Economic commentary

- *Share prices have fallen sharply on the world's major stock markets since mid-October. The Federal Reserve indicated its readiness to increase liquidity; interest rates have fallen, including cuts in UK base rates to 9%. The dollar weakened towards the end of the month.*

- *Until the fall in share prices, there had been an increase in long-term interest rates among the major overseas countries, partly reflecting a rise in inflation. Some firming of short-term rates was associated with tighter monetary conditions.*

- *Growth remained moderate overall among the major overseas countries in the first half, with robust growth in the United States, Canada and Japan and weak growth in continental Europe.*

- *The United Kingdom is one of the fastest growing economies among the major industrial countries. GDP rose by almost 4% in the year to the second quarter.*

- *The growth of manufacturing output has been particularly strong and has been accompanied by higher productivity. There was a further rise in capacity utilisation, according to the latest CBI survey.*

- *In the second quarter, all elements of private demand rose; consumer spending rose further in the third quarter. The strength of demand contributed to a deterioration in the visible trade deficit in the second and third quarters.*

Share prices have fallen dramatically on the world's major stock markets since early October. The collapse in share prices came after at least five years of strong growth in world equity markets. It appears to have been triggered by the markets' anxiety over the possibility of higher interest rates and a weakening of the dollar, associated with the continuing trade imbalances, as well as concern about higher inflation. Interest rates had firmed in the major economies between June and mid-October, partly reflecting a tightening of monetary conditions. Inflation, especially in the United States, had edged up since the beginning of the year because of firmer oil and commodity prices, contributing to a rise in long-term interest rates.

Monetary authorities responded swiftly to the problems of illiquidity caused by the fall in share prices, and interest rates declined after mid-October. Lower interest rates should help to ease the adverse effects of lower levels of wealth and a more difficult investment climate on economic activity, following the fall in share prices.

Growth *continued at a moderate rate in the first half*

Economic activity in the major seven industrial economies in aggregate rose by over 2½% at an annual rate in the first half of the year, compared with 2¼% in the second half of 1986. Growth was fairly strong in North America, Japan and the United Kingdom, but much slower in other European economies. The growth of domestic demand weakened to just 2¼% as the growth of both consumers' expenditure and private fixed investment slowed,

Components of GNP[a] growth in the major economies

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

	1985	1986 Year	1986 H2	1987 H1
Private consumption	3.6	3.8	4.1	1.6
Private fixed investment	5.2	3.2	3.2	1.3
Public expenditure	3.4	3.4	5.5	−0.2
Stockbuilding(b)	−0.6	0.2	−0.7	1.2
Domestic demand	**3.2**	**3.8**	**3.6**	**2.3**
Net trade(b)	−0.1	−1.1	−1.3	0.3
GNP	**3.1**	**2.7**	**2.3**	**2.6**

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

GNP growth in the major economies

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

	1985	1986 Year	1986 H2	1987 H1
Canada(a)	4.2	3.3	1.2	4.5
France(a)	1.7	2.0	2.3	1.4
Germany	2.0	2.5	3.9	−0.8
Italy(a)	2.7	2.7	2.7	2.1
Japan	4.7	2.5	3.2	3.4
United Kingdom(a)	3.6	3.3	3.6	4.3
United States	3.0	2.9	1.3	3.2
Total	**3.1**	**2.7**	**2.3**	**2.6**

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

the latter including a fall in private residential investment. Stockbuilding contributed 1¼ percentage points to growth. There was a positive contribution from net external trade for the first time in two years, reflecting a small increase in export volumes and virtually no growth in the volume of imported goods. The economies of the United States, Canada and Japan grew, on average, by 3¼% at an annual rate, whereas in Italy, the fastest growing of the three major continental European economies, GDP rose by just 2%. The low rates of growth among the continental European economies partly reflected unusually bad weather in the first quarter.

In the United States, GNP rose by 3¾% at an annual rate in the third quarter. Although residential investment remained weak, private consumption and, especially, business investment continued to strengthen after first quarter declines. However, net trade made a negative contribution to growth for the first time in a year as imports of petroleum products increased strongly. In the first half of the year, domestic demand rose by 2% (at an annual rate), although this was more than accounted for by stockbuilding, and GNP rose by over 3¼%. The rate of unemployment fell to just below 6% in September, its lowest level for over seven years. Activity in Canada was stronger and more broadly based than in the United States in the first half of 1987: in both the first and second quarters GDP there grew by around 6% at an annual rate.

In Japan, both domestic demand and GNP grew by almost 3½% at an annual rate in the first half of the year. Although there was a strong increase in domestic demand in the second quarter (up 4¾% at an annual rate), it was completely offset by a negative contribution from net trade, so that there was no growth then in GNP. The strength of domestic demand largely reflected a further modest increase in consumer spending and stronger private residential investment, following a reduction in interest rates on housing loans. There was a large rise in imports and a fall in exports during the quarter, although this partly reflected the unwinding of temporary factors which had led to a large positive contribution to growth from net trade in the first quarter. Indicators for the third quarter were mixed but overall suggested continued domestic expansion. Housing starts rose strongly in July and August, industrial production and employment appeared to be on an upward trend and, although retail sales fell in July, recent surveys of business sentiment point to increased activity in the second half of the year.

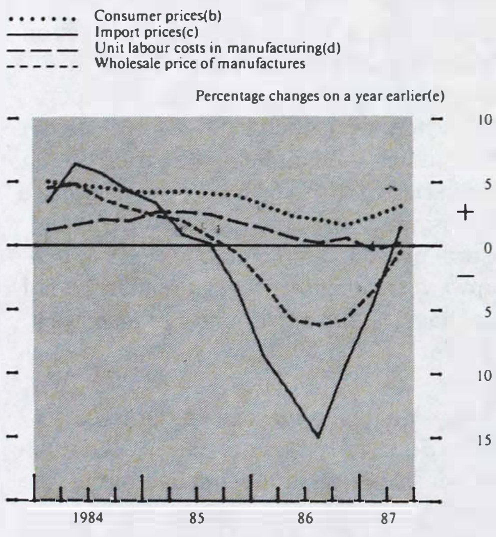
In Germany, GNP rose by 4% at an annual rate in the second quarter, after two successive quarterly declines, mainly the result of a strong rise in consumer spending. In the first half of the year, however, consumer spending was the only component of domestic demand to grow, and by the second quarter GNP was only ¾% higher than a year earlier. The latest indicators suggest some recovery: retail sales have picked up recently and industrial production and new orders, though erratic, are above the levels of a year ago. The unemployment rate has been fairly steady at around 8% over the last four and a half years. In France and Italy the growth of GDP was modest in the first half of the year, reflecting continued deterioration in net trade performance. The unemployment rate in both economies remains well above its level of a year ago.

The **prices of industrial raw materials** *strengthened, while* **oil prices** *fluctuated . . .*

Most spot non-oil commodity prices strengthened further in the third quarter—in SDR terms by almost 5½%—reflecting higher prices of industrial raw materials (metals and agricultural non-food products), which rose by 13¾% to regain their mid-1985 level in SDR terms, according to the Economist index. By contrast, prices of food products did not share in the general recovery earlier this year, reflecting plentiful supplies for most products. Despite the steady recovery in prices of most non-food commodities since their trough in August 1986, it is thought unlikely that a strong upward trend in real commodity prices will be sustained unless world activity grows much faster than is generally expected. Prices of some commodities (mainly metals) did, however, weaken in the second half of October, partly reflecting fears that the fall in equity prices would lead to slower economic growth.

Tension in the Gulf and concern about the extent of OPEC overproduction have unsettled the oil market in recent months. The price of UK Brent fluctuated in the range $17½–$19½ per barrel during September and October. Prices have, however, been underpinned by higher-than-expected consumption and strong stockbuilding. As announced in September, a ministerial team from OPEC's quota compliance committee is visiting OPEC members to urge production restraint in line with agreed quotas. It is reported that an OPEC committee has the task of devising a new quota formula for the next ministerial conference in December.

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



(a) Canada, France, Germany, Italy, Japan and the United States.
(b) Consumers' expenditure deflator.
(c) Average of national figures, thus including imports from other major economies.
(d) Adjusted to allow for cyclical fluctuations in productivity.
(e) 1987 figures include estimates.

. . . and **inflation** *has risen, particularly in the United States*

The average rate of consumer price inflation in the six major overseas economies rose steadily from 1% at the end of last year to 3¼% in August (although the increase in the twelve-month rate of inflation also reflected the fact that the fall in oil prices last year has dropped out of the twelve-month comparison). The most rapid rise has been in the United States. Elsewhere it has been modest—rising from 1% in the twelve months to December to 2% in the year to August. Moreover, average wholesale prices fell further in the first half of the year in the major overseas countries in aggregate (excluding the United States). Import prices rose only slightly and the increase in manufacturing unit labour costs is estimated to have been close to zero in the first half. The stability of unit labour costs partly reflected the continued moderate increase in hourly earnings over the last year—less than 3½% in Germany, Japan, France and Canada. The increase in earnings thus remains well below that experienced in the United Kingdom.

