Economic commentary

- *The growth of output among the major overseas industrial countries weakened in the fourth quarter. Bank forecasts of GNP growth in 1987 for these countries have been revised down to 2½%.*
- *Trade volumes are responding to the changes in competitiveness resulting from the fall in the dollar. But current account imbalances have tended to widen, and trade frictions have increased.*
- *Six of the major industrial countries agreed in Paris in February that a period of greater exchange rate stability was desirable. Since then, however, the dollar has weakened further.*
- *Consumer price inflation among the major six overseas countries was 2% in 1986, and may now be stabilising. However, in the United States the fall in the dollar has resulted in some increase in the rate of inflation, accompanied by higher interest rates.*
- *In the United Kingdom, growth was buoyant in the fourth quarter, especially in the manufacturing sector. The growth of output has been associated with a strong cyclical rise in manufacturing productivity. The rise in unit wage costs slowed to 2% in the year to the fourth quarter, a rate much closer to that of our major competitors.*
- *Non-oil trade volumes have responded to the improvement in competitiveness which resulted from the fall in sterling last year, and the visible trade deficit narrowed in the first quarter.*
- *The PSBR was only £3.3 billion in 1986/87, less than 1% of GDP, reflecting the strength of non-oil tax receipts. In the Budget, the Chancellor lowered the earlier PSBR projection for 1987/88 to £4 billion and cut the basic rate of income tax. Since early March bank base rates have been lowered in four stages from 11% to 9%.*

The main industrial countries experienced modest growth and low inflation in the second half of 1986. In the early months of this year the pace of activity appears to have been slower than had earlier been hoped, while consumer price inflation seems to have stabilised at a low level. The main exception has been the United Kingdom where growth is strong; the increase in export volumes has been appreciably faster than in other countries in aggregate; but the rate of retail price inflation remains above the average of the other major industrial countries. World trade was buoyant in 1986, but this was heavily dependent on strong growth of the volume of imports by the industrial countries. There are signs that US export volumes have begun to respond to the substantial gains in competitiveness secured over the last two years, and the export sectors in Japan and Germany are experiencing increasing difficulties. But the current account imbalances between these economies have changed very little. Exchange rates were more stable immediately after the Louvre accord, but recently the dollar has weakened further.

GNP growth in the major economies

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

	1984	1985	1986 H1	1986 Q3	1986 Q4
Canada	5.5	4.0	3.8	1.2	0.2
France	1.5	1.3	1.3	..	..
Germany	3.0	2.5	0.6	3.0	-0.6
Italy(a)	2.8	2.3	2.2	1.6	..
Japan	5.0	4.7	1.2	3.0	1.9
United Kingdom(a)	2.9	3.5	2.7	3.8	3.1
United States	6.4	2.7	2.5	2.8	1.1
Total	**4.7**	**3.0**	**2.0**	..	..

.. 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 H1	1986 Q3(b)
Private consumption	3.2	3.0	3.6	5.0
Private fixed investment	8.8	6.3	0.8	1.8
Public expenditure	2.5	3.0	0.2	4.7
Stockbuilding(c)	1.0	-0.5	0.9	-0.7
Domestic demand	**5.1**	**3.0**	**3.2**	**3.6**
Net trade(c)	-0.4	—	-1.2	-1.1
GNP	**4.7**	**3.0**	**2.0**	**2.5**

(a) Or GDP.

(b) Includes estimate for France.

(c) 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 H1	1986 Q3
Import volumes(a)				
Major seven economies(b)	12.7	5.6	11.7	7.4
of which:				
North America	22.9	8.3	14.2	9.0
Japan	10.7	0.4	21.0	- 0.9
Europe	6.9	4.8	7.6	8.8
Other OECD	7.4	6.3	3.1	4.5
OPEC countries	- 8.5	-16.5	-16.8	-13.0
Non-OPEC developing countries	7.0	4.2	1.4	- 1.0
Total	**8.7**	**3.7**	**6.2**	**4.3**
UK markets(c)	**7.1**	**3.8**	**4.1**	**3.8**

(a) Imports of goods only.

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

(c) UK trade-weighted index.

Business investment *prospects overseas appear subdued . . .*

Domestic demand in the major overseas economies is estimated to have grown strongly in the second half of last year, rising at an annual rate of nearly 3½%. Continued buoyancy of real incomes outside North America resulted in further strong growth in consumers' expenditure in most economies. In the United States, consumer spending increased by over 4% compared with a year earlier, as the saving ratio fell by more than 1½ percentage points, in part reflecting the bringing forward of consumption in response to car manufacturers' sales incentive schemes, and tax reform measures which took effect on 1 January. Although private residential investment in the major countries as a whole grew strongly in the second half of the year, private business investment is estimated to have been no higher than a year earlier. Business investment remained weak despite the substantial improvement in profits, the fall in interest rates and the low inflation experienced in 1986. In the United States, the fall in business investment in the second half of 1986—3% compared with a year earlier—can partly be explained by the abolition of the investment tax credit and other aspects of tax reform and (as in Canada) the collapse in energy-related investment. In Japan and Germany, lost competitiveness resulting from exchange rate movements has deterred investment in export and import-competing industries. Another factor may have been the weakness of activity elswhere, including OPEC and other developing countries.

Retail sales data have been fairly uniform in the early months of this year. Sales have strengthened in Canada, but elsewhere have shown little change. In January, the index of industrial production in the major overseas economies in aggregate was unchanged on a year earlier, reflecting weakness in all the individual countries. Investment intentions in the United States, Japan and Germany remain subdued, reflecting the same factors that depressed investment performance in the second half of 1986.

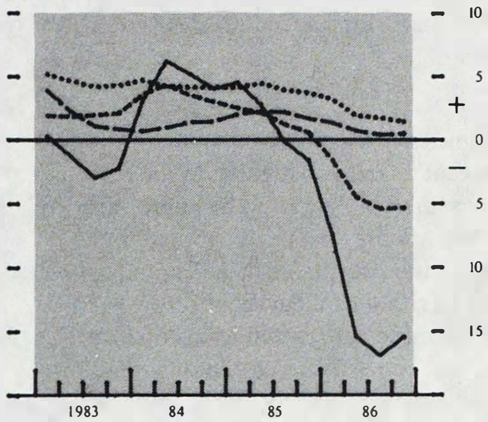
. . . while the growth of **output** *has been weak*

Output in the major overseas economies in aggregate is estimated to have increased by around 1¼% at an annual rate in the fourth quarter of 1986, compared with 2½% recorded in the third quarter. Industrial production in the major overseas economies stagnated in the fourth quarter, with declines in Japan and Germany, where manufacturing output has borne the brunt of the loss in competitiveness. The modest growth of output and the poor performance of exports in the major overseas economies in the first three quarters of the year reflected import retrenchment by OPEC countries and slow growth in imports of other developing countries. However, in the fourth quarter, net trade made a positive contribution to growth, for the first time since the first quarter of 1985, largely a result of an increase in exports from the United States, reflecting delayed adjustment to the depreciation of the dollar, and a fall in Japanese imports (especially of oil, because of the mild winter). In the United States, GNP rose by 4¼% at an annual rate in the first quarter of 1987, but this was more than accounted for by stock accumulation; GNP excluding stocks fell by 2¼% at an annual rate.

Inflation *remains low in the major overseas economies*[(a)]

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

Percentage changes on a year earlier

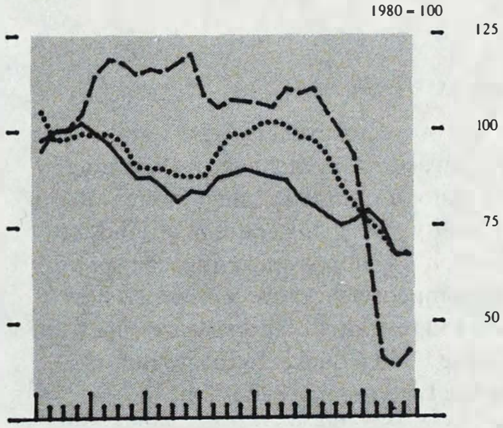


(a) Canada, France, Germany, Italy, Japan and the United States.
(b) Consumers' expenditure deflator.
(c) Adjusted to allow for cyclical fluctuations in productivity.
(d) Average of national figures, thus including imports from other major economies.

Real commodity prices[(a)] *stabilised at a low level in the second half of last year*

——— Food(b)
.... Industrial raw materials(b)
— — — Oil

1980 = 100



(a) Nominal dollar prices deflated by an index of the dollar price of world manufactured exports.
(b) Derived from UN data.
(c) Data for the fourth quarter of 1986 are partly estimated.

Inflation *may have stabilised at a low level among the major six overseas economies*

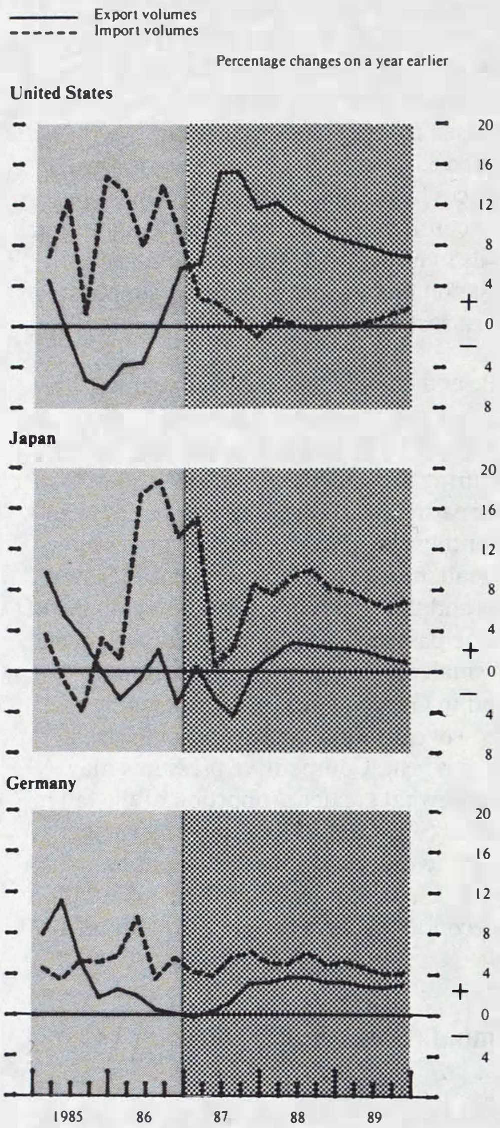
Consumer price inflation was 2% in 1986 in the major six overseas economies in aggregate, the result of small increases in both earnings and unit labour costs and a fall in local currency import prices of some 13%. Recent external developments may have slowed progress towards lower inflation. OPEC's production since the December agreement has been sufficiently restrained to encourage the market to believe that the agreement will hold, at least in the short term, and the spot price of oil (UK Brent) had risen from $14.8 per barrel at end-November to around $18 per barrel by the end of April. Non-oil commodity prices have risen by about 2½% in SDR terms this year, despite continued weakness in the foods sector. Firmer prices for metals in March and April are believed to stem from technical market factors; the underlying supplies remain plentiful in most sectors.

Prospects for wholesale and consumer prices this year will depend in part on whether any more of the benefits from the fall in import prices in 1986 will be passed through to final prices. In February, manufacturing wholesale prices stood about 3% below their level a year earlier, whereas consumer prices were 1¾% higher. Recent monthly changes in consumer prices have been a little higher overall, most notably in the United States, where firmer oil prices and the effects of a further weakening of the dollar appear to have passed rapidly into consumer prices. There has also been a small recent upward movement in inflation in France, and in Germany prices have begun to rise on a monthly basis. However, in Japan consumer prices fell in the early months of this year. Competitive pressures may help to ensure that a somewhat greater proportion of the fall in Japanese wholesale prices (9% lower in February than a year earlier) is passed through to domestic consumers; public utility prices have also fallen further recently. Overall, inflation in the major overseas economies seems to have broadly stabilised.

Current account imbalances *among the major economies persist . . .*

Although it is more than two years since the dollar began to fall against other major currencies, adjustment to the large changes in competitiveness that have resulted is far from complete. The picture in 1986 was distorted by the temporary surge in Japanese imports in the second quarter, by an increase in imports to the United States prior to the introduction of the customs user fee in December last year, and by a stronger volume of oil imports by most major economies during the period of exceptional oil price weakness in the summer. In the United States, the volume of exports of goods and services increased by over 7½% (at an annual rate) in the second half of the year, suggesting that a degree of adjustment is in process, although imports increased more rapidly. In the first quarter of the year, US exports actually fell (by 1¾% at an annual rate) but imports declined more rapidly (by 11% at an annual rate). In Japan the volume of imports rose strongly in 1986, and exports declined. Import growth also rose among the continental European countries in 1986, while the growth of exports slowed. The subdued growth of exports from Japan and

Trade volumes *in the United States, Japan and Germany are responding to movements in* **exchange rates**[(a)]



(a) The projections of changes in trade volumes from the first quarter of 1987 are taken from the Bank's most recent forecast of the world economy, summarised on pages 187–8.

continental European countries may have been attributable to depressed growth of import volumes outside the industrial countries, in addition to changes in competitiveness. The retrenchment by members of OPEC, and relatively slow import growth by some of the industrial countries outside the major seven group, meant that UK export markets grew less rapidly than world trade as a whole in 1986. This pattern may, however, be in the process of reversal as US import growth slows and domestic demand in many European industrial countries grows steadily.

The shifts in trade volumes among the three largest economies were insufficient to prevent a further widening of the current account imbalances (measured in dollars). The appreciation of the yen and the deutschemark may have contributed to the increases in the current account surpluses of Japan and Germany respectively, as a result of 'J curve' effects;[(1)] but all three countries also experienced substantial terms of trade gains from lower oil prices. The difficulties of adjustment for the United States are exacerbated by the value of imports being around 70% higher than that of exports, which requires a substantially higher rate of growth of exports than of imports to reduce the trade deficit, and by the deterioration in its net external asset position. The US current account deficit may now be stabilising in nominal dollar terms (at around $140 billion in 1986). The Japanese current account surplus of $8.4 billion (seasonally adjusted) in February suggests there is little immediate prospect of a substantial reduction from last year's level of $86 billion.[(2)]

. . . *and* **the dollar** *has weakened . . .*

A consensus that a period of greater exchange rate stability was desirable contributed to an accord on exchange rates among the governments of six major economies at the Louvre in Paris in February. Greater stability of exchange rates at around the then current levels would, it was hoped, encourage the growth of domestic demand to compensate for lost competitiveness in Germany and Japan, and restrain inflationary pressure from higher import prices in the United States. In the period immediately following the Louvre accord, both the deutschemark and the yen were stable against the dollar, but sterling and the Canadian dollar firmed. However, the dollar weakened further, particularly against the yen from mid-March, reflecting continued concerns about the US external trade position; the markets were also unsettled following the announcement that the United States was to impose a 100% tariff on imports of a narrow range of Japanese electronic products. In April the dollar weakened further, partly as a result of unfavourable market reaction to the communiqué following the meeting of the Group of Seven in Washington. By the end of April the dollar was 9% lower against the yen and 2% lower against the deutschemark than at the time of the Louvre accord.

(1) ie the tendency of a country with an appreciating currency to experience a rapid gain on its terms of trade, improving its current balance, while the unfavourable and ultimately stronger volume response takes more time to work through.

(2) Prospects for the world economy, including current accounts among the major economies, are discussed in the note on pages 187–8.

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

Monthly averages

	1985		1986	1987	
	Mar.	Dec.	June	Feb.	Apr.(c)
Canada					
Short-term interest rate	11.3	9.3	8.7	7.4	7.6
ERI	88.5	81.2	78.5	78.3	78.3
France					
Short-term interest rate	10.7	9.0	7.2	8.5	7.9
ERI	63.2	69.7	69.0	72.3	71.6
Germany					
Short-term interest rate	6.4	4.9	4.7	4.0	3.9
ERI	119.1	130.2	134.9	148.4	146.6
Italy					
Short-term interest rate	16.1	14.9	12.5	12.1	10.4
ERI	45.0	44.9	46.2	48.6	47.9
Japan					
Short-term interest rate	6.3	7.4	4.6	4.0	3.9
ERI	155.4	177.1	205.4	209.3	222.7
United Kingdom					
Short-term interest rate	13.7	11.7	9.8	10.9	9.8
ERI	73.4	79.1	75.9	69.0	72.3
United States					
Short-term interest rate	9.0	7.8	6.7	6.1	6.5
ERI	152.4	127.0	115.8	104.0	101.0

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

. . . *while* short-term interest rates *have fallen outside North America*

The decline in the dollar since mid-March was accompanied by a rise in US interest rates, particularly at the long end. This was in contrast to much of the dollar's fall from March 1985 onwards, which occurred in association with (and may have been encouraged by) a substantial fall in US interest rates. The more recent pattern suggests that the shift in sentiment against US dollar assets may have strengthened, while the authorities have desired greater exchange rate stability. In Japan the authorities lowered the discount rate by ½ percentage point at the time of the Louvre accord.[(1)] Between the Louvre accord and the end of April, Japanese long-term rates had fallen 1½ percentage points, contributing to a widening of the differential between US and Japanese long-term government bond rates by 2½ percentage points over this period. Short-term rates in France and Italy have fallen back from their temporary high prior to the EMS realignment in January. The steady fall in Canadian interest rates since the turn of the year has been reversed in recent weeks as the Canadian dollar has come under pressure.

Fiscal adjustment *is still sought . . .*

The Louvre accord recognised the need for continued reduction of the US fiscal deficit, while the German federal government announced its intention to bring forward to 1988 some of the reductions in direct taxes which had been scheduled for 1990. Although public expenditure in the major overseas countries as a whole was buoyant in the second half of 1986, plans for 1987–88 imply a considerable degree of restraint.[(2)] There is widespread recognition of the long-term need to control the level of public debt as a proportion of GNP, and also a perception that the scale of public expenditure may crowd out productive activity in the private sector. However, the additions to public expenditure recently proposed in Japan as part of their undertaking in the Louvre accord should be seen against the baseline entailed by the tight 1987 budget. In present circumstances, lower taxation to support faster growth of private domestic demand and improved foreign access to domestic markets may be required if the Japanese current account surplus is to fall.

. . . *and the developing countries also face* adjustment problems

In the majority of the heavily indebted developing countries, progress in improving creditworthiness remains slow. Some, however, are responding to the earlier initiative of US Treasury Secretary Baker and are pursuing growth-oriented structural adjustment policies in conjunction with World Bank and IMF programmes. The beneficial effects of these programmes will take some time to feed through. At the IMF Interim Committee meeting in April, the Chancellor proposed a three-point plan for the poorest and most indebted sub-Saharan African countries. If they follow appropriate adjustment policies, the plan provides for the waiver of repayment of past aid loans, longer rescheduling of officially-guaranteed debt (up to 20 years

(1) See also the note on monetary policy in the major overseas economies on page 174.
(2) See the note on fiscal policy in the major industrial countries in the February 1987 *Bulletin*, page 14.

Monetary policy in the major overseas economies

There has been a gradual fall in the average rate of consumer price inflation in the major overseas economies from around 10% per annum in the early 1980s to 2% last year. The decline reflects the firm commitment to anti-inflationary policies by governments in recent years, although last year the fall in oil and other commodity prices was also an important factor.

A further fall in inflation was achieved last year at the same time as fairly strong growth in the monetary aggregates was recorded in several countries. Only in France and Italy was there any slowdown in the rate of growth of the main aggregates. In some cases monetary growth overshot the target range—for example the US M1 aggregate and Germany's central bank money (CBM). These trends have been associated with a weakening in the consensus among the major countries on the relative importance of pre-announced monetary targets. Some have adopted a more 'interpretative' approach, with monetary outturns assessed in the light of other developments in the economy such as the exchange rate, growth prospects, and perceived movements in underlying inflation.

Monetary targets, outturns and projections

Percentage changes

	1986 Target	1986 Outturn	1987 Target
US M1	3–8	15.3	—
M2	6–9	9.0	5.5–8.5
M3	6–9	8.8	5.5–8.5
Canada M1(a)	—	4.9	—
Japan M2+CDs	8–9(b)	8.7	8–9(b)
Germany CBM	3.5–5.5	7.8(c)	3–6
France M3	3–5	4.6	3–5
Italy M2	7–11	10.2	6–9

(a) Canada does not have a monetary target.

(b) Japan does not have a formal target. The range of 8%–9% for 1986 has been imputed from the Bank of Japan (BOJ) quarterly projections. The projection for 1987 is based on the BOJ's projection of 'around 8%' over a year earlier for the first quarter in 1987 and 'around 9%' in the second quarter.

(c) Fourth quarter 1986 on fourth quarter 1985.

Financial deregulation is one reason for the fairly strong growth of the monetary aggregates relative to nominal GNP. In both the United States and Japan, deregulation of certain interest rates has affected the growth of monetary aggregates by increasing the attractiveness of interest-bearing liquidity. In the 1980s, chequable accounts paying market rates have increased substantially as a proportion of US M1 and, in Japan, assets bearing liberalised interest rates have accounted for an increasing proportion of the M2 + CDs aggregate. In Germany, a major factor in CBM growth during 1986 was the increase in residents' bank deposits which resulted from non-residents' purchases of deutschemark-denominated securities as the deutschemark rose.

In addition, monetary conditions were easier last year in the major three economies. Although there were concerns over the rapid growth of liquidity, these were largely overtaken by concerns about the configuration of exchange rates and the rate of economic growth. Enhanced co-ordination of monetary policy facilitated cuts in official interest rates in the spring of last year. In the United States

Short-term real interest rates(a)

	1985 Year	1986 Year	Q1	Q2	Q3	Q4
United States	5.3	4.8	6.3	5.6	4.2	3.0
Canada	4.4	3.8	5.3	3.9	3.1	3.0
Japan	4.8	5.0	5.8	4.8	4.9	4.6
Germany	4.3	5.0	5.1	5.6	5.1	4.3
France	5.6	5.0	6.4	5.1	3.9	4.5
Italy	7.0	8.2	10.0	8.6	7.4	6.7
Average	5.2	5.0	6.2	5.5	4.5	3.8

(a) Quarterly estimates are averages of monthly observations of nominal three-month interest rates deflated by the average rate of consumer price inflation during the year starting six months before the current month. Bank forecasts of price developments were used where outturn data were not available.

the discount rate was lowered further to 5½% in the summer (compared with 7½% at the beginning of 1986). In Japan the discount rate was cut again in October and in February this year (to 2½% compared with 5% at the beginning of 1986) reflecting domestic concern over the impact of the appreciation of the yen on the economy. The German authorities, however, did not reduce official rates again in 1986 after the cut in the spring because of monetary overshooting. The overall result was a significant fall in both nominal and real market interest rates during 1986, although less so in Germany than elsewhere.

The continuing pace of financial innovation means that the growth rates of the monetary aggregates could remain poor indicators of inflationary pressures. Nevertheless, the stance of monetary policy remains crucially dependent on the behaviour of prices; any generalised resurgence of inflation will tend to increase concerns about excessive monetary growth and lead to more sustained attempts in the major economies to restrain the growth in the aggregates. Federal Reserve Chairman Volcker, in his Humphrey-Hawkins testimony to Congress in February this year, put particular emphasis on the possible inflationary risks (and the implications for foreign capital inflows) arising from the decline of the dollar and rapid US monetary growth . However, the US authorities also continue to pay close attention to the debt problems in some developing countries as well as those within certain sectors of the domestic economy. In Japan, official sentiment appears to have shifted towards the view that monetary policy is reaching the limit of its effectiveness, and that fiscal measures should now be employed to sustain demand. In Germany, in the first three months of the new target period, CBM growth has remained above the upper bound of the (widened) range. Nevertheless, the authorities reduced both discount and Lombard rates in January in order to stabilise the foreign exchange market and safeguard the parities agreed at the EMS realignment. It is expected that external factors will have a less expansionary influence on German monetary growth this year, in turn reflecting a lower current account surplus.

Overall, given the concern over the durability of the economic recovery in some countries, continuing difficulties of interpreting monetary aggregates arising from financial innovation, and the relatively modest upturn in inflation envisaged by most forecasters, monetary policy is likely to continue to be focused on a wide range of monetary indicators, including real interest rates and exchange rates.

with more generous grace periods), and a reduction in interest rates on this debt to significantly below market levels. The details will be for negotiation in the Paris Club. In the case of middle-income debtors, commercial banks have signed an agreement providing a substantial amount of new finance for Mexico, while the banks' advisory committees have agreed to provide significant sums of new money for Argentina and Nigeria. Recent advisory committee agreements with several major debtors, notably Chile, Venezuela, the Philippines and Argentina, also involve the provision of relief through reductions in lending margins and further lengthening of maturities.

Adverse movements in the terms of trade contributed to a further deterioration in debt ratios in many debtor countries in 1986. Despite the progress that has been made in improving external performance in the face of the tight external financing constraint, much of the turnaround has been achieved by compressing imports, which may harm growth prospects in the longer run, rather than by an expansion of exports. Investment ratios remain low: for example, in the 15 debtor countries identified by US Treasury Secretary Baker, the ratio of investment to GDP was less than 17% in 1986, compared with almost 24% between 1980 and 1982, according to IMF estimates. There have recently been some setbacks in the earlier progress made by some of the relatively successful debtor countries, for example Brazil and Yugoslavia, perhaps indicating the difficulty of sustaining adjustment measures. Brazil's response to its deteriorating liquidity position was to announce a moratorium on interest payments on medium and long-term debt. Further efforts will need to be made to promote saving and investment in heavily indebted countries in order to improve growth prospects.

In the United Kingdom the **growth of output** *in the non-oil economy remains buoyant . . .*

In the United Kingdom the economy strengthened in the fourth quarter, having grown steadily in the earlier part of the year. Following upward revisions to the growth of manufacturing output in the fourth quarter, the average of the three measures of GDP rose nearly 1% to a level 3½% higher than a year earlier. GDP(O), generally regarded as the best measure of short-term changes, rose by only ½% in the fourth quarter, appreciably slower than the increase recorded in the second and third quarters. A sharp fall in output from the energy sector, especially from the oil industry (where production was affected by a pipeline leak), was mainly responsible for the slowdown in GDP(O). Growth in the non-oil economy was buoyant in the fourth quarter as output rose by 1% to a level 3¾% higher than a year earlier. The latest estimates of GDP indicate that the growth of domestic expenditure strengthened in the second half of last year, and that the composition of growth in domestic demand may now be changing. The increase in consumer spending slowed in the fourth quarter, whereas the contribution from stocks rose. In addition, there was an improvement in net trade performance as the growth of exports of goods and services strengthened and that of imports of goods and services slowed.

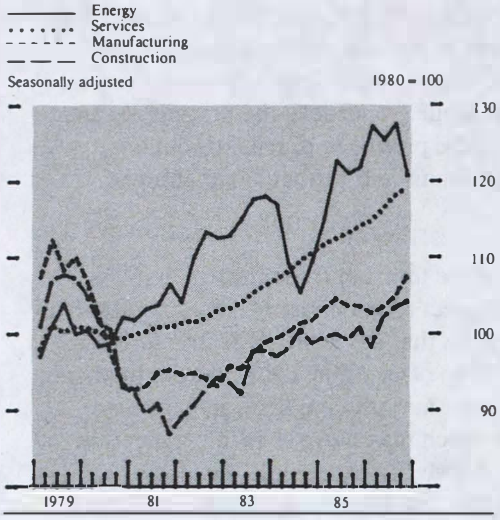
Growth in components of GDP

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

	1985	1986			
	Year	Year	H1	Q3	Q4
Consumer spending	3.6	4.7	4.7	5.2	4.3
Government consumption	0.2	1.2	0.2	2.3	2.0
Gross fixed investment	1.8	0.6	—	2.0	0.4
Stockbuilding	0.2	0.2	0.6	−0.4	0.6
Domestic demand	**2.8**	**3.2**	**2.9**	**3.5**	**3.6**
Exports	5.8	3.0	−0.1	4.5	7.6
Imports	3.1	5.8	1.9	9.5	10.0
GDP (E)	**3.6**	**2.4**	**2.3**	**2.2**	**2.9**

The fourth quarter increase in GDP(O) included a 2½% rise in manufacturing output and further gains in both the construction and the service sectors. Output from all three sectors is now shown to have grown steadily during 1986, and in the case of services to a level almost 4½% higher than a year earlier. Within the manufacturing sector, output from the metals, chemicals, motor vehicles and electrical engineering industries grew strongly in the fourth quarter. Manufacturing output fell in January, but the latest estimates for February indicate that this fall was largely attributable to the severe weather, as output returned to fourth quarter levels. Despite its recent strength, manufacturing output in the three months to February was still 2½% below its peak in the first half of 1979.

Output *of the manufacturing, construction and service sectors rose steadily in 1986*

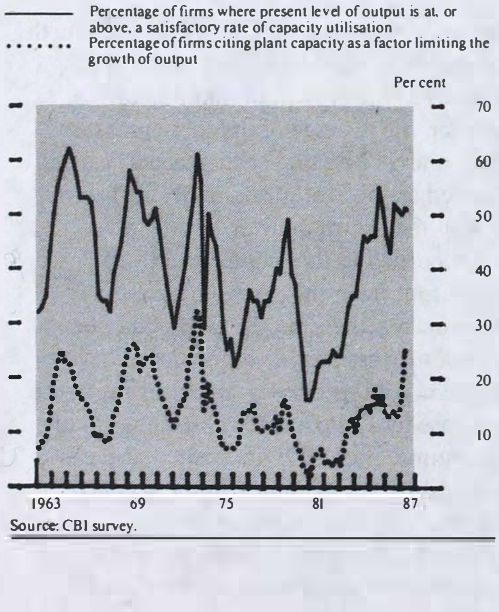


There has been a further improvement in the outlook for the manufacturing sector, according to the results of recent CBI industrial trends surveys. The April quarterly survey indicates that both output and orders are expected to increase at a faster rate over the next four months, with the balance of firms reporting an increase in new orders at its highest level in nearly ten years. Export order books also showed continued improvement, probably reflecting the gains in competitiveness resulting from the fall in the value of sterling last year. The fall in sterling may also largely explain why, in the previous quarterly survey, there had been a marked increase in the balance of manufacturers indicating they were likely to raise selling prices. In April, however, there was a fall in this balance. Although prices are still expected to increase, the latest survey results suggest that the main impact on manufacturers' prices of last year's fall in sterling may be over.

. . . *and* **capacity utilisation** *in manufacturing has risen*

The growth of output in the non-oil economy is now much the same as the growth of domestic demand—over 3½% in the year to the fourth quarter—and the question of whether manufacturers' intentions to increase output further can be achieved without running into capacity constraints is now of some importance. According to the CBI surveys, skill shortages exist in certain sectors, for example electronic industrial goods and electrical and instrument engineering, but overall the proportion of firms reporting skill shortages as a serious constraint on output has shown little change since 1985 and remains well below that recorded during previous peaks. However the average weekly number of overtime hours worked per operative in 1986 remained at the high levels recorded in 1985 (nine hours), an amount not previously exceeded for over twenty years.

Capacity utilisation *has risen in recent quarters*



Source: CBI survey.

CBI estimates of capacity utilisation show that the proportion of firms working at or above a normal or satisfactory rate of capacity utilisation has gradually risen since 1981. The latest figures, published in April, suggest that this proportion is now higher than in the previous cyclical peak of 1979, but lower than in mid-1985 before the slowdown in the growth of output, and lower than during the peaks of the 1960s and 1970s. The proportion of respondents citing plant capacity as an important factor limiting output rose sharply in April to 25%, having shown little change for three years, and plant capacity as a factor limiting output rose in importance in most sectors. The degree of spare capacity nevertheless differs between industries, as would be expected. For example, the proportion of firms reporting output below normal capacity is substantially less among those producing chemicals and pharmaceuticals than among firms in engineering, motor vehicles and shipbuilding.

There are considerable uncertainties surrounding the concept and measurement of normal capacity, partly because of doubts over the amount of capital which may have been scrapped during the recession. The official estimates show that the gross capital stock in the manufacturing sector has continued to grow at a modest rate in recent years. The capital-output ratio in manufacturing, which had been on a rising trend for a number of years, may now be close to trend after allowing for the fall in output in the early 1980s. The earlier increase in the capital-output ratio indicates a rise in the capital intensity of production. In 1986, however, manufacturing investment fell by 5%. This year it is expected to increase—by 2% according to the most recent DTI investment intentions survey, or by 4% according to the latest CBI forecast. Given the strength of profits, sufficient internal funds should be available for financing further capital spending. Many manufacturers claim that they are using existing capacity more flexibly than before and it is therefore quite possible that they may be able to operate at a higher level of capacity utilisation than in the past.

Consumer spending *has remained unchanged although* **incomes** *have risen . . .*

Consumers' expenditure was flat in both the fourth quarter of last year and the first quarter of this, according to provisional estimates, following several quarters of strong growth. Expenditure on durables remains below the level attained in the third quarter of last year, mainly because of lower spending on motor vehicles in the fourth quarter and on other durables in the first. Although there was a small increase in spending on non-durable goods and services as a whole over the last two quarters, within this category, expenditure on food (accounting for about 15% of total spending) fell. By the first quarter of 1987, in real terms, total spending was 3½% higher than a year earlier, a markedly slower rate of growth than occurred in the year to the third quarter. The reasons why consumer spending has remained flat are unclear, especially in view of the further growth in incomes, although there was a slower increase in credit in the fourth quarter.

The latest estimates nevertheless suggest that the growth of consumer spending has slowed, a conclusion supported by the most recent data on retail sales. In the three months to March, the volume of sales is provisionally estimated to have fallen 1%, although it remains 5% higher than a year earlier. Even if its rate of growth has begun to slow, consumer spending is likely to rise further, as real incomes continue to rise and the tax cuts announced in the Budget take effect.

Real personal disposable income rose by 1% in the fourth quarter as a result of a further increase in incomes, particularly wages and salaries. The rate of growth in the year to the fourth quarter was 3½%, rather less than the increase in the year to the third quarter, reflecting the profile of personal income in the previous year. With consumers' expenditure rising less rapidly than disposable incomes, the saving ratio, which had fallen to 10¼% in the third quarter, rose to just over 11% in the fourth.

. . . and **borrowing** *increased in the second half of the year*

Despite its weakness in the fourth quarter, consumer spending nevertheless rose in the second half of last year, supported by a strong increase in borrowing by the personal sector.[1] Bank lending for consumption rose to an annual rate of £4½ billion in the third quarter, but fell back in the fourth. There was also a strong rate of growth of mortgage lending for house purchase in the third quarter to an annual rate of almost £30 billion, although it, too, fell back in the fourth quarter. The growth of mortgage lending in the second half of the year ocurred despite the rise in interest rates towards the end of 1986. Although there was an increase in households' income gearing as a result, there is some evidence that fewer households may now be in difficulty in maintaining mortgage payments. For example, in the second half of last year, the number of properties repossessed by building societies fell. Lower mortgage rates for all borrowers with effect from May this year are likely to sustain the growth of personal borrowing.

In 1986 the personal sector acquired financial assets at a faster rate than it increased its borrowing, with the result that the sector's net acquisition of financial assets rose sharply, from £15 billion in 1985 to over £21 billion in 1986. This is in marked contrast with movements in the sector's recorded financial surplus, which fell between 1985 and 1986 as a whole, resulting in a large increase in the balancing item and making some of the figures difficult to interpret. Rapid growth in total acquisition of assets in the first half of the year was followed by slower growth in the third quarter as the rate of growth of building society deposits and bank deposits weakened, which might be explained by the withdrawal of funds to purchase shares in TSB and British Gas. The sector's acquisition of assets rose in the fourth quarter, as the growth of building society deposits strengthened. In addition, there was a sharp increase in personal sector holdings of company securities and gilts (included in 'Other' in the table). It should be emphasised, however, that these particular estimates are calculated by residual and are subject to considerable error.

Mortgage lending by both banks and building societies fell in the fourth quarter, but was partly offset by higher lending by other financial institutions which included a transfer of loans by some banks to their non-bank subsidiaries. By the fourth quarter the building societies' share of mortgage lending had fallen to 66%, from 84% in the first quarter of 1986. Building societies' lending fell by £1 billion to £3.7 billion in the first three months of this year, and their lending commitments suggest that no resurgence is likely to occur for some months. Last year the societies met the strong demand for mortgages in part by borrowing extensively in the wholesale markets and by reducing liquidity. Many societies are unlikely to be able to repeat this on the same scale in 1987. The societies' average liquidity ratio is close to the level of 15%

Personal sector, income, expenditure and financial transactions

£ billions

	1985	1986			
		Year	H 1(a)	Q3(a)	Q4(a)
Personal disposable income	240.7	260.3	256.3	262.0	266.6
Less consumers' expenditure	213.2	231.6	227.1	235.4	237.0
Saving	27.5	28.6	29.2	26.6	29.5
Less capital expenditure	16.3	19.6	17.8	20.7	22.0
Financial surplus	**11.2**	**9.0**	**11.4**	**5.9**	**7.5**
Acquisition of financial assets					
Building society shares and deposits	13.3	11.9	13.7	4.8	15.6
Bank deposits	5.1	8.5	13.3	5.9	1.3
National savings	2.5	2.5	2.0	3.0	3.9
Life assurance and pension funds	18.0	18.7	18.5	19.2	18.6
Other	2.3	10.6	10.7	0.1	20.2
Total	**41.2**	**52.2**	**58.2**	**33.0**	**59.6**
Borrowing					
For house purchase	19.0	24.8	22.3	30.2	24.5
of which:					
from banks	*4.2*	*4.7*	*4.0*	*6.4*	*4.3*
from building societies	*14.7*	*19.1*	*17.8*	*21.8*	*19.0*
Bank borrowing for consumption	2.9	3.5	3.3	4.5	2.9
Other bank borrowing	3.0	1.9	3.3	−0.5	1.6
Other borrowing	1.3	0.6	0.6	−0.7	1.6
Total	**26.2**	**30.8**	**29.5**	**33.5**	**30.6**
Net acquisition of financial assets	**15.0**	**21.4**	**28.7**	**−0.5**	**29.0**
Balancing item	3.8	12.4	17.3	−6.4	21.5

(a) Seasonally adjusted at annual rates.

