Economic commentary

- *Growth in the major overseas economies was particularly strong in the third quarter of last year, before the stock market fall. World interest rates have been further reduced, and business confidence appears to be holding up.*
- *World trade growth recovered in the second half of last year, although little progress was made in reducing trade imbalances among the three largest economies.*
- *The dollar has come under further downward pressure, and the authorities of the seven major industrial countries have reaffirmed their commitment to policy co-ordination and stable exchange rates.*
- *In the United Kingdom, output and productivity growth have fallen a little from the exceptionally high rates seen in the third quarter of last year but remain buoyant.*
- *Unit labour cost increases were very low in the third quarter and profitability again improved.*
- *Consumption has grown strongly, with the personal saving ratio falling to a very low level. Despite improved supply performance, the strength of domestic demand has led to a deteriorating current account.*

Although the extreme conditions that typified the world's major stock exchanges in the second half of October have receded, financial markets remain hesitant about the prospects for the world economy. The early signs are that world economic activity has not been affected appreciably by the decline in equity prices. Indeed, the decline was preceded by a period of much greater than expected strength in activity, which may carry over for some time to come. While encouraging from the point of view of maintaining the level of activity, the pattern of strength in the world economy in the third quarter of last year highlighted the slow rate of progress in the adjustment of large external imbalances. In the United States, growth was sustained by strong domestic demand, while in both Germany and Japan net exports made a positive contribution. These developments hindered the reduction of nominal dollar trade and current account imbalances, leading to a further large depreciation of the dollar. In the face of considerable uncertainties, the major industrial countries demonstrated their resolve to maintain stable exchange rates by taking a series of steps culminating in a reaffirmation of key aspects of the Louvre accord in mid-December and substantial official intervention in the foreign exchange markets early in January.

Growth *was particularly strong in the third quarter . . .*

The growth in output in the six major overseas economies increased significantly to about 1¼% (not annualised) in the third quarter of 1987. This was the strongest growth performance since the first quarter of 1984. For the major economies as a whole, domestic demand rose sharply, with a revival in private

GNP/GDP growth in the major economies

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

	1986	1987		
	Q4	Q1	Q2	Q3
Canada	—	1.5	1.5	1.1
France	0.2	-0.1	0.9	1.0
Germany	-0.3	-0.8	1.0	1.4
Italy	0.2	-0.1	1.8	0.5
Japan	0.7	1.5	0.0	2.0
United States	0.4	1.1	0.6	1.1
Total	**0.3**	**0.8**	**0.7**	**1.3**

Components of GNP/GDP growth in the major economies

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

	1986	1987		
	Q4	Q1	Q2	Q3
Private consumption	0.2	0.4	0.8	1.2
Private fixed investment	1.2	-1.5	2.4	3.1
Public expenditure	2.1	-1.6	0.8	0.9
Stockbuilding(a)	-0.5	0.1	-0.2	-0.3
Domestic demand	0.3	0.7	0.9	1.2
Net trade(a)	0.1	0.1	-0.2	-0.1
GNP/GDP	**0.4**	**0.8**	**0.7**	**1.2**

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

consumption and a particularly strong contribution from fixed investment. The strength in final demand led to weaker stockbuilding, helping to reverse some of the stock accumulation which occurred in the first half of the year. There was a modest negative contribution from net trade.

Among individual countries, growth was most rapid in Japan, where output rose by about 2% in the third quarter alone. Domestic demand grew by about 1¾%, fuelled by a strong rise in business and residential investment. The resilience of the traded goods sector in the face of the appreciation of the yen was illustrated by the positive contribution made by net trade in goods and services, following a large negative contribution in the second quarter. While import volumes continued to rise, export volumes recovered sharply, rising by nearly 7% in the third quarter alone.