In the United States, the twelve-month increase in consumer prices had risen from 1% at the end of 1986 to over 4% by August. Most of the upward pressure on inflation has come from import prices, which rose 8% at an annual rate in the first half, the result of the depreciation of the dollar and higher commodity prices. If oil and food prices are excluded, the increase in inflation has been less marked. Although unemployment has fallen steadily since the end of last year, this does not as yet appear to have been reflected in any strong upward pressures on

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

Monthly averages

	1985 Sept.	1986 Sept.	1987 Mar.	1987 Sept.
Canada				
ERI	85.8	77.2	79.0	78.5
Short-term interest rate	9.1	8.4	7.2	9.4
Long-term interest rate	11.0	9.4	9.0	11.0
France				
ERI	67.2	69.8	71.8	71.4
Short-term interest rate	9.6	7.1	8.0	8.0
Long-term interest rate	12.0	8.5	9.4	11.1
Germany				
ERI	125.6	140.3	147.1	146.7
Short-term interest rate	4.7	4.5	4.0	4.0
Long-term interest rate	6.5	6.1	6.0	6.7
Italy				
ERI	44.2	47.6	48.2	47.2
Short-term interest rate	14.5	11.7	11.7	12.2(c)
Long-term interest rate	13.8	10.4	10.0	11.3
Japan				
ERI	159.1	216.6	211.7	222.2
Short-term interest rate	6.3	4.7	4.0	3.8
Long-term interest rate	5.9	5.0	3.7	5.5
United Kingdom				
ERI	81.3	70.4	71.9	73.1
Short-term interest rate	11.5	10.1	10.0	10.2
Long-term interest rate	10.4	10.0	9.2	10.0
United States				
ERI	138.4	110.4	103.3	100.9
Short-term interest rate	7.8	5.7	6.2	7.4
Long-term interest rate	10.7	8.1	7.6	9.6

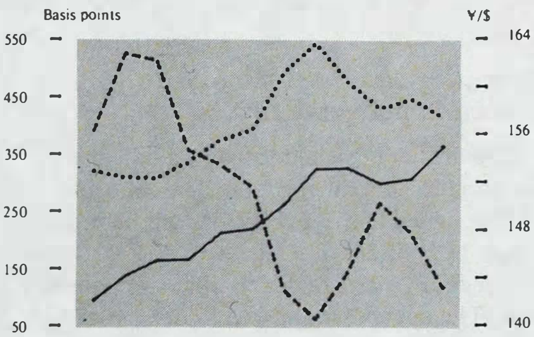
(a) Exchange rate index (ERI) 1975 = 100.
(b) Per cent per annum. Short-term rates are three-month market-determined rates. Long-term rates are government bond yields on the secondary market.
(c) Estimate.

Despite a widening of **short-term interest rate differentials** *recently, the dollar has weakened*

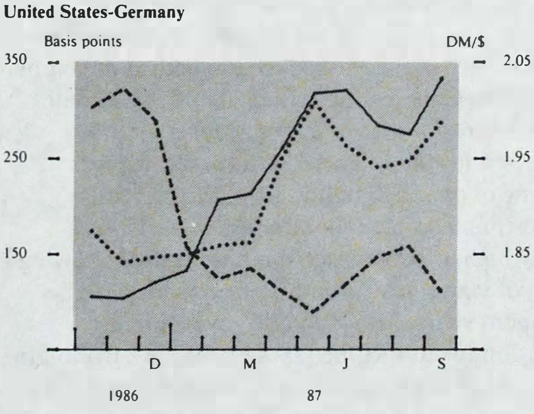
.... Long-term differentials(a)
——— Short-term differentials(b)
- - - - Exchange rate

Monthly averages

United States-Japan



United States-Germany



(a) Long rates are yields on composite bonds over 10 years for the United States; yields on 7-15 year public sector bonds for Germany; and yields on central government bonds for Japan.
(b) Short rates are three-month prime commercial paper rates for the United States; three-month FIBOR for Germany; and three-month Gensaki rates for Japan.

wages; earnings are estimated to have risen by some 3% in the year to September. The outcome of the recent pay negotiations in the US car industry suggests that job security may be as important a factor as the growth of real wages.

Interest rates *rose between June and mid-October*

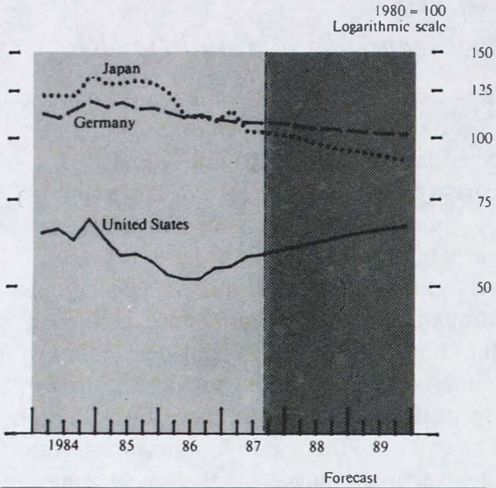
Long-term government bond yields rose in all the major overseas economies between the end of June and mid-October. Some of the rise may have reflected factors peculiar to individual countries, including bearish sentiment about the dollar, which affected US bond yields, concern over the higher-than-expected public borrowing forecasts in Germany and, more recently, adverse market reaction to the German government's decision to impose a 10% withholding tax on investment income, including income from government bonds, from 1989. Continued rapid rates of growth in monetary aggregates and in some asset prices were probably also factors affecting inflation expectations in both Japan and Germany. The extent of the rise in long-term interest rates during this period nevertheless suggested there was some increase in inflation expectations.

Short-term money-market rates also rose until mid-October, especially in the United States where the further rise contributed to a decision by the Federal Reserve Board to tighten monetary policy. The discount rate was raised from 5½% to 6% in early September. The accompanying statement said 'the decision reflects the intention of the Federal Reserve to deal effectively and in a timely way with potential inflationary pressures'. Money-market rates, however, moved up further, partly because of market concerns that monetary policy might be tightened again.

The increase in borrowing costs led major US banks to raise prime rates by half a percentage point to 9¼% in early October. There was a slight tightening of monetary conditions in Germany from the second half of September as the Bundesbank raised its minimum tender rate on securities repurchase agreements on three occasions in response to the growth of the monetary aggregates. Three-month money-market rates rose sharply (from 4% at the end of September to 5% by mid-October), although part of the increase is thought to have reflected seasonal factors such as end-year tax payments. In Japan, towards the end of September the commercial banks agreed with the Bank of Japan to limit their lending in the fourth quarter, following a surge in lending in the third. This contributed to some upward pressure on Japanese interest rates.

One effect of these increases in market interest rates was that short-term interest rate differentials between the United States and Japan and Germany, which had fallen from their peaks earlier in the year, widened. Longer-term interest rate differentials remained below the peaks recorded in May. The dollar, which had firmed during the summer, nevertheless fell during August and September, partly because of the continuing high level of the monthly trade deficits. By mid-October the dollar had fallen to DM 1.8 from an average of about DM 1.85 in July: against the yen the dollar fell to around ¥143 from ¥150 over the same period.

US trade volumes *are adjusting to the dollar's fall*



Trade adjustment *in nominal dollar terms has been modest*

In recent months, the Japanese and German trade and current account surpluses have broadly stabilised, but the US trade and current account deficits have widened further. Although US export volumes rose by over 8% at a seasonally adjusted annual rate in the first half of the year and import volumes fell by 3%, further terms of trade losses helped widen the nominal trade deficit. The trade deficit for August of $15¾ billion, although lower than that for July, exceeded the market's expectations. In the first eight months of the year, the US trade deficit amounted to $114 billion, compared with $109 billion in the corresponding period last year. In Japan, export volumes fell further than import volumes in the first half, and there was a deterioration in the terms of trade. In recent months, Japan's trade surplus has been running at an annual rate of around $90 billion, compared with an outturn of $93 billion last year, and the trade surplus with the United States has narrowed slightly. In Germany, export volumes were stable and import volumes rose by over 5% at a seasonally adjusted annual rate in the first half. The terms of trade have improved, however, and these trends contributed to a trade surplus of some $42 billion in the first eight months of the year, compared with $34 billion over the corresponding period last year.

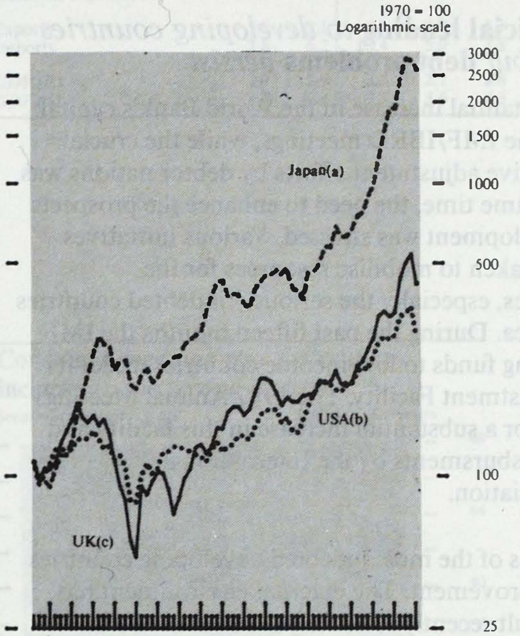
At the IMF/IBRD Annual Meetings in Washington in late September, the Finance Ministers and central bank Governors of the seven major industrialised countries reviewed events since the Louvre agreement in February on exchange rate stability. They reaffirmed their belief that 'currencies are within ranges broadly consistent with underlying economic fundamentals', and noted that in general the evolution of policies since the Louvre accord had been along the lines intended.

In the United States, legislation was passed in September to reduce the **budget deficit**

In the United States, the President signed into law a bill intended to reinforce progress in reducing the federal budget deficit. The new law is designed to achieve a balanced budget by 1993, compared with 1991 under the original Gramm-Rudman-Hollings law, parts of which were subsequently ruled unconstitutional. The new bill mandated a package of expenditure cuts for the 1988 financial year (commencing 1 October 1987) worth $23 billion in the absence of an agreement on a package of measures designed to reduce the budget deficit by at least this amount. The Congressional Budget Office estimates that these measures will result in a deficit of around $156 billion. The deficit for the financial year just ended was $148 billion, a decline of over $70 billion from the previous financial year. It is estimated that about a third of the fall is a result of temporarily higher than expected tax revenues following the implementation of tax reform, and this effect is likely to be unwound in subsequent years. The Japanese government announced its intention to cut income taxes by over ¥2 trillion in both fiscal 1988 and fiscal 1989, following scheduled cuts of ¥1.5 trillion in the present financial year. These tax cuts, combined with the announcement in May of a large rise in public spending, are expected to result in a more expansionary fiscal policy, by an estimated 0.3% of GNP both this year and next. In

Germany, the authorities have again raised their projection for the 1987 federal borrowing requirement, from DM 26 billion to DM 29 billion, thought to reflect the sluggishness of tax revenues owing to weak economic growth. The IMF expects the thrust of German fiscal policy, assuming it is as announced, to be unchanged this year and provide only a mild expansionary impulse to the economy in 1988, despite the DM 14 billion of direct tax cuts.

Share prices *fell sharply in October*



(a) Tokyo Stock Exchange in dollar terms.
(b) NYSE composite index.
(c) FT all-share index in dollar terms.
* Indices for 1987 fourth quarter are as at 30 October.

A comparison of three upswings in the major seven economies

	Present upswing	Preceding upswings	
Trough quarter	1982 Q4	1975 Q1	1971 Q4
Peak or latest quarter	1987 Q2	1980 Q1	1973 Q1
Numbers of quarters	*18*	*20*	*5*
Average real GNP growth(a)	3.5	4.0	7.4
Average nominal GNP growth(a)	7.4	12.2	14.1
Average inflation rate(a)(b)	3.5	8.7	5.1
Average employment growth(a)	1.6	1.8	2.0

(a) Per cent, at annual rates.
(b) As measured by consumer price indices.

Share prices *fell sharply on world stock markets in the second half of October*

Until their sharp fall in mid-October, equity prices had risen strongly in most major stock markets for several years, reflecting the markets' optimism as economic growth was sustained over this period, inflation remained low and interest rates gradually declined. The sharp fall in prices appeared to reflect the markets' uncertainty over the dollar, including the possibility that US interest rates would need to rise further to defend it, and the larger-than-expected US trade deficit in August. To some extent the fall may also have reflected an adjustment from the very high levels of prices attained in some markets this year while the size and speed of the fall may also have been strengthened by the strong linkages which now exist between the major markets. In the two weeks from 16 October—the day of the large fall in share prices on the New York stock exchange—prices fell by 24% in the United Kingdom according to the Financial Times 100 index, by 15% in the United States on the Dow Jones index, and by 13% in Japan on the Nikkei Dow index. In association with the decline in share values, interest rates fell across the maturity spectrum in many countries as investors sought to move out of equities and into other financial instruments, especially government securities.

Monetary authorities responded swiftly to the fall in share prices. Federal Reserve Chairman Greenspan indicated the Federal Reserve was 'ready to serve as a source of liquidity to support the economic and financial system'; major US banks subsequently cut prime rates to 9%. The Bundesbank changed its policy on securities repurchase agreements by announcing a fixed-rate tender and a slight easing of the rate. In the United Kingdom base rates were lowered in two steps from 10% to 9%. By the end of October US short rates had fallen about one and a half percentage points from their level two weeks earlier. After remaining stable during the first week of the fall in share prices, the dollar eased and by the end of the month was 5% lower in effective terms than at the time of the Louvre accord in February.

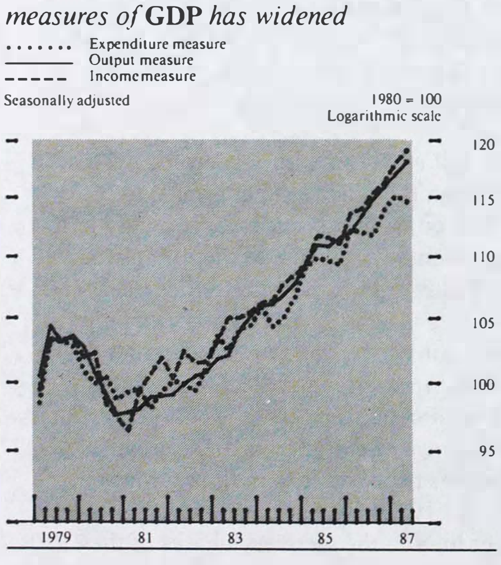
The fall in share prices will have some impact on the level of economic activity, although the precise effect is hard to determine. The growth of consumer spending, especially in the United States, could weaken owing to the reduction in wealth, and investment might be lower than expected, since the cost of equity capital to companies is likely to have risen and there is likely to be greater uncertainty over the growth of demand. But such effects would also dampen any inflationary pressures. During the present economic recovery, which is now entering its twentieth quarter, the average rate of growth among the industrialised countries has been lower than in previous upswings of the 1960s and 1970s. The average rate of inflation has not only been lower than in the recovery phases of the 1970s, reversing the tendency for average inflation rates to rise in successive upswings, but is now also lower than at the start of the present recovery. Two factors have been the severity of the recession in the early 1980s and the abundance of supply of many commodities, which have resulted in weak primary product prices for much of the period. Cautious macroeconomic policies have also been influential: both fiscal and monetary policies have, on balance, been much less expansionary than in earlier upswings. However, the large current account imbalances between the three major industrial nations persist.The Bank's latest forecast of the world economy (pages 496–7) is for some weakening of growth over the next two years.

Prospects for **official lending** *to developing countries have improved, but* **debt problems** *persist*

Proposals for a substantial increase in the World Bank's capital were supported at the IMF/IBRD meetings, while the crucial importance of effective adjustment efforts by debtor nations was reaffirmed. At the same time, the need to enhance the prospects for growth and development was stressed. Various initiatives have recently been taken to mobilise resources for the low-income countries, especially the seriously indebted countries of sub-Saharan Africa. During the past fifteen months the IMF has started disbursing funds to low-income countries under its new Structural Adjustment Facility. The 1987 Annual Meetings endorsed the need for a substantial increase in this facility and also for increased disbursments by the International Development Association.

The creditworthiness of the most indebted developing countries has shown little improvement. The external environment has become more difficult recently following the overall rise in interest rates and weaker growth of export markets this year. Furthermore, while some countries have benefited from the increases in the prices of oil and raw materials, the terms of trade of food exporters may have deteriorated further. Policy in debtor countries has been varied, with Brazil continuing its moratorium on servicing medium and long-term debt to commercial banks. However, several other major debtor countries, notably Mexico, have benefited from earlier policy adjustments, especially to their exchange rates. The performance of Mexico's non-oil exports and the evidence of continued success in limiting capital flight have been particularly striking, although, as elsewhere, domestic inflationary pressures remain a cause for concern.

The discrepancy between the alternative measures of **GDP** *has widened*



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

In the United Kingdom the strong growth of activity was maintained during the second quarter. The output measure of GDP, GDP(O), rose by almost 1% following a similar increase in the first quarter. On this measure GDP remained over 4% above its level a year earlier. The rise in GDP(O) in the second quarter mainly reflected higher output from the manufacturing and service sectors which in both cases rose by some 1½% to a level 5% higher than a year earlier. This more than offset a decline in output from the energy sector, which partly reflected maintenance work on North Sea oil installations, and a fall in activity of the construction sector from the high level attained in the first quarter. This rate of growth was probably maintained in the third quarter; output from both the manufacturing and energy sectors rose in July and August, and recent CBI surveys suggest that manufacturers remain optimistic about orders and the prospects for the further growth of output.

These indicators suggest that the growth of output has continued to respond well to the increase in demand. It is still difficult, however, to reconcile the movements of the output and expenditure estimates of GDP in recent quarters. Despite some recent upward revisions to consumer spending and investment in 1986, the fact that the gap between the alternative measures of GDP widened in the second quarter suggests that some of the estimated expenditure components may eventually be revised upwards again. In the second quarter, domestic demand strengthened, led by a recovery in consumer and capital spending. As recorded in GDP (E), domestic demand rose so little as to be almost completely offset by the negative contribution from net trade, mainly reflecting a sharp increase in the volume of imports. The composition of recorded expenditure was, therefore, markedly different from that in the first quarter, when, although domestic demand weakened, the contribution from net trade was positive as import volumes fell.

Growth in components of GDP

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

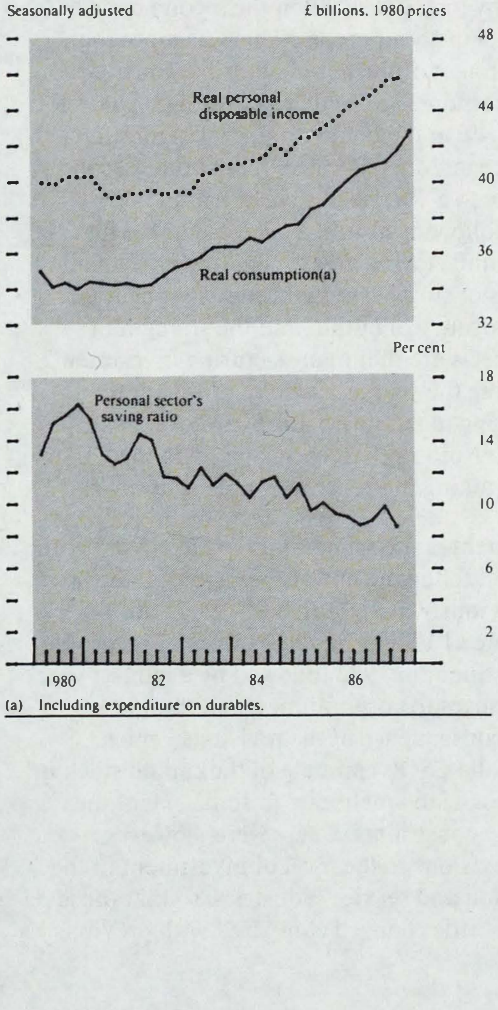
	1985	1986		1987	
	Year	Year	H2	Q1	Q2
Consumer spending	3.7	5.8	5.7	4.1	4.2
Government consumption	—	0.9	1.2	−0.5	0.1
Gross fixed investment	3.1	0.3	0.3	2.9	6.2
Stockbuilding	0.1	—	0.1	−1.1	—
Domestic expenditure	**2.9**	**3.8**	**2.1**	**1.9**	**3.8**
Exports	5.6	3.1	6.2	9.0	4.3
Imports	2.8	6.2	10.4	5.9	7.8
GDP(E)	**3.7**	**2.9**	**3.3**	**2.7**	**2.8**
GDP (A)	*3.7*	*3.1*	*3.7*	*3.6*	*3.8*

Consumer spending *strengthened in the second and third quarters . . .*

The increase in domestic demand in the second quarter mainly reflected a recovery in consumer spending. Real consumer spending rose further in the third quarter, by 2½% to a level 5¼% above that of a year earlier, according to provisional estimates from the CSO. The growth in spending in both the second and third quarters is in marked contrast to the slowdown around the turn of the year. The variations in the quarterly growth of consumer spending are not easy to explain, and may reflect measurement problems. These variations included an unexpectedly sharp rise in food expenditure last year, after several years of very low growth, and a fall in expenditure on durables around the turn of the year, despite continued growth in personal disposable income and consumer credit.

Consumer spending *rose faster than* **incomes** *in the second quarter*

Seasonally adjusted £ billions, 1980 prices



(a) Including expenditure on durables.

The current strength of consumer spending is borne out by increases in the volume of retail sales—up by 6½% in the year to the third quarter, a slightly faster rate than recorded in the year to the second quarter. In recent years (with the exception of 1986) the growth of retail sales volume has exceeded that of consumer spending, partly on account of differences in coverage of the two series (retail sales cover about 45% of consumers' expenditure).

Although strong, the growth of real consumer spending is nevertheless below the increase recorded in 1986, now estimated at 5¾%, following upward revisions. This was appreciably faster than the increase in real personal disposal income (the growth of which has been revised down by a small amount), resulting in a fall in the saving ratio from just under 10½% in 1985 to a little over 9% last year. Growth of real personal disposable income in the first and second quarters was affected by the large changes in 'other income', reflecting unusually large dividend payments by companies in the first quarter and the effect of interest rate reductions in the second. These movements in 'other income', much of which is probably saved in the first instance, affected the

Personal sector's income, expenditure and financial transactions

£ billions

	1985	1986 Year	1986 Q4(a)	1987 Q1(a)	1987 Q2(a)
Personal disposable income	238.4	257.5	264.0	269.8	270.8
Less consumers' expenditure	213.7	234.2	240.2	243.0	247.5
Saving	24.7	23.3	23.8	26.8	23.3
Less capital expenditure	15.7	18.6	24.0	16.0	17.8
Financial surplus	**9.0**	**4.7**	**–0.2**	**10.8**	**5.5**
Acquisition of financial assets					
Building society shares and deposits	13.3	11.2	16.3	13.2	11.8
Bank deposits	5.1	8.4	1.3	9.0	10.4
National savings	2.5	2.5	2.9	3.8	2.6
Life assurance and pension funds	19.3	20.1	21.3	19.7	..
Other	3.3	5.8	16.5	0.1	..
Total	**43.5**	**48.0**	**58.3**	**45.8**	..
Borrowing					
For house purchase	19.0	25.5	28.0	25.3	..
of which:					
from banks	*4.2*	*4.7*	*4.3*	*6.3*	*9.8*
from building societies	*14.6*	*18.7*	*18.4*	*17.6*	*14.1*
Bank borrowing for consumption	2.9	3.5	2.8	3.3	6.2
Other bank borrowing	3.0	2.0	1.8	5.1	1.4
Other borrowing	2.6	1.1	0.2	4.6	..
Total	**27.5**	**32.1**	**32.8**	**38.3**	..
Net acquisition of financial assets	**16.0**	**15.9**	**25.5**	**7.5**	..
Accruals adjustment	1.0	1.0	0.8	0.2	2.9
Balancing item	8.0	12.2	26.5	–3.1	..

.. not available.

(a) Seasonally adjusted at an annual rate.

saving ratio, which rose sharply in the first quarter, but then fell to almost 8½% in the second. The growth of real personal disposable income in the year to the first half was a little over 4%, similar to the recorded increase in consumer spending over the period. The strength of consumer spending in the third quarter suggests the saving ratio may have fallen further.

The decline in saving in the second quarter, combined with a further increase in capital investment (mainly in housing), resulted in a fall in the personal sector's financial surplus from £11 billion in the first quarter to an estimated £6 billion in the second. Although data are not yet available for all the personal sector's financial transactions in the second quarter, provisional estimates suggest that the sector's holdings of deposits in banks and building societies, taken together, rose at a similar rate to that recorded in the first quarter. There was a further increase in mortgage borrowing, especially from banks, although borrowing from building societies was below first quarter levels. An accurate assessment of the personal sector, especially for last year, is complicated by the large discrepancy between savings and total financial transactions, reflected in the sharp increase in the balancing item for the year as a whole.

. . . *and* **capital spending** *rose, especially in manufacturing*

Total investment rose by just under 1¼% in the second quarter to a level over 6% higher than a year earlier. This was more than accounted for by investment of the manufacturing, construction, distribution and service industries, which (following the latest revisions) rose by over 4% in the quarter and now stands over 12% higher than a year ago. Most of the increase in the second quarter was attributable to a 7% rise in investment in the manufacturing sector, following a similar increase in the first quarter. The rise in manufacturing investment in the first half follows several quarters of sluggish growth, and is thought to be a response to the buoyancy of output and the strength of profitability. The prospects are that manufacturing investment will remain strong during the year as a whole. Although the balance of firms expecting to authorise more capital expenditure over the following twelve months fell back slightly in the CBI's latest survey, the trend taking the year as a whole is upwards.

Manufacturing investment is shown not only to have risen in the first half of the year, but, following upward revisions, to have been stronger than previously thought in both 1985 and 1986—by a total of some £1 billion (in 1980 prices). The profile of a strong rise in investment in 1985 followed by a fall last year, partly reflecting the changes to corporation tax in the 1984 Budget, remains. One consequence of the revisions, which amount to about ½% of the CSO's estimate of the capital stock in the manufacturing sector, is to ameliorate to some extent the concerns about capacity constraints. There were, however, offsetting downward revisions to the level of investment in the construction, distribution and service industries, so that the level of total investment was little changed compared with previous estimates.

The latest estimates of stockbuilding in the second quarter indicate that stocks rose by a little more than £100 million (in 1980 prices) in the second quarter, following a revised fall of

£275 million in the first. There was a rise in manufacturers' stocks of almost £50 million, following three successive quarterly falls. The increase is consistent with the results of recent CBI industrial trends surveys suggesting that the number of firms regarding their stocks as more than adequate is similar to the number with inadequate stocks. There was, however, a further fall in the stock/output ratio as the growth of output exceeded the rise in stocks. There was also a sharp rise in retailers stocks, more than sufficient to offset a further fall in stocks held by the energy industry.

The strength of domestic demand contributed to an increase in the **visible trade deficit**

The visible trade deficit deteriorated in the second and third quarters following a relatively small deficit in the first. During the first nine months of the year the trade deficit amounted to £6½ billion—over £¾ billion more than in the same period last year. The latest projections suggest the surplus on invisibles was maintained at last year's levels—some £5¾ billion in the first three quarters, implying a current account deficit of £¾ billion. For the year as a whole the current account deficit is estimated to be £2½ billion, according to the latest official forecast in the Chancellor's *Autumn Statement*, in line with the previous forecast made at the time of the Budget.

The deterioration in the visible trade balance has reflected developments in trade volumes rather than prices. Non-oil import volumes have risen strongly and by the third quarter were 11% higher than a year earlier. Most of the increase reflected a strong rise in the volume of imports of manufactured goods after the sharp fall in the first quarter. Over the year as a whole the increase has been broadly based and would appear to be related to the strength of consumer spending, the need to import capital goods to maintain the growth of output, and possibly, too, restocking. The rise during the third quarter was concentrated in finished rather than semi-manufactured goods, particularly cars, which rose by over 20%. But compared with a year earlier, imports of cars were only 3½% higher. Within finished manufactures (other than cars) imports of capital and intermediate goods rose by 16% and imports of consumer goods by 12% in the year to the third quarter. Despite the strength of domestic demand, it remains difficult to explain fully the extent of the rise in imports over the last two quarters. Manufacturing output has been particularly strong over this period, and in some sectors, (cars for example), domestic output has taken an increased share of the domestic market. It is possible that there may have been a further rise in manufacturers' stocks in the third quarter, following the small increase in the second, and that this has contributed to the rapid growth in imports.

The volume of non-oil exports rose by 5% in the third quarter, following little growth in the early months of the year. Non-oil export volumes are now nearly 10% higher than a year earlier. Although the trend remains upward, it is not as strong as that of non-oil imports, which may reflect the faster growth of demand in the United Kingdom compared with that abroad. The faster growth of non-oil import volumes was partly offset by a strengthening in the non-oil terms of trade in the second quarter, mainly the result of lower import prices following sterling's

The UK current account

£ billions

	1986	1987		
	Year	Q1	Q2	Q3
Visible trade	**– 8.5**	**–1.1**	**–2.4**	**–3.1**
of which:				
Oil	+ 4.1	+1.2	+1.0	+0.9
Non-oil	–12.5	–2.3	–3.4	–4.0
of which:				
Manufactures (ex erratics)	– 7.2	–1.3	–2.3	–2.7
Erratics(a)	+ 1.8	+0.6	+0.4	+0.5
Other(b)	– 7.1	–1.6	–1.5	–1.8
Invisible trade	**+ 7.5**	**+1.8**	**+2.2**	**+1.8**(c)
of which:				
Services	+ 5.0	+1.2	+1.6	..
IPD (net)	+ 4.7	+1.3	+1.3	..
Transfers (net)	– 2.2	–0.8	–0.6	..
of which, EC institutions	*– 0.7*	*–0.4*	*–0.3*	..
Current balance	**– 1.0**	**+0.7**	**–0.2**	**–1.3**

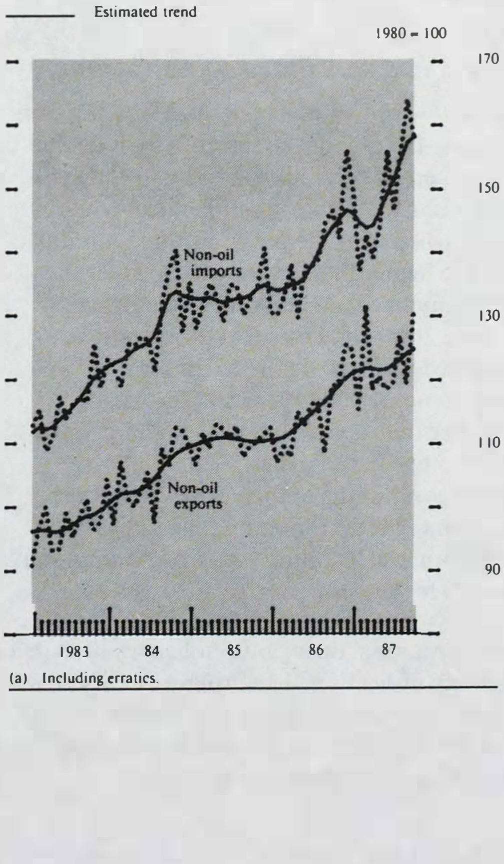
.. not available.

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

(b) Food, drink and tobacco, non-oil fuels, basic materials and miscellaneous.

(c) CSO projection.

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

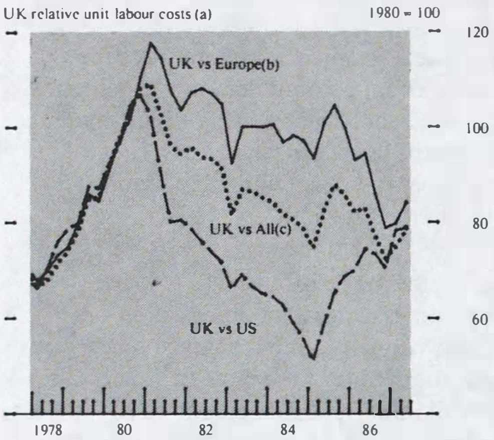


(a) Including erratics.

Analysis of recent changes in non-oil trade balance
£ billions, changes on preceding year or quarter

	1986	1987 Q1	Q2	Q3
Change in non-oil balance	-2.2	+1.2	-1.1	-0.6
of which:				
Export volume	+2.6	-0.2	-0.3	+0.9
Import volume	-4.1	+1.4	-1.3	-1.4
Terms of trade	-0.8	—	+0.5	-0.1

Some of last year's gains in **competitiveness** *have been reversed*



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

appreciation. Although there was a modest fall in the non-oil terms of trade in the third quarter, they remained 3% higher than in the first. Nevertheless, the volume developments were the dominant factor and contributed to a sharp deterioration in the deficit on trade in manufactures; the deficit amounted to some £4¾ billion in the first three quarters of the year, compared with £5½ billion for 1986 as a whole.

The competitive position of UK manufacturing industry (as measured by relative unit labour costs in common currency terms) improved in the second half of last year—as a result of the strength of manufacturing productivity and the fall in sterling. Some of this gain was reversed in the first half of this year as the annual increase in underlying earnings in manufacturing remained at some 8%, slightly faster than the growth of productivity, and sterling appreciated. Cost competitiveness is estimated to have deteriorated by around 7% in the first half, although it remains 6% better than a year earlier. There appears to have been little change in competitiveness in the third quarter, as domestic cost increases are estimated to have been offset by productivity growth and the exchange rate remained stable. Thus UK manufacturing industry remains considerably more competitive now than the average experience of the last few years.

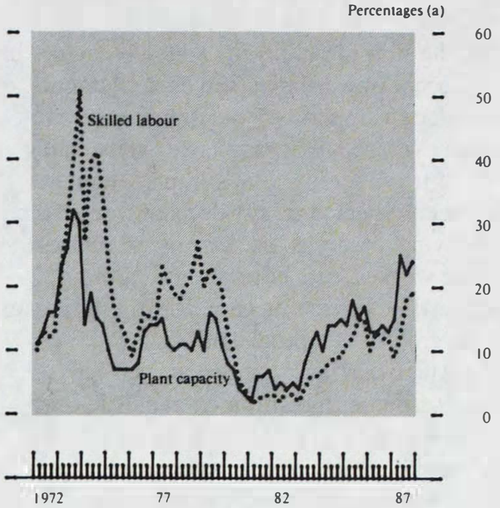
The improvement in competitiveness compared with a year earlier conceals important variations between markets. Much of the improvement has been against countries of the European Community, reflecting sterling's sharp fall against EMS currencies last year which has been only partially offset by the modest appreciation this year against these currencies. By contrast, the appreciation of sterling against the dollar in the first half has been greater. By mid-year the gain in competitiveness against the European Community was estimated at some 10%, compared with a year earlier, whereas competitiveness against the United States had deteriorated by 5%.

Manufacturing output *has continued to rise strongly*

Manufacturing output is now shown to have grown steadily from the first quarter of last year, in response to the growth in demand, although there was a weather-related fall in activity in January of this year. In the three months to August, manufacturing output is estimated to have risen by 1¾% over the previous three months, reaching a level almost 6% higher than a year earlier. Over the past year, motor vehicles, metals and 'other manufacturing', which accounted for some 26% of the manufacturing base in 1980, have recorded the fastest rates of growth. In the strongest-growing sector—motor vehicles and parts, where output is nearly 14% higher than a year earlier—its share of the domestic market has steadily risen to over 48% of total car registrations in the first eight months of the year, despite the sharp rise in imports of cars in recent months. The indications are that manufacturing output will continue to grow; output may need to increase simply to replenish stocks.

