Economic commentary

- *There was a modest pick-up in activity in the first quarter in the major industrial countries, largely the result of an improvement in net trade; domestic demand remained weak.*
- *Despite firmer oil and commodity prices, inflation remains at moderate levels among the major overseas economies, chiefly because the growth of earnings remains restrained.*
- *In the United States, trade volumes have begun to respond to the earlier fall in the dollar; the response of trade volumes in Japan and Germany has been only moderate in recent months. The large external imbalances persist.*
- *A number of major banks have increased their provisions against sovereign developing country debt in recent months.*
- *In the United Kingdom, output has responded to the growth of demand. The rise in manufacturing output has led to higher capacity utilisation and a deceleration in unit wage costs.*
- *Growth of domestic demand weakened in the first quarter; but consumer demand appears to have recovered in the second, and the prospects for an increase in manufacturing investment in 1987 are favourable.*
- *The deficit on non-oil trade improved in the first quarter as import volumes fell, reflecting an improvement in competitiveness. But there was a sharp rise in imports in May.*
- *Inflation remains at moderate levels; the strength of sterling in recent months has partly offset the impact of higher commodity prices. But the underlying increase in annual earnings has edged up and house prices continue to rise strongly.*

Economic activity in the major economies in aggregate rose by over 3% at an annual rate in the first quarter, with fairly rapid growth in the United Kingdom, the United States, Japan and Canada, but a fall in both Germany and Italy. Most of the expansion was, however, accounted for by stronger net exports and by stockbuilding; underlying domestic demand was, on balance, weak. Some upturn in inflation has occurred, associated with the firming of oil prices since the beginning of the year and a limited recovery in the prices of other primary products. The increase in the twelve-month rate of inflation also reflects the fall in oil prices this time last year. But, with earnings in the major overseas countries restrained, inflation is likely to remain subdued. The central prospect continues to be for steady growth combined with low inflation, although lower oil prices and the reduction in inflation are no longer expected to boost growth in the major overseas industrial economies this year to the extent envisaged earlier. Although there is some evidence of adjustment, current account imbalances remain very large. The dollar has been fairly stable in recent months, after having weakened further in the first quarter. The governments of the seven major industrial countries at the Venice summit confirmed their earlier agreement that stability of exchange rates at around current levels would be desirable, and also agreed to conduct multilateral surveillance of their economies using indicators of economic performance.

GNP growth in the major economies

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

	1985	1986			1987
		Year	H1	H2	Q1
Canada	4.0	3.1	3.8	1.2	6.7
France	1.7	2.2	1.4	2.8	0.4
Germany	2.5	2.4	0.6	3.9	-3.1
Italy(a)	2.7	2.7	3.0	2.6	-1.7
Japan	4.7	2.5	1.2	3.2	4.9
United Kingdom(a)	3.5	3.0	3.5	3.3	4.5
United States(b)	2.7	2.5	2.5	1.8	4.4
Total	**3.0**	**2.5**	**2.1**	**2.6**	**3.1**

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

(b) Figures for 1985 and 1986 for the United States have been revised recently. However, a full calendar-year breakdown is not yet available.

Components of GNP(a)(b) growth in the major economies

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

	1985	1986			
		Year	H1	Q3	Q4
Private consumption	3.1	3.8	3.6	5.3	-0.4
Private fixed investment	6.0	3.2	0.6	2.2	5.3
Public expenditure	3.2	3.3	0.3	5.0	10.1
Stockbuilding(c)	-0.5	0.1	0.9	-0.8	-1.9
Domestic demand	**3.1**	**3.6**	**3.2**	**4.0**	**0.6**
Net trade(c)	-0.1	-1.1	-1.1	-1.4	0.8
GNP	**3.0**	**2.5**	**2.1**	**2.6**	**1.4**

(a) Or GDP.

(b) Figures for 1985 and 1986 do not reflect the latest revisions to US GNP data because a full breakdown of components is not yet available.

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

There are mixed indications of the strength of **activity**

Output in the major overseas economies[1] in aggregate is estimated to have increased by over 3% at an annual rate in the first quarter of 1987, compared with around 1½% in the final quarter of last year. There was strong growth in Japan, Canada, and the United States, although this was partially offset by weakness elsewhere, especially in Germany. Net trade was a powerful supporting influence on activity in the major countries in aggregate for the second consecutive quarter. Imports into the United States fell as the effects of improved competitiveness associated with dollar depreciation continued to feed through, and there was also an unexpectedly large net trade contribution to growth in Japan, despite the appreciation of the yen. The strength of Japanese trade performance in the first quarter may partly reflect temporary factors such as a surge in automobile exports to the European Community at the beginning of a new year of voluntary restraint agreements, unusually large exports of ships and the cessation of government gold imports.

Domestic demand in the major overseas economies is estimated to have increased by about 2% at an annual rate in the first quarter. The improvement on the fourth quarter, however, mainly reflected a large build-up of stocks, especially in the United States. Consumer spending, public consumption and fixed investment were weak. In the United States the increase in stocks more than accounted for the growth in GNP (4.4% at an annual rate) in the first quarter.

By contrast, the acceleration in growth in Canada appears to have been broadly based. In Japan, domestic demand increased by just over 2¾% at an annual rate in the first quarter, as a result of a strengthening of private consumption following a fall in the previous three months. Private fixed investment would have been weak had it not been for a large increase in investment by electric power companies undertaken at the Japanese government's request. In Germany, domestic demand is estimated to have fallen by 3¾% at an annual rate in the first quarter as private consumption declined, after having shown little change in the two previous quarters; there was also a substantial fall in construction investment.

Indications for the second quarter are mixed. In the United States GNP grew by 2½% at an annual rate and this was more balanced than the first quarter increase, with gains in most domestic sectors (except residential investment) and a narrowing of the trade deficit for the third consecutive quarter. In both Germany and France, retail sales have picked up from the levels in the first quarter. Industrial production declined in Japan in the second quarter; it fell in France in April but recovered in May, and there has been some recovery from its first quarter trough in Germany.

Oil prices *remain firm and* **non-oil primary product prices** *show some signs of recovery . . .*

Spot prices for UK Brent oil have firmed in recent weeks and at the end of July were around $20 per barrel. The firmness of oil prices in recent months reflects OPEC's adherence to the

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

Consequences of world agricultural policies

Over the past 25 years, the growth of trade in manufactures has continued to exceed that of manufacturing output, suggesting continued specialisation and competition among producers. But the reverse has occurred in agriculture. In 1986 for example, although world agricultural output is estimated to have risen by 3%, the volume of agricultural exports rose by only 1%. Agricultural policy objectives in developed countries in the post-war era have been to secure stable and adequate food supplies at reasonable cost, with the associated objective of stabilising and enhancing farmers' incomes. These aims have mostly been achieved. Production has grown substantially, reflecting technical developments and improved practices, but there has also been increased incidence of trade barriers, intervention to stabilise prices and subsidisation. Serious problems have now emerged. Although production has increased, consumer demand has changed little. Agricultural support policies have prevented the necessary price adjustments from taking place, with the result that stocks of unsold products have also increased (or have had to be disposed of at low, subsidised prices) and the budgetary costs of agricultural support have risen steadily in many countries. Support policies may also have stimulated production in countries not possessing a true comparative advantage in agriculture, implying a loss of welfare to the world economy as a whole and to some poorer countries in particular.

The various effects of agricultural support may be listed under three main groupings. Although the actual methods of support vary between countries, the result is usually that domestic prices are raised above the level of world prices (which are themselves depressed by subsidised trading), as for example occurs in the European Community (EC) through the operation of the variable import levy and intervention buying. Thus *consumers* pay more for food. An indication that the gap between world prices and domestic EC prices for selected commodities has widened in recent years is shown in the table. *Tax payers* also lose to the extent that domestic producer support prices can exceed consumer prices by the amount paid on export subsidies, representing the difference between the support price and the world price, and the costs of storage of unsold surpluses. Agricultural *producers* gain, but World Bank estimates suggest that in the EC, Japan and the United States the sum of the consumers' and tax payers' losses substantially exceeds producers' gains. These losses have to be balanced against the non-quantifiable benefits of the policy in social, environmental and strategic terms, although it is possible these latter aims could be achieved at less cost.

Estimates of the extent of agricultural support in the major industrial countries have been calculated by the OECD.(1) Producer subsidy equivalents—the payments to farmers that would be required to compensate them for the loss of income resulting from the removal of assistance—were shown to be high in most major countries, especially Japan. This reflects the high level of protection including large producer subsidies on rice and milk in Japan, although dairy products and meat are heavily supported in most other OECD countries.

Estimates of EC and world prices for selected commodities

1980 = 100

	1983		1986	
	EC	World	EC	World
Beef	125.3	88.0	121.0	76.3
Wheat	133.8	86.8	128.5	73.3
Maize	127.5	99.3	130.2	71.6
Sugar	123.5	55.1	126.0	60.5
Butter	120.8	88.3	117.7	62.1

The costs of agricultural support by industrial countries are not confined to their own consumers and tax payers. The exportation of surpluses depresses world prices so that developing country production is crowded out from markets. The loss of export revenue undermines their capacity to purchase manufactured goods and services and can cause diversion of resources into the non-agricultural sector, accentuating the tendency to create additional trade barriers as well as increasing their dependence on imports of food. However, some developing countries that rely mainly on food imports benefit from low world prices.

Liberalisation of trade in agriculture by industrial countries alone should, in principle, provide a net benefit to themselves even if producers were compensated for the resulting loss in income. According to World Bank estimates,(2) industrial countries could benefit by almost $50 billion in 1980 prices (based on rates of protection between 1980 and 1982). The effects of such liberalisation on developing countries are more difficult to determine. Much depends on a country's commodity composition of trade and whether it is a net importer or net exporter. The World Bank study estimated that developing countries as a whole could lose since they are net importers of temperate products, whose price would rise. But such estimates ignore the secondary effects of agricultural protection: Other studies suggest that the benefits to developing countries of importing cheap food are more than offset by the higher cost of non-food imports from developed countries and by slower growth of export markets. On this analysis, developing countries could benefit overall from liberalisation of agricultural trade. The net losers from liberalisation are likely to be the Eastern bloc countries, which would have to pay higher prices for commodities currently in surplus.

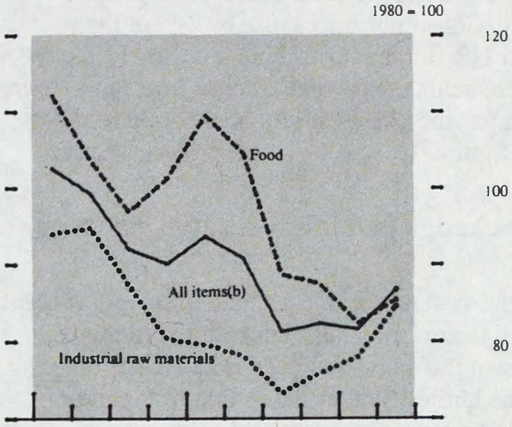
Governments have begun to respond to some of these pressures and recent reforms in the United States, the EC and Japan have attempted to introduce greater sensitivity of domestic prices to world prices. The most encouraging development has been a general commitment to agricultural reform in international discussions. The GATT ministerial meeting at Punta del Este in September 1986 to launch a new round of multilateral trade negotiations ended with a declaration which included, for the first time in GATT discussions, a comprehensive negotiating mandate for agriculture. The Venice economic summit in June 1987 further committed the participants to the long-term objective of allowing market signals to influence agricultural production. A similar conclusion was reached at the May OECD Ministerial Council, which also advocated greater use of direct income support not linked to production. Discussions on the reform of agricultural policies on a world wide basis are now taking place under the auspices of the GATT. A measure of the success of agricultural reform will be the extent to which the wedge between world and internal market prices is narrowed.