In North America, GNP grew by about 1% in the third quarter. In the United States, consumption resumed its upward trend, helped by a strong increase in spending on durable goods, particularly motor vehicles. More encouragingly, non-residential fixed investment rose by nearly 6% in the quarter. Although most of the third-quarter increase was in information processing and related equipment, the depreciation in the dollar will have set the conditions necessary for a sustained rise in investment—particularly in manufacturing—in the future. Export volumes continued to respond to improved competitiveness, but buoyant domestic demand stimulated import volumes, and net trade made a modest negative contribution to growth. This development underlines the need for moderation in the growth of domestic demand if adequate external adjustment is to be achieved. The picture was much the same in Canada, where final domestic demand rose by about 1¾%, spurred by a strong rise in business investment. Net external demand was a drag on growth, with import volumes rising by nearly 4%—far in excess of export volumes, which rose by less than 1%.

Following a period of particularly sluggish performance in the winter of 1986/87—partly related to bad weather—activity in continental Europe has picked up, although output levels remain only modestly above those achieved in the second half of 1986. In Germany, output rose by about 1½% in the third quarter, following a 1% rise in the second. Taken in isolation, this performance appears impressive. However, it reflects largely a bounce-back from a particularly weak period in the previous six months, and output in the third quarter was less than 1½% above its level a year earlier. Domestic demand rose a little less than output, with net external demand positive for the second consecutive quarter, thereby adding to the current account surplus. In France, output rose just over 1% in the third quarter, and was about 2% above its level a year earlier. In Italy, output growth was more sluggish, rising by only ½% in the third quarter.

. . . and some indicators point to **continued strength** *since October*

Although it is too early to assess properly the effect of the decline in share prices on activity, there are signs that it has had only a limited impact so far. In the United States, where the recent fall in the dollar will have encouraged activity in sectors open to international trade, industrial production increased in both

November and December, while unemployment fell slightly. Surveys of orders point to continued strength in the economy in the months ahead. A Commerce Department survey taken after the fall in stock market prices forecast that capital spending would rise by about 7½% in real terms in 1988, with manufacturing industries expecting to raise spending by about 8½% after a 3% increase in 1987. However, the US personal sector appears to be less buoyant. The volume of retail sales fell 1¼% in the fourth quarter, while indicators of consumer confidence, at very high levels before the stock market fall, subsequently fell sharply and have made only a modest recovery since. The preliminary estimate showed real GNP to have risen 1% in the fourth quarter, with positive contributions from stockbuilding and net exports offset by a fall in personal consumption.

In spite of the yen's further appreciation, the immediate indicators in Japan show a very strong picture. Recent surveys by the Economic Planning Agency and the Bank of Japan suggest that firms are still confident and have revised upwards their investment intentions for 1988. The government recently forecast a rise in GNP of 3.8% for fiscal 1988 (beginning 1 April 1988), slightly higher than their forecast for fiscal 1987. Domestic demand is expected to continue to grow rapidly, with business fixed investment taking over from construction activity as the main driving force and personal consumption remaining firm. By contrast, indicators point to continued weakness in Germany, not necessarily a consequence of the decline in share prices. According to provisional GNP data, output growth is likely to have been slow in the fourth quarter and manufacturing orders fell by 0.7% in both October and November. Domestic and export orders have declined, particularly in the capital goods industries. In France, both industrial and consumer confidence appear to have been little affected by weak equity markets.

