Economic commentary

- *The recovery among the major industrial countries from the pause in growth at the beginning of 1986 continued at a moderate rate in the third quarter.*
- *Inflation has continued to decline among the major overseas economies. However, in the fourth quarter spot oil prices rose to over $18 per barrel.*
- *Current account imbalances persist, with only slight adjustment so far of US trade volumes to the substantial decline in the dollar.*
- *A further weakening of the US dollar around the turn of the year contributed to a realignment of EMS currencies in mid-January. Later in the month there was a cut in official interest rates in Germany.*
- *In the United Kingdom, the rate of economic growth strengthened in the third quarter, according to the output measure of GDP.*
- *There was a steady increase in the growth of domestic demand during 1986, led by consumer spending, reflecting a further rise in real personal disposable income.*
- *Manufacturing output has risen further, partly reflecting a strong cyclical increase in productivity. Associated with this, the growth of unit wage costs slowed: in the three months ended November they were 3% higher than a year earlier.*
- *The deficit on current account narrowed in the fourth quarter of 1986, and the increase in non-oil export volumes exceeded that of imports. Recent survey evidence indicates manufacturing firms are more optimistic about export prospects.*

The industrial countries have recovered from the pause in activity early in 1986, and in the third quarter experienced moderate growth combined with low and falling inflation. While external factors such as lower oil prices may have less of an impact on inflation this year than they did in 1986, increases in labour costs have eased in the United Kingdom and in most overseas countries. There are signs that trade volumes in Germany and particularly in Japan may be adjusting to the large exchange rate changes over the last two years. However, these adjustments have so far been insufficient to prevent the current account surpluses (measured in dollars) of both countries from growing. Meanwhile, US trade volumes have so far shown little response to the decline in the dollar, and the current account deficit of the United States has widened further. Exchange rates and interest rates were less volatile in the second half of 1986 than for some time, though around the turn of the year the dollar came under renewed downward pressure, triggering an EMS realignment. Although higher oil prices may ease pressures on some of the major oil exporters, most non-industrial countries continue to face severe balance of payments constraints, and their difficulties could be exacerbated if further protectionist measures were to be introduced by the developed countries.

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	Q3
Canada	5.5	4.0	3.8	3.8	1.2
France(a)	1.5	1.3	3.2	1.3	..
Germany	3.0	2.5	4.5	0.6	2.9
Italy(a)	2.8	2.3	1.4	4.4	
Japan	5.0	4.7	4.3	1.2	2.6
United Kingdom(a)	2.9	3.4	1.3	2.9	2.5
United States	6.4	2.7	3.2	2.5	2.8
Total	**4.7**	**3.0**	**3.3**	**2.1**	..

.. not available.

(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	3.8	3.6
Private fixed investment	8.8	6.3	8.5	0.6
Public expenditure	2.5	3.0	6.2	0.2
Stockbuilding(b)	1.0	-0.5	-0.7	1.1
Domestic demand	**5.1**	**3.0**	**4.4**	**3.4**
Net trade(b)	-0.4	—	-1.0	-1.3
GNP	**4.7**	**3.0**	**3.3**	**2.1**

(a) Or GDP.

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

Growth *has been moderate in the industrial countries . . .*

Output in the major overseas economies in aggregate is estimated to have grown by 2½%–3% at an annual rate in the third quarter. This moderate performance suggests that the stronger second quarter growth was partly a rebound from the pause in the first quarter. Early indications for the fourth quarter are mixed. In the United States, preliminary estimates suggest GNP growth slowed to an annual rate of 1¾%, as consumer spending weakened. On the other hand, retail sales in Japan remained buoyant in October, and retail sales in both France and Italy have strengthened according to recent estimates.

The moderate growth of GNP in the third quarter among the major overseas countries has been accompanied by even weaker growth of industrial production (on which information is usually more readily available). For example, in both the United States and Japan, industrial production was less than 1% higher in December than twelve months earlier. In Germany, industrial production in November was virtually unchanged on the corresponding month in 1985 and orders in manufacturing fell in both October and November. Overall, industrial production in October was only about 1% higher in the major overseas economies than a year earlier, but the rate of unemployment was unchanged. These developments suggest that much of the growth in output in recent quarters has been concentrated in the service sector.

. . . but **demand** *has been stronger*

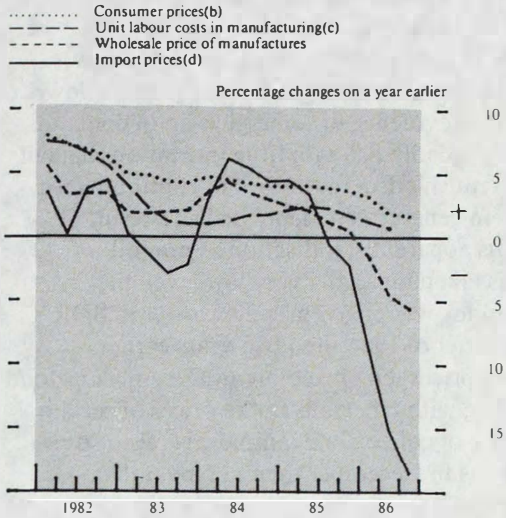
Domestic demand in the major economies has in general been buoyant for four years now, with private consumption playing a leading role. Private consumption continued to grow strongly in the third quarter in Germany (to stand over 3½% higher than a year earlier); in Japan consumer spending rose at a similar rate in the year to the third quarter; in the United States, preliminary fourth quarter data support the view that some of the strength of spending in the third quarter reflected a bringing forward of consumption from the fourth quarter, the result of incentive schemes to increase car sales. The growth of consumer spending is still supported in most of the major economies by strong increases in real disposable incomes associated with low inflation rates. Public expenditure, by contrast, was generally restrained in the first half of 1986[1] and there was also a sharp downturn in the growth of private investment in the major seven as a whole. In Japan, the actual and expected fall in demand from overseas has been a key factor, while in the United States the setback in the energy industry has not been offset by higher capital spending in other sectors, and uncertainty over tax reform may also have acted as a temporary disincentive. While the growth of investment in Germany also appears to have been weak in the first half of 1986, in both France and Italy it was relatively strong, encouraged by more buoyant domestic economic prospects than in the recent past.

Inflation *has fallen further . . .*

Consumer price inflation measured over twelve months has continued to decline in the major overseas economies, and there were further actual falls in prices in Germany and Japan in the

(1) See the note on page 14 for a medium-term perspective on fiscal policy.

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



(a) Canada, France, Germany, Italy, Japan and the United States.
(b) Consumers' expenditure deflator.
(c) Adjusted to allow for cyclical fluctuations in productivity.
(d) Average of national figures, thus including imports from other major economies.

autumn of last year. Developments in the external sector have contributed most to lower inflation. Although oil prices have risen since the summer, there was a substantial fall in non-oil commodity prices in the third quarter. Moreover, the effects of previous falls in import prices were probably still working through in the third quarter, when wholesale prices in the major seven in aggregate fell at an annual rate of 5%. However, there are signs that wholesale prices are beginning to stabilise. There have been small rises in the respective indices in the United States since July and in France and Italy since August. The increase in wholesale prices in Japan in November was the first for nearly two years. Germany was the only country among the overseas majors in which wholesale prices fell in November.

. . . but continued progress may require restraint in **labour costs** . . .

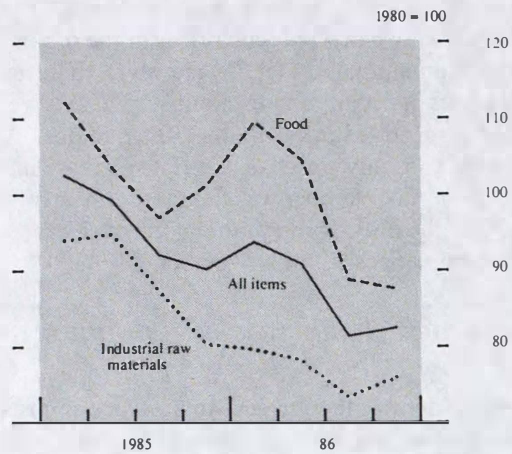
In the year to the second quarter the increase in unit labour costs in manufacturing had slowed to about 1½% over a year earlier in the major overseas economies.[1] Complete information is not yet available on developments in earnings and unit labour costs abroad in the third quarter. However, it appears that manufacturing earnings in the major overseas economies in aggregate continued to grow at around 4% over a year earlier,with manufacturing unit labour costs rising at a similar rate to that recorded in the year to the second quarter. The twelve-month growth rate of whole-economy earnings eased in the second quarter, and appears to have fallen further, to around 2½%, in the year to the third quarter. These developments suggest that whole-economy unit labour costs in the major overseas economies in aggregate may have been only around 1% higher in the three months to September than a year earlier. This trend may need to be maintained if consumer price inflation is to remain close to its current level—about 1¼% at an annual rate.

. . . as **oil prices** *have firmed*

External factors may contribute less to reducing inflation rates than in the past. Spot oil prices (Brent) have risen from $14.5 per barrel in early December to over $18 following the agreement achieved at the OPEC Ministerial Conference in Geneva in mid-December. Under the terms of the agreement, OPEC intends to limit its output to 15.8 million barrels per day in the first half of 1987, and to 16.6 million barrels per day on average in the year as a whole, and will return to a fixed pricing system, based on a reference price of $18 per barrel, to take effect from February. Given the usual differentials, this would entail Brent trading at around $19 per barrel. The agreement suggests there has been a shift on the part of several OPEC producers away from a policy designed to increase market share significantly, and a number of non-OPEC producers may also restrain production or exports this year. Egypt, Norway and Oman, for example, have promised cuts in production, while others, such as Mexico and the USSR, have said they will cut back oil exports. Nevertheless the agreement faces many problems. The agreed output figures include quotas for Iraq which that country has rejected, and there may be difficulty in preventing other key OPEC producers exceeding their quotas. There is still a stock overhang stemming from the period of very high OPEC production in mid-1986; the

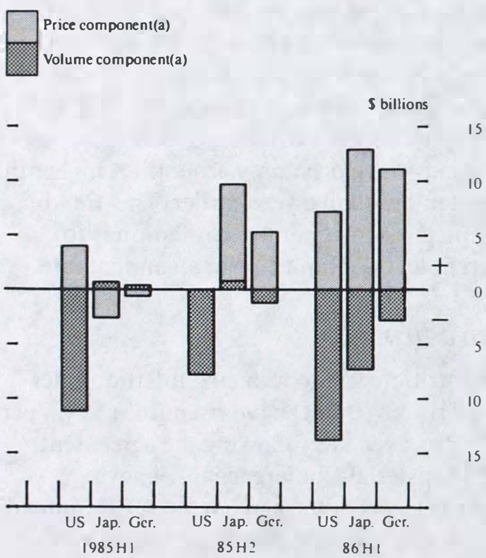
(1) See the note on unit labour costs in the United Kingdom and abroad in the December 1986 *Bulletin*, page 468.

Non-oil **commodity prices**[(a)] *stabilised in the fourth quarter as a whole*



(a) Economist indices in SDRs (quarterly averages).

US trade volumes *showed little response to the fall in* **the dollar** *in the first half of 1986*



(a) Change in half year over the preceding half year.

World trade and UK markets

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

	1984	1985 Year	1985 H2	1986 H1
Import volumes(a)				
Major seven economies(b)	12.8	5.5	5.5	10.8
of which:				
North America	23.1	8.2	8.8	11.1
Japan	10.7	0.4	− 1.5	21.0
Europe	6.9	4.8	4.9	7.6
Other OECD	8.0	6.0	6.3	5.5
OPEC countries	−8.6	−15.4	−19.7	−19.8
Non-OPEC developing countries	7.0	5.4	− 1.1	2.1
Total	**8.8**	**3.9**	**3.1**	**6.1**
UK markets(c)	**7.1**	**3.8**	**4.5**	**4.2**

(a) Imports of goods only.

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

(c) UK trade-weighted index.

problem of adjusting seasonal fluctuations in demand has not yet been resolved; and there may be initial difficulties in implementing the new price differentials.

Spot non-oil commodity prices were little changed in the fourth quarter as a whole, with higher industrial material prices offsetting further falls in food prices. Among industrial raw materials, agricultural non-food prices rose from the very low third quarter levels, with evidence of some pick-up in demand. Metal prices remained broadly flat with little indication that cuts in output had yet had much effect in the face of continuing weak demand. Food prices in general were depressed as a result of plentiful supplies. This apparent stabilisation in non-oil commodity prices has taken place at a very low level: the Economist all-items index was on average 20% lower in SDR terms in the fourth quarter of 1986 than two years earlier. Moreover, commodity prices fell once more in December as food prices weakened further, with large falls in the prices of certain commodities. The price of coffee, for example, averaged some 15% lower in SDR terms in December than in November.

Current account imbalances *continued to worsen . . .*

There is still little sign that the depreciation of the dollar over the last two years has brought about a significant adjustment of US trade volumes. In the six months to October, US import volumes were 9% higher than in the same period a year earlier, while export volumes were static, and the improvement in the terms of trade was insufficient to prevent a deterioration of the trade balance. Tentative signs that the trade deficit was beginning to stabilise in September and October were followed by a $15½ billion deficit (not seasonally adjusted) in November. However, the deficit in December, initially estimated at $10¾ billion, suggests the high November figure may in part be attributable to a rush in imports prior to the imposition of customs user fees on 1 December. Meanwhile, the Japanese trade surplus in December was an all-time high of $10¼ billion (not seasonally adjusted). Although Japanese trade volumes have shown some adjustment to the appreciation of the yen, the large reduction in import prices entailed by this appreciation, as well as by lower oil and commodity prices, resulted in a current account surplus of $86 billion in 1986. Terms of trade gains also outweighed a net trade volume deterioration in Germany. The trade surplus in December, at $5¾ billion, was a record; the current account surplus in 1986 is estimated at $36 billion. The continued absence of adjustment of the US deficit has focussed debate on the competitiveness of the US economy and has increased pressure for protectionist measures from some quarters in the United States.

Any increase in trade protection, in the United States or elsewhere, would damage prospects for continued recovery in world trade. Although information in this area is subject to particular uncertainties at present, it appears that world trade was growing at an annual rate of some 6% in the first half of 1986, and was dominated by continuing strong growth of imports into the industrial countries, especially Japan. Meanwhile, OPEC countries and several other developing countries found it necessary to take further adjustment measures as a result of falls in the prices of oil and other primary commodities. OPEC imports may have been 20% lower in the first half of 1986 than a year earlier, according to Bank estimates, and imports of non-OPEC developing countries in aggregate may have been static over the same period.

. . . the **dollar** *has fallen further since December . . .*

The Baker-Miyazawa agreement at the end of October helped to steady the yen-dollar rate in November and early December. However, the poor US trade figures for November, and the growing market view that the German and Japanese authorities would not act to relax fiscal or monetary policy significantly, contributed to a renewed depreciation of the dollar from mid-December onwards. The strength of the deutschemark, in combination with industrial disputes in France, produced strains within the exchange rate mechanism (ERM) of the European Monetary System (EMS). In a realignment of parities effective from 12 January, the deutschemark and the Netherlands guilder were revalued by 3%, and the Belgian and Luxembourg francs by 2%, against currencies of the other countries adhering to the ERM arrangements. Between the Baker-Miyazawa pact and the EMS realignment, the dollar had fallen by over 6% against the deutschemark but by only 2% against the yen. Following the realignment, the dollar fell further against the deutschemark and also resumed its decline against the yen, leading to a reaffirmation by the United States and Japan of their willingness to co-operate on economic and exchange market issues.

. . . and **official interest rates** *were lowered in Germany . . .*

Short-term market interest rates tended to decline through most of 1986 in the United States, as the authorities sought to encourage domestic economic activity. However, there was little further movement in the fourth quarter. The broader targeted US monetary aggregates (M2 and M3) grew by around 9% in the fourth quarter of 1986 over a year earlier, at the top of their respective target ranges. The Japanese authorities cut official interest rates by half a percentage point at the beginning of November in an attempt to stabilise the exchange rate and to contribute to sustained economic growth. The German authorities resisted pressure to follow suit until late January reflecting their concern over the inflationary consequences of monetary growth. In 1986, the rate of growth of central bank money (CBM) exceeded the target (3½%–5½%) for the first time in seven years. However, the German authorities decided to reduce both discount and Lombard rates by half a percentage point with effect from 23 January in order to contribute to stability in the foreign exchange markets and the EMS, following the EMS realignment. At the same time as the cut in official interest rates, the Bundesbank announced liquidity-absorbing measures—reducing rediscount quotas and raising minimum reserve requirements—intended to offset in part the effects of recent intervention in exchange markets. The mid-point of the CBM target range remains unchanged this year, but the range has been widened to 3%–6%.

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

Monthly averages

	1985		1986	
	Mar.	Dec.	June	Dec.
Canada				
Short-term interest rate	11.3	9.3	8.7	8.4
ERI	88.5	81.2	78.5	77.5
France				
Short-term interest rate	10.7	9.0	7.2	8.0
ERI	63.2	69.7	69.0	71.0
Germany				
Short-term interest rate	6.4	4.9	4.7	4.8
ERI	119.1	130.2	134.9	143.5
Italy				
Short-term interest rate	16.1	14.9	12.5	11.4
ERI	45.0	44.9	46.2	48.4
Japan				
Short-term interest rate	6.3	7.4	4.6	4.4
ERI	155.4	177.1	205.4	205.0
United Kingdom				
Short-term interest rate	13.6	11.7	9.8	11.4
ERI	77.2	77.9	76.2	69.2
United States				
Short-term interest rate	9.0	7.8	6.7	6.0
ERI	152.4	127.0	115.8	110.3

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

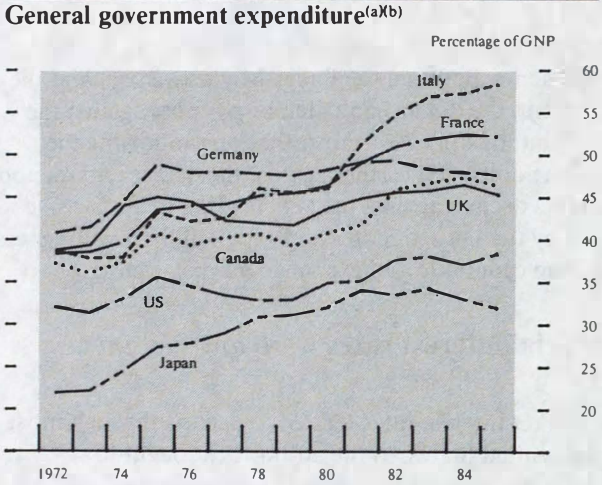
. . . while **public expenditure** *plans are cautious*

If fiscal plans are realised, fiscal policy will impart a contractionary impulse in the major seven in aggregate in 1987, for the first time since 1980. In Germany, planned federal

Fiscal policy in the major industrial countries: a medium-term perspective

In the 1980s most of the major industrial countries have committed themselves to reducing both the relative importance of government transactions in their economies and their fiscal deficits as a percentage of GNP. Their aim has been to free resources for the private sector, particularly by reducing the public sector's demands on capital markets. In general, however, reductions in the share of public spending in GNP have proved very difficult (see chart), while only Japan, Germany and, to a lesser extent, the United Kingdom have achieved a significant reduction since 1980 in the general government financial deficit as a percentage of GNP. Higher debt service payments and rapid growth in social security spending have accounted for much of the upward pressure on deficits. In the United States, tax reductions in 1980–81, the introduction of investment incentives and sharply higher defence spending were also important factors.

General government expenditure(a)(b)



(a) Excluding net lending to other sectors and other financial transactions.
(b) Based on OECD data for 1972-84 and Bank estimates for 1985. UK data are CSO estimates.

Governments of some major countries have also paid increasing attention to the ratio of public debt to GNP. The Japanese authorities, for example, have stated their aim of 'keeping to a minimum the outstanding national debt as a percentage of GNP', though without specifying a target. There are two main strands to this general concern. Rising government indebtedness could create an expectation that future governments might attempt to reduce the real value of the public debt through inflation, thus putting upward pressure on longer-term interest rates. A related concern is that if real post-tax interest rates remain above real growth rates, public debt might accelerate because of the compounding effects of debt service payments. A recent OECD study (see *OECD Economic Outlook*, May 1986) concluded that, taking account of demographic changes and the likely course of pension costs, the need for further fiscal restriction may be greatest in the United States, Canada and Italy. However, it also noted that the likely stability in the debt ratios in Germany and Japan in the next few years may be only transitory.

General government net debt(a)

Per cent of GNP(b)

	1974	1978	1982	1984	1986	1988
United States	22.2	21.6	22.1	26.0	30.0	31.4
Canada	1.0	11.6	18.8	30.0	37.0	40.9
Japan	– 5.4	11.2	23.1	26.4	25.8	25.1
Germany	– 4.7	9.4	19.8	23.0	22.6	21.3
France	8.8	10.2	11.3	15.1	18.2	20.0
Italy	49.2	64.5	70.8	91.0	99.0	108.9
Total	**13.1**	**19.2**	**23.7**	**28.7**	**31.6**	**32.9**
United Kingdom	54.9	53.5	46.5	49.0	48.0	..

(a) General government net financial liabilities at the end of calendar year.
(b) OECD estimates except for 1988 figures which are Bank estimates.

An important feature of most of the major countries' medium-term strategies is the objective of lower deficits, and this is likely to be pursued by further efforts to restrain the growth of public spending, rather than by increasing the tax burden. Unforeseen events, such as the sharp fall in oil prices, have had little effect on these fiscal plans. In Japan, government expenditure could fall in real terms in fiscal 1987, and in France the budget envisages a cut in real expenditure for the first time in nearly thirty years; if the US Administration's budget plans for fiscal 1988 are implemented, government expenditure could fall there in real terms. In Germany, nominal federal government expenditure is planned to rise by 2½% in fiscal 1987 over the outturn in fiscal 1986 and, given the favourable outlook for inflation, is likely to increase in real terms. In the United Kingdom general government expenditure, excluding privatisation proceeds, is planned to grow in real terms by only 1% per annum between fiscal 1986/87 and 1989/90, and fall as a proportion of GDP from 44½% to 42¼% over this period.

General government financial balances(a)

Per cent of GNP

	1978	1980	1982	1984	1986	1988(b)
United States	0.2	–1.3	– 3.5	– 2.7	– 3.4	– 2.5
Canada	–3.1	–2.8	– 5.7	– 6.6	– 5.4	– 3.6
Japan	–5.5	–4.4	– 3.6	– 2.2	– 1.5	– 0.6
Germany	–2.5	–2.9	– 3.3	– 1.9	– 1.0	– 0.6
France	–1.9	0.2	– 2.7	– 2.9	– 2.9	– 1.5
Italy	–9.7	–8.0	–12.6	–13.0	–12.5	–11.9
Total	**–2.1**	**–2.4**	**– 4.1**	**– 3.3**	**– 3.3**	**– 2.4**
United Kingdom	–4.4	–3.5	– 2.3	– 3.9	– 2.9(c)	..

(a) OECD estimates.
(b) Bank forecasts, see December 1986 *Bulletin*, pages 472-3.
(c) CSO estimates: average of first three quarters (seasonally adjusted).

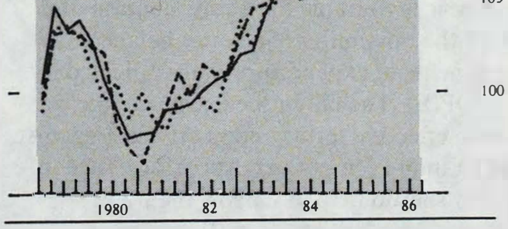
According to Bank forecasts, government deficits as a percentage of GNP are likely to fall in all the major overseas economies between 1986 and 1988. The aggregate general government deficit is forecast to decline from 3¼% of GNP in 1986 to 2½% by 1988. Germany is perhaps closest to achieving its medium-term goal—that of reducing the federal borrowing requirement to 1% of GNP by 1989 (from 1¼% in 1986). The Japanese government has not altered its plan to reduce issues of deficit-financing bonds to zero by the end of fiscal 1990, although the Finance Minister has recently suggested that the target may need to be reviewed. In the United States the Gramm-Rudman-Hollings legislation envisages the elimination of the federal deficit by 1991.

More emphasis is now being placed on tax reform and privatisation in the medium-term fiscal strategies of the major industrial countries, with the intention of improving the supply potential of the private sector. Most tax reform plans involve a shift away from personal direct taxation towards indirect taxation. Privatisation has been particularly important in the United Kingdom—since 1981 the sale of nearly twenty publicly-owned enterprises has thus far realised about £10 billion. A number of other governments are now adopting similar policies. For example, the French government plans to privatise sixty-five undertakings over the next five years with an estimated market value of some Fcs 300 billion (about £30 billion).

government expenditure in 1987 has been reduced by some DM 2½ billion from the level foreseen in the draft 1987 budget approved by the Cabinet in July. After allowing for a shortfall in spending last year, expenditure in nominal terms is planned to rise by 2½%, although the authorities have indicated that they would respond flexibly if the official growth forecast of 2½% looked in jeopardy. The Japanese draft budget for fiscal 1987 (commencing on 1 April) contained the smallest increase in spending for over thirty years—a negligible increase in nominal terms—whereas tax revenues are projected to increase by 1½%. The Japanese cabinet has adopted a revenue-neutral tax reform programme to be phased in over three years. This follows the proposals of the ruling Liberal Democratic Party's tax council which broadly endorsed the earlier recommendations of the Advisory Council to Prime Minister Nakasone. For fiscal 1987 the plan consists of corporate and income tax cuts, the introduction of a 5% sales tax along VAT lines, and a 20% tax on interest earned on personal savings which are currently tax exempt. The reforms will be phased so that, while the revenue cuts will occur at the beginning of the fiscal year, the revenue-increasing measures will not be implemented until the second half of the year. In the United States, the President presented the Administration's budget for fiscal 1988 (commencing on 1 October 1987) to Congress. The projected deficit is consistent with the Gramm-Rudman-Hollings deficit target of $108 billion. The budget proposals include limited growth in spending, some revenue increases and a small number of asset sales. The proposals are likely to be the subject of considerable debate in Congress before the emergence of an agreed package. Congress is expected to seek to limit the Administration's proposed growth in defence spending and give greater priority to non-defence spending.

At home the **growth of output** *has strengthened*

The growth of **output** *strengthened in the third quarter*



In the United Kingdom the rate of economic growth almost certainly strengthened in the third quarter, although there is some uncertainty about the extent of the improvement, as the alternative measures of GDP, published in December, showed markedly different rates of growth. GDP(O), generally regarded as the best measure of short-term changes in the economy, rose by 1¼% in the third quarter to a level almost 3½% higher than a year earlier. The income measure, GDP(Y), fell slightly in the third quarter and the profile of the expenditure measure, GDP(E), has been flat since the first quarter of 1986. The growth of domestic demand strengthened during the first three quarters of the year, mainly reflecting the increase in consumer spending, but the contribution of the latter to GDP(E) was diminished by the rise in net imports. Although the volume of non-oil exports rose, a rapid rise in consumer spending resulted in sharply higher imports of consumer goods, especially in the third quarter, contributing to a much faster increase in the volume of non-oil imports in the year to the third quarter. Over this period, domestic demand increased by over 3%, whereas GDP(A) at constant factor cost rose by only 2%.

However, the discrepancies between the various measures of GDP suggest the published figures understate the growth in domestic demand. A variety of other indicators suggest there has been an increase in activity in recent months. These include the

Growth in components of GDP

Percentage changes over the same period a year earlier; at constant market prices; *seasonally adjusted*

	1985	1986		
	Year	H2	H1	Q3
Consumer spending	3.7	4.6	4.6	4.9
Government consumption	0.1	−0.6	1.0	2.4
Gross fixed investment	1.9	−0.4	−1.0	1.4
Stockbuilding	0.3	0.3	0.8	0.7
Domestic expenditure	**2.9**	**2.6**	**2.8**	**3.3**
Exports	5.9	2.9	−0.5	4.8
Imports	3.0	0.2	2.0	9.8
GDP(E)	**3.7**	**3.4**	**2.1**	**2.0**

Contributions to the growth of GDP

Percentage changes over the same period a year earlier as a percentage of GDP (E); at constant market prices; *seasonally adjusted*

	1985	1986		
	Year	H2	H1	Q3
Consumer spending	2.2	2.8	2.7	3.0
Government consumption	0.0	−0.1	0.2	0.5
Gross fixed investment	0.4	−0.1	−0.2	0.3
Stockbuilding	0.3	0.0	0.0	−0.4
Domestic expenditure	**2.9**	**2.6**	**2.8**	**3.3**
Exports	1.7	0.8	−0.1	1.4
Imports	−0.8	−0.1	−0.6	−2.7
GDP (E)	**3.7**	**3.4**	**2.1**	**2.0**

more favourable picture emerging from the labour market as unemployment has fallen and vacancies have risen, and the strong rise in tax receipts, especially of corporation tax as profits have risen, as well as VAT, reflecting the buoyancy of consumer spending. The increase in the domestic output of investment goods and the increase in imports (some of which were of capital and intermediate goods) cannot be easily reconciled with the subdued recorded growth in fixed investment. Thus it is possible that consumer spending and investment have all grown faster than is indicated by the latest estimates of GDP(E).

The growth in output in the third quarter reflected an increase in the output of the service industries and the manufacturing and construction sectors as well as increased output from the North Sea following a fall in production in the second quarter. Within the production industries, higher growth was recorded across all the market sectors, particularly in consumer and intermediate goods. Manufacturing output rose by nearly 1½% in the three months ended November and is now shown to have increased fairly steadily since the end of the first quarter. Much of the growth reflects increases in production of electrical engineering and chemicals and (during the latest three-month period) of motor vehicles and parts. These were all sectors in which output had fallen in the year to mid-1986, contributing to a fall in manufacturing output in the year to the second quarter of 1986. Manufacturing output is now estimated to be nearly 2% higher than a year ago. Higher manufacturing output has, since April 1986, been accompanied by an increase in capacity utilisation, according to CBI surveys. However, the percentage balance of firms reporting plant capacity as a constraint on the growth of output has shown little change over the last three years.

The January quarterly industrial trends survey conducted by the CBI confirms the improved outlook contained in its recent monthly surveys. There was an increase in the balance of manufacturing firms reporting higher output over recent months, as well as expectations of a moderate increase in output over the next four months. This is reflected in the improvement in business optimism and in a fall in the balance of firms reporting total order books as below normal—to the lowest level since October 1985. There was a marked improvement in export prospects, thought mainly to reflect the effect of the fall in sterling during the past year, with a decline in the balance of firms reporting export order books as below normal compared with the level in the previous quarterly survey.

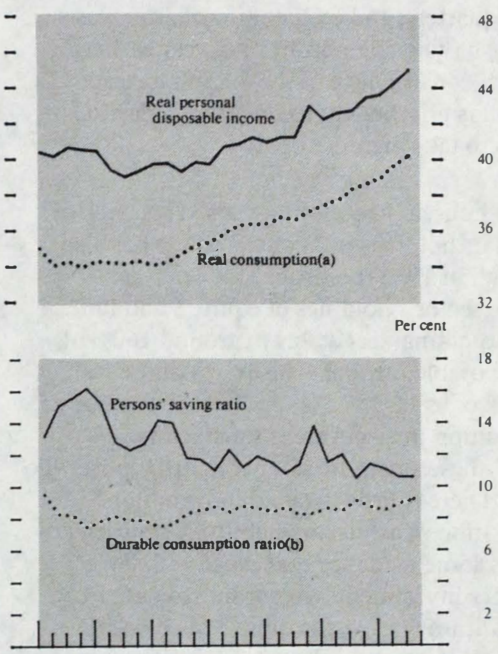
Overall the prospects appear favourable for a continuation of growth during 1987, with the possibility of a better balance between the main components of expenditure than indicated by the latest estimates of GDP(E). The fall in the exchange rate during 1986 (some 11% in effective terms and nearly 20% against the deutschemark) and an improvement in cost performance in the second half of the year should help to narrow the trade imbalance in volume terms. Much depends on the response of domestic output; the rise in imports of capital and intermediate goods in recent months may be an indicator of an imminent increase in the growth of output. Without such a response, however, the expected growth in export demand will not be fully met and a disproportionately large share of the increase in domestic demand will continue to leak into imports.

Consumer spending *is the main source of growth . . .*

Consumers' expenditure rose by $1\frac{1}{2}$% in real terms in the third quarter, to a level nearly 5% higher than in the corresponding period of 1985. Even though the rate of growth of consumer spending may be understated by the expenditure measure of GDP, as noted above, there is little doubt that it has been the main source of growth during 1986. Provisional estimates for the fourth quarter suggest that the growth of consumer spending slowed, partly because expenditure on durables was flat. However, consumers' expenditure was nearly 5% higher than in the fourth quarter of 1985, and durable goods, especially household appliances, represented the fastest growing item of expenditure, up by more than 12% over this period. The volume of retail sales was more buoyant in the fourth quarter, rising by $2\frac{1}{2}$%, to 7% above the level recorded a year earlier. The difference in the two estimates for the fourth quarter is partly explained by the weaker growth of those components of spending not covered by the index of retail sales; for example spending on energy products (in 1980 prices) fell by nearly 3% in the fourth quarter.

The growth in **consumer spending** *reflects the rise in* **incomes**

Seasonally adjusted £ billions. 1980 prices



(a) Including expenditure on durables.
(b) Durables consumption as a ratio of total personal disposable income.

The main factor behind the continued strong growth in consumption was the growth of real incomes. According to provisional estimates, total personal incomes rose by $2\frac{3}{4}$% in the third quarter. After allowing for deductions of taxes and social security contributions as well as the increase in consumer prices, real disposable incomes rose by nearly $1\frac{3}{4}$% in the third quarter to a level 5% higher than a year earlier. Despite the sharp rise in personal sector incomes, the saving ratio remained close to $10\frac{1}{2}$% in the third quarter of 1986, similar to its level in the corresponding quarter of 1985.

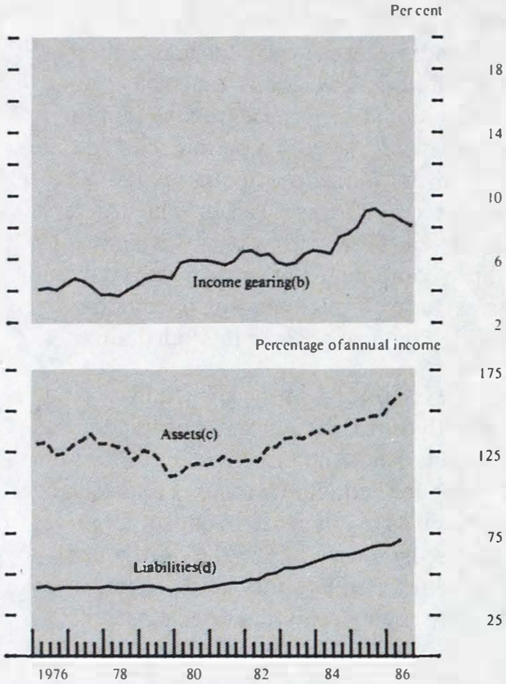
Consumer spending, especially on durable goods (other than vehicles), may also have been boosted by favourable relative price movements. Latest estimates suggest that the annual rate of growth of prices of durable goods fell from just under 4% in the first quarter of 1986 to only $\frac{1}{4}$% in the third. This compares with only a slight slowing in the rate of increase of prices of non-durable goods and services—from $4\frac{3}{4}$% to $4\frac{1}{4}$% over the same period.

. . . supported by increases in **consumer credit** *and* **mortgage lending**

Consumer spending has also been supported by a rise in consumer credit, which rose by £$1\frac{1}{2}$ billion in the third quarter of 1986, after an increase of £$1\frac{1}{4}$ billion in the second. Net increases in consumer credit during the first nine months of the year were estimated to be almost 25% above those recorded in the corresponding period of 1985.

During the third quarter there was a further strong increase in mortgage lending by building societies, banks and other institutions. Mortgage lending amounted to some £$7\frac{3}{4}$ billion in the third quarter, compared with £5 billion in the first and £6 billion in the second. However, according to preliminary estimates, new mortgage lending may have slowed during the fourth quarter, to little over £6 billion. This may reflect in part the weakening in demand associated with the rise in the ratio of house prices to average earnings that occurred in certain regions during 1986, and also perhaps the initial impact of the rise in mortgage interest rates.

The household sector's[a] **debt** *and* **assets** *have continued to rise*



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

Nevertheless, in recent quarters the household sector has continued to build up its liabilities, with the result that the total outstanding stock of liabilities now represents more than 70% of annual disposable income, compared with some 40% in 1980. Part of this reflects the increase in mortgage borrowing. Borrowing for house purchase represents over 80% of the household sector's stock of liabilities, although this proportion has been fairly constant over the last five years. Between 1980 and 1985, income gearing (defined as the ratio of gross interest payments to income before tax relief) rose from below 6% towards 9%. Part of the increase in this ratio reflects the spread of owner occupation in recent years. Nevertheless, the increase in the ratio also reflects an increase in the average size of mortgage in relation to income per individual. The average advance to income ratio exceeded 2 in the third quarter of last year for the first time since the early 1970s. The gearing ratio has, however, fallen slightly in recent quarters, and by the third quarter was estimated at around 8%, having fallen from 9% a year earlier. This reduction is a direct consequence of the fall in mortgage rates earlier in 1986, and is not thought to represent a decline in households' willingness to take on more debt.

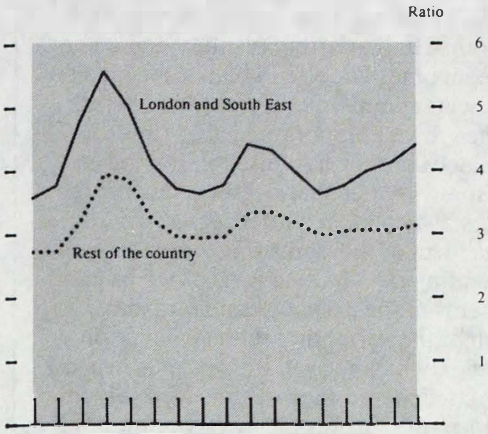
At the same time as the household sector has raised its stock of borrowing, the value of its holdings of financial assets has also increased. In the first half of 1986 the strong stock market boosted the value of the sector's holdings of equities and unit trusts, helping to raise total financial assets to around 160% of households' annual disposable income. The excess of the household sector's stock of assets over that of liabilities suggests that its net financial position in aggregate is satisfactory. However, the owners of these assets are not necessarily those who are accumulating debt. There is little detailed information available on the distribution of assets and liabilities between households, but there is some evidence that those with large mortgages have few other investments. According to data from the 1984 Family Expenditure Survey, for those owner-occupier households in the process of purchase, less than 2% of gross normal weekly income comes from investments, while the comparable figure for those households that already own their properties outright is 10½%. This suggests that, as might be expected, it is mainly younger households that owe debt, but older households that hold assets, a conclusion borne out by the fact that, of recent mortgagees, more than 60% are aged 35 or less and only 4% are aged 55 or over.

The sharp fall in housing starts in the first quarter of 1986 has been followed by a strong recovery to nearly 215,000 at an annual rate in the third quarter, although provisional estimates suggest a slight slowing in more recent months. The likely outturn for 1986 as a whole may be a little more than 200,000, a figure which has been exceeded only once since 1979. Private sector starts are likely to have been above 170,000 in 1986—the highest figure since 1973—while the public sector total of around 30,000 is likely to have been the lowest annual figure since the war.

The rate of increase in **house prices** *has slowed*

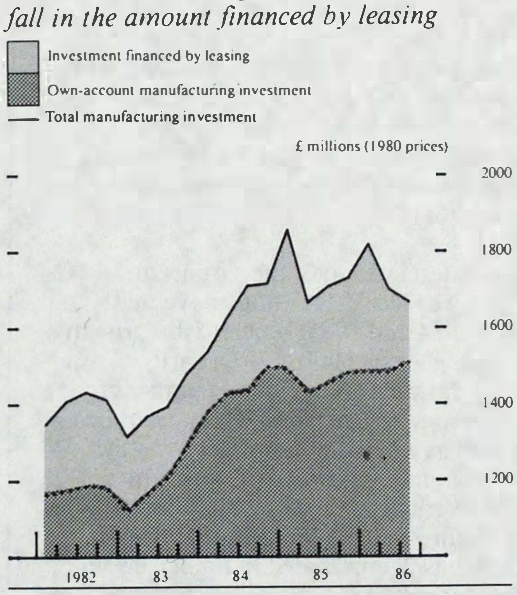
House price inflation, as measured by the Halifax mix-adjusted index, has fallen to an annualised rate of around 12½% in the three months to December, compared with the previous three

The ratio of **house prices**[(a)] *to* **earnings**[(b)] *has risen faster in London and the South East than elsewhere*



(a) Department of the Environment's mix-adjusted house price index.
(b) New Earnings Survey. Average gross weekly pay of all full-time males on adult rates for the regions shown.
(c) Partly estimated.

Lower **manufacturing investment** *reflects a fall in the amount financed by leasing*



months, from a peak of 17% in the summer. Large regional disparities persist. Although the increase in house prices eased in London and the South East in the fourth quarter, prices were, nevertheless, some 20% higher there than a year earlier. The increase in house prices exceeded the growth of average earnings in these two areas, resulting in a rise in the house price to earnings ratio to around 4½ during the year, similar to its previous peak in 1978/79, but well below that of the early 1970s. House prices in several northern regions continue to rise at only a modest rate, if at all, with the result that the average house price earnings ratio for all regions, other than London and the South East, was just over 3, a ratio little changed in recent years.

Capital spending by business *remains subdued*

In the third quarter, capital expenditure by the manufacturing, construction, distribution and financial industries fell 1%, and was 2½% lower than a year earlier. The fall in manufacturing investment accounted for all the decline between the second and third quarters. The weakness of manufacturing investment included a sharp fall in the contribution of leasing, following the abolition of first year allowances from April. The proportion of manufacturing investment financed by leasing has fallen from over 18% in the first quarter of 1986 to just below 10% in the third. Overall the volume of capital spending by business during 1986 was weaker than had been expected at the beginning of the year, probably reflecting uncertainties in the first half of the year about the prospective strength of demand.

Business investment is expected to increase in the next twelve months. There are already some tentative indications that this could occur, to judge from the 1¼% rise in production of investment goods in the three months ending November, the large increase in imports of capital goods recently, and the widening in profit margins (which suggests there will be no shortage of internal funds to finance investment). The latest DTI investment intentions survey, published in December, indicates that spending could increase by 6% this year, comprising a 2% growth in manufacturing and over 8% growth among the construction, distribution, and service industries.

There was a further fall in stock levels in the third quarter. Much of the de-stocking occurred in wholesale distribution, at a rate similar to that recorded in the previous quarter; some of this may have been an involuntary consequence of the strength of consumer demand in this period. The fall in manufacturers' stocks in the third quarter took the stock output ratio to its lowest level since 1973.

The **current account deficit** *narrowed in the fourth quarter*

The deficit on current account, which had emerged in the third quarter, narrowed by more than £½ billion in the fourth, although the improvement was insufficient to prevent a small deficit being recorded for the year as a whole, for the first time since 1979.

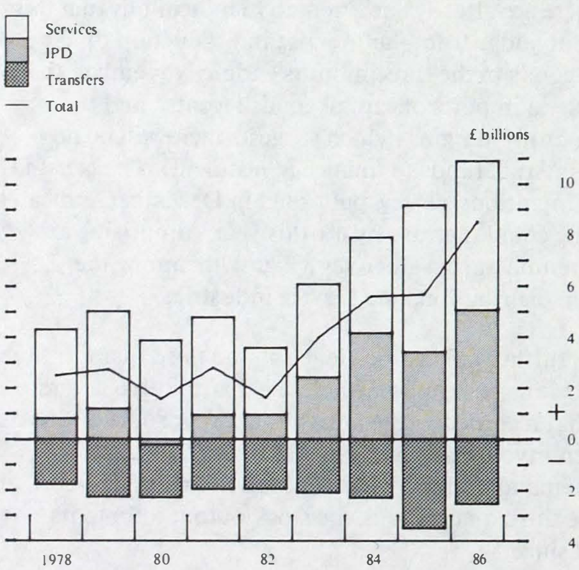
While the invisibles' surplus is projected to have improved last year (see the note on page 20), the visible trade deficit widened. Much (about £4 billion) of the overall deterioration in the trade account reflected the sharp drop in oil prices and a 1% decline in

The United Kingdom's earnings on invisibles

According to latest projections,[1] the surplus on UK invisible trade in 1986 was £8½ billion, which represents a trebling in the nominal value of the surplus since the late 1970s. In the post-war period, the annual surplus on invisibles broadly offset the deficit on visible trade in most years up to 1980, before rapidly rising net oil exports resulted in a visible trade surplus. During the early 1980s, a strong growth in invisible earnings helped to offset the deteriorating balance of trade in manufactures. In 1986 there was a further deterioration in the visible trade deficit as oil prices fell and the surplus on trade in oil was reduced. The latest trade figures indicate there was a small deficit on current account in the year as a whole, as the surplus on invisibles almost offset the higher deficit on visible trade.

The increase in the surplus on invisibles reflects the growth in the surplus on trade in services from £2½ billion in 1982 to an estimated £6 billion in 1986, and in the surplus on interest, profits and dividends (IPD) from £1 billion to an estimated £5¼ billion over the same period (see chart). This increase in the surpluses on both services and IPD has however been offset in part by the gradual increase in the deficit on transfers, mainly reflecting a rise in the United Kingdom's net contribution to the Budget of the European Community.

Invisibles balance[a]



(a) See footnote (1) below.

Within trade in services, net earnings from *financial and other services* have grown substantially from £4¾ billion in 1982 to an estimated £9 billion in 1986. This has partly reflected gains made by UK-based financial institutions in providing services abroad, helped by new technology and the dismantling of controls on capital markets, which have increased the importance of London as a financial centre. Much of the recent growth in earnings has come from a cyclical recovery in insurance underwriting earnings and a rise in UK banks' fee income. The rise in banks' fee income partly reflects a greater emphasis on securitised forms of lending and the growing importance of off-balance-sheet activities in response to pressures on banks' capital. Thus a greater share of their income is being taken in fees, which are recorded as services, rather than in the form of the 'spread' between borrowing and lending rates (which is recorded as part of IPD). Movements in the exchange rate probably account for much of the variability in the balance on earnings from *travel*, which moved into surplus in 1985 after four years of deficit, but then declined sharply in 1986. Movements in the surplus on *civil aviation* tend to be closely linked to changes in the balance on travel. Until 1980 *sea transport* usually recorded a small surplus, but the decline in the size of the UK merchant fleet has contributed to a growing deficit on this account from 1981.

The growth in the surplus on IPD mainly reflects the growth of the United Kingdom's net external assets in recent years, the sterling value of which was estimated at £80 billion at the end of 1985. Receipts from *overseas portfolio investments* rose strongly from a net deficit of £¼ billion in 1981 to a net surplus of over £4¾ billion by 1986. Part of the rise in portfolio investment earnings reflects a shift in UK banks' assets from traditional lending to securitised assets, and earnings from the former have fallen back. Net earnings from *direct investment* have also risen since 1982, although they were temporarily depressed in 1985 by special factors.

According to the latest estimates, the surplus on invisibles in 1986 was over £2¾ billion above that recorded in both 1984 and 1985. Much of this growth in 1986 reflects a higher surplus on IPD, partly reflecting the trends noted above. But a number of additional factors were also at work. The surplus on IPD was increased as a result of lower debits in the form of profits from foreign-owned oil companies operating in the North Sea, reflecting the sharp fall in oil prices. The sterling value of net earnings from overseas investments denominated in foreign currency has increased as a result of the fall in the exchange rate during the year. The lower overall value of sterling should also have enhanced the competitiveness of UK services. A fall in the deficit on transfers between 1985 and 1986 partly reflects the erratic pattern of transactions with the European Community. These developments were more than sufficient to offset the sharp fall in the surplus recorded on travel and civil aviation, compared with 1985, which is likely to have reflected the adverse effects of sterling's recovery against the dollar and perhaps overseas tourists' concerns about terrorism in Europe.

(1) Although official estimates of the invisibles surplus for 1986 as a whole were included in the December trade figures, the projection for the fourth quarter does not break down the components of the surplus into services, IPD and transfers. The figures quoted in the text and chart for the surplus on services, IPD etc for 1986 are Bank projections, based on the assumption that their share of the total invisibles surplus in the fourth quarter was the same as that recorded in the third quarter.

Changes in the UK current balance 1985–86

£ billions

	1985	1986	Change
Visible trade	− 2.1	− 8.7	−6.6
of which:			
Oil	8.2	4.1	−4.0
Non-oil	−10.3	−12.8	−2.6
of which:			
Manufactures (ex erratics)	− 3.8	− 7.5	−3.7
Erratics(a)	0.7	1.6	+0.9
Other	− 7.3	− 7.0	+0.3
Invisibles(b)	5.7	8.5	+2.8
Current balance	**3.5**	**− 0.2**	**−3.7**
Memoranda: Contributions to the change in the visible trade balance			
Volume balance(c)	..	..	−2.6
Price and terms of trade effects(d)	..	..	−4.0

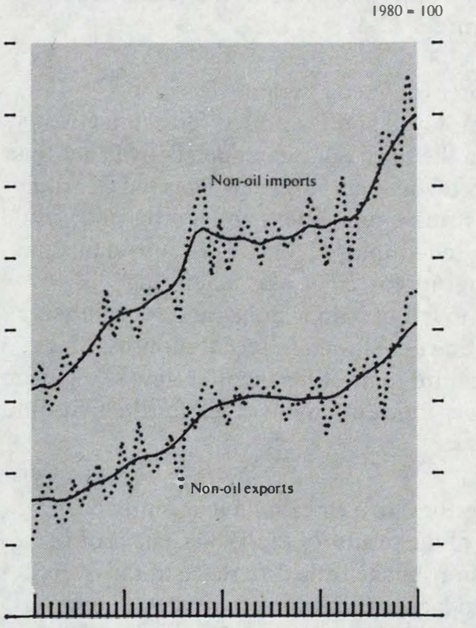
(a) Balance of trade in ships, North Sea installations, aircraft, precious stones and silver.

(b) Based on a projected surplus of £2.4 billion in the fourth quarter.

(c) Change in volume balance of trade expressed in 1985 prices.

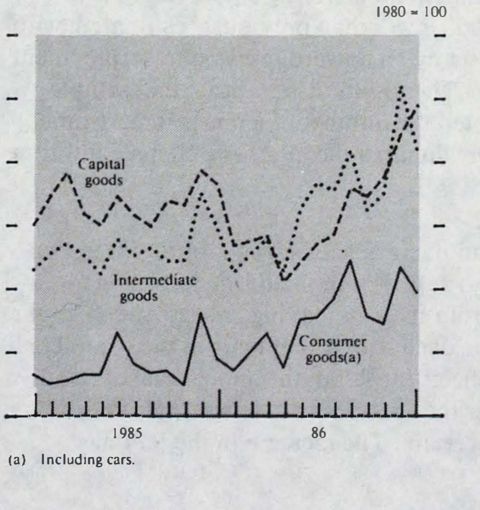
(d) Calculated as the difference between the visible trade balance in current and 1985 prices.

The trend in **non-oil trade volumes**(a) *is upwards*



(a) Including erratics.

Imports of finished **manufactured goods** *have risen*



(a) Including cars.

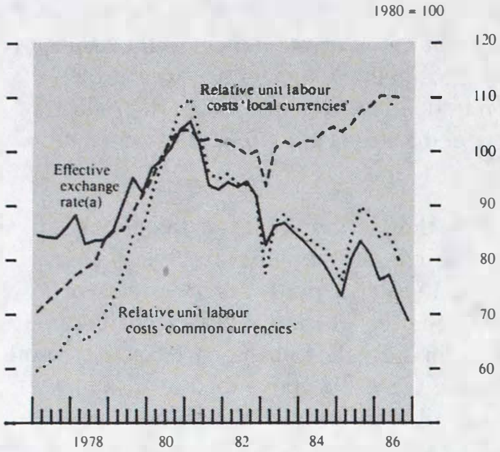
the non-oil terms of trade in 1986 over 1985. However there was also a £2½ billion adverse movement in the volume balance of trade. The large deterioration in the manufacturing trade balance would have been greater but for an improvement in the balance of erratic items (largely attributable to higher net exports of aircraft). The deficit on trade in other goods fell, partly reflecting weak commodity prices and a strong growth in the volume of food exports.

In the last three months of the year non-oil export volumes (excluding erratic items) rose faster than imports. This improvement in the volume balance partly reversed the sharp deterioration in the third quarter, which was largely attributable to a very rapid rise in imports. By the fourth quarter both non-oil import and export volumes were 9½% above their levels of a year earlier. However, the non-oil terms of trade deteriorated as import prices rose and, by December, were 3¼% worse than their August peak, leaving the non-oil balance (excluding erratics) little changed between the two quarters. After falling in the first quarter, the volume of exports of manufactures (excluding erratics) recovered in the second and since then has risen by nearly 9%. Moreover, the volume of exports of non-manufactures other than fuels jumped 20% between the two halves of the year (however, these categories account for less than 12% of non-fuel exports). Imports of finished capital and intermediate goods, together with raw materials, rose sharply in the second half, while a strong underlying growth in consumer goods, evident since late 1985, continued.

The strength of exports, and the recent rise in imports of capital and intermediate goods and raw materials, suggest that domestic output will respond to the buoyant growth of domestic demand. Producers may also be beginning to take advantage of the potential improvements in price competitiveness afforded by sterling's depreciation, as well as the renewed growth in overseas markets after a slack first quarter. Moreover, the latest CBI survey evidence points to further increases in manufactured exports. The volume of consumer imports (including cars) fell back a little in the fourth quarter after a surge of more than 18% in the year to the third quarter of 1985. However, in view of the likelihood of continuing strong growth in disposable incomes, some further growth of imports in this category seems probable.

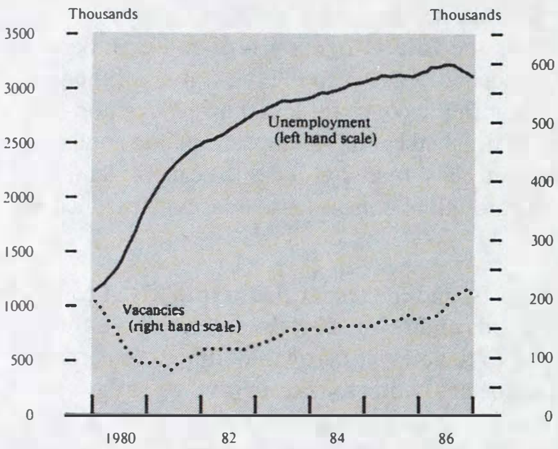
Manufacturing industry's cost performance has improved in the last six months. Recent productivity gains have meant there was no further deterioration in relative unit labour costs in local currency terms, according to provisional estimates. There was a further decline in the value of sterling, its effective rate falling from a little over 76 in the second quarter to just under 72 in the third, there having been a sharp fall against the deutschemark and a slight fall against the dollar. Relative unit labour costs fell, in common currency terms, by almost 5¾% in the third quarter. Because of lags, this improvement in competitiveness is unlikely to affect trade volumes until later this year. The depreciation has also improved relative price competitiveness, particularly for exports, and this is also reflected in the surveys, which show fewer exporters citing relative prices as a limiting factor on export sales. However, the improvement in price competitiveness of domestic output relative to imports has not been as marked, and this may provide a partial explanation for the surge in imports in the second half of 1986.

UK cost competitiveness *improved in the third quarter*



(a) Weighted by 13 countries

Unemployment[(a)] *fell and* **vacancies**[(b)] *rose in the second half of the year*



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

Changes in employment in Great Britain

Thousands; *seasonally adjusted*

	Employees in employment			Self-employed (b)	Employed labour force
	Total	*of which:* Female part-time workers	Full-time equivalent (a)		
Level at March 1983	20,529	3,713	18,673	2,147	22,998
Quarter on quarter change					
1984 Mar.	+ 36	+20	+26	+69	+106
June	+ 21	+ 9	+16	+68	+ 89
Sept.	+ 50	+10	+45	+27	+ 80
Dec.	+108	+39	+89	+27	+134
1985 Mar.	+ 58	+ 9	+53	+27	+ 84
June	+ 33	+12	+27	+27	+ 59
Sept.	+ 33	+20	+23	+31	+ 64
Dec.	+ 34	+ 7	+31	+30	+ 62
1986 Mar.	+ 4	+28	−10	+31	+ 34
June	+ 11	+17	+ 2	+30	+ 40
Sept.	+ 40	−15	+48	+31	+ 71
Level at September 1986	21,099	3,999	19,100	2,696	24,117

(a) Assumes two part-time jobs to be equivalent to one full-time: adjustment has been made to female employment only (data are only available for male part-time employees on a non-seasonally-adjusted basis). 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*.

Although the decline in sterling's value has improved competitiveness, it has also inevitably meant an increase in import prices. Since the sharp fall in sterling in July, non-oil import prices have risen by 5½%, compared with an increase of just 1½% in the previous six months. Meanwhile, non-oil export prices have risen only 3¼% since July and so the terms of trade have begun to deteriorate, after improving steadily since the beginning of 1985.

There was a further fall in **unemployment** *in December*

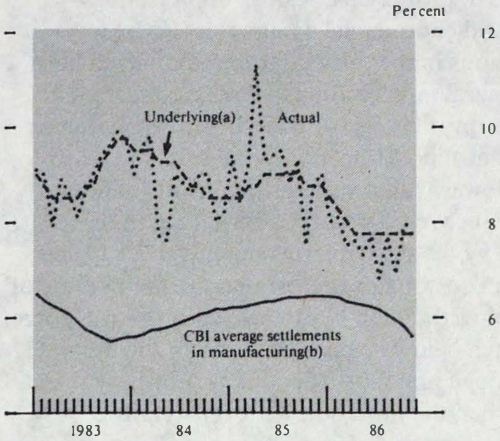
The number unemployed in the United Kingdom (seasonally adjusted and excluding school leavers) fell in December for the fifth consecutive month, and the unemployment rate fell to 11.3%. Unemployment has fallen by an average of 21,000 per month since July and most regions, with the exception of Scotland and Northern Ireland, have experienced a decline over this period. The fall in unemployment reflects the growth of output and the effect of employment measures, including the introduction of the Restart scheme for the longer-term unemployed on a national basis and some further expansion of the Community Programme.

The employed labour force (defined as employees in employment, the self-employed and the armed forces) in Great Britain rose by 71,000 in the third quarter, appreciably faster than earlier in the year. The growth in employment reflected a further increase in service industries' employment and a projected increase in the numbers self-employed, partly offset by a further decline in manufacturing employment. Manufacturing employment continued to fall in both October and November, although the rate of decline has slowed in recent months. Male employment rose in the third quarter for the first time in eighteen months, while female part-time employment fell for the first time since March 1983.

The employment figures for Great Britain have recently been revised to take account of the results of the 1984 Census of Employment. The revisions make little difference to the overall increase in the employed labour force, now estimated at over 1.1 million between March 1983 and the third quarter of 1986, with increases in employees in employment and the self-employed each accounting for half of the overall rise in employment. But there were large changes in sectoral composition. In particular, manufacturing employment is now shown to be some 187,000 lower than previously estimated, with almost all of the fall offset by an upward revision to employment in the service industries. The results also indicate that sample surveys had overestimated the number of females in part-time employment, and underestimated the number of female full-time employees.

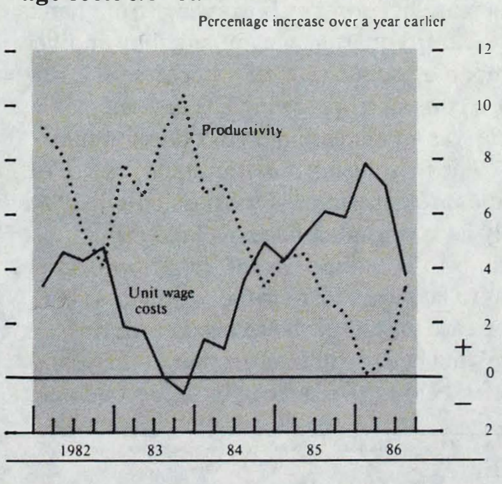
Wage settlements in manufacturing averaged around 5% in the fourth quarter compared with 5½% in the third, according to provisional estimates from the CBI, having fallen from 6% in the first half of the year. The decline in settlements in the second half of last year probably reflects the fall in the annual rate of retail price inflation. Whether the new lower settlement rate is firmly established remains uncertain. The increase in the RPI has

Settlements *have fallen, but there was no change in the underlying increase in* **manufacturing earnings**



(a) Percentage increase on a year earlier.
(b) The CBI settlement data is a twelve-month moving average.

Manufacturing productivity *rose sharply in the third quarter and the rise in* **unit wage costs** *slowed*



picked up in recent months, the number of settlements on which the CBI's fourth quarter estimate was based is small, and the average figure for settlements is unweighted. The underlying increase in average earnings in manufacturing in the twelve months ended November remained at 7¾%, a rate unchanged since April. Thus the average earnings increase in manufacturing might not appear to have reflected lower settlements, but the increase in average earnings is taken over a twelve-month period and there are relatively few pay settlements during the autumn. In addition, the recovery in manufacturing output may have led to higher earnings because of higher bonus payments. The annual increase in underlying earnings in the whole economy remained at 7½% in November, a rate virtually unchanged since mid-1984.

The annual rate of **retail price inflation** *has risen . . .*

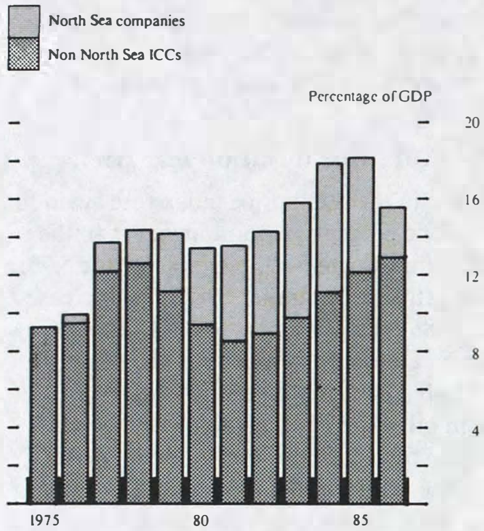
The twelve-month increase in the retail price index rose again in December to 3.7%—over one percentage point higher than the low point recorded in July and August, although below the 5.7% recorded in the twelve months to December 1985. The increase during the latter part of 1986 reflected a number of factors, of which the rise in mortgage rates in November was the most significant, adding over half a percentage point to the rate of inflation. The recovery in oil prices (initially to some $14 per barrel, but more recently to over $18) has meant higher petrol prices. Partly as a result, the transport component of the RPI (with a weight of 15¾%), was over 3% above its trough recorded in May. The depreciation of sterling in the second half of the year is also likely to have resulted in upward pressure on prices.

The impact of the fall in sterling and higher oil prices was particularly evident in the pattern of manufacturers' input prices during the second half of the year. Recent monthly increases meant that by December input prices (not seasonally adjusted) were only 3¼% lower than a year earlier, compared with a fall of 10% in the twelve months ended July. Most of the increase reflects higher fuel prices, although prices of some non-fuel materials have also risen steadily.

. . . but the increase in **manufacturers' total costs** *may have slowed . . .*

Despite increases in prices of materials, manufacturers' cost position has continued to improve. Unit wage and salary costs rose 7% in the year to the second quarter. However, after a fall in the third quarter and only a modest increase in October and November, unit wage costs in the three months to November were estimated to be only 3% above their level a year earlier. Some of this slowdown in the growth of unit wage costs reflects the improvement in the growth of manufacturing productivity. Output per head in the three months to November was 4½% higher than a year earlier, following a period of sluggish growth in the first half of the year. But much of the increase in productivity almost certainly reflects the cyclical rise in manufacturing output in recent months, and overstates the underlying trend growth of productivity. In the economy as a whole the improvement in productivity and the corresponding slowdown in the growth of unit wage costs has been less marked as the service sector is less responsive to cyclical fluctuations. In the year to the third quarter whole economy productivity and unit wage costs were, respectively, 2½% and nearly 5% higher than a year earlier.

The share of **non North Sea ICCs' profits** *in GDP has risen*[a][b]



(a) Gross trading profits (less British Telecom) net of stock appreciation expressed as a percentage of the current price income measure of GDP.

(b) Data for 1986 cover only the first three quarters of the year.

. . . contributing to higher **profits** *in the third quarter . . .*

There was an increase in profits (net of stock appreciation) earned by industrial and commercial companies (ICCs) from their domestic operations in the third quarter after falls in both the first and second quarters, according to CSO estimates. The sharp fall in North Sea profits was halted in the third quarter as oil prices stabilised at around $14 per barrel; profits in this sector remained some 60% lower than a year earlier. Profits of non North Sea companies recovered slightly, after falling in the previous quarter, and by the third quarter were over 7% higher than a year earlier. Bank estimates suggest that the pre-tax rate of return on capital employed in non North Sea activities was some 7½% in the third quarter, below its previous peak in the first quarter of 1986. Although non North Sea ICCs' profits were higher than a year earlier, the third quarter level was little different from that recorded in the first and second quarters. The failure of profits to rise in the first nine months of 1986 is difficult to explain, and may be a further illustration of the gap between the output and the income measure of GDP mentioned above. During 1986, output has increased; there has been only a modest decline in the twelve-month increase in manufacturers' output prices—by December these prices remained 4¼% above their level a year earlier—and margins appear to have been expanding. The decline in sterling's value during the autumn may permit some further widening of margins among companies in the tradable goods sector. The most recent CBI surveys suggest an increasing number of firms are planning to raise prices as the effect of higher input prices feeds through.

Data on companies' financial transactions in the third quarter are still incomplete, although there appears to have been a continuation of the financing pattern in the first half of the year. Capital issues, for example, remained exceptionally strong, increasing towards the end of the year, so that the total for the second half (£3¾ billion for all ICCs' issues of ordinary shares) was almost as large as for the whole of 1985. This strength occurred despite the British Gas flotation, which might have been expected to limit the market for other issues to some extent. Merger and acquisition activity also remained strong in the third quarter, although less so than in the first half. There was a large rise in direct investment abroad in the third quarter which mainly reflected an increase in acquisitions of companies in the United States.

There was a further increase in company borrowing (from banks and other sources) in the third quarter, accompanied by another substantial rise in companies' acquisition of liquid assets. Over the past twelve months, company borrowing has totalled £10½ billion while there was an increase of £12½ billion in their liquid financial assets. The reasons for this simultaneous rise in both assets and liabilities are uncertain.[1] One possibility is that companies may simply be taking advantage of favourable capital market conditions to raise funds as the opportunity arises, and using the proceeds to acquire short-term investments. This seems to have been the case in the eurobond markets during 1986, with firms borrowing heavily in the first half of the year when long bond rates fell below 10%, but not in the second half.

(1) Some of the reasons for the growth in ICCs' liabilities and assets in recent years are reviewed in the December 1986 *Bulletin*, pages 504–5.

. . . and buoyant **tax receipts,** *including those from corporation tax, have contributed to a small* **PSBR** *in recent months*

The public sector had a surplus of £1.2 billion in December following negligible borrowing requirements in both October and November. The cumulative PSBR for the first nine months of the financial year amounted to only £4½ billion compared with £7½ billion over the corresponding period of last year. The low level of the PSBR in recent months mainly reflects the buoyancy of tax receipts, particularly the strong growth in receipts of corporation tax, following the recovery in company profits, as well as VAT. Although general government expenditure in 1986/87 is now projected to be £1 billion higher than the Budget estimate, the Chancellor said in the House of Commons in December that the PSBR is more likely to undershoot than overshoot the Budget forecast. In December the PSBR benefited from the proceeds of privatisation of British Gas, and there will be further receipts in February from the sale of British Airways.

The expenditure plans announced in the White Paper in mid-January give further details of those outlined in the Chancellor's Autumn Statement. Public spending is projected to increase by 1% per year in real terms between 1986/87 and 1989/90, with much of the increase allocated to education, health and law and order. Even allowing for this increase, expenditure (not treating privatisation proceeds as negative expenditure) is projected to fall as a proportion of GDP from 44½% in 1986/87 to 42¼% by 1989/90.