(1) OECD, *'National Policies and Agricultural Trade*, OECD, Paris, July 1987.

(2) World Bank *'World Development Report 1986'*. OUP, New York, 1986.

December agreement on quotas, steady demand for oil and improved market confidence. At the half-yearly ministerial conference in Vienna in June, OPEC agreed to raise its overall production ceiling from 15.8 million barrels per day in the first half of 1987 to 16.6 million barrels per day for the remainder of the year, while leaving unchanged the fixed pricing structure (based on a reference price of $18 per barrel). This new ceiling is in line with the provisional quotas for the third quarter established at last December's OPEC meeting, but its extension to the end of the year represents a significant reduction on the 18.3 million barrels per day which had been tentatively set for the fourth quarter. OPEC ministers appointed a committee to monitor differences between fixed contract prices and those on the spot market, with powers to call an extraordinary ministerial meeting if it were to decide that spot prices had moved out of line with term contracts.

Non-oil commodity prices *have firmed*[(a)]



(a) Spot non-oil commodity prices—Economist index in SDRs.
(b) The reason why the all-items index rose more rapidly in the second quarter of 1987 than either of its components arises from the chain weighting used in The Economist's construction of the index.

Spot non-oil commodity prices have strengthened in recent months. By July of this year the Economist all-items index was some 14% above its trough in August 1986 in SDR terms (the comparable increases in dollar and sterling terms were 20% and 10% respectively). Industrial raw material prices (30% higher in SDRs) have led the recovery. In dollar terms the (all-items) index has returned to 1984 levels, but SDR prices have only returned to their levels of a year ago. Various structural factors have tended to exert downward pressure on industrial raw materials prices in recent years.[(1)] However, short-term factors have also contributed to recent price movements, particularly in metal markets. Industrial disputes have resulted in short-term supply difficulties in several markets and, with users maintaining very low stock levels, this has produced sharp price rallies. However, world stocks remain healthy for almost all products, and idle capacity and other longer-term structural factors may continue to overshadow the markets, thus forestalling any sustained recovery in prices.

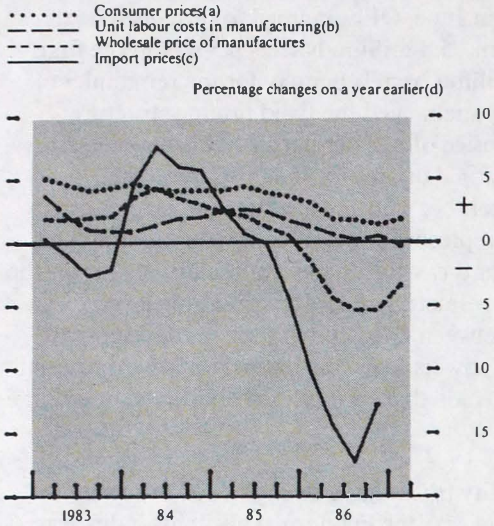
Although food prices have not rebounded as strongly as those of industrial materials, they have risen—by 2% between January and July in SDR terms. Estimates for harvests in 1987 have been lowered for several commodities, notably grain (in the USSR, the United States, Canada and Australia). Stocks, however, are plentiful and are likely to be more than adequate to meet projected demand. Although acreage reduction programmes in the United States will affect production of some commodities, including grains and soya this year, output in the European Community is expected to be high—particularly of products such as vegetable oils and sugar which are also produced and exported by developing countries. World trade in agricultural commodities continues to grow slowly (in 1986 it grew by just 1%, well below its average rate during the 1970s)—reflecting the increase in output of many products in the traditional importing countries, especially in Western and Northern Europe. (See the note on agricultural policy on page 324.)

. . . and while internal cost pressures remain subdued, **inflation** *has risen*

In the major overseas economies, manufacturing unit labour costs in local currencies are almost static. In the second half

(1) See the June 1986 *Bulletin*, page 172.

Inflation *remains low in the major overseas economies*



(a) Consumers' expenditure deflator.
(b) Adjusted to allow for cyclical fluctuations in productivity.
(c) Average of national figures, thus including imports from other major economies.
(d) 1987 first quarter figures include estimates.

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

Monthly averages

	1985 Mar.	Dec.	1986 Sept.	1987 Mar.	July(c)
Canada					
Short-term interest rate	11.3	9.3	8.4	7.2	8.8
ERI	88.5	81.2	77.2	79.0	78.6
France					
Short-term interest rate	10.7	9.0	7.1	8.0	8.0
ERI	63.2	69.7	69.8	71.8	71.6
Germany					
Short-term interest rate	6.4	4.9	4.5	4.0	3.9
ERI	119.1	130.2	140.3	147.1	146.6
Italy					
Short-term interest rate	16.1	14.9	11.7	11.7	11.2
ERI	45.0	44.9	47.6	48.2	47.1
Japan					
Short-term interest rate	6.3	7.4	4.7	4.0	3.7
ERI	155.4	177.1	216.6	217.7	213.7
United Kingdom					
Short-term interest rate	13.7	11.7	10.1	10.0	9.1
ERI	73.4	79.1	70.4	71.9	72.8
United States					
Short-term interest rate	9.0	7.8	5.7	6.2	6.7
ERI	152.4	127.0	110.4	103.3	103.3

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

of last year they are estimated to have risen by just 1% at an annual rate. This was mainly the result of restrained growth of nominal earnings (up 2¾% at an annual rate) rather than rapid productivity increases (up 1½% at an annual rate). Unit labour costs fell in the first quarter of this year, partly because of the continuation of low wage settlements in the United States.

The twelve-month increase in consumer price inflation in the six major overseas economies in aggregate declined steadily during 1986, from 3½% in January to around 1% at the beginning of this year, as falls in oil and other commodity prices fed through, but has since risen to 2¾%. Wholesale prices overseas, having fallen by 4½% in the year to January, were only 1¼% lower in May than twelve months earlier. The rise in recorded measures of inflation may not, however, portend any increase in underlying inflationary pressures given the restrained growth of earnings and the fact that sustained increases in real primary product prices do not appear to be in prospect. With the fall in the dollar, the rise in inflation has, nevertheless, been more marked in the United States than elsewhere. Consumer prices rose by 3½% in the year to June, compared with 1½% in the year to January. Clearly, the more the burden of reducing the current account imbalances were to fall on exchange rates, the greater would be the inflationary threat in the United States.

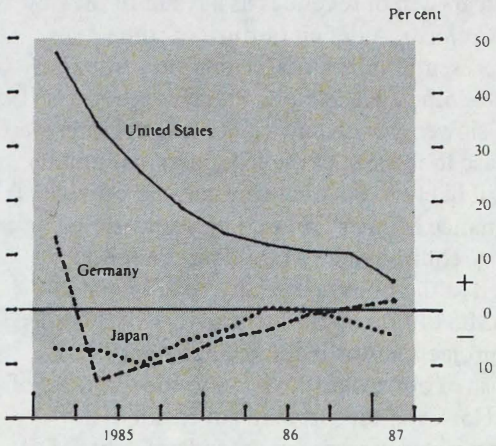
The pattern of **exchange and interest rates** *has been stable . . .*

The dollar has been fairly stable against other currencies in recent months. A number of factors may have contributed to this, including the firming of the oil price, which is less harmful to the current account of the United States than to that of Japan or Germany. Policy developments have probably also been important, including heavy intervention in exchange markets in the three months to the end of April; market perceptions of the Japanese economic package (see below); the spirit of international economic co-operation seen at the Venice summit; and the Japanese Ministry of Finance's request that financial institutions refrain from making 'speculative foreign exchange transactions'. Interest rate differentials between German and Japanese assets, on one side, and US assets, on the other, widened substantially during the period of dollar weakness in the spring. In part this was associated with attempts by the Japanese and German authorities to ease domestic short-term market rates down and with the slight tightening of US monetary policy in April. Since May, greater exchange rate stability has been associated with relative stability in short-term interest rates. There has, however, been an upward movement in longer-term interest rates in several countries. In Japan this may reflect a revival of institutional interest in US bonds as against Japanese assets.

. . . following large changes in **relative competitive positions . . .**

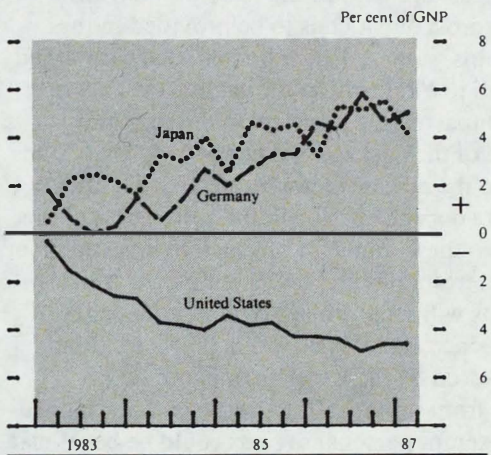
Since its peak in February 1985, the dollar has fallen by around 45% against both the yen and the deutschemark. Reflecting this, the dollar's effective exchange rate has depreciated by 35% and those of the yen and the deutschemark have appreciated by some 35% and 25% respectively. This realignment of exchange rates has meant that the competitive positions of the United States, Japan

US price **competitiveness** *has improved since early 1985*[(a)]



(a) Percentage deviations of relative export price competitiveness from 1961–86 average for each country. Negative numbers indicate that the competitiveness of a particular country was stronger than on average during the period shown on the chart. A downward movement in the lines shows an improvement in competitiveness.

Current account imbalances *of the United States, Japan and Germany have stabilised*



and Germany (measured by relative export prices in common currency) are now much closer to their respective averages over the last twenty-five years than was the case two years ago. The improvement in US competitiveness is of greater magnitude than the deterioration in that of Japan or Germany. Nevertheless, on this measure the United States remains less, and Japan more, competitive than on average during the last twenty-five years.

. . . *but* **trade adjustment** *has been only limited . . .*

US trade volumes have started to adjust to the large changes in competitiveness. Exports of goods and services have grown more strongly than imports over the last three quarters; in the second quarter of 1987, exports were up nearly 13% at an annual rate, compared with a 5½% rise in imports. Recent movements in Japanese and German trade volumes have been less encouraging. In the first quarter, Japanese exports rose by 6% at an annual rate and imports fell by 5%. Although this partly reflected temporary factors, it was the second quarter running in which net trade volumes had failed to adjust in the desired direction. In Germany the volume of imports of goods and services rose and that of exports fell in the final quarter of 1986. In the first quarter, however, while exports continued to decline, imports fell more sharply (reflecting weak domestic demand).

The adjustments in trade volumes are not fully reflected in a greater reduction in the current account imbalances, chiefly because of terms of trade effects. Nevertheless there are some limited signs that the external imbalances between the three largest economies have begun to diminish. The US trade deficit narrowed from $15.1 billion (not seasonally adjusted) in February to little over $13 billion in both March and April—but rose to over $14 billion in May. Even so, the deficits in recent months are significantly smaller than those recorded in the second half of 1986. The seasonally adjusted Japanese surplus has fallen in dollar terms for five successive months, from a record level of $9.6 billion in January to just below $7 billion in May. The German surplus, however, although somewhat erratic on a monthly basis, was higher in dollar terms during the first six months of 1987 than during the second half of last year.