Inflation *remains moderate . . .*

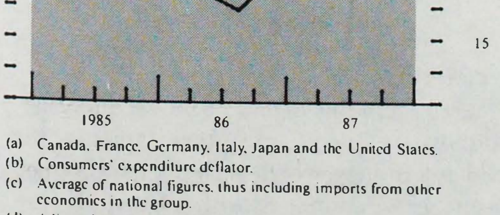
The rise in bond yields in the third quarter of 1987 was widely attributed to a resurgence in inflation expectations. However, the fall in equity markets may have reduced the more pessimistic forecasts and recent data suggest that earlier fears of a sharp rise in inflation may have been overstated. Consumer prices in the six major overseas countries rose by 3.2% in the twelve months to December, similar to the increases observed earlier in 1987. Most concern has centred on the United States, where the pressure of demand and a depreciating currency were thought likely to fuel inflationary pressures. However, consumer prices have shown no tendency to accelerate over recent months. Indeed, cost pressures may have eased somewhat, as reflected in an emerging gap between producer and consumer prices. In the second half of 1987, producer prices rose at an annual rate of 2½% while consumer prices rose by just over 4%. Despite a relatively low level of unemployment, wage settlements remain moderate. In countries with strongly appreciating currencies, inflationary pressures remain slight; consumer price inflation is around 1% in both Japan and Germany. In France and Italy, inflation rates are significantly higher, at 3% and 5% respectively.

For the industrial countries as a whole, inflationary pressures have been eased by the fall in oil prices since July. In part, this stems from a weakening in OPEC discipline. Before OPEC's December meeting, most members had been producing in excess

Costs and prices *increase slowly in the major overseas economies*(a)

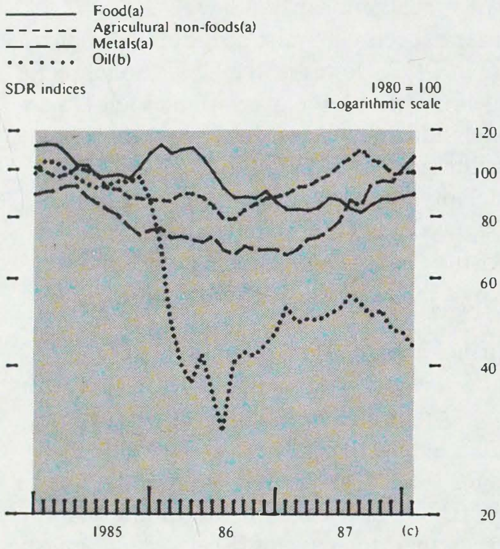
.... Consumer prices(b)
——— Import prices(c)
— — — Unit labour costs in manufacturing(d)
- - - - - - Wholesale prices of manufactures

Percentage changes on a year earlier(e)



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

Commodity prices *show varying trends*



(a) 'Economist' indices of spot commodity prices.
(b) North Sea Brent price.
(c) January 1988 is average of first three weeks.

Short-term interest rates[(a)] **in the major economies**

Per cent per annum; monthly averages

	1986		1987			
	June	Dec.	Mar.	June	Sept.	Dec.
Canada	7.7	7.2	6.4	8.4	9.2	8.5
France	7.2	8.0	8.0	8.3	8.0	8.6
Germany	4.7	4.8	4.0	3.7	4.0	3.7
Italy	12.5	11.6	11.7	11.0	12.1	11.5
Japan	4.6	4.4	4.0	3.7	3.8	3.9
United Kingdom	9.8	11.4	10.0	8.9	10.2	8.8
United States	6.7	6.0	6.2	6.9	7.4	7.6

(a) Three-month market rates.

of their quotas and discounts on official prices were common. Persistent production in excess of demand also led to high levels of stocks in both producing and consuming countries. In mid-December, spot market prices fell back to levels last seen in autumn 1986, with UK Brent trading between $15 and $16 per barrel. At its December meeting, OPEC decided to continue its existing quota agreement and to make no change to its reference price of $18 per barrel. Since then some production cuts have been made, and there are indications that most producers are currently close to, or within, their output quotas. Prices of non-oil primary commodities have been volatile since mid-October. After weakening in the immediate aftermath of the stock market falls, non-oil commodity prices subsequently recovered to stand above mid-October levels, especially in the metals sector where perceptions of supply shortages, particularly of copper, have persisted.

. . . which has helped monetary authorities sustain easier monetary conditions

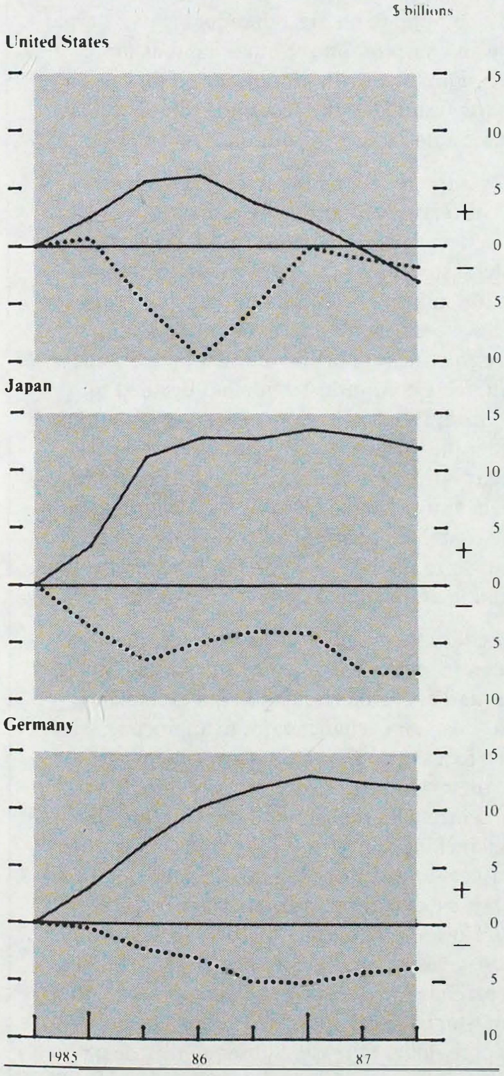
In the aftermath of the share price fall, which represented a *de facto* tightening of monetary conditions, monetary authorities in the industrial countries provided liquidity in order to accommodate the immediate rise in the demand for money. In the United States, short-term interest rates fell by about 1½ percentage points. Elsewhere, the initial decline in interest rates was less significant. Indeed, short-term Japanese interest rates have barely moved since the end of September, although money-market rates did fall in Germany by about 1 percentage point in the two week period commencing 19 October. Consequently, there was a narrowing in the differential between short-term rates in the United States and those prevailing elsewhere, which may have contributed to the renewed weakening in the dollar from late October.

These exchange rate pressures subsequently elicited several further co-ordinated adjustments in official short-term interest rates in continental Europe. In early November, the German authorities reduced Lombard rate by ½% to 4½% and the more closely watched securities repurchase rate by ¼% to 3½%, while the French authorities raised key interest rates by ¾% in an effort to ease ERM tensions, which had been exacerbated by the weakening in the dollar. With pressure on the dollar continuing and the US authorities apparently reluctant to tighten their own monetary policy, the Bundesbank further reduced its securities repurchase rate to 3¼% in late November, again as part of a co-ordinated action, with the French and Dutch authorities reducing key market rates on the same day. In another co-ordinated move in early December, the Bundesbank cut its discount rate by ½% to 2½%, the lowest rate since the war. French official rates fell by a further ½% in January, to a level beneath that of early November.

In countries with appreciating currencies, the rate of growth in monetary aggregates generally remains high. For the second year in a row, the German authorities failed to meet their target for the rate of growth of central bank money, which grew 8% between the fourth quarters of 1986 and 1987, compared with a target of 3%–6%. In Japan, broad money (M2 plus CDs) rose by 11.5% in the year to November. In France, M3 had grown at an annual rate of about 10% by the end of October over its base of the

Cumulative changes in trade balances

——— Changes attributable to net price
····· Changes attributable to net volume



World trade and UK markets

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

	1986		1987	
	H1	H2	H1	Q3(a)
Import volumes(b)	3.4	2.3	0.5	4.1
Major seven economies(c)	5.4	2.5	1.7	1.7
of which:				
United States	5.3	1.0	6.0	2.6
Japan	9.7	6.4	-1.2	6.7
Europe	2.9	1.6	4.3	0.2
Other OECD	4.6	1.6	0.4	2.3
OPEC countries	-10.7	-5.6	-3.6	4.9
Non-OPEC developing countries	0.4	3.6	-2.1	13.6
UK markets(d)	**2.3**	**1.4**	**1.0**	**2.2**

(a) Change over Q2 at a half-yearly rate.
(b) Imports of goods only.
(c) Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
(d) Total UK trade-weighted.

fourth quarter of 1986, compared with a target of 3%–5%. By contrast, the growth in money aggregates has been modest in the United States, where M3 rose by about 5% in the year to December. The unusual fall in velocity in many countries has been ascribed to a variety of factors, including the degree of exchange market intervention this year, but also, and more fundamentally, financial innovation and a change in portfolio preferences in an environment of lower inflation. As in the United Kingdom, it has encouraged policy makers abroad to interpret growth of certain monetary aggregates with particular caution. In Germany, the Bundesbank has dropped CBM as its target aggregate, replacing it with M3, to which, however, the same target range of 3% to 6% growth will apply in the year to the fourth quarter of 1988. The French authorities have announced that a target for M3, which comprises all means of payment issued by banks and the Treasury, will no longer be set in 1988. A target for M2 will, nevertheless, be retained, of 4% to 6% growth in the year to the fourth quarter.

External imbalances *remain a major threat to stable growth . . .*

The fall in share prices was triggered by a combination of developments which included concern that there had been a breakdown in policy co-ordination, a rise in bond yields, and adverse news on the US merchandise trade deficit. Subsequently, the US monthly trade data have shown little sign of improvement. In October the trade deficit rose to a record level of $17.6 billion and, while the November deficit of $13.2 billion was better than the most optimistic market forecasts, the average for the two months was still nearly $1 billion higher than that for the first nine months of the year. According to the available figures, there was no sustained reduction in the German and Japanese trade surpluses in dollar terms in the final months of the year. The magnitude of these imbalances threatens to undermine the restoration of confidence in financial markets. They have persisted in spite of significant adjustment in trade volumes over the past year. Although there was a pause in the process of volume adjustment in the third quarter of 1987, real trade flows have responded strongly to the exchange rate changes of recent years. However, this improvement has been masked in the balances expressed in dollars by contrary developments in the terms of trade, as well as the sharp depreciation in the dollar itself, which has amplified the existing imbalances in dollar terms.

Overall, growth in the volume of world trade is estimated to have recovered in the second half of 1987, having fallen in the first half of the year. The decline in the first half was associated particularly with a 5% fall in oil imports by OECD economies, although the weakness in domestic demand in the industrial countries also depressed import demand. At the same time, there was a modest contraction in developing countries' import volumes, despite the strengthening in commodity prices. In the second half, OECD countries are estimated to have increased both oil and non-oil imports and non-OECD economies also appear to have increased import volumes. The recovery in world trade was reflected in stronger growth in the markets for UK exports as the year progressed.

An increasing share of world exports has in recent years been attributable to four Asian newly-industrialising countries

The Asian NICs

In recent years, the four Asian NICs (newly industrialising countries)—South Korea, Taiwan, Hong Kong and Singapore—have emerged as important contributors to world trade. With less than 1.5% of the world's population, they have almost doubled their share of world manufactured exports from 5% in 1976 to around 9% in 1986 and in aggregate are fast approaching the share of Japan. Largely as a result, their real growth rates have been some of the highest in the world. Growth has been particularly strong over the last two years, with only Singapore, recovering from an uncharacteristic contraction, recording below double-digit rates. Inflation is low in all four countries, although rising in South Korea and Hong Kong.

Growth and inflation

Percentages

	Average growth (per cent per annum) 1976–86		Real GDP growth			Consumer price inflation
	Real GDP	Population	1985	1986	1987(a)	1987
South Korea	8.0	1.5	5.4	12.5	12.0	5.8(b)
Taiwan	8.6	1.6	4.3	11.6	11.0	1.7(b)
Hong Kong	9.2	2.0	0.6	11.0	12.0	6.3(c)
Singapore	6.9	1.2	−1.8	1.8	8.6	1.4(c)

(a) Estimates.
(b) Change on twelve months earlier in December.
(c) Change on twelve months earlier in November.

The NICs are not a homogeneous group of countries. South Korea and Taiwan tended to concentrate in the initial stages of their development on import substitution before changing to mostly export-oriented policies. As a result, they retain a number of import barriers and exchange controls and have only comparatively recently, under the mounting threat of protectionism, begun to take significant steps to dismantle them. Hong Kong and Singapore on the other hand have long since abandoned exchange controls and their markets are among the most open in the world. Moreover, while Hong Kong, Singapore and Taiwan have financed their development largely through domestic savings and inward direct investment, South Korea has relied heavily on external borrowing.

Given very different import regimes, rapid export growth has led to varied positions on trade and current account. South Korea and Taiwan more than account for the NICs' combined trade surplus, while Singapore remains in sizable deficit on visible trade and Hong Kong very close to balance. Virtually all of the combined current account surplus, which probably exceeded US$30 billion last year, is attributable to South Korea and Taiwan. However, South Korea's current account surplus has emerged only recently and has enabled the country to make a commendable start in reducing its external debt burden. Taiwan's surplus, on the other hand, is more long-standing and, combined with limitations on private capital outflows, has resulted in the accumulation of official reserves, which amounted to US$75 billion at end-1987.

Trade and current accounts

US$ billions, *percentages in italics*

	Merchandise trade balance(a)				Current account balance			
	1985	1986	1987(b)	Per cent of GDP 1987(b)	1985	1986	1987(b)	Per cent of GDP 1986
South Korea	−0.9	3.1	6.6	*7*	−0.9	4.6	10	*5*
Taiwan	10.6	15.6	19.0	*22*	9.2	16.2	20	*22*
Hong Kong(c)	0.5	0.1	—	—	1.9(d)	1.6(d)	..	*4(d)*
Singapore(c)	−3.5	−3.0	−3.9	*−20*	—	0.5	..	*3*
Total	**6.7**	**15.8**	**21.7**		**10.2**	**22.9**	..	

.. not available.
(a) Fob-cif.
(b) Estimates.
(c) Includes re-exports and excludes transactions in non-monetary gold.
(d) Goods and services only, ie, excluding IPD and transfers, which according to Hong Kong Government estimates would be likely to result in a deficit on the full current account.

The United States is the NICs' predominant export market, although in 1987 its relative importance declined. Although, in a multilateral system, there is no need for bilateral trade to balance, the bilateral surpluses of the NICs with the United States have been the subject of criticism in that country. These surpluses have been increasing, even in 1987, and represent a slowly growing proportion of the total US trade deficit. As a result, the US Administration has decided to remove the NICs from its list of nations receiving favourable import terms under the Generalised System of Preferences. By contrast, all four NICs recorded sizable and rising trade deficits with Japan, amounting to about US$20 billion at an annual rate in the first three quarters of 1987. This was despite strong growth in the NICs' exports to Japan, reflecting increasing integration among the Asian economies.

In an attempt to reduce the world trade imbalance, there has been external pressure on the NICs, led by the United States, to liberalise their markets further, relax foreign exchange restrictions and allow their exchange rates to appreciate. Most attention has been focused on the NICs' recent exchange rate policies and here their responses to external pressure have varied. With their currencies tied either directly to the US dollar (in the case of Hong Kong) or (in the cases of the other three NICs) to baskets in which the US dollar is the dominant component, the NICs lost competitiveness when the US dollar was strong. However, between March 1985, when the US dollar began to weaken, and the middle of 1986, the New Taiwan dollar depreciated in nominal effective terms by 10%, the South Korean won by some 19%, the Hong Kong dollar by 9% and the Singapore dollar by 7%.(1) