985/86 pay round are estimated to have averaged about 6%. However, there have been indications of a slight moderation in those settlements completed towards the end of the round within the private sector. According to provisional estimates from the CBI, settlements in manufacturing averaged 5½% in the third quarter, down from 6¼% in the first half of the year. Settlements within the private service

Unit labour costs in the United Kingdom and abroad

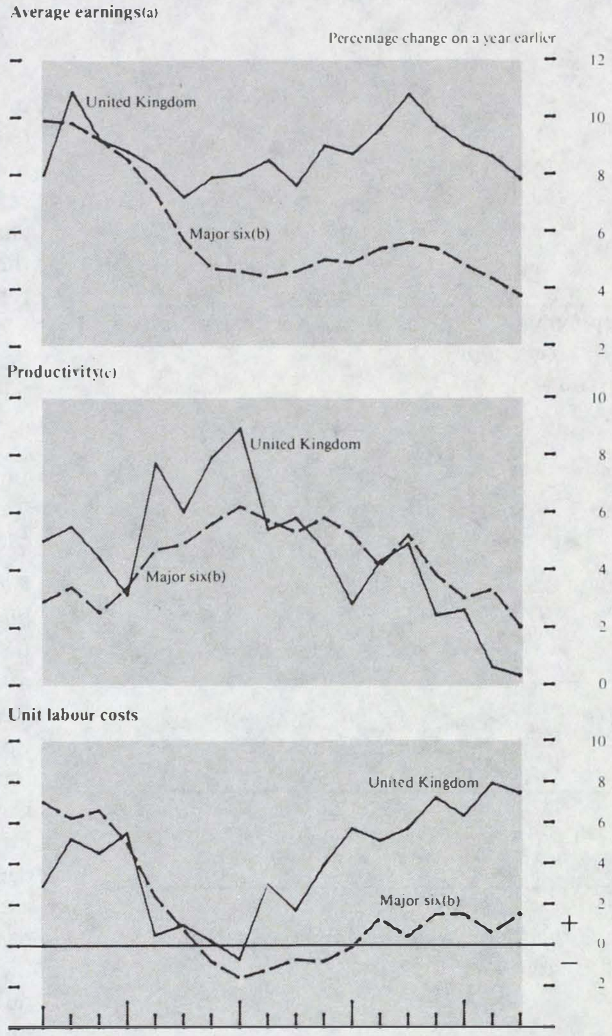
Unit labour costs in manufacturing have grown more rapidly in recent years in the United Kingdom than in the major six overseas countries in aggregate (see chart). In the year to the second quarter of 1986, this gap widened further as unit labour costs in manufacturing rose by 7½% in the United Kingdom, compared with only 1½% in the major six. The growth of average earnings has remained little changed since mid-1982 in the United Kingdom, while it has fallen over this period in the major six. Furthermore, the growth of productivity in manufacturing has, since 1983, slowed down more in the United Kingdom than in the major six. Despite the welcome reduction in the growth of unit labour costs to 4½% in the year to the third quarter in the United Kingdom, these costs are still likely to be rising faster than those of our competitors.

These international comparisons relate to the manufacturing sector, for which data are most readily available. The manufacturing sector, however, accounts for no more than a third of GDP in any of the major industrial countries. Tentative estimates suggest that the United Kingdom's relative unit labour cost performance was better in the economy as a whole than in manufacturing in 1984–85, with comparable productivity growth to that of the major six and less of a gap in earnings growth. Furthermore, productivity figures are much affected by the state of the cycle. The strong recovery in the growth of UK manufacturing productivity to 2¾% in the year to the third quarter, close to its trend rate of growth, is indicative of this. IMF estimates indicate that, discounting the cycle, the United Kingdom's underlying manufacturing productivity performance has not recently been inferior to that of the major six. Even so, 'normalised' unit labour costs in the United Kingdom have risen by a little over 5% in the year to the second quarter on this measure compared with less than 1% in the major six on average.