. . . *highlighting the need for continued* **international co-operation . . .**

At the Venice summit the seven major industrialised countries reaffirmed the agreement reached at the Louvre in February on the desirability of exchange rate stability. This reflected the view that a further substantial realignment of exchange rates might damage the prospects for non-inflationary growth. The importance that participants at these meetings attached to exchange rate stability had been underlined by the extent of the intervention to support the dollar in the three months to April. But it is recognised that a reduction in the current account imbalances over the longer term will be helped by the broad co-ordination of macroeconomic policies in the major countries. Towards this end, governments agreed at Venice to examine the individual and collective consistency of medium-term objectives and projections and to use performance indicators to monitor trends in their economies.

A further reduction in the US fiscal deficit remains an important requirement. In the United States, the Congressional Budget Office has recently revised its estimate for the Budget deficit for fiscal 1987 from \$176 billion to \$161 billion, mainly because of stronger-than-expected growth of revenues as a result of the implementation of tax reform. A deficit outturn of some \$160 billion would represent a substantial reduction compared with last year's deficit—some \$220 billion. There are concerns that a combination of slower growth and higher interest rates could lead to an increase in the size of the federal deficit in later years, although it is still likely to fall over time as a percentage of GNP. The German Finance Ministry revised up its projected 1988 federal borrowing requirement by DM 2 billion following its decision, announced at the Louvre meeting, to advance to January 1988 some DM 5 billion of tax cuts originally scheduled for 1990. In July this projection was increased again (by DM 1.3 billion) because of downward revision to the forecasts of growth and inflation. However, the German government is concerned about the projected increase in the federal debt/GDP ratio and remains opposed to bringing forward more of the net tax reduction associated with the 1990 tax reform, despite a growing number of forecasts that growth in 1987 will be less than the 2.4% achieved last year.

Immediately prior to the summit, the Japanese government unveiled an economic package amounting to some ¥6 trillion (around $1\frac{3}{4}$% of GNP), most of which is to be provided in the current fiscal year. Of this, some ¥$3\frac{1}{2}$ trillion has been earmarked for public works and up to ¥1.3 trillion for income tax cuts in October. The overall impact of the package on the economy remains unclear. Some of the package will be in the form of loans to be made available to the private sector at preferential rates, and its impact therefore depends partly on the willingness of the private sector to take up these funds for productive investment at a time when market interest rates are low. Moreover, it is likely that the income tax cuts will merely help to offset a tendency of the effective tax rate to increase. It is probable that the cut in income tax will be financed by the larger-than-expected tax revenues last year and from privatisation proceeds. The planned taxation of currently exempt personal savings could be beneficial to consumption. These factors may be among those which underlie the Economic Planning Agency's estimate that the package would reduce the annual current account surplus, which was \$94 billion in the last financial year, by only around \$5 billion.

. . . *not least in dealing with* **developing country debt**

Although debtor countries remain severely constrained in their access to external funds, there are indications that their terms of trade may stabilise this year following a deterioration in 1986. In addition, some increase in oil exports and in non-oil developing countries' export market share is expected. Consequently, in a number of countries debt service ratios may ease somewhat, at the same time as non-oil imports grow—by a forecast 4% per annum on average.[1]

In May, Citicorp increased its provisions against sovereign debt by \$3 billion and similar action was subsequently taken by other

(1) For a further discussion of prospects see the note on the economic outlook for a selection of developing countries on pages 340–43.

banks in the United States and by major clearing banks in the United Kingdom. These moves were greeted favourably by the markets in that they were indicative of the growing strength of the banks' balance sheets and of a realistic valuation of their sovereign loans. Fears have been expressed that such a move may lead to a hardening of banks' negotiating stance in future financing packages, particularly regarding the provision of new money. However, the banks that have increased their provisions have given assurances that they will continue to participate fully and co-operate in debt negotiations. The 'menu' approach, a feature of the recently negotiated package for Argentina whereby each bank is given some flexibility over the form of participation, represents a useful innovation in fostering the banks' continued co-operation. Most countries continue to maintain adjustment policies, often in conjunction with IMF programmes, recognising that these offer the best foundation for sustainable medium and long-term growth.

The recent proposal by the Managing Director of the IMF for a significant increase in the IMF's Structural Adjustment Facility for poor countries was endorsed at the Venice summit. The United Kingdom is actively seeking support for the Chancellor's initiative for the poorest and most indebted countries in sub-Saharan Africa, including interest relief, a waiver of repayment of past aid loans and a longer period for the rescheduling of officially-guaranteed debt. The Venice summit endorsed the need for action in this area and urged completion of discussions by the end of the year.

At home the growth of **output** *remains strong*

In the United Kingdom there was further strong growth in activity during the first quarter. The output measure of GDP, GDP(O), normally considered to be the most reliable indicator of short-term changes in GDP, rose by 1% to a level 4¼% higher than a year earlier, according to the latest published estimates. Growth in the quarter was concentrated in the construction sector, where output surged by 5%, and in energy; there was only a modest increase in output from the service sector, while manufacturing output is now shown to have risen by ¼%. The increase was less than that in each of the previous three quarters, mainly because of the severe weather which lowered output in January. The latest data indicate that manufacturing output continued to grow in the second quarter; output in both April and May was well above first quarter levels, and car production rose strongly in the second quarter. Recent CBI surveys have reported further increases in orders and in the prospects for the growth of output.

The pattern of output growth in recent quarters reflects both improvements in market share in response to the earlier depreciation of sterling and strong increases in demand last year. In the first quarter of 1987, however, the growth of domestic demand slowed; consumers' expenditure showed little change despite a strong rise in real disposable incomes, and investment remained weak. The expenditure measure of GDP, GDP(E), nevertheless rose by 1½%, reflecting a sharp increase in the contribution from net trade, more than accounted for by a large fall in the volume of imports from the unusually strong levels last year. Even so, GDP(E) rose by only 2½% in the year to the first

Growth in output

Percentage changes over the previous period: *seasonally adjusted*

		1985	1986				1987
	Weight	Year	Year	Q2	Q3	Q4	Q1
Manufacturing	*266*	3.0	0.9	1.2	1.0	2.0	0.3(a)
Energy	*95*	9.0	4.4	−0.7	1.1	−4.6	3.5(a)
Services	*544*	3.5	3.8	1.6	1.2	1.4	0.4
Construction	*63*	1.3	2.3	2.8	0.9	2.3	5.0
Total GDP(O)(b)	*1000*	**3.7**	**2.9**	**1.1**	**1.3**	**0.8**	**1.0**

(a) The latest estimate of the increase in output in this sector in the first quarter.
(b) Includes agriculture.

Contributions to the growth of GDP

Changes over the previous period as a percentage of GDP(E); at constant market prices; *seasonally adjusted*

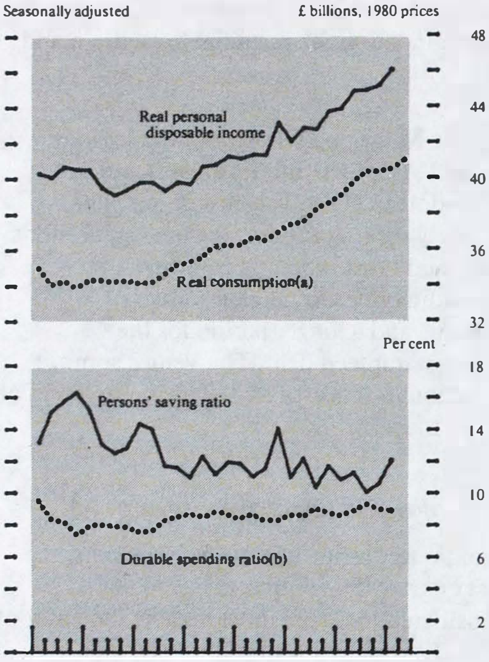
	1985	1986				1987
	Year	Year	Q2	Q3	Q4	Q1
Consumer spending	2.2	3.1	1.1	0.9	—	0.2
Government consumption	0.1	0.2	0.2	0.2	−0.1	—
Gross fixed investment	0.4	0.2	−0.6	0.5	−0.1	−0.1
Stockbuilding	0.2	0.1	−1.1	—	1.0	−0.2
Domestic expenditure	**2.9**	**3.5**	**−0.5**	**1.6**	**0.7**	**−0.1**
Exports	1.7	0.9	0.9	0.3	1.6	−0.2
Imports	−0.9	−1.6	−0.7	−1.6	−0.9	1.8
GDP(E) (percentage change)	**3.6**	**2.7**	**−0.2**	**0.3**	**1.4**	**1.4**

quarter. It remains difficult to reconcile some of the output and expenditure estimates over this period. The continued growth of real disposable incomes, especially in the first half of last year, and the large increase in imports of capital and intermediate goods in the second half, suggest that some of the estimated expenditure components may eventually be revised upwards. The average measure of GDP rose by over 1¼% in the first quarter to a level 3¼% higher than a year earlier.

Consumer spending, *which was flat in the first quarter, rose further in the second*

Consumer spending *rose in the second quarter*

Seasonally adjusted



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

Consumer spending rose only ¼% in the first quarter, despite further growth in incomes and an increase in consumer credit. Spending on durables, which had been the fastest growing component of consumer spending during 1986, fell for the second successive quarter; spending on non-durables has barely increased since last autumn and there has been a fall in expenditure on food, drink and tobacco. The volume of retail sales, which had risen strongly in the fourth quarter, was depressed in the first, although part of the decline in spending and sales in January reflected the poor weather. There was a marked divergence between the growth of personal income and spending in the first quarter of this year as real disposable incomes rose by 2%. The growth of real disposable labour income slowed and an unusually large proportion of the increase was income from dividends and interest, reflecting the strong rise in industrial and commercial companies' dividend payments over this period (see page 339), a relatively large proportion of which tends to be saved in the first instance. The saving ratio is estimated to have risen in the first quarter to over 12% from around 10½% in the fourth quarter.

The buoyancy of earnings, the stimulus to disposal incomes from tax cuts, and further increases in consumer credit are expected to be reflected in stronger growth of consumer spending during the remainder of the year. There are indications of some strengthening during the second quarter. Although movements in the volume of retail sales were erratic during the second quarter, partly explained by the lateness of Easter this year, there was a strong recovery in sales in June, bringing their rise to 2¼% in the quarter. Consumer spending rose by nearly 1¾% according to provisional estimates, although in the year to the second quarter the growth of spending remained at 3½%.

The rise in the personal saving ratio in the first quarter permitted an increase in personal investment (mainly in housing) and a rise in persons' financial surplus from close to £1½ billion in the fourth quarter to £2¾ billion, enabling the sector to increase its acquisition of financial assets, including bank deposits, unit trust units and national savings. There was also a further increase in liabilities—during the first quarter total personal sector debt rose by £8¾ billion, of which some two thirds represented borrowing for house purchase. The stock of bank borrowing for consumption grew at an annual rate of almost £9 billion in the first quarter, compared with £6–7 billion during the past two years. Overall, the increase in debt in the first quarter was broadly compensated by the fall in mortgage rates and faster growth of incomes, so that the household sector's income gearing ratio remained little changed at some 8¾% (before tax relief).

Capital spending *by business was also weak in the first quarter . . .*

Capital expenditure by the manufacturing, construction, distribution and financial services sectors was little changed in the first quarter from its level at the end of 1986. Within this, total investment by the manufacturing sector rose almost 5%. The latest figure suggests investment remains relatively depressed despite the surge in imports of capital goods in the second half. The recent weakness of manufacturing investment stemmed in part from uncertainty about market prospects at the beginning of last year. The combined effects of the falls in oil and raw material prices and the lower exchange rate led to improvements in both profitability and output, although in the case of output it did not become apparent until the second half of the year. Several other factors may also have played a part. The phasing out of capital allowances in line with the corporate tax reforms announced in the 1984 Budget had implications both for the timing of investment and for the marginal cost of finance facing some firms. Some projects originally scheduled for 1986/87 will have been brought forward into earlier tax years to take advantage of higher rates of allowance, thereby depressing investment in the later period. In addition, the phasing out of allowances has led to a realignment of the differential between leasing rates and other interest rates. Leasing finance allowed tax-paying companies to transfer the benefits of investment allowances to tax-exhausted companies (ie those which had no taxable profits against which to offset investment allowances). With the phasing out of first year allowances, the latter group, of which a high proportion comes from the manufacturing sector, experienced a rise in leasing rates without yet gaining any benefit from the lower rate of corporation tax. Investment by companies in the construction, distribution and financial sectors fell in the first quarter, although it was 1% higher than a year earlier.

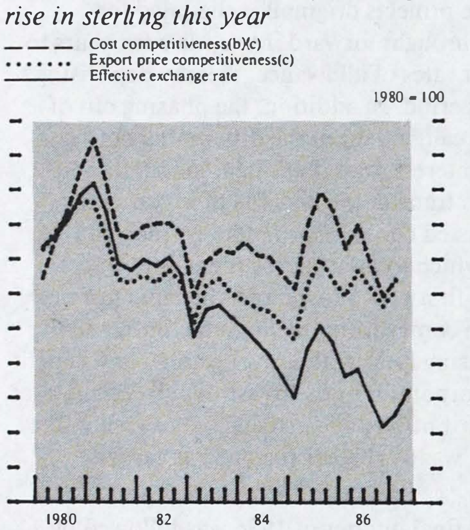
The rise in stocks in the final quarter of 1986 was followed by a further increase of some £300 million (1980 prices) in the first quarter. Much of the increase was the result of a rise in stocks held as work in progress in the manufacturing sector. Stock/output ratios in manufacturing have declined steadily in recent years, reflecting improvements in stock management techniques and the high cost of stock holding. Nevertheless, the most recent increase in manufacturers' stocks may indicate some levelling off in the stock/output ratio, especially as the balance of respondents in recent CBI surveys reporting their stock levels as more than adequate has gradually fallen.

. . . and **non-oil import volumes** *fell, until their rebound in May*

Net external trade made a positive contribution to growth in the first quarter, mainly the result of a fall in the volume of imports following their sharp rise in the second half of last year. The volume of exports was broadly maintained at its fourth quarter level, which was appreciably higher than those recorded earlier in 1986. As a result there was an improvement in the visible deficit in the first quarter of £1.5 billion. Some of the improvement (£0.4 billion) can be attributed to the higher surplus on trade in oil, reflecting both higher prices and an increase in net export volumes. The major factor, however, was the reduction in the deficit on trade in manufactures from £1.8 billion in the fourth quarter to £0.8 billion in the first.

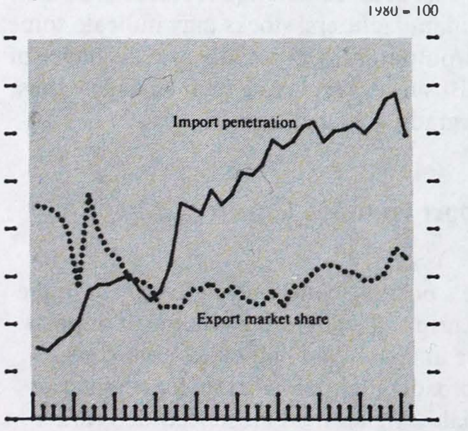
The fall in imports in the first quarter was followed by a moderate increase in April and a much larger than expected increase in May. The rise in non-oil import volumes in May was broadly based and amounted to over 10%, which, when combined with a weakening of non-oil exports, resulted in a large deficit on non-oil trade, especially in manufactures. In view of the extent of the surge of imports in May, it is too early to assess whether this represents a deterioration in the underlying trend or is simply a random fluctuation. Despite the disappointing May figures, in the three months ended May non-oil export volumes (excluding erratics) were 6½% higher than in the same period a year earlier, while the growth of imports on the same comparison was only slightly faster (7½%) at a time when the UK economy was growing faster than most others.

Some of the gains in **competitiveness**[(a)] *in 1986 will have been eroded following the rise in sterling this year*



(a) A downward movement indicates an improvement in UK competitiveness.
(b) Relative unit labour costs in manufacturing.
(c) Bank estimates for first quarter 1987.

During 1986 there was an improvement in the United Kingdom's **market share for exports of manufactures**[(a)]



(a) Provisional estimates for first quarter 1987.

Competitiveness *and* **profitability** *have improved*

Despite the sharp rise in imports in May, there has been an overall improvement in non-oil trade performance since the third quarter of 1986. The deficit on non-oil trade of £4¾ billion in the year to date compares favourably with the deficit of £7 billion in the second half of last year. The improvement appears to have reflected favourable movements in competitiveness as growth in overseas markets is thought to have been relatively subdued. The improvement in export competitiveness between 1985 and 1986 was largely in terms of relative costs rather than relative prices, suggesting that better profit margins have stimulated a supply response. This impression is reinforced by the speed and extent of the response of net export volumes to the gains in competitiveness associated with the depreciation of sterling in the second half of 1986. It might have been expected that there would have been a J-curve effect (the tendency of the trade balance to deteriorate temporarily after a depreciation as prices react faster than volumes) but, although the terms of trade deteriorated, such was the response of trade volumes that the non-oil trade balance was little changed in the fourth quarter of last year and improved sharply in the first quarter of this. But, even allowing for the faster than expected response, the extent of the improvement in trade volumes is hard to explain in terms of competitiveness alone. The additional element, reflecting the divergent paths of export costs and prices, appears to have been the improved profitability both of exporting and of domestic production. Profit margins (as measured by the ratio of prices to costs) have risen considerably above their previous peak in 1978 while the profitability of exporting to the United Kingdom may have fallen.

As a result of these developments, the United Kingdom's share of the world market for manufactures (weighted by the composition of UK exports) rose during 1986. Much of the increase in exports of manufactures between the first quarters of 1986 and 1987 was to developed countries, especially to those in the European Community, where the value of UK exports is estimated to have risen by 23% over this period; by contrast, exports of manufactures to the main oil exporters have fallen. Import penetration rose during 1986, despite a probable narrowing in margins on exports to the United Kingdom, but then fell sharply in the first quarter of this year. Much of the improvement will have been unwound by the increase in imports in May.

UK exports of manufactures

	Percentage share in total UK exports of manufactures			Percentage change in value; six months ended the first quarter of 1987 compared with year earlier
	1985	1986	1987 Q1	
UK exports of manufactures to:				
Developed countries	75.3	77.0	78.0	18.1
of which:				
European Community(a)	*42.0*	*44.5*	*46.2*	23.3
Other Western Europe	*9.4*	*9.7*	*9.6*	14.8
North America	*17.5*	*17.1*	*16.7*	11.9
Other(b)	*6.3*	*5.7*	*5.5*	3.5
Developing countries	22.4	20.4	19.9	2.4
of which:				
Oil exporters	*9.6*	*8.6*	*7.7*	-8.4
Other developing	*12.8*	*11.8*	*12.2*	10.4
Centrally planned economies	2.4	2.6	2.1	12.3
Total	100	100	100	14.6

(a) Data for 1985 adjusted to include Spain and Portugal.
(b) Japan, Australia, New Zealand and South Africa.

The effective rate for sterling has risen from 68.5 at the end of January to a little over 72 by the end of July, representing a 5% appreciation over this period. Although the rise in the value of sterling will have resulted in the loss of some of the gains in competitiveness in the second half of last year, the full effect on trade performance is likely to be spread over several quarters. According to the latest CBI survey, manufacturers remain optimistic about export prospects and export order books are above normal levels.

The favourable developments in trade volumes during the first four months of the year, combined with an improvement in the terms of trade following the appreciation of sterling since February and an estimated surplus on invisibles of £600 million per month, contributed to a surplus on current account over this period. However, a current account deficit of over £0.5 billion in May left the current account in broad balance over the first five months of the year. This follows a revised estimate of a current account deficit of only £0.1 billion in 1986, (compared with an earlier figure of £1 billion), mainly reflecting an upward revision to the surplus on interest, profits and dividends owing to higher estimates of net direct investment earnings, especially of the UK monetary sector.

Manufacturing output *has risen strongly, leading to concerns about supply constraints*

Manufacturing output, trade volumes and employment[a]

Percentage changes: first quarter 1987 over a year earlier

	1980 output weights	Output	Exports	Imports	Employment
Metals and minerals	*90*	5.1	16.3	- 1.5	-1.4
Chemicals and man-made fibres	*92*	6.2	9.2	4.9	-0.6
Mechanical engineering	*144*	-1.5	0.0	- 3.1	-4.3
Electrical engineering	*129*	9.5	18.9	19.8	-3.6
Other engineering(b)	*168*	3.3	6.3	-10.9	-5.5
Food, drink and tobacco	*135*	2.9	8.4	- 3.2	-3.1
Textiles and clothing(c)	*71*	1.6	8.1	- 1.4	-0.9
Other	*171*	6.9	..	..	1.9
Total	*1,000*	**4.5**	**8.9**	**5.2**	**-2.2**

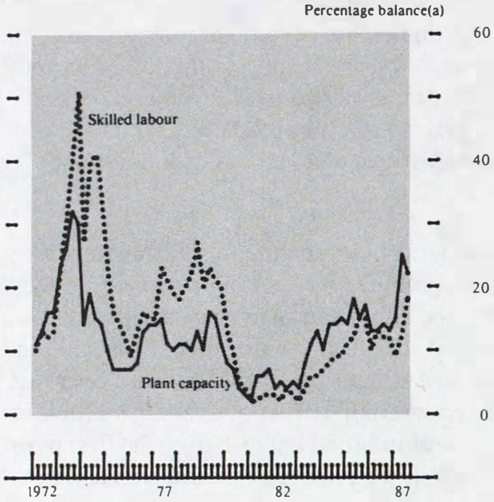
.. not available.
(a) Data for output and employment refer to SIC; those for trade volumes to SITC and will therefore not necessarily exactly correspond.
(b) Motor vehicles and other transport equipment, other engineering and metal goods not elsewhere specified.
(c) Includes also footwear and leather.

Although there was only a modest increase in manufacturing output in the first quarter, this was primarily because of the weather-related fall in activity in January. Output recovered in subsequent months and has grown strongly over the last year—in the three months ending May output was 4½% higher than a year earlier. In the year to the first quarter the growth of output was strongest in electrical engineering, chemicals and metals—sectors which also recorded strong increases in exports—and output in these sectors rose further during April and May. The fall in imports in the first quarter of 1987 was reflected in all sectors except electrical engineering and chemicals; employment levels continued to decline during the period in most sectors, contributing to the increase in output per head.

The strength of growth of output has led to concerns in some quarters that supply constraints may soon emerge. Shortages of skilled labour have been reported more widely in recent months, particularly in industries such as construction and electrical engineering where output has grown very rapidly over the past year. The balance of manufacturing firms reported by the CBI as citing skill shortages as a constraint on output rose in July, but remains low when compared with earlier cycles. Even in the capital goods sector, where the requirement for skilled labour is greatest, the latest survey data indicate that shortages are no more of a constraint now than two years ago.

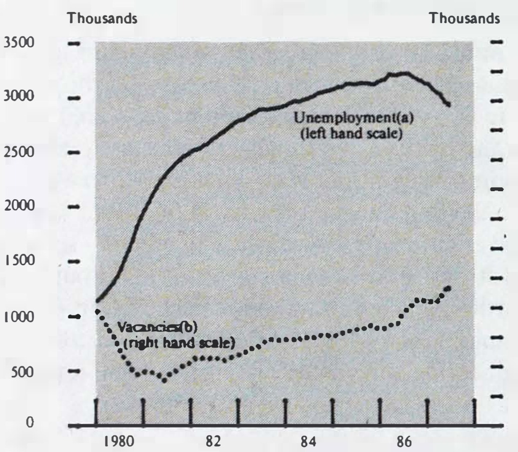
The strong growth of manufacturing output appears to have resulted in an increase in capacity utilisation. The proportion of firms working at or above a normal rate of capacity utilisation has risen to 55% compared with 51% in April, according to the latest CBI quarterly survey. This proportion is higher than the

Capacity and skilled labour constraints *in manufacturing have increased this year*



(a) Percentage reporting plant capacity and/or shortage of skilled labour as a factor limiting output in CBI industrial trends surveys.

Unemployment *has fallen over the past year*



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

previous cyclical peak of 1979, but lower than the earlier peak in 1973. In contrast, however, the proportion of CBI respondents regarding plant capacity as the main constraint to the growth of output declined from 25% in April to 22% in July. Furthermore, there was also a rise in the balance of firms regarding capacity as more than adequate, suggesting they may be well placed to increase output further in the coming months without running into serious capacity constraints.

Nevertheless, a faster rate of capital accumulation will be required if output growth is to be sustained. The prospects for a higher rate of investment are encouraging. Not only is the growth of output strong, but because of the strength of equity prices the real rate of return on capital now exceeds the rate attainable on financial assets; if this were to persist, it would provide an incentive to increase capital spending. Manufacturing investment could rise by 4% this year according to the latest DTI investment intentions survey, and the July CBI survey also reports a sharp increase in manufacturers' investment intentions for plant and machinery. Although the CBI surveys indicate that the desire to increase efficiency remains the principal reason for investment, the proportion of new investment undertaken to raise capacity has been rising and may now be higher than its previous peak in 1979.

The trend in **unemployment** *is now downwards . . .*

Unemployment fell by 27,000 in June, following the record fall in May, when the total (seasonally adjusted and excluding school leavers) fell below 3 million for the first time since July 1984. On this measure unemployment has fallen in each month over the last year, a cumulative fall of some 287,000, representing a decline in the unemployment rate from about 11½% in June 1986 to 10½% in June of this year. This reflects the recovery of output, the effect of employment and training measures and the Restart scheme, although it remains difficult to determine the precise contribution of each.

The recovery in the growth of output from the first quarter of 1986 will have contributed to the fall in unemployment. Unemployment is a lagging indicator of economic activity—Bank estimates indicate that half the effect of a rise in output feeds through to unemployment in about nine months—suggesting that even without employment and training measures and Restart, unemployment would have been falling in recent months because of stronger economic growth.

Restart scheme interviews with the longer-term unemployed are also likely to have been important in moving people from the unemployment count. The scheme was introduced in July of last year (and subsequently extended in April of this year to those unemployed for 6 months or more rather than a year) and by the end of April almost 1.4 million interviews had been completed. In addition to Restart, the stricter tests on eligibility for benefit relating to the availability for work (introduced in November 1986) will have had an increasing impact on the unemployment count. Their effects on unemployment are difficult to estimate, although, according to official figures, nearly 9,000 had been disqualified from benefit by February of this year.

The number of participants on employment schemes rose steadily during 1986, mainly reflecting the growth in the largest

Numbers covered by special employment measures, the YTS and Restart interviews

Thousands

	March 1986	Oct./Nov. 1986	April/ May 1987
Community Programme	200	243	242
Community Industry	..	8	10
Enterprise Allowance Scheme	55	70	89
Job Release Scheme	43	29	22
New Workers Scheme	—	26	29
Young Workers Scheme	51	8	—
Total	349	384	392
Youth Training Scheme(a)	265	347	308
Restart	—	528(b)	1,371(c)

.. not available.

(a) The YTS is a training scheme. The numbers refer to the end of the latest month shown.

(b) Cumulative to mid-November for Great Britain.

(c) Cumulative to beginning of May for Great Britain.

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	+69	+106
June	+ 25	+ 9	+20	+68	+ 93
Sept.	+ 51	+16	+43	+29	+ 82
Dec.	+113	+46	+90	+29	+141
1985 Mar.	+ 59	+23	+48	+29	+ 87
June	+ 49	+21	+38	+28	+ 77
Sept.	+ 34	+49	+10	+ 4	+ 38
Dec.	+ 32	+14	+25	+ 4	+ 34
1986 Mar.	+ 10	+47	−14	+ 5	+ 13
June	+ 20	+34	+ 3	+ 4	+ 23
Sept.	+ 27	+22	+16	+25	+ 53
Dec.	+ 52	+21	+42	+26	+ 75
1987 Mar.	+ 79	+34	+62	+25	+105
Level at March 1987	21,257	4,198	19,158	2,643	24,221

(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 and March 1987 are based on the assumption that the average rate of increase between 1981 and 1986 has continued.

of the schemes—the Community Programme. Any assessment of the effect of this programme and the other measures on the unemployment count is complicated by the difficulty of estimating how many of those on the schemes would have found work in any event. Department of Employment estimates suggest that the unemployment count is lowered by over 90% of those on the Community Programme—accounting for about 20,000 of the fall in unemployment in the second half of last year. These measures are unlikely to have had much effect on the count during 1987, since there has been little change in the total number on these schemes. Indeed there has been a slight reduction in the numbers on the Community Programme. The new Job Training Scheme (which provides training to those aged under 25 unemployed for 6 months or more) will have had some effect from May this year.

. . . and the **labour market** *has tightened a little*

The employed labour force in Great Britain rose by 105,000 in the first quarter, indicating that the strengthening of the growth of employment since mid-1986 has been maintained. Much of the growth reflected a further rise in employment in the service industries; there was also a sharp increase in employment in other industries such as construction. The number of self-employed is estimated to have risen by 25,000 on the Department of Employment assumption that the average rate of increase between 1981 and 1986 has been maintained. Manufacturing employment fell further in the first quarter, although the increase in employment of 2,000 in May suggests some slowdown in the rate of decline.

Other indicators also show a slight tightening in the labour market. Vacancies at job centres have tended to rise during 1987 and by June were 27% higher than a year earlier. The number of overtime hours worked has also risen steadily during the year and by May was well in excess of the peak level of 12 million hours per week recorded in much of 1985. The underlying increase in whole-economy average earnings was 7$\frac{3}{4}$% in the year to May, having been 7$\frac{1}{4}$% in the first quarter. The rise included the effect of higher overtime and bonus payments in the service sector where the corresponding rise in earnings was 7$\frac{3}{4}$% in May, compared with 7$\frac{1}{4}$% throughout much of last year. Wage settlements in manufacturing rose to some 5$\frac{1}{2}$% in the second quarter, according to provisional estimates from the CBI. Since August of last year, however, wage settlements in manufacturing have averaged around 5%, compared with a little over 6% in 1985/86. The underlying increase in annual average earnings in manufacturing has remained at 8% in recent months, mainly because the effect of lower settlements over the past year has been offset by an increase in the hours of overtime worked.

The rate of **inflation** *remains low . . .*

The twelve-month increase in retail prices rose slightly to 4.2% in June, although there was no change in the overall level of prices between May and June. Excluding mortgage payments, retail prices rose by 3$\frac{1}{2}$% in the year to June—the lowest figure since December of last year. Alternative measures of inflation also suggest that inflationary pressures remain moderate. The consumers' expenditure deflator (CED), for example, grew by

The underlying growth of manufacturing productivity

Output per head in the manufacturing sector has risen steadily over the past year and in the three months ended May was 6¾% higher than a year earlier. The growth of productivity reflects various influences, including technical progress and the substitution of capital for labour as well as the effect of short-run or cyclical variations in demand. The rate of growth of productivity in manufacturing is an important influence, together with wages and the exchange rate, on the United Kingdom's international competitiveness, since manufactured goods represent over 80% of non-oil trade. In addition, through its contribution to the increase in productivity in the whole economy, it is an important determinant of the overall rate of economic growth. It is therefore useful to distinguish between the part of the recent growth of manufacturing productivity which simply reflects the strong recovery in output (combined with further falls in manufacturing employment) from early 1986 and the part which might be regarded as sustainable in the longer run.

The growth of output per head in the manufacturing sector averaged some 3¾% per annum between 1964 and 1973, before slowing to less than 1% per annum during the remainder of the 1970s. In 1979–80 output per head fell as output fell more than employment during the recession. Productivity, as measured by output per hour, fell more slowly, mainly because of government incentives to encourage the use of short-time working. From 1981 onwards, however, there has been a strong increase in output per head, which has been slightly faster than that of output per hour, reflecting the continued fall in manufacturing employment and the rise in average hours worked, including overtime. From 1983 there has been a gradual rise in the volume of gross fixed investment (including leased assets) in manufacturing. According to survey evidence, the main reason for investment has been the desire to increase efficiency and cut costs. Investment in advanced technology will also have contributed further to productivity gains.

A number of recent studies have attempted to estimate the underlying trend in manufacturing productivity. Muellbauer[1] has estimated that labour productivity grew at an underlying rate of almost 4½% per annum in the first half of the 1980s, based on an estimate of total factor productivity and the rate at which capital was substituted for labour. More recently, he has forecast the trend rate of growth over the next few years at some 3½%, reflecting a more cautious view of the rate at which capital will be substituted for labour. Spencer,[2] taking account of recent data revisions, has estimated that the underlying growth of productivity was in excess of 4¾% per annum in the first half of the 1980s and is likely to be about 4% per annum for the next few years.

Bank estimates of the underlying growth rate of productivity have been derived in two ways, the results of which are largely supported by the conclusions of the studies mentioned above. According to the demand for labour equations in the Bank's model of the UK economy, the underlying trend in manufacturing productivity may be 3%–4% per annum, though the result is sensitive to judgements as to what part of the rise in real wages has been warranted by a sustained increase in labour productivity. The second method was to use a time series technique—the Kalman Filter (KF)—which attempts to distinguish the trend in productivity from cyclical or other temporary influences. The KF was applied to recorded output per hour between 1975 and 1986. The analysis confirms the fall in the trend growth rate in the 1970s, with a low at the end of 1980. The trend growth rate then rose fairly steadily through the 1980s until 1984 when it peaked at a little over 4¼%. It has since slowed to around 3½% per annum. These movements in the trend growth rate of productivity may themselves reflect longer-term movements in, for example, relative factor prices. There is some evidence that, when such factors are taken into account, underlying productivity growth, attributed here to technical progress, has remained very steady at around 3.0% since the 1960s, a similar result to the steady growth of 2.6% for the period 1963-83 obtained by Harvey et al.[3] The difference between the underlying growth of productivity, of some 3%–4% per annum, and the current recorded rate may reflect not only cyclical factors but also permanent adjustments to the level of productivity which are independent of its underlying growth rate.These adjustments are thought to reflect mainly the delayed shedding of labour following the recession of the early 1980s.

Growth of output per head

Average annual percentage changes

	United Kingdom			Average of major seven industrial countries		
	1964–73	1973–79	1979–86	1964–73	1973–79	1979–86
Manufacturing	3.8	0.7	3.6	5.0	3.2	2.8
Non-manufacturing(a)	2.9	0.6	1.5	..	..	..
Whole economy	2.7	1.1	1.9	3.6	1.5	1.3

.. not available.

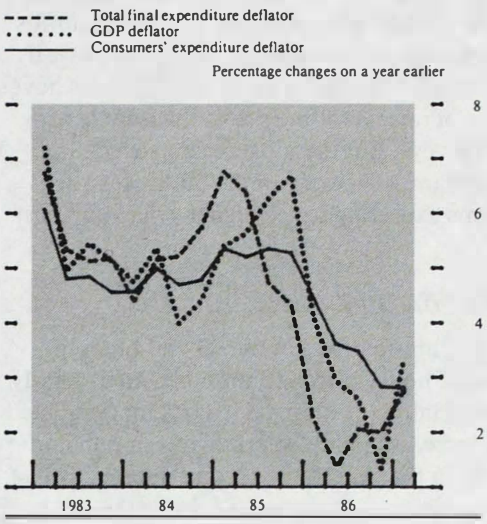
(a) Excluding public services and North Sea oil and gas.

The underlying growth of manufacturing productivity in the United Kingdom now compares favourably with that recorded in earlier periods, as well as with the comparable growth rates for other major industrial countries. The improvement in UK manufacturing productivity has also contributed to an average growth rate of productivity of some 2% per annum in the whole economy between 1979 and 1986. This more modest rate of growth reflects traditionally slower productivity growth in the rest of the economy, principally services.

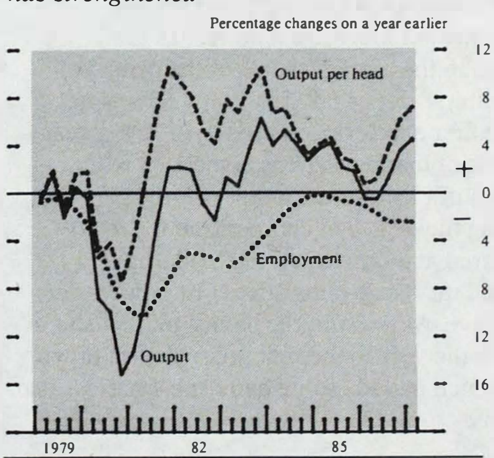
This rather encouraging picture needs qualification in two ways. First, despite better productivity performance in the United Kingdom in recent years than in other industrial countries, UK *levels* of productivity remain below those of many of our major competitors.[4] Second, although there has been a marked slowdown in the growth of actual unit wage costs, most of the deceleration reflects the improvement in productivity. The annual increase in 'underlying' earnings in manufacturing is now estimated at 8%. This could slow in response to lower settlements this year as compared with last, as reported by the CBI. But with settlements at current levels these estimates of the trend growth of productivity imply an underlying increase in unit wage costs above that of other major countries.

(1) Muellbauer J. 'Productivity and Competitiveness in British Manufacturing.' *Oxford Review of Economic Policy*, OUP, 1986.
(2) Spencer P. *Britain's Productivity Renaissance.* Credit Suisse First Boston, June 1987.
(3) Harvey A C et al 'Stochastic Trends in Dynamic Regression Models: An Application to the Employment-Output Equation' *The Economic Journal*, December 1986.
(4) Ray G E 'Labour Costs in Manufacturing' *National Institute Economic Review*, May 1987.

Inflation *remains at moderate levels*



The growth of **manufacturing productivity** *has strengthened*



only 2.8% in the year to the first quarter of 1987, compared with a 4% increase in retail prices over the same period. The divergence between the two measures is largely a reflection of the difference in the coverage of the two indices.

Private consumer spending is, however, only one component of domestic expenditure and to obtain a broader view of inflation in the domestic economy it is necessary to examine other deflators. The total final expenditure deflator (TFE), which measures the price of total domestic expenditure and exports, rose by $2\frac{3}{4}$% in the year to the first quarter. While the domestic expenditure deflators have tended to rise more rapidly than the CED, export prices fell by around $1\frac{1}{2}$% in the year to the first quarter, partly on account of lower oil prices. Import prices have also played an important part in lowering inflation. Their influence may be seen from movements in the GDP deflator, which removes the imported content from the TFE deflator to produce a measure of the cost of domestic value added (essentially the extent to which profits and employment income are rising faster than real output). Although the year-on-year increase in the GDP deflator fell sharply during 1986, its $3\frac{1}{4}$% rise in the year to the first quarter was more pronounced than that of the other deflators. Nevertheless inflation remains low by the standards of earlier years.

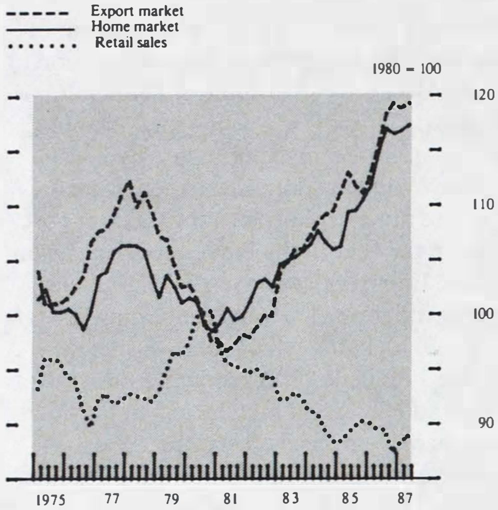
. . . and the growth of **unit wage costs** *has slowed . . .*

The prospects for further reduction of inflation depend in part on movements in labour and materials costs. Unit wage costs in manufacturing have decelerated as a result of the strong rise in output per head, estimated at $6\frac{3}{4}$% in the year ending in the three months to May. Unit wage costs rose by only $\frac{3}{4}$% in the year to May and, as there has been little change in the annual increase in earnings, most of the deceleration in unit costs reflects the strength of productivity growth. Bank estimates suggest that the underlying growth of productivity in manufacturing is currently around 3%–4% per annum (see the note on page 336), which at the current rate of increase in average earnings is sufficient to hold the increase in unit wage costs to around $3\frac{1}{2}$% per annum. The growth in productivity is slower in the service sector, so that whole-economy productivity rose by some $3\frac{1}{4}$% in the year to the first quarter, associated with a 4% increase in unit wage costs. However, even in these other sectors, the growth in unit labour costs is likely to be more subdued than in recent years.

. . . but **margins** *have risen . . .*

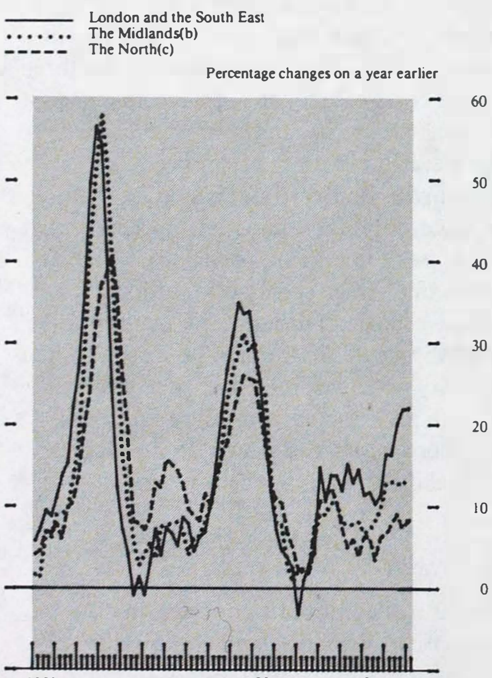
Manufacturers' input prices rose almost 1% (not seasonally adjusted) in June, in response to firmer oil and commodity prices. There was also a sharp rise in the twelve-month rate of increase, from 1.3% in May to 4% in June, reflecting the fall in oil prices a year ago. But in recent months the exchange rate has remained firm, helping to offset some of the inflationary pressure from higher oil and commodity prices. With only moderate increases in unit wage costs, producers' margins have become a more prominent component of inflation. Margins in manufacturing have risen steadily since their trough in the early 1980s, and almost without interruption since mid-1985, adding some $4\frac{3}{4}$% to output prices last year (see the table on page 387). With continued growth of output and higher rates of capacity

Manufacturers' margins[a] *have continued to rise*



(a) Price/cost ratios.

House prices *continue to rise faster in London and the South East than elsewhere*[a]



(a) Department of Environment's mix-adjusted price series (based on completions).

(b) 'The Midlands' includes East Anglia, the South West, the West Midlands and the East Midlands.

(c) 'The North' includes the North, the North West, Yorkshire and Humberside, Scotland, Wales and Northern Ireland.

utilisation, there may be further increases in margins, especially in the domestic market. There has been a modest increase in manufacturers' output prices (excluding those of food, drink and tobacco) in recent months, with the increase over twelve months rising from some 4% at the end of last year to a little over 4½% by June of this. In the first half of the year more manufacturers have indicated their intention of raising selling prices than did last year, according to CBI surveys. But the most recent survey provided some signs of an improvement in the outlook, with a fall in the balance of firms expecting to see higher prices and costs in the coming months.

. . . *and* **house prices** *continue to rise rapidly*

There was a further rise in house prices in the second quarter, although the annual rate of house price inflation declined slightly, to 14½%, according to the Halifax Building Society's mix-adjusted house price index. The increases in house prices in London and the South East, over 24% in the year to the second quarter, are thought to reflect the buoyancy of incomes and the relatively more favourable employment prospects in these areas. House prices in East Anglia are now over 20% above their level a year earlier. The increase in prices in other regions is much slower.

The levelling-off in the twelve-month rate of increase in house prices has been accompanied by a weakening in the growth of mortgage lending; loans extended by banks, building societies and other institutions amounted to around £7 billion in the fourth quarter of last year, but declined to some £6 billion in the first quarter. Initial indicators suggest there may have been an increase in the amount of mortgage lending in the second quarter The slowdown in the growth of mortgage lending has been accompanied by changes in the market shares of the principal mortgage lenders. Building societies provided only 60% of net mortgage lending in the first quarter compared with 85% a year earlier. The societies' loss of market share is associated with difficulties in obtaining sufficient funds to meet mortgage demand, partly reflecting the degree of competition for retail deposits. This has occurred at a time when the banks have competed vigorously and mortgage rates offered by new lenders have appeared competitive. As a result, the banks' market share rose from 15% to 25% in the year to the first quarter, with other financial institutions (which include some bank subsidiaries) also making substantial gains.

The slower growth in mortgage lending in the first quarter appears to reflect some weakening of demand, possibly the result of the rise in mortgage rates at the end of last year and the increase in the house price to earnings ratio, which has diminished the ability of first-time buyers to enter the housing market. In addition, the tendency for building societies to tighten lending standards, apparent since mid-1986, may also have had some effect on total mortgage lending. But other influences on demand conditions remain strong. Real incomes continue to increase, competition is strong in the mortgage market and the cuts in mortgage rates which began earlier in the year are likely to add some further stimulus to demand. The supply of housing, as reflected in the number of housing starts, appears to have responded to demand. Housing starts were over 8% higher than a year earlier in the first half of 1987, with all the increase recorded in private sector starts. There has also been a sharp rise in the number of housing renovations.

Industrial and commercial companies' income and capital accounts

£ billions, *seasonally adjusted*

	1986 Year	Q3	Q4	1987 Q1
Total income(a)(b)	69.1	**17.7**	**17.3**	**19.0**
of which:				
Gross trading profits(b):	55.7	14.2	13.7	14.9
North Sea	8.4	1.6	2.0	2.5
non North Sea	47.3	12.7	11.7	12.4
Total allocations	38.9	9.2	10.1	10.9
of which:				
Dividend payments(c)	8.5	2.2	1.9	3.2
Other payments(d)	12.9	3.1	3.5	3.3
UK taxes	12.8	2.9	3.3	2.9
Undistributed income(b)	30.3	8.5	7.2	8.1
Less: expenditure on fixed capital	25.0	6.3	6.8	6.3
other	—	−0.2	—	0.7
Identified financial surplus	**5.3**	**2.4**	**0.4**	**1.1**
Financial transactions (outflow/acquisition of assets −)				
Investment in UK company securities	− 3.7	−1.0	−0.9	−1.0
Investment abroad	− 4.9	−2.2	−2.7	−1.0
Liquid assets	−11.6	−5.7	0.8	−3.4
Borrowing from banks(e)	5.3	−0.5	4.9	1.9
Other finance(f)	10.8	2.5	3.5	1.6
Other identified transactions	− 2.6	0.7	−3.2	..
Balancing item	**1.3**	**3.8**	**−2.7**	..

.. 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.

Company profits *rose in the first quarter*[1]

A combination of higher margins and stronger growth of output resulted in a 9% increase in the gross trading profits (net of stock appreciation) earned by industrial and commercial companies (ICCs) from their domestic operations in the first quarter. Profits rose to almost £15 billion in the quarter, compared with a quarterly average of £14 billion last year. The recovery in sterling oil prices led to an increase of North Sea company profits, though to only half the peak levels of two years ago. Profits of non North Sea companies recovered from their fall in the fourth quarter, although comparisons with earlier periods are distorted by the inclusion of British Gas and British Airways in the latest figures.

There was a further sharp rise in income from abroad during the first quarter, reflecting sustained overseas investment by companies in the past few years. Companies' payments of dividends on ordinary shares rose strongly in the quarter, maintaining the recent upward trend in the dividend payout ratio. The increase in the ratio is thought to reflect the continued optimism among companies over the prospects for further growth, although the corporation tax reforms of 1984 may also be a contributory factor. Undistributed income rose to over £8 billion, and amounted to more than 40% of company income. With a fall in investment spending (at current prices), ICCs' estimated financial surplus rose to a little over £1 billion.

The trends in company financial transactions observed last year persisted into the first quarter: these included continued high expenditure on UK company securities, related to the increase in acquisitions and a greater company reliance on capital issues as opposed to banks as sources of external borrowing. In 1986, for example, companies borrowed just over £5 billion from banks,[2] less than in the previous two years. By contrast, they raised some £8 billion from capital issues—over 50% higher than the 1985 total. This pattern continued in the first quarter, with ICCs raising nearly £1½ billion in ordinary share issues and a similar amount on the eurobond market. Bank borrowing was also strong, but was almost all accounted for by foreign currency borrowing, probably for hedging purposes, given the fluctuations in the exchange rate. The shift towards greater use of capital issues is thought to reflect a number of factors, including the lower level of interest rates (encouraging companies to switch towards longer maturity, fixed interest debt), the buoyancy of the stock market and the changes in corporation tax (which had the effect of reducing the relative cost of equity).

The PSBR *remained low in the first three months of the financial year*

The cumulative PSBR in the first three months of 1987/88 was £0.6 billion, including a net repayment in May and June, compared with £2.2 billion in the same period last year. Privatisation receipts totalled some £2.4 billion in the first three months of the year. The projection for the PSBR, as set out in the Financial Statement and Budget Report, is £4 billion, equivalent to 1% of GDP, similar to the outturn in 1986/87, with privatisation proceeds expected to yield £5 billion this financial year.

(1) A more detailed account of trends in the company sector during 1986 may be found on page 386.
(2) See footnote (3) on page 391.

The economic outlook for a selection of developing countries

This note[1] summarises the Bank's latest forecast of the economic prospects facing a selection of developing economies. The forecast, completed in mid-June 1987, considered the domestic, balance of payments and debt prospects of twenty-three developing countries[2] which, in 1985, together accounted for some 50% of developing countries' trade flows, around three quarters of their international debt and 60% of the world's population. A central feature of the forecast continued to be the diversity of prospects, which is concealed in the aggregate picture.

Each country forecast was prepared individually using the Bank's models of developing countries. These models provide a consistent framework for the projections by imposing common external factors, including the prices of oil, commodities and manufactures and the level of dollar interest rates, as well as the likely rate of growth of each country's export markets. In addition, a distinction was made between countries where the medium-term import profile is expected to be constrained by available finance, particularly from the banking community, and those countries that do not appear to be so constrained. In the latter case, net commercial borrowing became a residual of changes in net exports, invisibles, reserves and other capital flows.

Background to the forecast

Between 1982 and 1985 the sample countries in aggregate undertook considerable adjustment, with an initial current account deficit of over \$56 billion narrowing to only \$6 billion. This was largely achieved by severe restraint of domestic absorption in the face of a marked reduction of commercial lending and deteriorating terms of trade. Over this period, growth of GDP per capita averaged only 1% per annum for the sample countries in aggregate, despite a relatively strong contribution from the external sector.

Although external factors were the dominant influence on developing countries' economic performance in 1986, domestic policy responses differed markedly. The sharp decline in oil prices necessitated a further tightening in austerity programmes for oil exporting countries such as Algeria, Indonesia, Mexico and Nigeria, while Venezuela maintained import volumes by drawing heavily on reserves. Elsewhere, the direct foreign exchange 'savings' from a lower oil price boosted activity; for Brazil, Korea and Taiwan taken together these totalled some \$6 billion. But in the case of Brazil the economy overheated, resulting in both a diversion of exports to domestic demand and a surge in imports. As a result, by early 1987 the Brazilian authorities adopted a more confrontational stance. Overall, debt ratios deteriorated in 1986 and, reflecting the difficult prevailing conditions, some debt negotiations became more protracted. More recently, a number of agreements between bank advisory committees and several middle-income debtor countries have been reached, partly as banks have sought to resolve outstanding issues in order to be able to concentrate their attention on Brazil, where negotiations are expected to begin in the near future.

The assumptions for the present forecasts were taken from the Bank's latest world economy forecast (WEF), extrapolated to 1991.[3] The level of activity in the seven major industrial countries is forecast to rise at an average of $2\frac{1}{2}$% per annum between 1987 and 1991, and as a consequence the growth of import volumes slows to less than 4% per annum over the same period. Thus the growth of developing countries' export markets is forecast to be weaker than it was between 1984 and 1986. In addition, partial adjustment of present trade imbalances results in import growth rates of around $1\frac{1}{2}$% per annum for the United States and $6\frac{1}{2}$% per annum for Japan between 1987 and 1991, so that those developing countries exporting to Japan generally fare better than those whose major export market is the United States. Oil prices are assumed to average \$20 per barrel in 1988–89 and are unchanged in real terms thereafter. Other real primary product prices are projected to remain weak. World manufactured export prices were assumed to rise by some 12% this year, as a result of the earlier dollar depreciation, and by $3\frac{1}{2}$% per annum between 1988 and 1991.

Summary of the forecast

Compared with the forecast of a year ago[4] there is little change in the aggregate picture, despite changes at the margin in the country coverage.[5] Export market growth, however, is now projected to be slower than last year, leading to slower growth of export volumes and a weaker import profile. As a result, the problems for a number of countries appear to have become much more acute, with declining per capita incomes and continued net transfers to commercial creditors. Nevertheless, the economic performance of the sample countries *in aggregate* between 1987 and 1991 is expected to improve compared

(1) Prepared by A J Bascand and C A J C Butler in the Bank's International Division.
(2) Algeria, Argentina, Brazil, Chile, China, Côte d'Ivoire, Egypt, India, Indonesia, Jordan, Kenya, Malaysia, Mexico, Nigeria, Peru, Philippines, South Africa, South Korea, Taiwan, Turkey, Venezuela, Yugoslavia and Zimbabwe.
(3) A summary of the WEF was given in the May 1987 *Bulletin*, pages 187–8.
(4) See the September 1986 *Bulletin*, pages 355–8.
(5) South Africa, Jordan and Turkey have been added to the sample while Morocco and Israel have been dropped.

with the previous five-year period; in particular, the growth of income per head rises, import volumes grow and there is an improvement in the ratio of debt to exports. Following a deficit of some $13 billion in 1986, the current account of the sample countries in aggregate is expected to remain roughly in balance over the forecast period and, although official lending continues at a healthy pace, there is virtually no increase in bank exposure to developing countries.

The marked differences in the economic performance of various countries have been a major theme of Bank forecasts of the economic prospects for developing countries in recent years. These differences are expected to continue. In a subcategory of 'problem debtor' economies[(1)]—those with current debt servicing difficulties—economic performance is expected to improve in the forecast period compared with their experience between 1982 and 1986. Although the absolute level of growth in these countries remains below that of the sample as a whole, there is nevertheless a larger proportionate improvement in performance, as indicated by the size of the 'diamonds' in Chart 1. Within the sample, however, the projected outturns vary enormously. Among some of the problem debtor countries, successful programmes of adjustment could lead to accelerating progress and stronger GDP per capita growth than experienced in recent years. But the continuing weak outlook for real non-oil commodity prices may constrain growth in several other countries in this group. Those countries not in current servicing difficulties, for example South Korea and Taiwan, are projected to experience stronger import growth, consistent with further trade liberalisation, an acceleration in the growth of domestic demand and some loss of competitiveness.

Table A
Growth in export market share
Annual average percentage increa es(a)

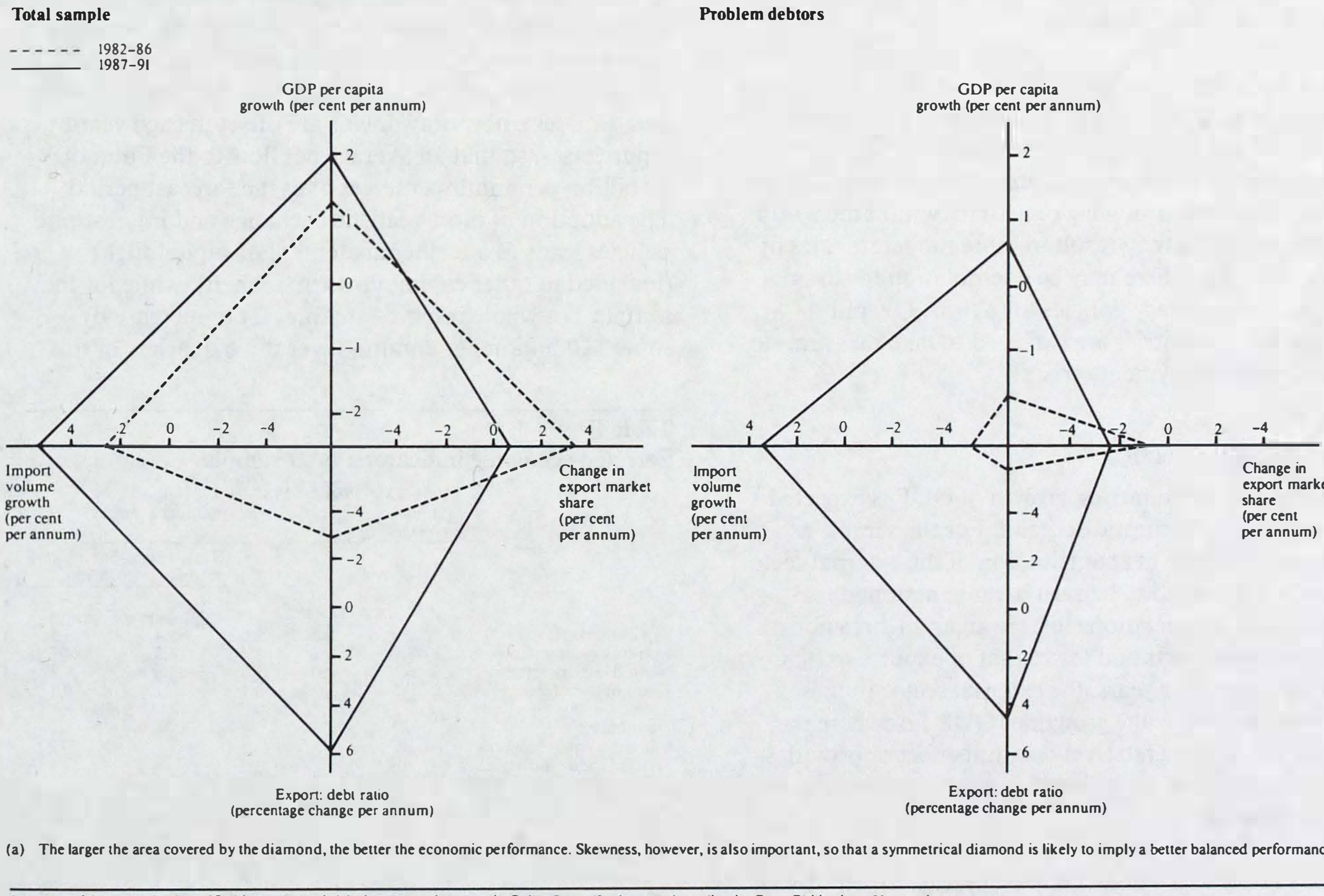
	Actual	Forecast	
	1982–86	1987–91	1982–1991
Main oil exporters(b)	4.2	1.6	2.9
Non-oil commodity exporters(c)	–0.6	–3.1	–1.9
Main manufacturing exporters(d)	7.2	2.6	4.9
Problem debtors	*–1.0*	*–2.2*	*–1.6*
Other sample countries less Taiwan	*7.0*	*2.3*	*4.6*
Total sample	**3.5**	**0.8**	**2.2**