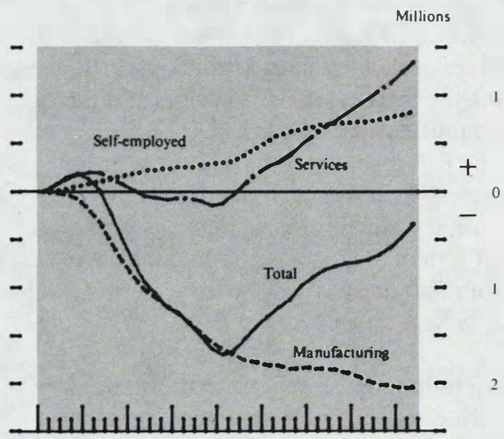
The strength of growth of manufacturing output has resulted in a further increase in capacity utilisation. The proportion of firms working at or above a normal rate of capacity utilisation rose to 59% in October, compared with 55% in July and 51% in April, according to the latest CBI quarterly survey. The level of

Capacity and skilled labour constraints *in manufacturing have increased*



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

The growth of **employment** *has strengthened*



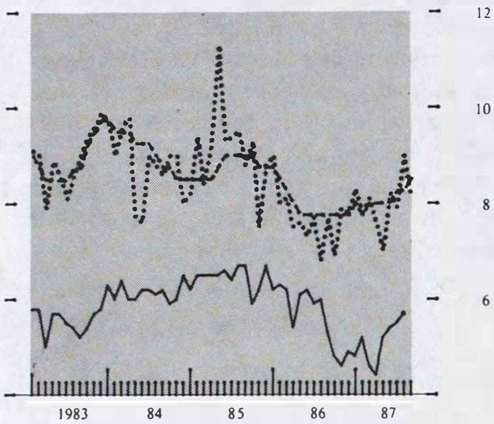
utilisation exceeds the previous cyclical peak of 1979, although it remains below that of 1973. There was a rise in the proportion of firms citing plant capacity and skilled labour shortages as potential constraints on output, according to the latest CBI industrial trends survey, although for all firms the main factor remains a shortage of orders or sales. The proportion of firms citing plant capacity as a constraint is above the previous cyclical peak of 1979; in the case of skilled labour shortages the proportion remains below it. In both cases, however, these factors, especially skilled labour shortages, are less important than in 1973. The latest survey results indicate that the chemical industry is significantly more capacity-constrained than it was during the previous cyclical peak in 1979. Industries in the food, drink and tobacco, and engineering and allied sectors also report plant capacity as a more serious constraint on output now than it was eight years ago. In contrast, the metals sector is reported to be less capacity-constrained than in 1979, despite its strong increase in output.

. . . *and* **employment** *has risen further*

The strength of output growth contributed to a further rise in employment in Great Britain in the second quarter. Indeed, the growth of the employed labour force has strengthened steadily from 13,000 in the first quarter of 1986 to 134,000 in the second quarter this year. The service sector continues to provide the bulk of the increase in employment, reflecting its large weight in the economy (some 55% of total output) and the strong increase in the volume of its output (up 5% in the year to the second quarter). There was a further rise in employment in construction and the first increase in manufacturing employment since the fourth quarter of 1984. Although manufacturing employment fell in both July and August, there seems little doubt that the decline in employment in this sector has slowed since the end of last year. The overall increase in employment in the employed labour force since March 1983 now amounts to over 1.3 million. This comprises an increase of almost 850,000 among employees, which in turn consists of an increase of some 1.46 million in the service sector (some of whom are part time), partly offset by a fall of 400,000 in manufacturing and a smaller decline in other industries. The numbers of self-employed are estimated to have risen by over half a million over this period.

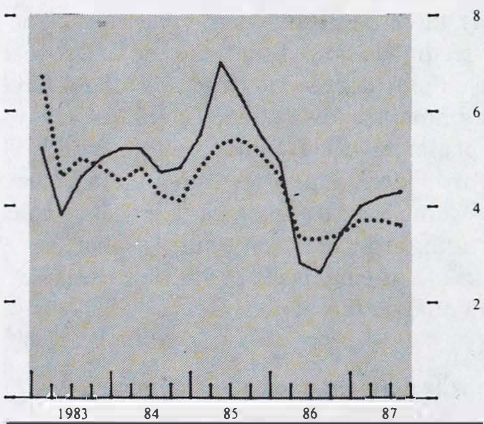
Unemployment (seasonally adjusted and excluding school leavers) fell by a further 54,000 in September and the unemployment rate declined to 10.0%. Unemployment has fallen each month since July of last year, with the average monthly decline over the last six months now estimated at some 40,000. The decline in recent months partly reflects the growth of output. Other factors, including the Department of Employment Restart programme and stricter tests of claimants' availability for work, have also had an impact, although their contribution to the continuing fall in unemployment remains hard to determine. Although unemployment rose in September on the unadjusted measure, the fall in the number unemployed over the last year (463,000) is greater than on the seasonally adjusted measure. This is partly explained by the fall in unemployment of school leavers over the last year, reflecting the increasing numbers starting the second year of the new Youth Training Scheme.

Manufacturing **settlements and earnings** *have edged up*



(a) Percentage increase on a year earlier.

Retail price inflation *remains around 4%*



. . . *while* **wage settlements** *have risen*

Wage settlements have tended to edge up in the manufacturing sector and averaged 5¾% in the third quarter compared with 5% and 5¼% in the first and second quarters respectively, according to the latest estimates from the CBI. The strength of activity, reflected in skilled labour shortages in some areas, rapid productivity growth and the strength of profits could be factors in accounting for the more recent upward pressure on settlements. The overall level of manufacturing settlements in the twelve months ended July, which averaged 5%, was nevertheless below the previous year's level of just over 6%. The fall in settlements over this period has not been reflected in any deceleration in the annual increase in 'underlying' earnings, because of the increase in the amount of overtime worked, reflecting the strength of output growth. Higher overtime payments have contributed to an increase in the underlying growth of annual earnings in manufacturing to 8½% in August. Within the private service sector the average level of settlements, estimated at a little over 6½% in the second quarter, is generally higher than that in manufacturing, but the growth in underlying earnings is lower—7¼% in the year to August—reflecting the more limited overtime opportunities. The underlying increase in whole economy earnings is 7¾%.

. . . *but* **inflation** *remains moderate* . . .

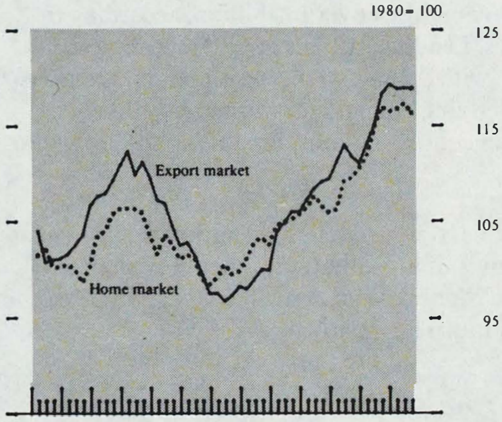
The twelve-month increase in the retail price index (RPI) fell to 4¼% in September, despite an increase in the prices of food and household goods, and is expected to fall to 4% in the fourth quarter, partly reflecting the increase in petrol prices and the rise in mortgage rates in the fourth quarter of last year. Indeed much of the acceleration in the RPI from below 2½% in the year to August 1986 to just below 4½% in August of this year reflects movements in interest rates. If the mortgage interest component is excluded from the RPI, then the increase in the index was much less marked—from 3¼% to 3¾% over the same period (and to only 3½% in the year to September).

Some other measures of inflation also suggest that inflationary pressures remain moderate. For example the consumers' expenditure deflator (CED), which excludes interest rate effects, rose by only 2½% in the year to the second quarter. The total final expenditure deflator (TFE), a measure of the price of total domestic expenditure and exports, rose by 3¾% over the same period. The rate of growth of the GDP deflator (which measures the cost of domestic value added) has, however, risen sharply from a low of around 1½% at the end of last year to a little above 4% in the year to the second quarter of 1987. The faster rate of increase in the GDP deflator compared with the TFE deflator is largely explained by the exclusion in the former of the import content of domestic expenditure, implying that the slower rise of import prices has contributed to the moderate rate of price inflation over this period. The difference between the movement in these deflators and the CED deflator reflects, among other factors, the recovery in oil prices.

In recent months, however, the cost of raw materials and fuel purchased by manufacturers has risen, reflecting firmer oil prices and the increase in commodity prices. The impact of higher input costs has been most marked in the manufacturing sector excluding food, drink and tobacco industries. The latter group tends to rely on agricultural commodities and, as world food prices have remained weak, input prices to this sector rose by just over 2% in the year to September. This, combined with the Chancellor's decision not to raise excise duties on drink and tobacco in the Budget, meant that output prices in these industries were only 1½% higher than a year earlier. By contrast, input prices to the remainder of the manufacturing sector rose by 11% over the same period, reflecting their greater dependence on industrial raw materials and oil, the prices of which have risen more sharply on world markets in recent months. Although the strength of the year-on-year increase in these input prices partly reflects the falls in raw material prices that occurred last year, input prices have risen by nearly 10% at an annual rate in the six months to September. Outside the food, drink and tobacco sectors, manufacturers' output prices are now some 4¾% higher than a year earlier.

Some of the increase in input costs has been offset by the deceleration in unit wage costs. Manufacturing productivity (output per head) has risen rapidly this year and by August was 6¾% above its level a year earlier, the strong increase in manufacturing output being accompanied by further modest falls in employment. The increase in unit wage costs therefore slowed to some 1½% over this period (and the rise in unit labour costs has probably been even slower). The growth of productivity in the whole economy has been more modest—up 2¾% in the year to the second quarter, partly the result of the strong rise in employment in services. Unit wage costs rose by 4½% over this period.

Manufacturers' margins[(a)] *remain strong*



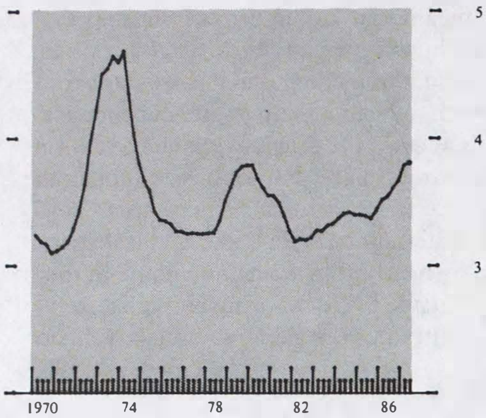
(a) Manufacturers' price/cost ratios, which indicate the direction, but not necessarily the scale, of changes in profit margins.

Price developments in coming months will depend heavily on movements in profit margins. Margins rose strongly during the first half of 1986 as the oil price fell, and in the second half of the year the depreciation of sterling enabled producers to increase margins further. In the first half of the year margins remained strong despite the increase in oil prices and the appreciation of sterling. Thus manufacturers appear to have scope to absorb some cost increases should raw material prices rise further or should there be some acceleration in the growth of unit wage costs (if, for example, the cyclical boost to the growth of productivity were to weaken). It is hard to assess how far manufacturers would absorb any subsequent cost increases to defend their market share, or alternatively would seek to maintain the current level of margins. Results from recent CBI surveys suggest that the proportion of manufacturers expecting to raise prices in coming months is less than in the first half of the year.

. . . despite a continuing high rate of increase of **house prices**

According to the Halifax Building Society the annual rate of increase of house prices rose from 14¼% to 14¾% between June and September. This may have been associated with the fall in mortgage rates in the spring and early summer. The current annual rate of increase, however, remains below the peak of over 15% recorded in March, while the rise in September was the lowest for five months, possibly reflecting the rise in mortgage rates for first-time buyers. The slight acceleration in prices in recent months has been in regions outside the South East, notably East Anglia, where prices rose nearly 27% in the year to

The **ratio of house prices to earnings** *has risen further*(a)



(a) The ratio is based on the Department of the Environment's mix-adjusted house price index and the Department of Employment's index of whole-economy average earnings.

September, and in the South West. There has also been a modest rise in the annual rate of increase of house prices in the Midlands—to some 14% in the year to September. In some other regions, including Scotland and Wales, the annual rise of house prices remains around 7%. In both London and the South East it appears to have eased somewhat from around 25% in March to 23% in September. The strong increase in house prices in these two regions was, however, mainly responsible for the rise in the national ratio of house prices to earnings to 3.8 by the second quarter, slightly above the previous peak attained in 1979, although still well below the levels reached in 1973.

Net mortgage lending rose by almost £6¾ billion in the second quarter, up from £6 billion in the first. This latest increase may be associated with the fall in mortgage interest rates between March and August, which appears to have offset the impact of the continued rise in the house prices to earnings ratio on first-time buyers' demand. The building societies' share of the mortgage market has continued to decline—from an average of 75% of net new loans in 1986 to just over 50% in the second quarter. This decline reflects the societies' difficulties in obtaining adequate funds to meet mortgage demand, together with vigorous competition from the banks offering fixed-rate schemes and a variety of other special inducements. The banks' market share in the second quarter was over 35%, the highest for more than five years. The newer lenders in the mortgage market, many of which offer relatively attractive mortgage rates, have sustained the gains they made last year.

These trends may have continued into the third quarter, with a rise in total mortgage lending of over £7½ billion, according to preliminary estimates. Lending by banks appears to have strengthened further, with societies' lending remaining broadly unchanged. The underlying demand for mortgages is likely to remain quite strong in coming months, because of the growth in real incomes.

In recent months there has been some moderation in the increase in housing starts. Provisional estimates for the third quarter suggest that starts are running at an annual rate of 217,000, some 5% higher than the outturn last year.

Industrial and commercial companies' income and capital accounts

£ billions, *seasonally adjusted*

	1986		1987	
	Year	H2	Q1	Q2
Total income(a)(b)	70.7	35.7	19.9	19.8
of which:				
Gross trading profits(b)	55.6	27.7	15.2	15.5
non North Sea	47.2	24.1	12.9	13.2
North Sea	8.4	3.6	2.4	2.3
Total allocations	38.4	18.9	10.7	10.1
of which:				
Dividend payments(c)	8.7	4.4	3.0	2.4
Other payments(d)	12.4	6.3	3.3	3.1
UK taxes	12.5	5.6	2.8	3.5
Undistributed income(b)	32.3	16.9	9.2	9.8
Less: expenditure on				
fixed capital	26.0	13.5	6.7	7.2
other	− 0.1	0.1	− 0.1	− 0.2
Identified financial surplus	**6.4**	**3.3**	**2.6**	**2.8**
Financial transactions				
(outflow/acquisition of assets −)				
Investment in UK company securities	− 1.2	− 0.6	− 0.3	− 0.9
Investment abroad	− 5.4	− 5.1	− 0.9	− 3.1
Liquid assets	−11.5	− 5.0	− 1.6	− 3.1
Borrowing from banks(e)	5.3	5.0	1.9	− 1.6
Other finance(f)	11.2	5.7	2.2	4.2
Other identified transactions	− 0.8	− 1.7	− 0.5	..
Balancing item	**4.0**	**1.6**	**3.4**	..

.. 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.

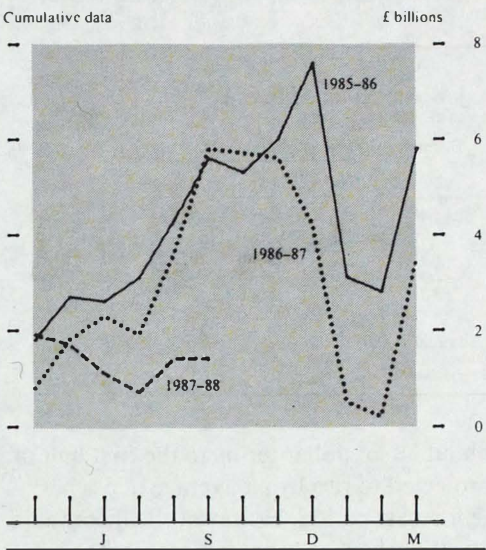
Company profits *rose again in the second quarter*

The strength of both output and margins resulted in a further rise in gross trading profits (net of stock appreciation) earned by industrial and commercial companies (ICCs) during the second quarter. Profits rose by 2% in the quarter to a level 16½% higher than a year earlier. The profits of non North Sea companies remain buoyant, although comparisons with the level of profits in the first quarter are distorted by the inclusion of British Airways following its privatisation in February. The increase was partly offset by a small decline in the profits of North Sea companies during the second quarter. Profits in this sector have, however, recovered since the middle of last year owing to the firmer sterling oil prices, and are now almost 40% higher than a year earlier.

The high level of ICCs' income from abroad, which amounted to some £2½ billion in the first quarter, was sustained in the second, in part a reflection of the growth in overseas investment by the company sector in 1985 and 1986. There was a further large rise in investment abroad in the second quarter, bringing the increase in the first half of the year to £4 billion. Capital expenditure rose in the second quarter and, although dividend payments fell back from the high first quarter levels, the amount paid in the first half of the year was well above that recorded in the second half of 1986. The increase in ICCs' income during the first half exceeded the rise in capital spending, dividends and other payments, resulting in an increased financial surplus of almost £5½ billion.

Companies' expenditure on UK company securities increased by almost £1 billion in the second quarter, and was more than accounted for by cash expenditure on acquiring subsidiaries. (The estimate of expenditure on securities last year reported in the August *Bulletin* has been revised downwards from £3¾ billion to only £1¼ billion.) There was a surge in capital issues in the second quarter. Borrowing other than from banks rose to a historically high £4.2 billion and was accompanied by repayment of bank borrowing and further investment in liquid assets. Companies have been building up liquid assets in most quarters for several years—these are now estimated to have risen by over £11 billion last year and by £4¾ billion in the first half of this.

The **PSBR** *remains at a low level*



Buoyant **tax receipts** *have contributed to a low* **PSBR**

The PSBR amounted to £1.4 billion in the first half of the financial year, compared with £5.8 billion over the corresponding period in 1986/87. Last year, however, lower oil prices resulted in a rebate on payments of petroleum revenue tax (PRT) in September, thus boosting the figure for the PSBR in the first half of 1986/87 (a further refund was also paid in February). This year, PRT payments were initially at a low level, but firmer oil prices led to an additional payment in September. The smallness of the PSBR to date also reflects, as last year, the buoyancy of non-oil tax receipts, especially from income tax, corporation tax and VAT, and privatisation proceeds. The latter amounted to £4.0 billion in the first half of the current financial year, compared with £1.1 billion in the first half of the previous financial year. Privatisation proceeds are expected to yield £5 billion in the financial year as a whole. In the *Autumn Statement*, the Chancellor lowered the forecast of the PSBR for the current financial year from £3.9 billion, made at the time of the Budget, to £1 billion, equivalent to ¼% of GDP.

World economic prospects—latest Bank forecasts

The Bank's latest forecast of world economic prospects, the results of which incorporate an initial assessment of the recent fall in prices on equity markets, is for a moderate rate of economic growth over the next two years, accompanied by only a small rise in inflation. The difficulties of gauging what the effects of the fall in equity prices will be suggest a greater than normal degree of caution should be attached to the results. The fall in share prices dampens the outlook for both world activity and inflation. However, supply-side conditions remain favourable so that, although growth is forecast to weaken in 1988 and 1989, it is maintained at a moderate rate. Real trade flows are projected to adjust further to the changes in competitiveness that have occurred in the past two years, contributing to a gradual correction of the large nominal current account imbalances. The recent higher levels in commodity prices may permit stronger rates of growth in developing countries, but the expected weakness in export markets and continued low net capital flows may offset some part of this gain.

Following a period of moderate growth in the first half of this year, it is likely that output in the major overseas industrial countries will grow in the range 2½%–2¾% for the year as a whole (see Table A), similar to the rate achieved in 1986. It seems likely, however, that the pattern of growth in demand will be significantly different. Domestic demand will slow considerably, mainly reflecting a fall in the growth of private consumption. The external sector should be less of a drag on growth, with the rate of growth in import volumes less than half that recorded in 1986. In 1988 and 1989, the growth of both GNP and domestic demand is forecast to slow further. The rate of growth of private fixed investment is projected to increase in response to recent improvements in profitability and favourable supply-side factors. The sluggish rate of growth of domestic demand throughout the forecast will, however, continue to limit the impetus given to world activity by the major industrial countries.

Table A
Demand and output in the major overseas economies(a)

Percentage changes

	Estimate	Forecast		
	1986	1987	1988	1989
Domestic demand	**3.8**	**2.9**	**2.4**	**2.3**
of which:				
Private consumption	3.8	2.7	2.4	2.1
Private fixed investment	3.4	3.4	3.9	3.7
Public expenditure	3.6	2.4	2.7	1.8
Stockbuilding(b)	0.2	0.2	−0.2	—
Net external demand(b)	−1.1	−0.3	−0.2	−0.2
GNP(c)	**2.7**	**2.6**	**2.3**	**2.2**

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

In recent months, there has been some concern about the possible resurgence in inflationary pressures. This concern seems exaggerated in the light of actual and forecast price developments. A modest rise in inflation is projected for the period 1987–89 (see Table B), although it is forecast to remain below the rate prevailing before the sharp declines in commodity prices in 1985–86. There has been some recovery in oil and non-oil primary commodity prices since the third quarter of 1986, but the increase is expected to moderate over the forecast. Oil prices firmed in 1987 and it is assumed OPEC increases its reference price to $20 per barrel from 1988. Non-oil commodity prices rose by about 8% in dollar terms in the first half of 1987, and are projected to rise by an average of 5% per annum over the forecast period. However, the increase in industrial countries' import prices is forecast to be considerably slower than during periods of rising commodity prices in the 1970s. Domestic cost pressures are forecast to increase moderately, as wage growth strengthens somewhat and productivity growth slows.

Table B
Prices in the major overseas economies

Percentage changes

	Estimate	Forecast		
	1986	1987	1988	1989
Import prices(a)	−11.5	0.3	2.9	2.9
Unit labour costs in manufacturing	1.3	0.5	1.8	2.2
Consumer prices(b)	2.4	3.0	3.4	3.7
GNP deflator	3.3	3.0	3.8	4.0

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

Developments in the United States will continue to be overshadowed by adjustment efforts to correct the large imbalances in the economy. Fiscal policy is assumed to be contractionary this year and in 1989, but neutral in 1988 when income tax rates are due to be reduced. Monetary policy is assumed to remain flexible, aimed at limiting the increase in inflation while ensuring there is sufficient liquidity in financial markets. Domestic demand is forecast to rise by about 2% in 1987, but less rapidly in 1988–89. The growth of real personal income is projected to moderate and the saving ratio may rise modestly as consumers attempt to rebuild wealth reduced by the recent decline in share prices. Consequently, the growth in private consumption is forecast to slow to about 1½% per annum over the period 1987–89, compared with 4% in 1986. Fixed investment may rise by about 2% per annum, spurred by a recovery in the manufacturing sector. Following strong growth in the first half of 1987, the increase in stocks is likely to slow in 1988–89. Net external demand is forecast to add about a quarter of a percentage point to growth in each year between 1987 and 1989. Exports are forecast to rise by about 9% each year, while imports may rise by only 1% per annum. Overall, GNP growth is projected to be about 2½% in 1987, slowing to 2% in 1988 and 1¾% in 1989.

Economic activity in Japan was more buoyant in the first half of this year than had been expected in the spring. In addition, the stance of fiscal policy has become more expansionary, following the announcement of a ¥6½ trillion package in May. Private consumption is projected to rise by 3½% in 1987 and 3¾% per annum in 1988–89. Fixed investment, particularly in construction, seems likely to rise rapidly. Despite the recent sharp loss in competitiveness in manufacturing, private business investment has remained buoyant and is forecast to rise by about 5% per annum in 1987–89. Overall, domestic demand is projected to rise by 4¼% per annum between 1987 and 1989 and much of the increase in demand is projected to spill over into higher import volumes. GNP growth seems likely to be 3¼% in 1987, and may remain at that level in 1988–89.

In continental Europe, there is the prospect of weak growth throughout the forecast period. In Germany, domestic demand slowed in the first quarter of the year and is expected to rise by only 3% in the year as a whole. On the assumption of a continuing cautious approach to monetary and fiscal policy, domestic demand is projected to rise at similar rates in 1988 and 1989, led by a recovery in business investment, which responds—albeit sluggishly—to improved profitability and a more stable pattern of exchange rates. As the process of external adjustment continues, the contribution from net trade is expected to be negative, and thus the growth of GNP is somewhat weaker than that of domestic demand—1¾% in 1987, and 2¼% per annum in 1988–89. Activity in France has slowed this year and output may rise by only 1½% in the year as a whole. Demand in Italy has accelerated as a result of higher real earnings and an expansionary fiscal position, and GNP may rise by 2½% in 1987. In both France and Italy, fiscal policy is projected to exert a contractionary influence on activity in 1988–89 and the growth in domestic demand is forecast to fall to an average of about 2¼% per annum in France and 2½% per annum in Italy over 1988–89. With export markets remaining weak, GNP is projected to rise by an annual average of 2% in France and of 2½% in Italy in 1988–89.

World trade (as measured by import volumes) is expected to rise by 3½% in 1987, less than that recorded last year, and may grow at about the same rate in 1988 and 1989 (see Table C). The growth of UK export markets may exceed slightly that of world trade, reflecting the relative strength of imports in Europe, which is the United Kingdom's major export market. For the OECD as a whole, merchandise import volumes are expected to increase by 4% this year, about half of last year's growth, reflecting some weakening of the growth of domestic demand and of imports of oil and oil products. After several years of adjustment in response to lower oil prices, OPEC's import volumes may increase during next year—the first such increase in seven years. The prospects for non-oil developing countries are difficult to assess given the heterogeneous nature of the group.[1] However, the growth of import volumes may rise this year, reflecting a moderation of the strenuous adjustment efforts of 1986. A higher average level of interest rates and the limited availability of net new credits seem likely to contain the growth of imports in 1988, but an expected fall in the rate of reserve accumulation may allow a recovery in import volumes in 1989.

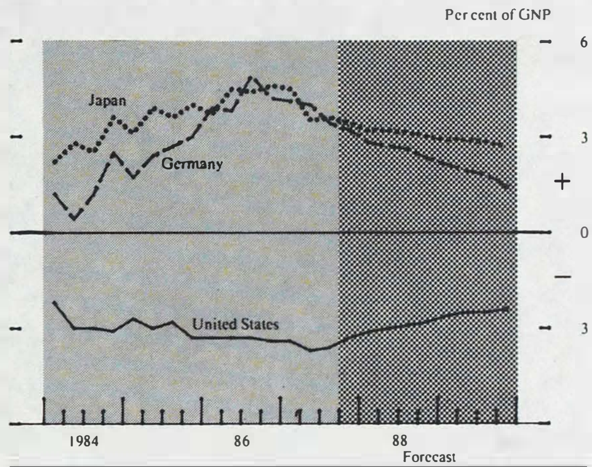
Table C
World trade and UK markets

Percentage changes

	Estimate	Forecast		
	1986	1987	1988	1989
World import volumes	**5.6**	**3.4**	**3.3**	**3.7**
of which:				
OECD	7.9	3.9	3.9	3.6
Non-OPEC developing countries	1.5	3.9	2.6	5.7
OPEC	−18.6	−5.7	−0.7	2.3
UK markets(a)	**4.0**	**3.2**	**3.6**	**4.0**

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

Current account balances



Despite continuing adjustments in trade volumes, large nominal current imbalances in the United States, Japan and Germany are corrected only gradually on these assumptions (see the chart). The magnitude of existing imbalances, terms of trade developments and changes in investment income flows all militate against a rapid return to balance. Nevertheless, the projected slowdown in the growth of domestic demand in the United States contributes to a significant reduction in the current account deficit to 2.4% of GNP at the end of 1989, down from 3.7% in the first half of 1987.

(1) See 'The economic outlook for a selection of developing countries', in the August 1987 *Bulletin*, pages 340–43.