This suggests that the United Kingdom's basic problem lies less with productivity than with its relatively high wage settlements. In earlier years this could be explained in part by higher UK price inflation than the average in the other major industrial countries. However, in the past two or three years UK earnings have continued to rise significantly more rapidly than elsewhere despite the fact that UK inflation had converged towards the average for the major six. The latest estimates indicate that UK whole-economy earnings are continuing to rise at 7%–8% over a year ago, compared with 3½% on average in the major six; the corresponding rates of increase of consumer prices are 3% and 1½% respectively. Furthermore, unemployment in the United Kingdom is still higher than in most of our major competitors.

The apparently limited responsiveness of UK earnings to relatively low inflation and high unemployment may be attributable to a number of factors which are discussed in the Commentary (see page 469). It appears there may be growing segmentation in the labour market between those with jobs and those without. As much of the rise in unemployment in recent years has reflected an increase in the duration of unemployment, the numbers of long-term unemployed are likely to have a diminishing effect over time on the wages of those in employment. If the labour market is becoming increasingly segmented, and there are also strong pay comparability effects, earnings could continue to grow faster than can be explained by factors traditionally thought to be their main determinants.

Average hourly earnings, productivity and unit labour costs in the United Kingdom and abroad



Source: IMF

(a) Figures for average earnings relate to total compensation per man hour.
(b) Weighted (by GNP) average of Canada, France, Germany, Italy, Japan and the United States.
(c) Per man hour.

This year the competitiveness of British industry will have been maintained, with little damage to UK inflation prospects, by the fall in the exchange rate which has accompanied the fall in oil prices. Stronger growth of manufacturing output next year should mean faster productivity growth, which should moderate the rise in unit labour costs, as occurred in the third quarter. The recent evidence of greater moderation in manufacturing pay settlements is also encouraging. However, this has so far not been sufficient to bring the United Kingdom into line with its major competitors, especially as the underlying growth in UK manufacturing earnings remains at 7¾% per annum, and the growth of productivity seems likely to rise overseas as well as at home. Trends in unit labour costs, therefore, remain a source of concern, because of their implications for the underlying competitiveness of the UK economy and for UK inflation in the medium term.

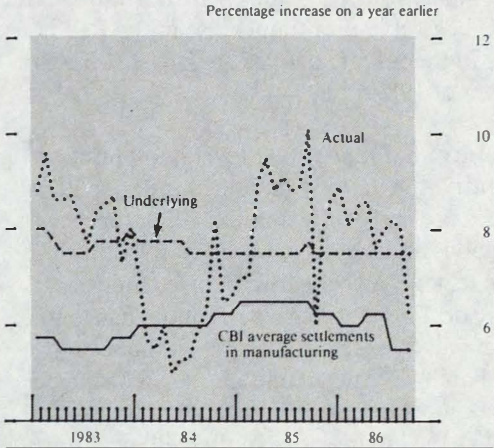
Average gross weekly earnings for all employees[(a)]

	1983/84	1984/85	1985/86
Public sector	5.8	6.4	8.0
Public service	5.6	6.1	8.0
Central government	4.7	6.9	8.2
Local government	6.1	5.7	7.9
Public corporations	6.5	7.5	7.6
Private sector	9.6	7.8	8.1
All industries and services	**8.1**	**7.2**	**8.0**

Source: New Earnings Surveys 1984–86. Full-time adult employees whose pay is not affected by absence. Figures between successive years will be influenced by the timing of pay settlements and by changes in the coverage of the sectors.

(a) Percentage change between April of the years shown.

The underlying increase in whole economy **average earnings** *remains steady at* $7\frac{1}{2}\%$



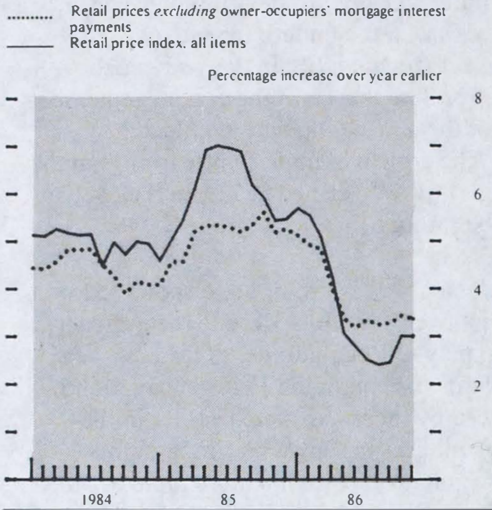
industries averaged $6\frac{1}{2}\%$ in the second quarter, compared with an average of 7% for 1985 as a whole. Recent settlements in the public sector have risen towards those in the private sector, following a period when increases in earnings in the public sector have lagged behind those in the private sector.

The indications of some moderation in private sector settlements have not been reflected in the earnings series. In the year to September, the underlying rate of growth of average earnings in the whole economy remained at $7\frac{1}{2}\%$, a rate little changed since the end of 1983. The increase in the underlying rate of manufacturing earnings remained at $7\frac{3}{4}\%$ in the year ended September, although lower than the 9% in the year to September of last year, with most of the decline thought to reflect the reduction in overtime. The growth of underlying earnings in the private service sector has however firmed to $7\frac{1}{4}\%$ in the twelve months ended September, from $6\frac{3}{4}\%$ a year earlier.

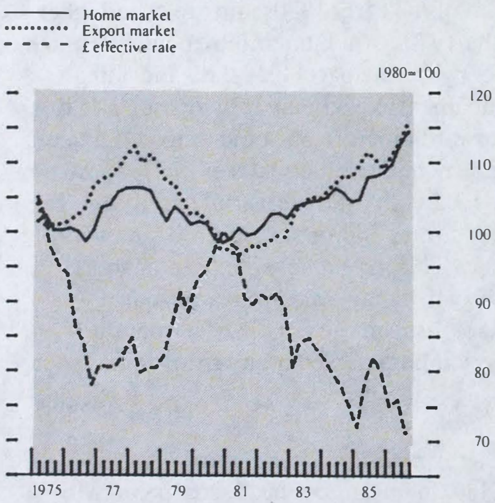
The failure of both settlements and earnings to respond to lower price inflation in the past twelve months, despite the persistence of high unemployment, may reflect a number of factors. Settlements agreed towards the end of the 1985/86 pay round may have been influenced by those negotiated earlier in the round when the rate of inflation was higher. Comparability considerations may also help to explain the more rapid earnings growth in the public sector. Demand for labour may also have been stronger in certain parts of the labour market than is suggested by the unemployment figures. During 1986 there has been a steady increase in the number of vacancies reported to Job Centres, with 213,000 outstanding in October (seasonally adjusted and excluding vacancies in the Community Programme). Vacancy levels are currently well above the lows seen during the recession of the early 1980s and are even higher than in some years of the 1970s, when unemployment was much lower. The mis-match between the particular skills most in demand and those of the unemployed may be widening and this may have resulted in upward pressure on some wage settlements. In addition the relatively high pay settlements of the 1985/86 pay round were generally agreed with little industrial disruption. In 1985 both the number of strikes and the total number of working days lost fell to low levels. This may reflect the need of some firms to concede relatively high pay awards to recruit or retain staff with specific skills, and the growth of corporate profitability over the period has enabled many firms to pay such increases.

The recovery of manufacturing output in the third quarter brought a sharp rise of $1\frac{3}{4}\%$ in output per head, compared with only a modest increase in the first half of the year. In the year to the third quarter, output per head rose by $2\frac{3}{4}\%$, close to its estimated trend rate of growth, suggesting that the pick-up was mainly due to cyclical factors. The rise contributed to a marked slowdown in the growth of unit wage costs, from $7\frac{1}{4}\%$ in the year to the second quarter to a little under $4\frac{1}{2}\%$ in the year to the third. The growth of productivity and unit labour costs in the whole economy will have followed a similar, but less dramatic pattern, as the services sector is less subject to cyclical movements. In the year to the second quarter whole economy productivity and net labour costs were, respectively, $1\frac{1}{4}\%$ higher and nearly $6\frac{1}{4}\%$ higher than a year earlier.

Inflation, *as measured by the retail price index, is now 3%*



Manufacturers' margins *may have widened this year*[(a)]



(a) Price: cost ratios in manufacturing.

. . . faster than the rate of **inflation**

The twelve-month increase in the retail price index remained at 3% in October, having risen in September from just under 2½%. The rise was not unexpected and reflected a combination of higher petrol prices and the disappearance of the mortgage rate reduction of September 1985 from the twelve-month comparison. Some of the earlier fall in the rate of inflation, from 7% in the second quarter of 1985 to 2½% a year later, reflected lower mortgage rates; if this component of the index is excluded, the fall in the rate of inflation is less pronounced. Much of the remainder of the decline in retail price inflation during 1986 occurred in the transport sector, as petrol prices fell, and in the durable goods sector. The average rate of increase in prices of most other components of the index was between 3% and 4%. The immediate prospects are for an increase in the rate of retail price inflation to some 3¼% by the end of the year, partly reflecting the impact of higher mortgage rates, which will increase the RPI in November. The twelve-month increase in the RPI is expected to rise slightly in the middle of 1987, before slowing to 3¾% by the fourth quarter of 1987.

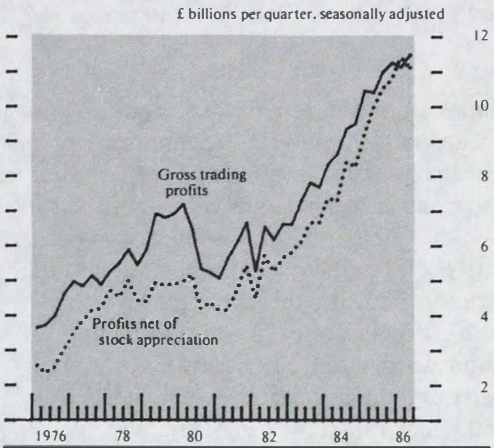
The continuing uncertainty about the future level of oil prices makes it difficult to identify the underlying rate of inflation. The impact of lower oil prices is clearly shown in the fall in the price deflator for exports of goods and services, which was 9% lower in the second quarter than its level a year earlier. Lower export prices contributed to the decline in the twelve-month change in the GDP deflator, which had fallen from over 6% in the second half of last year to less than 3% in the second quarter. The effects of the fall in oil prices are most evident in the movement of producers' input prices, as the buying price of fuel fell by almost 17% in the year to October. The prices of non-fuel materials have risen in recent months, so that the beneficial effects of the fall in commodity prices during much of 1985 and in the first half of this year are gradually diminishing. Manufacturers' input prices in October were about 5% below their level a year earlier, compared with an equivalent figure of 10% in the middle of the year. Manufacturers' output prices rose at about 4¼% per annum in the year to October, a rate little changed since April.

These trends, combined with the growth of unit labour costs, imply that manufacturers' margins have widened in both domestic and external markets since late 1985. The fall in export margins in the latter part of last year, reflecting the appreciation of sterling in the first half of 1985, has been reversed in 1986, and domestic margins have increased even more strongly. The apparent widening of margins is, however, surprising in view of the moderate growth of output earlier in the year and indications from CBI surveys that prices are the main factor limiting export growth. It is possible that manufacturers may have been content to maintain existing shares in both export and domestic markets.

Company dependence on **bank borrowing** *has fallen*

The profits (net of stock appreciation) earned by industrial and commercial companies (ICCs) from their domestic operations fell in the second quarter to a little over £12½ billion, compared with a quarterly average of about £14¾ billion during 1985. This mainly reflected a sharp fall in the profits on North Sea activities to a level only a third of that attained a year earlier. There also

Profits *of non North Sea industrial and commercial companies are over 10% higher than a year earlier*



seems to have been a slight fall in the profits earned by non North Sea companies in the second quarter, although profits were 11% higher than in the same quarter of last year. In the second quarter the pre-tax rate of return for all ICCs was 8% and for non North Sea ICCs was 7½%, according to Bank estimates. The profitability of the non North Sea sector during the second half of the year will depend partly on whether companies have sought to maintain profit margins or increase their market share through more competitive pricing. As selling prices more fully reflect recent falls in fuel and material costs, margins could begin to narrow the end of the year. But, offsetting this, the recent depreciation of sterling could permit some widening of margins.

There are signs that, during 1986, companies have become more dependent on capital markets than on banks as a source for their external funds, although it is unclear whether the new pattern of financing will be more than temporary. Sterling bank borrowing by ICCs rose in the first quarter, but was followed by lower borrowing in the second quarter which may partly reflect the quarterly profile for fixed investment. In addition, the quarterly banking numbers may possibly have been distorted by the adjustments made for the activities of securities dealers who were formerly counted as ICCs in the banking returns, but who have been transferred to the financial companies' sector for statistical purposes. ICCs' reduced dependence on banks for external finance since the first quarter is probably also associated with the high level of capital issues. ICCs have raised some £3 billion by way of equity issues during the first nine months of the year, almost as much as was raised in the whole of 1985. The reduction in long-term bond rates in the spring prompted an increase in issues of long-term bonds in both the domestic and the eurosterling markets, amounting to some £1½ billion in the first nine months of the year. But the amounts raised in the bond markets have shown signs of tailing off since the summer, reflecting a firming of long-term rates.

The PSBR *is forecast to remain below 2% of GDP*

The public sector borrowing requirement (PSBR) amounted to £5.7 billion in the first seven months of the financial year, compared with £5.3 billion over the corresponding period in 1985/86. In the Autumn Statement, the PSBR forecast for the current financial year was confirmed at £7 billion, equivalent to just 1¾% of GDP. However, both revenues and spending plans were revised compared with the Budget forecast. Non-oil receipts, especially from corporation tax and VAT, have been more buoyant than originally forecast, and have been more than sufficient to offset lower-than-expected North Sea oil revenues. Overall, revenues in the current financial year were revised up by £½ billion, after taking account of Advance Petroleum Revenue Tax. General government expenditure in 1986/87 is now projected to be £1 billion higher than the Budget estimate, amounting (excluding privatisation proceeds) to 44½% of GDP. The PSBR estimate remains unchanged at £7 billion because public corporations' market and overseas borrowing is expected to be £½ billion less than predicted at the time of the Budget. The Chancellor has also indicated that the PSBR in the 1987/88 financial year will be held at 1¾% of GDP.

World economic prospects—latest Bank forecasts

After the pause in growth around the turn of the year, output in the major seven industrial countries is expected to grow at some 3% per annum from the second half of this year through to 1988. Domestic demand is forecast to remain buoyant, while net trade is projected to exert less of a drag on growth. The falls in primary product prices over the last year have increased real incomes within industrial countries, and should contribute to further growth of private consumption. Investment is also expected to increase owing to improved profitability, and to recent declines in interest rates.

Demand and output in the seven major economies[a]
Percentage changes

	1985	Forecasts 1986	1987	1988
Domestic demand	**3.0**	**3.5**	**3.4**	**3.1**
of which:				
Private consumption	3.0	3.6	3.5	3.1
Private investment	6.2	3.6	4.9	4.8
Public expenditure	3.0	2.3	1.6	1.3
Stockbuilding(b)	-0.6	0.2	—	—
Net trade(b)	-0.1	-0.9	-0.3	-0.2
GNP(c)	**2.9**	**2.6**	**3.1**	**2.9**

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

(b) Percentage contribution to GNP or GDP.

(c) Or GDP.

Consumer price inflation in the main industrial countries is forecast to remain at about 2% on average this year and next. This reflects large falls in oil and non-oil commodity prices over the last twelve months, as a result of which local currency import prices for the major seven are likely to decline by some 15% in 1986. The oil price remains a key area of uncertainty; the assumption made in the spring (see June 1986 *Bulletin* page 170) that OPEC will achieve a degree of production restraint has been maintained, and hence the oil price is projected to rise from an assumed average of $15 per barrel in the fourth quarter of 1986 to $20 per barrel by the beginning of 1988. Real non-oil primary product prices, which have continued to decline this year, are expected to recover slightly over the forecast period. Unit labour costs in manufacturing in the major economies are expected to rise by just ½% in both 1986 and 1987, and by only about 1% in 1988. These factors, together with the assumption of generally non-accommodating monetary and fiscal policy in the major seven, underpin the prospect of low inflation. However, by 1988 inflation is forecast to edge up to nearly 3%, as the impact of the large declines in input prices disappears.

Prices in the seven major economies
Percentage changes

	1985	Forecasts 1986	1987	1988
Import prices(a)	1.3	-14.6	-0.8	4.4
Unit labour costs(b)	2.6	0.6	0.5	1.0
Consumer prices(c)	4.0	2.1	2.0	2.8

(a) Weighted average of individual countries' local currency average value indices for imports.

(b) Unit labour costs in manufacturing, adjusted to reflect variations in productivity over the economic cycle.

(c) Consumers' expenditure deflators.

In the United States, domestic demand is forecast to grow by 3½% this year, slowing to around 2½% per annum in subsequent years. Private consumption in 1986 remains buoyant owing to gains in real personal disposable income. However, the rate of inflation is forecast to rise to 3½% by 1988, partly reflecting the 30% depreciation of the dollar since February 1985, and this slows the growth of consumer spending. Private sector fixed investment increases only moderately as a result of low investment in the energy industry and the uncertainties associated with tax reform. Fiscal policy is assumed to be slightly contractionary over the next two years taken together, reflecting a limited implementation of Gramm-Rudman-Hollings; tax reform has also been allowed for in the forecast. However, improved competitiveness is projected to contribute to a turnaround in trade volumes: in 1987 and 1988 import volumes are static, and export volumes rise by over 10% per annum. Hence, GNP is forecast to grow by 2½% this year, and nearly 3% per annum in 1987 and 1988.

In Japan, economic growth over the forecast period is affected by the negative contribution of net trade, with the growth of export volumes expected to be very weak relative to past performance. In part this is the result of the appreciation of the yen. Japanese fiscal policy is projected to remain cautious, and the general government financial balance is expected to fall from a deficit of 1½% of GNP in 1985 to ½% by 1988. However, low interest rates and low inflation should stimulate domestic demand. Profit margins of Japanese companies in aggregate should have increased as a result of the substantial falls in input prices which to date have only been partially passed through to consumers. The improvement in profitability is expected to contribute to a rise in investment. Nevertheless, the forecast rate of domestic demand and GNP growth in 1987–88 (4½% per annum and 3¼% per annum respectively) may be viewed as only moderate in relation to the expansion of productive potential.

Large terms of trade gains this year arising from both falls in raw material prices and appreciating exchange rates are expected to result in fairly strong growth in Europe. In Germany, consumer prices have fallen this year, but are forecast to rise slightly in both 1987 and 1988. Although German fiscal and monetary policy is assumed to remain restrained, direct tax cuts were implemented earlier this year and the authorities plan further reductions. These provide a powerful boost to the growth of personal consumption. In addition, the sharp rise in the savings ratio in the first quarter of 1986 is reversed as consumers adjust with a lag to increased real personal disposable income, and to falls in both inflation and interest rates. Investment is also expected to show an upturn, following the slump in the construction sector last year. German domestic demand is therefore expected to rise sharply in 1987 and 1988, by nearly 4½% per annum, with GNP growth about one percentage point per annum less than this owing to trade volume developments. Employment prospects are relatively buoyant, with unemployment projected to fall to around 8½% next year. Growth in France and Italy is expected to benefit from both a marked fall in the rate of inflation and some decline in savings ratios. Strong increases in profitability coupled with falling interest rates should facilitate investment. Despite a more favourable outlook for employment than in recent years, particularly in France, unemployment may continue to edge upwards in these countries.

World trade is expected to grow by 4½% in each of the forecast years. Within the total, imports by the United States are forecast to stabilise, but this is offset by strong growth of imports in most of the other major industrial countries, particularly Japan and Germany. Certain non-oil developing countries have had to rein back import growth this year. However, their financing constraints are expected to ease, reflecting a reduction in the real cost of

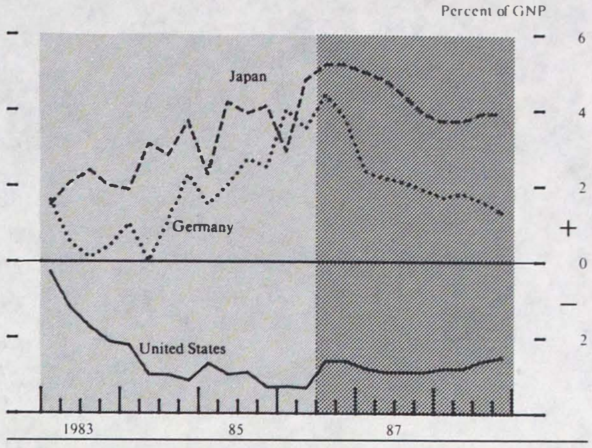
World trade and UK markets
Percentage changes

	1985	Forecasts 1986	1987	1988
World trade	**3.6**	**4.4**	**4.5**	**4.5**
of which:				
OECD	5.5	6.8	5.1	4.9
OPEC	−15.4	−18.2	−7.6	−2.8
Other developing countries	3.6	1.9	5.5	6.3
UK markets(a)	**3.1**	**4.7**	**4.6**	**4.6**

(a) UK trade-weighted index of import volumes.

servicing dollar-denominated debt, induced by recent declines in the dollar and US interest rates. In addition, the projected modest recovery in primary product prices would increase export earnings. Non-oil developing countries' import volume growth may, therefore, recover from the low rate of 2% expected this year to an average of about 6% per annum. The volume of imports into OPEC countries is estimated to have fallen by some 18% this year, although the degree of retrenchment is expected to slow over the forecast period. Cutbacks in imports by OPEC countries affect the growth of UK export markets, particularly in 1986, but buoyant domestic demand in the major overseas countries, especially in Europe, should

Current account imbalances



more than compensate for this. UK markets, therefore, look set to grow very much at the same rate as world trade as a whole.

The US-Japanese current account imbalance is expected to persist over the forecast period. The US current account deficit is projected to stabilise at around $125 billion per annum, although it may fall slightly as a proportion of GNP by 1988. Japan and, to a lesser extent, the European countries have experienced huge terms of trade gains, the result of falls in primary product prices and the appreciation of their exchange rates. However, relatively buoyant domestic demand and losses in competitiveness should result in a worsening of net trade volume performance in these countries. The outcome of these forces is that the Japanese current account surplus is forecast to rise to around $100 billion next year (from $50 billion in 1985) and to moderate only very slightly by 1988, whereas the German surplus is forecast to decline appreciably from an estimated $35 billion this year.

Given the projection of large and sustained current account imbalances in the central forecast, an alternative scenario was investigated to consider policy changes that might bring about more consistent and sustainable external positions. To achieve the objective of bringing the US current account back towards balance, a package was imposed consisting of severe government expenditure cuts and personal direct tax increases in the United States (entailing a cumulative fiscal contraction amounting to 5% of GNP over four years), together with some relaxation of the fiscal stance in Japan and Germany in comparison with the central forecast. It was also assumed that the dollar would be lower than in the central forecast, as would US interest rates. The extent of the measures required in this scenario to eliminate the prospective current account imbalances emphasises the risks to the central forecast implied by these imbalances.