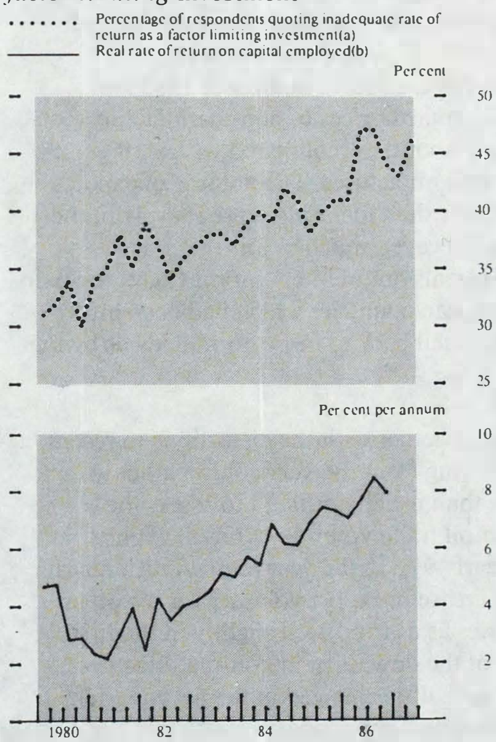
(1) Trends in the financial behaviour of the personal sector are discussed in more detail in the article on page 223.

recommended by the Building Societies Commission as a prudential minimum, while the scale of wholesale inflows is likely to diminish as the larger societies become constrained by the limits on this activity included in the Building Societies Act.

Housing starts fell by 6% in the three months to February compared with the previous three months, reflecting the severe weather. Starts were still 4% higher than a year earlier (when the weather was also bad). The twelve-month increase in the Halifax mix-adjusted house price index rose again in February and March. In the year to March, house prices in the United Kingdom had risen over 15%, compared with an increase of some 13% in the year to December. The acceleration appears to reflect a faster rate of increase in the South East to around 25% in the year to the first quarter, similar to that recorded for Greater London in recent quarters, as well as an acceleration in other regions of the country where previously the increase in house prices had been modest. In the North, for example, house prices rose by over 8% in the year to the first quarter, compared with $1\frac{3}{4}$% in the year to the first quarter of 1986; in the West Midlands the comparable figures were 12% and $6\frac{1}{2}$%, although in the North West the increase remained at 7%. This may suggest that the rapid increase in house prices in the South last year is spreading to some other regions.

Capital spending *by business remains weak . . .*

Despite an increase in the **real rate of return on capital,** *more manufacturing firms cite inadequate rates of return as a factor limiting* **investment**



(a) CBI survey.
(b) Bank estimate.

Capital expenditure by the manufacturing, construction, distribution and financial industries rose by 1% in the fourth quarter but was nevertheless 3% lower than a year earlier. With the exception of manufacturing, investment in these industries, which had shown little change during the first three quarters of the year, strengthened in the fourth quarter. By contrast, investment in the manufacturing sector steadily weakened after the first quarter. This may reflect the weaker growth of output in manufacturing than in other sectors, especially services, in the second half of 1985 and early 1986, which may have led some manufacturers to doubt the continued strength of the recovery. For some manufacturers the cost of capital in relation to the real rate of return (estimated at $7\frac{3}{4}$% in the fourth quarter) may have acted as a constraint. Although there has been a steady increase in the real rate of return on capital, the percentage of respondents in CBI surveys of manufacturing industry stating that inadequate rates of return are a factor limiting capital expenditure has also risen. This may in part reflect the effects of the phasing out of capital allowances, announced in the 1984 Budget and completed in April last year. The phasing out also affected the pattern of financing of investment, with a sharp fall in the proportion of manufacturing investment financed by leasing.

An increase in investment is nevertheless expected this year. The latest CBI forecast suggests manufacturing investment might rise by 4% and non-manufacturing investment by over 8%. The latter represents an upward revision from the CBI's earlier forecasts, and the expected increase in manufacturing investment is consistent with survey evidence, which shows an increase in the balance of firms expecting to authorise more capital expenditure this year.

The UK current balance 1985–87

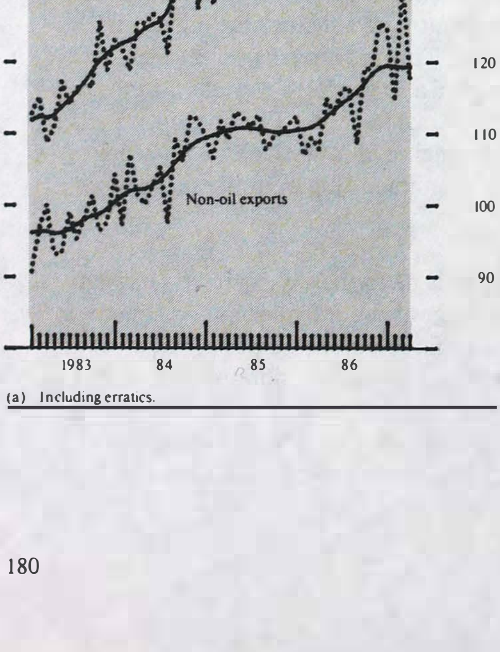
£ billions

	1985	1986 Year	1986 Q4	1987 Q1
Visible trade	**-2.2**	**- 8.3**	**-2.6**	**-1.2**
of which:				
Oil	8.1	4.2	0.8	1.2
Non-oil	-10.3	-12.4	-3.4	-2.3
of which:				
Manufactures (ex erratics)	-3.8	-7.2	-2.5	-1.3
Erratics(a)	0.8	1.8	0.7	0.5
Other	-7.3	-7.0	-1.7	-1.5
Invisible trade	**5.1**	**7.1**	**1.8**	**1.8(b)**
Services				
of which:				
Transportation and travel	-0.3	-2.0	-0.5	
Financial and other	7.3	8.7	2.3	
General government	-1.3	-1.4	-0.3	
Sub-total	5.7	5.3	1.5	
IPD (net)	2.9	4.3	1.2	
Transfers (net)	-3.5	-2.4	-0.9	
of which EC institutions	*-2.0*	*-0.8*	*-0.5*	
Current balance	**2.9**	**-1.1**	**-0.8**	**0.6(b)**

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

(b) Central Statistical Office projection.

Non-oil export volumes(a) *are 11% higher than a year ago*



(a) Including erratics.

. . . *but* stocks *rose in the fourth quarter*

Stocks rose by £0.4 billion in the fourth quarter. Most of the increase was in the wholesale and retail sectors, partly offset by a further fall in stocks held by manufacturers. Survey evidence indicates that manufacturers are more optimistic about prospects for the growth of output, and although the balance of companies that regard their level of stocks as more than adequate remains positive, it has fallen recently according to the CBI.

Non-oil import volumes *have fallen sharply . . .*

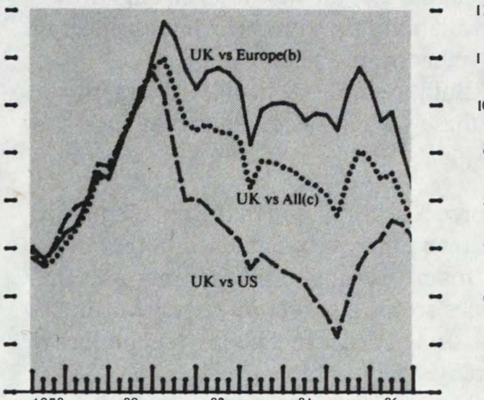
The deficit on trade narrowed by nearly £1½ billion and the current account moved back into surplus in the first quarter. The oil surplus rose by £300 million as oil prices firmed and the volume of net oil exports increased. The non-oil terms of trade stabilised, having fallen sharply since mid-1986, while non-oil trade volumes moved favourably. The volume of exports of manufactured goods (excluding erratics), which had risen strongly in the fourth quarter, was broadly maintained in the first quarter at a level 9½% higher than a year earlier. The volume of imports of manufactures fell in the first quarter, with a particularly sharp drop in finished goods, following their steep rise in the second half of last year. A continued growth in imports of basic materials suggests a further strengthening of the response of domestic output to the continued growth of demand. Overall, these trends in volumes contributed to a sharp reduction in the deficit on trade in manufactures. This deficit had risen by almost £2½ billion to nearly £5½ billion in 1986, but fell to £800 million in the first quarter of this year.

Although the volume of imports of non-manufactured goods other than fuels has continued to rise, the impact on the trade balance has been cushioned by falling world non-oil commodity prices. Between the fourth quarter of 1985 and the first quarter of 1987, import prices of non-manufactures other than fuels rose only about 3%, compared with a 10% rise in the price of imported manufactures. The volume of exports of non-manufactures (other than fuels) also rose sharply in the second half of last year. However, much of this increase was the result of the sale of cereals out of intervention stocks to Spain and other southern European countries which had been hit by drought, and food exports fell back to more normal levels by the end of the first quarter.

These exports of cereals, together with the distortions to recent monthly trade figures arising from the very cold weather in January, makes it more than usually difficult to assess the underlying trend in non-oil trade volumes. Non-oil export volumes, which rose nearly 9½% in the year to the fourth quarter (compared with a ½% increase in export volumes for the other major industrial countries as a group), fell slightly in the first quarter, partly because of the downturn in non-manufactures. Manufactured exports were little changed in the first quarter, but the improvement in export order books reported in the April CBI survey suggests an upward trend over the next few months. Import volumes have fallen back after the very rapid rise last year. However, an upward trend may resume if output and domestic demand continue to grow at rates seen over the last twelve months.

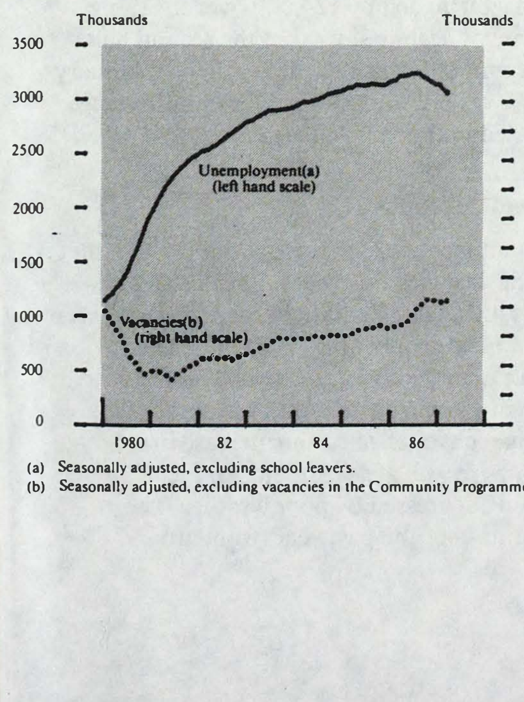
The United Kingdom gained **competitiveness** *last year, especially against European countries*

UK relative unit labour costs(a) 1980=100



(a) Common currency: not adjusted (or normalised) for cyclical movements in productivity.
(b) Belgium, France, Germany, Italy and the Netherlands.
(c) Weighted average of 16 countries.

By March **unemployment** *had fallen for eight successive months*



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

. . . and there have been gains in **competitiveness**

Much of the recent improvement in the United Kingdom's non-oil trade performance, especially in manufactures, can probably be attributed to the response of trade volumes to the gains in competitiveness following the fall in the value of sterling from late 1985. UK unit labour costs(1) in manufacturing rose by 6% in the year to the fourth quarter of 1985, but slowed to only 2% in the year to the fourth quarter of 1986, a rate much closer to that of our main competitors measured in their own currencies. Thus, relative unit labour costs continued to deteriorate, albeit more slowly. However, the decline in sterling's effective rate by over 14% over this period led to a substantial improvement in cost competitiveness in common currency terms. The gains against major European competitors and Japan have been particularly large. By the fourth quarter, UK unit labour costs relative to these countries' were 23% and 30% respectively below their peak in the third quarter of 1985. In contrast, the United Kingdom lost competitiveness against the United States over this period.

Further growth of non-oil export volumes can be expected this year. According to Bank estimates, less than half of the adjustment of volumes to the improvement in competitiveness occurs within the first year. However, the outlook is tempered by the downward revisions for growth in UK overseas markets (see the note on world economic prospects on page 187), and since early February sterling has appreciated by nearly 7% in effective terms, reversing some of the earlier gains in competitiveness.

The surplus on invisibles in 1986 is now estimated to have been a little over £7 billion, substantially below earlier estimates. The revision mainly reflects new data for earnings on UK insurance companies' portfolio investment abroad. On the other hand there were also upward revisions to the visible trade balance. Overall, preliminary estimates show a current account deficit of £1.1 billion in 1986, the first deficit since 1979. Despite the downward revisions, the invisibles surplus in 1986 is provisionally estimated to have been £2 billion higher than in 1985. Over half the improvement represents an erratic swing in the balance of official transactions with EC institutions; net earnings from financial and other services continued to grow strongly, but overall, the surplus on services declined as the transport and travel accounts deteriorated; the surplus on IPD rose by £1 billion to slightly above its 1984 level of over £4 billion. Moreover, net capital gains in sterling terms on the UK's external assets and liabilities, which are not recorded as income in the current account but nevertheless form a major element of the return on overseas investment, are likely to have been substantial last year, reflecting both the buoyancy of world stock markets and the fall in the value of sterling.

Unemployment *has fallen further . . .*

There was a further fall of 30,000 in unemployment (seasonally adjusted and excluding school leavers) in March, the eighth successive monthly fall. The average monthly decline in unemployment since July of last year exceeds 20,000 per month and the unemployment rate now stands at 11.0%. The

(1) Strictly, wages and salaries per unit of output.

factors likely to account for the fall in unemployment include the growth of output, a slowdown in the growth of the labour force, and the effect of the Government's special employment and training measures. These include the Restart scheme for the longer-term unemployed, which is now to be extended to those unemployed for six months or more rather than at least a year. In addition, it is also probable that the new tests on eligibility for benefit relating to availability for work, which took effect in November, will also have had some effect on the unemployment figures. But it remains difficult to assess the precise contribution of these various factors to the fall in unemployment.

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	22,997
Quarter on quarter change					
1984 Mar.	+ 36	+22	+25	+68	+106
June	+ 25	+ 9	+20	+68	+ 93
Sept.	+ 51	+16	+43	+29	+ 82
Dec.	+113	+46	+90	+29	+141
1985 Mar.	+ 59	+23	+47	+28	+ 87
June	+ 49	+21	+38	+29	+ 77
Sept.	+ 32	+49	+10	+ 4	+ 38
Dec.	+ 32	+14	+25	+ 4	+ 34
1986 Mar.	+ 8	+47	−16	+ 5	+ 11
June	+ 21	+34	+ 4	+ 4	+ 24
Sept.	+ 27	+21	+16	+25	+ 54
Dec.	+ 64	+32	+48	+26	+ 87
Level at December 1986	21,189	4,174	19,101	2,618	24,127

(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 1986 New Earnings Survey suggests average weekly hours worked by full-time employees is 37.3 and by part-timers is 19.4.

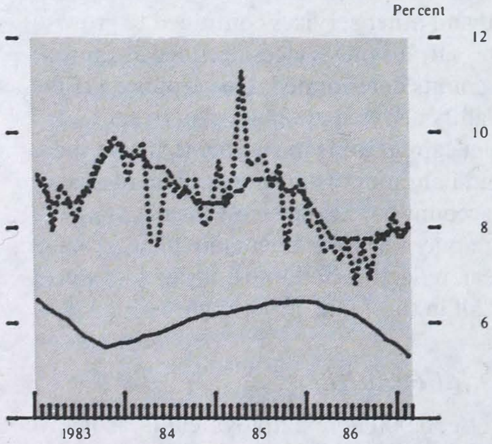
(b) Change in self-employed persons from the estimates published in the *Employment Gazette*. According to the Department of Employment, the figures for September and December 1986 are based on the assumption that the average rate of increase between 1981 and 1986 has continued.

The employed labour force rose by 87,000 in the fourth quarter, and its growth is now shown to have strengthened in the second half of last year, mainly because of further increases in employment in the service sector, a slower rate of decline in manufacturing and an assumed faster increase in the number of self-employed. The employed labour force rose by 176,000 in the year to December 1986, below the increase of 236,000 recorded in the previous year. The faster increase in the employed labour force in the second half followed a period of slower growth in the year to June 1986, partly the result of much lower estimates of the increase in the number self-employed. The latest estimates, which take into account the provisional findings of the 1986 Labour Force Survey, show that the number self-employed rose by just 17,000 in the year to June 1986, compared with an earlier estimate of 122,000. In addition, the revisions indicate that only one third of the increase in female employment has been in full-time work, compared with previous estimates of a little over half. However, the number of employees in employment was also revised upwards. The net effect of these revisions was that the increase since March 1983 in the number of full-time equivalents in employment was slightly less than previously estimated, but they made little difference to the growth in the employed labour force since March 1983, now estimated at just over 1 million.

The services sector accounted for all the increase in employees in employment in the fourth quarter. The number of employees in services rose by almost 70,000, resulting in an increase of 290,000 in the year to the fourth quarter. By contrast, employment in manufacturing fell by 124,000 over the same period, although the rate of decline slowed in the second half. There was a large fall in manufacturing employment in January, but the fall in February was only 1,000—similar to the average monthly decline recorded in the fourth quarter.

The gap between* settlements *and* manufacturing earnings *has widened recently

.... Actual earnings(a)
------ Underlying earnings(a)
—— CBI average settlements in manufacturing(b)



(a) Percentage increase on a year earlier.

(b) The CBI settlement data is a twelve-month moving average.

. . . *as have* wage settlements . . .

Wage settlements in manufacturing averaged around 5% in the first three months of the year, according to CBI estimates, although the average is unweighted and there were relatively few reported settlements in February or March. The increase in 'underlying' earnings in manufacturing rose to 8% in the year to February, from 7¾% in January. The rise in the 'underlying' increase in February may have reflected the increase in overtime hours, which were well above the January level, which itself was probably depressed by poor weather. The gradual fall in settlements over the past year (from around 6%

in early 1986) has widened the gap between settlements and earnings. Part of this is explained by differences in timing—the monthly settlement data refer to the settlements reached within that month whereas the earnings series include the effect of settlements over the previous twelve-month period. Another part of the gap probably reflects higher bonus payments. The increase in underlying earnings in the whole economy remained at 7½% in the year to February after having been slightly higher in November and December.

. . . although the annual rate of **inflation** *has risen slightly*

The twelve-month increase in the retail price index was 4.0% in March, similar to the increase in the previous two months. Commencing with the February data the index was re-referenced to January 1987 (which made no difference to the percentage changes in prices shown by the RPI) and incorporated most of the recommendations of the Retail Prices Advisory Committee,(1) published in July last year, with other changes being held over pending further work by the Department of Employment. Prices of a variety of additional goods and services, such as financial services, are to be included in the index, and a new arrangement of sub-indices, such as leisure goods and services, has been created from existing components.

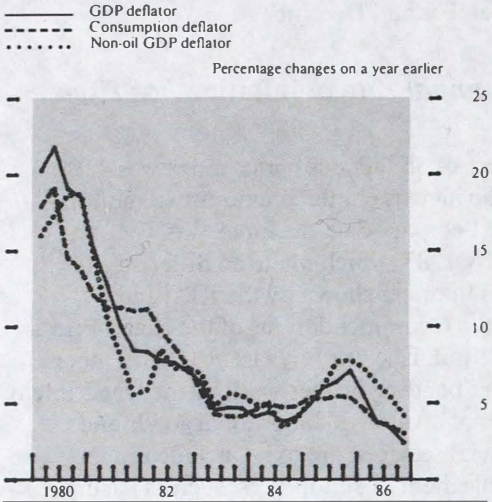
Retail price inflation is now some 1½ percentage points above its low point last summer. While the depreciation of sterling at the end of last year is likely to lead to some modest rise in retail prices in coming months, the absence of any increase in excise duties in the 1987 Budget and the fall in mortgage rates in May will help to lower the RPI. A one percentage point cut in the mortgage rate reduces the 'all items' index by about 0.35%. These developments suggest that the twelve-month increase in the RPI is unlikely to rise much above 4%–4½% over the next few months.

It is possible, however, that the recent increase in oil prices has not yet been fully passed through to domestic prices of final goods. Manufacturers' input prices have increased by about 5% over the past six months and as a consequence the twelve-month fall has decreased from its July 1986 trough of 10¾% to only ¾% in March. Partly as a result, the gradual downward drift in the twelve-month change in manufacturers' selling prices had stabilised at around 4¼% in recent months. The twelve-month increase in selling prices fell to 3¾% in March, partly reflecting the decision not to raise excise duties in the 1987 Budget.

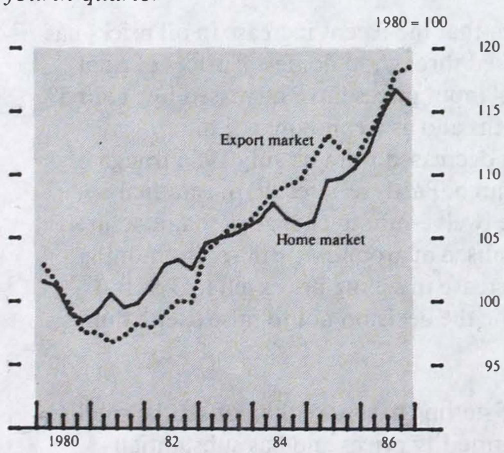
The recent strength of sterling has more than offset the small recovery in world commodity prices and has substantially reduced the impact of the increase in oil prices. Towards the end of March, sterling non-oil commodity prices were some 2½% lower than at the end of 1986. And although oil prices have firmed since the end of last year, the combined effects of higher oil prices and the exchange rate will, if current levels are maintained, have little net impact on prices. Bank estimates suggest that, around current levels, a fall in the sterling oil price of £1 per barrel, combined with a fall in sterling's effective rate

(1) *Methodological Issues Affecting the Retail Prices Index* Cmnd. 9848 (HMSO), July 1986.

There was a sharp fall in the growth of the **GDP deflator** *last year*



The **ratio of prices to costs**[(a)] *appeared to have narrowed in domestic markets in the fourth quarter*



(a) Manufacturers' price/cost ratios which indicate the direction, but not necessarily the scale, of changes in profit margins.

of about one percentage point, would result in little change in retail price inflation after three years. Between the third quarter of 1985 and the end of April this year, oil prices in sterling terms had fallen about £8 per barrel, compared with a 9 percentage point decline in the effective rate.

The fall in the sterling oil price contributed to the decline in the rate of inflation during 1986, although the effect is difficult to measure precisely. One estimate is provided by the different movements of the GDP deflators. The non-oil GDP deflator rose nearly 4% between the fourth quarters of 1985 and 1986, compared with an increase of some 8% in the previous year. The GDP deflator (at market prices), which is a measure of the domestic component of prices, including oil prices, had slowed from 7% to below 2½% over the same period. The gradual fall in the four quarter increase in the consumers' expenditure deflator (which excludes mortgage rates), suggests that much of the increase in retail price inflation in the second half of 1986 was the result of higher interest rates.

There has also been a marked deceleration in the growth of unit wage costs in manufacturing, reflecting the strong growth in productivity associated with the increase in manufacturing output. In the fourth quarter, unit wage costs were just 2% higher than a year earlier, as the steady increase in earnings was largely offset by a 6% rise in productivity. The rise in unit wage costs has slowed from an average increase of 7¼% in the year to the first half of 1986. In the whole economy, however, the improvement is less dramatic, as the service sector is less responsive to cyclical fluctuations. In the year to the fourth quarter unit wage costs rose by over 5%, associated with an increase in the rate of growth of productivity to almost 3%.

Manufacturers' profit margins may have deteriorated slightly in the fourth quarter, despite firmer selling prices and slower growth of unit labour costs. Higher costs of fuel and raw materials may have led to a fall in margins on domestic sales—though not on exports, where the depreciation of sterling appears to have resulted in a further rise in margins. To a certain extent some narrowing of margins on domestic sales was to be expected. Manufacturers appear to have retained some of the gain from lower oil prices in early 1986 in the form of wider margins, rather than to have passed it on fully to consumers in the form of lower selling prices. Firmer oil prices may, therefore, lead to some narrowing of margins.

Non North Sea companies' **profits** *rose over 14% in 1986 . . .*

Gross trading profits (net of stock appreciation) of non North Sea industrial and commercial companies fell in the fourth quarter, but remained more than 11% above their level a year earlier. It is uncertain whether this fall reflects the narrowing of margins referred to above: output continued to grow in the fourth quarter, and comparisons with earlier quarters are affected by the inclusion of British Gas with effect from December. The data for earlier quarters have, however, been revised and now show a steady increase in profits up to and including the third quarter, whereas previously profits were estimated to have fallen in the second quarter. Overall, profits of non North Sea industrial and commercial companies rose by

Industrial and commercial companies' income and capital accounts

£ billions, *seasonally adjusted*

	1985	1986			
	Year	Year	H1	Q3	Q4
Total income(a)	**72.0**	**66.8**	**32.8**	**17.0**	**17.1**
of which:					
Gross trading profits (b):					
North Sea	18.4	8.4	4.8	1.6	2.0
non North Sea	39.6	45.3	21.7	12.0	11.6
Total allocations	**43.2**	**39.2**	**19.9**	**9.2**	**10.1**
of which:					
Dividend payments(c)	7.1	8.8	4.4	2.2	2.1
Other payments(d)	14.1	12.9	6.3	3.1	3.5
UK taxes	15.3	12.9	6.8	2.9	3.3
Undistributed income(b)	28.8	27.7	12.9	7.7	7.0
Less: expenditure and fixed capital	23.5	24.9	12.3	6.4	6.2
other	-0.3	0.1	-0.2	-0.4	0.4
Financial surplus	**5.7**	**2.9**	**0.8**	**1.8**	**0.3**
Identified financial transactions (outflow/ acquisition of assets –)					
Investment in UK company securities	-4.6	-3.7	-1.8	-1.0	-0.9
Investment abroad	-3.6	-4.9	-0.1	-2.2	-2.6
Liquid assets	-5.0	-11.6	-6.3	-5.7	0.4
Borrowing from banks(e)	7.3	4.7	-0.5	0.9	4.4
Other borrowing(f)	3.6	10.5	5.4	2.3	2.7
Other identified transactions	-0.7	..	0.2	0.3	..
Unidentified financial transactions	-2.7	..	-2.3	3.6	..

.. not available.

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

(b) Net of stock appreciation.

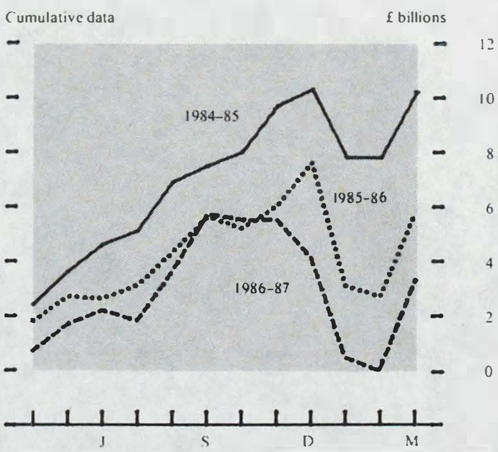
(c) Net of tax. ACT payments on dividends included in tax payments.

(d) Including North Sea royalties.

(e) Including Issue Department holdings of commercial bills.

(f) Mainly capital issues including equities.

The **PSBR** *in 1986/87 was below that of earlier years*



14% in 1986 over 1985. As a result of the revision to nominal profits, the (pre-tax) real rate of return is estimated to have risen from 7½% in the first quarter of 1986 to over 8¼% by the third, before falling back to around 7¾% by the fourth. The profits of North Sea oil companies rose in the fourth quarter, mainly as a result of the recovery in oil prices. Nevertheless, profits from North Sea activities during 1986 were less than half their level in 1985.

The fall in profits from North Sea activities led to a fall in total industrial and commercial company income in 1986. Total allocations also fell, primarily as a result of lower tax and royalty payments by North Sea companies. By contrast, payments of other taxes (mainly corporation tax) by non North Sea industrial and commercial companies rose by nearly 26%, reflecting a higher effective corporation tax rate as a result of the changes in company tax introduced with the 1984 Budget, despite the reduction in the nominal rate. Payments of dividends on ordinary shares also rose sharply. These trends, combined with an increase in expenditure on investment and stocks, resulted in a fall in the recorded financial surplus to £3 billion, compared with £5¾ billion in 1985.

Information on companies' financial transactions for 1986 as a whole is incomplete. However, there does appear to have been a reversal in the pattern of borrowing and lending in the fourth quarter. Bank borrowing, which had shown only a small increase in the first three quarters of the year, rose by almost £4½ billion in the final quarter. Companies also increased their acquisition of financial assets during the first three quarters, but then reduced them by almost £½ billion in the fourth. However capital issues were strong throughout the year.

. . . and buoyant receipts of **corporation tax** *contributed to a lower than expected outturn on the* **PSBR**

The PSBR was provisionally estimated at £3.3 billion in March, following five successive monthly surpluses. For the financial year 1986/87 as a whole, the borrowing requirement was also £3.3 billion, the cumulative outturn in the first eleven months of the year having been zero. The PSBR in 1986/87 was at least £3½ billion below the estimate made at the time of the 1986 Budget, and equivalent to just under 1% of GDP. This favourable development occurred in spite of an estimated £1 billion increase in general government expenditure (compared with the 1986 Budget forecast) and a shortfall of some £1¼ billion of North Sea oil revenues as a result of the fall in dollar oil prices in mid-1986. The buoyancy of non North Sea tax receipts more than offset these factors, mainly because of the strong growth in receipts of corporation tax. The growth in VAT receipts appears to have been significantly higher than the growth in aggregate consumers' expenditure, which may indicate a shift in the composition of spending away from zero-rated goods and services.

In the March 1987 Budget the Chancellor lowered the basic rate of income tax from 29% to 27%, and lowered the PSBR projection for 1987/88 from £7 billion to £4 billion, equivalent to 1% of GDP. The PSBR is projected to remain at 1% of GDP for the following three financial years. Privatisation proceeds are projected at £5 billion per year for the period 1987/88 to 1990/91. If privatisation proceeds are added back to the PSBR, the latter is projected to fall from 2¼% of GDP in 1987/88 to 2% in 1990/91.

In addition to the lower borrowing requirement, there was a fiscal adjustment in 1987/88 amounting to a reduction of £2.6 billion from an indexed base, mostly through the reduction in the basic rate of income tax. Personal allowances were also fully indexed. The share of the tax burden borne by higher rate tax payers has been increased, since, although the higher marginal rates remain unchanged, only the first higher-rate threshold was fully indexed. The major indirect taxes were not adjusted for inflation, and the VAT rate was not altered, although the collection system is to be modified to assist small businesses.

World economic prospects—latest Bank forecasts

The outlook is for moderate growth in the major seven industrial countries, combined with low inflation. Growth in 1986 fell short of the projections made in the spring of last year (see the June 1986 *Bulletin*, page 170), in part reflecting a larger than expected adjustment by those countries adversely affected by falls in primary product prices. The growth of output this year is also now projected to be below that contained in earlier forecasts. Thus the disappointing performance in 1986 is not expected to be compensated for by more vigorous growth in 1987 among net importers of oil and other primary products. Nevertheless, the forecast of steady growth for a further three years reflects several favourable factors, including low inflation, restrained growth of wages and lower nominal interest rates.

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

	Estimate	Forecast		
	1986	1987	1988	1989
Domestic demand	**3.6**	**2.7**	**2.9**	**2.7**
of which:				
Private consumption	3.7	2.7	2.9	2.5
Private investment	3.4	3.7	3.8	4.1
Public expenditure	3.1	2.5	1.7	1.8
Stockbuilding(b)	0.0	-0.1	0.1	0.0
Net trade(b)	-1.1	-0.2	-0.1	-0.1
GNP(c)	**2.5**	**2.5**	**2.8**	**2.6**

(a) Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
(b) Percentage contribution to GNP or GDP.
(c) Or GDP.

Output in the major seven is forecast to grow at 2½% this year and by slightly more over the following two years. Domestic demand growth, however, is projected to be substantially lower than last year, mainly because of weaker private consumption. This in turn results from slower growth of real personal incomes as a result of modest increases in earnings and the absence of any further large stimulus from falls in primary product prices. Private investment is likely to increase only moderately, reflecting the subdued prospects for growth. But net trade is predicted to make much less of a negative contribution to growth than last year, as exports to non-OPEC developing countries show some recovery, the rate of OPEC import retrenchment eases, and major seven import growth falls. The latter reflects slower domestic demand growth and the absence of various temporary factors which boosted the growth of imports in 1986.

Consumer price inflation in the main overseas industrial countries is forecast at 2½% in 1987, rising thereafter to some 3% per annum. Within this aggregate, inflation in 1989 ranges from 1¼% in Japan and Germany to 4½% in Italy and Canada. The assumption that OPEC can exercise a degree of output restraint has been retained—the nominal dollar oil price is projected to average $18 per barrel this year and $20 per barrel in 1988–89. Real non-oil commodity prices are expected to show some limited recovery over the forecast period. Hence, import prices in local currencies stabilise this year, after a fall of 12% in 1986, and then rise at 2½% per annum on average in 1988–89. However, the gains to industrial countries' disposable incomes in 1986 are not expected to be passed through fully to consumers. We expect only modest growth in manufacturing earnings. Thus normalised unit labour costs in manufacturing are forecast to grow by under 1% per annum in 1987, increasing only slightly to 1% per annum growth in 1988 and 1989. However, earnings outside the manufacturing sector are likely to be more buoyant.

Prices in the seven major economies
Percentage changes

	Estimate	Forecast		
	1986	1987	1988	1989
Import prices(a)	-12.1	0.5	3.2	1.6
Normalised unit labour costs(b)	1.1	0.7	1.0	1.2
Consumer prices(c)	2.1	2.5	3.0	3.1

(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.

The growth of domestic demand in the United States is projected to average 2% per annum over the next three years. This profile reflects sluggish growth in personal consumption, the result of a rise in the saving ratio in the first half of 1987 and the subdued pace of real personal income growth. The latter reflects both higher inflation following the depreciation of the dollar and continued wage restraint. US inflation is expected to rise to 3½% by 1989. Some rebound in private sector fixed investment is expected after the fall last year, but only at a modest rate, because of the existence of excess capacity and the effects of tax reform. Fiscal policy is assumed to be contractionary in each of the forecast years, although the budget deficit remains above the Gramm-Rudman-Hollings targets. A substantial boost to growth is predicted from net trade as the gains in competitiveness take effect. Export volumes are projected to grow by as much as 10% per annum in 1987–89, while import volumes could be roughly static over the next three years.[1] GNP growth, therefore, is forecast at 2½% this year, picking up in subsequent years to nearly 3% per annum.

(1) Projections of trade volumes between 1987 and 1989 are shown in the chart on page 172.

In Japan domestic demand is projected to grow by 3¾% in 1987. Trade volume developments, especially an expected stagnation in export volumes this year in response to the appreciation of the yen, constrain the growth of GNP to 2½%. Fiscal policy is expected to continue to be restrained. Although it is assumed that stimulatory packages will be introduced, it is thought likely that they will contain only modest expenditure increases. Allowance was also made for a revenue-neutral tax reform programme which, at the time of the forecast, was assumed would commence later this year. Profitability in the manufacturing sector is likely to be affected by poor export performance, and this in turn is expected to slow the growth of wages. The effect of the tax reform assumed in the forecast is to boost the growth of consumer spending this year, but weaken it in 1988. Business investment continues to be dampened by the weak external trade performance. As the effects of the yen's appreciation ease, GNP is forecast to rise at about 3% per annum in 1988–89.

Germany, like Japan, is expected to experience a substantial negative contribution to growth from the external sector, especially this year, as a result of the loss of competitiveness associated with the strong deutschemark. Although the domestic economy may be affected by difficulties in the export sector, it is expected to continue to benefit from lower primary product prices. Domestic demand is forecast to grow by some 3½% per annum and GNP by about 2¾% per annum during the forecast period. In 1988, consumer spending will receive a boost from direct tax cuts, part of which consist of personal tax reductions worth ¼% of GNP advanced from the planned 1990 tax reform. Despite these tax cuts, the stance of fiscal policy in Germany is expected to remain tight. Notwithstanding several favourable influences on investment, including low interest rates and healthy profitability, only a moderate increase in private investment is forecast. GNP in France and Italy is expected to grow by 2%–2½% per annum during the forecast period, supported by fairly buoyant consumer spending, although net trade is expected to exert a drag on growth as a result of poor competitiveness. The outlook for employment in these countries will be influenced by the extent of further industrial restructuring; no appreciable decline in unemployment in France and Italy is envisaged.

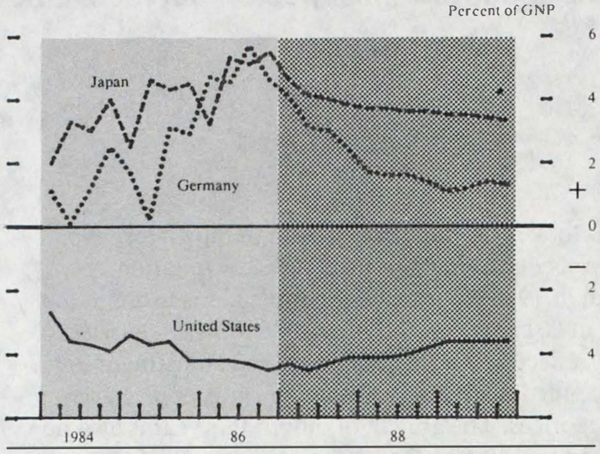
World trade and UK markets

Percentage changes

	Estimate	Forecast		
	1986	1987	1988	1989
World trade	**4.9**	**2.9**	**3.7**	**3.7**
of which:				
OECD	7.5	3.6	4.1	3.9
Non-OPEC developing countries	1.2	2.9	4.4	4.5
OPEC	−16.7	−9.5	−4.3	−1.6
UK markets(a)	**4.0**	**3.3**	**4.3**	**4.2**

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

Current account balances



World trade is forecast to grow by an average of 3½% per annum over the forecast period, considerably slower than last year, mainly because of sluggish growth in OECD import volumes after a surge in 1986. A sharp retrenchment in import volumes occurred in the developing countries in aggregate last year, reflecting both financing constraints and low export revenues associated with falls in primary product prices. Bank estimates suggest that this could have depressed GNP growth in the major seven industrial countries by up to ¼ percentage point in 1986. Non-OPEC developing countries' import volumes are forecast to grow at some 4% per annum in the forecast period as their terms of trade stabilise and capital inflows increase somewhat. OPEC countries' import volumes fall in each of the forecast years, though by less than the severe retrenchment in 1986. OPEC is a key market for the United Kingdom, but any depressing influence on exports is likely to be more than offset by the relative buoyancy of the European majors and some of the smaller industrial countries, so that UK markets are forecast to grow slightly faster than world trade as a whole.

A continuing large current account imbalance is projected between the United States and Japan. Over the forecast period, both the US current account deficit and the Japanese current account surplus decline as proportions of GNP although they show less movement in dollar terms; the US deficit falls from $140 billion in 1986 to about $125 billion by 1989, but the Japanese surplus remains around $85 billion. The substantial turnaround in trade volumes which occurs is masked by the sheer size of the initial disparities between exports and imports in both the United States and Japan. The persistence of these imbalances emphasises the importance of securing sufficient capital flows to allow the US current account deficit to be financed without unwelcome repercussions on asset prices. By contrast, the German current account surplus shows a marked reduction, declining in dollar terms from $37 billion last year to some $15 billion in 1989.