(a) Calculated by dividing the growth of non-oil export volumes by that of export markets.
(b) Algeria, Egypt, Indonesia, Mexico, Nigeria and Venezuela.
(c) Argentina, Brazil, Chile, Côte d'Ivoire, Jordan, Kenya, Malaysia, Peru, Philippines, South Africa and Zimbabwe.
(d) China, India, South Korea, Taiwan, Turkey and Yugoslavia.

Trade prospects

The gain in *export* market share for the sample countries in aggregate is expected to weaken over the forecast period, relative to their experience during the first half of the 1980s (Table A). Within the sample, countries which are

Chart 1
Indicators of economic performance[(a)]



(a) The larger the area covered by the diamond, the better the economic performance. Skewness, however, is also important, so that a symmetrical diamond is likely to imply a better balanced performance.

(1) Ten of the countries identified in the Baker initiative (Argentina, Brazil, Chile, Côte d'Ivoire, Mexico, Nigeria, Peru, Philippines, Venezuela and Yugoslavia) plus Egypt and South Africa.

primarily exporters of manufactures continue to gain market share, albeit at a slower rate than before, while non-oil commodity exporters continue to lose market share. This latter result occurs despite enhanced competitiveness in several countries and reflects a number of factors. First, the significant slowing in investment in some countries over the past five years is expected to constrain export growth; in particular, severe import retrenchment may well have reduced the short-run potential of semi-manufactured and manufactured export sectors. Second, in a few of the economies examined, resources may continue to be channelled into domestic consumption rather than into exports. Finally, agricultural protection and other trade barriers are expected to continue limiting the extent to which developing countries can expand their agricultural exports.

Import volumes of the sample in aggregate are projected to increase from their 1986 levels and grow around 5½% per annum between 1987 and 1991 (or by 4% if Taiwan is excluded). However, the outturn is highly dependent on domestic policies. For the purposes of this forecast it was assumed that several countries would adopt IMF programmes (supported by both official and commercial creditors). For these countries, adjustment is expected to bring about a stronger external position. As a result, several countries among the problem debtors' group set in train 'virtuous circles' whereby enhanced competitiveness, achieved by market-oriented exchange and interest rates, results in both higher production and an increase in domestic savings.

Around one third of the sample were assumed to follow IMF-type programmes but not necessarily with formal Fund involvement. Some of these countries have achieved impressive economic growth in the past; however, a projected slowing of activity within the world economy generally may result in more moderate rates of growth. Therefore there may be a temptation towards pursuing expansionary policies for a time. Overall, however, most countries are expected to take measures to avoid balance of payments crises.

Domestic prospects

In the majority of countries, growth of GDP is expected to exceed that of domestic demand. For the sample as a whole, however, the net contribution of the external sector to growth is expected to be zero because assumed real exchange rate appreciations in Taiwan and Korea boost the growth of imports and lower that of exports so that, in contrast to earlier years, the external sector in these economies may slow the growth of GDP. Elsewhere the external sector has a relatively neutral effect or provides a positive contribution, reflecting some improvement in competitiveness.

For the sample as a whole, GDP is forecast to grow by an average of 3¾% per annum between 1987 and 1991, resulting in growth of GDP per capita of around 2% per annum. In the majority of countries, however, the level of per capita income will still be lower in 1991 than a decade earlier. The prospects are most favourable among the Latin American and Asian countries, and least favourable for some African countries where weak growth of domestic demand, rapid population growth and the need to service debts in the face of only moderate receipts of official financing may impose a particular strain.

Capital flows

A feature of the projections is that banks continue to provide some new finance through conventional new money, lower interest spreads, interest retiming, debt-equity swaps and perhaps other techniques now being considered under the menu approach—although access to new sources of commercial finance for many countries in the forecast is assumed to remain limited. The projections for net bank lending in aggregate are lower than were forecast last year, mainly reflecting debt repayments by some countries. Although bank exposure to one or two 'underborrowed' economies may increase, the level of commercial lending shown in Table B is consistent with a continued general strengthening in capital to lending ratios.

In contrast to bank lending, official lending is forecast to recover, with IBRD lending meeting Baker targets. Thus there is an underlying trend in the forecasts whereby borrowers who since the 1970s have traditionally used private commercial sources turn more to official financing. Another feature is that the IMF is assumed to have a markedly reduced role as a supplier of finance to the sample in aggregate compared with the first half of the 1980s. In fact, new drawdowns are offset in each year by repurchases, so that an average net flow to the Fund of $2 billion per annum emerges over the forecast period. The adoption of more realistic exchange and interest rate policies leads to a further abatement of capital flight (included in other capital flows in Table B), while for the sample as a whole reserves are forecast to increase by some $20 billion per annum. Over three quarters of this

Table B
Selected economic indicators; total sample

	1981–85 (annual averages)	1986	1987	1987–91 (annual averages) Total sample	Sample less Taiwan
				Percentage changes	
Export markets	3.8	5.2	2.6	3.4	*3.5*
Non-oil export volume	8.7	6.2	3.7	4.3	*4.0*
Non-oil import volume	6.1	– 1.0	3.9	5.6	*4.1*
Terms of trade (change)	– 0.5	– 3.9	– 0.1	0.1	*0.1*
				$ billions	
Trade balance	29	29	37	38	*22*
Current account balance	– 27	– 13	– 1	– 1	*– 19*
Selected capital flows:					
Commercial borrowing	28	9	3	3	*3*
Official borrowing	10	13	18	16	*17*
Direct investment	8	7	8	9	*10*
Other capital flows	– 27	– 9	– 10	– 9	*– 9*
Reserves change(a)	– 4	– 4	– 21	– 19	*– 3*
Use of IMF credit	4	– 1	– 2	– 2	*– 2*

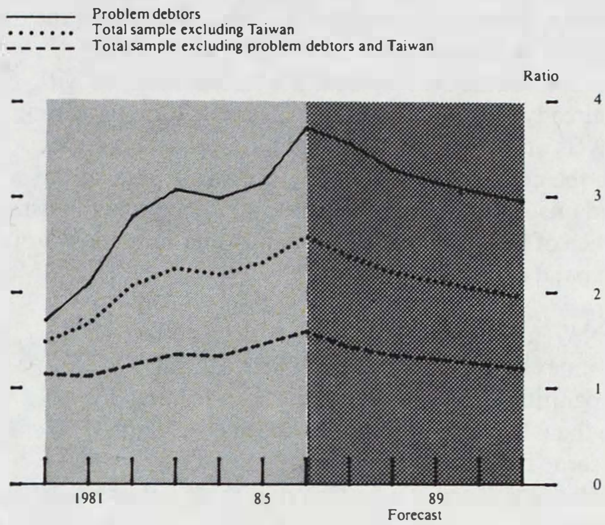
(a) Increase represented by minus sign.

accumulation of reserves, however, is attributable to Taiwan, so that reserve import cover for the remainder of the sample declines slowly from around 4 months this year to 3½ months by 1991.

Debt implications

For the sample *in aggregate* the external debt burden is forecast to ease over the next five years. In most problem debtor countries, debt ratios drift down from the peak reached in 1986, the result of modest increases in debt (as some is repaid or converted into equity) and continued

Chart 2
Selected debt to export ratios[(a)]



(a) Total external debt: exports of goods and services.

export growth. Nevertheless, as shown in Chart 2, the ratio of debt to exports of goods and services is still much higher in 1991 than it was in 1982, despite ten years of adjustment in a number of countries.

Net transfers in dollar terms to creditors by the problem debtor group are expected to continue at levels similar to that of the 1984–86 period. When scaled by exports of goods and services, however, this implies a gradual fall in the outward flow to creditors over the forecast period to some 15% of revenue from exports of goods and services compared with 20% in 1985–86.

Risks in the forecast

The shape of the forecast is, of course, determined not only by macroeconomic assumptions (eg on interest rates, oil and commodity prices)[(1)] but by judgements regarding the sustainability of adjustment policies and the progress in negotiations between debtors and creditors.

As indicated earlier, although a small recovery in living standards occurs from now on, by the end of the decade per capita domestic demand in several countries may still be below 1980 levels. Where countries have a sizable surplus on trade and net service receipts, there may be a short-term incentive to exceed the import profile permitted by net financing flows, so that a balance of payments gap emerges which is financed by increasing arrears. The longer-term consequences of following such a strategy (even accidentally through policy slippage) have been highlighted in several economies when the gains from initially strong import growth have been rapidly dissipated. In these cases, a breakdown in adjustment programmes could result in lower production of tradables and an acceleration of capital flight, and could threaten debt-equity schemes. On the other hand, in some countries the forecast may underestimate the beneficial impact upon the supply side from further reductions in fiscal deficits and measures to liberalise trade.

As regards the evolution of creditor/debtor relations there is the danger that the stance of both parties may become more confrontational. Commercial lenders continue to strengthen their financial positions and hence may become, or perceive themselves to be, less dependent on the concerted lending process. Meanwhile, market access for many problem debtors remains a remote prospect, sapping their incentive to continue with adjustment. However, recent indicators appear relatively favourable, with Brazil apparently moderating its earlier tough stance on payments of interest, and major banks committing themselves to the financial package for Argentina. Looking further ahead, the recent sharp increases in provisions against sovereign LDC debt by some large US and UK banks may in the medium term open the way for additional efforts on the part of the banks to normalise relations between creditors and middle-income debtor countries.

Conclusions

Over the forecast period, most countries in the sample experience modest growth in per capita incomes; interest is fully serviced and debt ratios fall. But the balance of risks concerning economic prospects is on the downside. In part, this reflects concerns about the outcome in a handful of individual debtor countries where problems resulting from the excessive accumulation of debt are not resolved over the forecast period, even if adjustment policies are pursued. Meanwhile, the importance of developed countries maintaining growth and market access for developing countries is highlighted by the somewhat fragile picture painted.

(1) See the September 1986 *Bulletin*, page 358, for a sensitivity analysis of these factors.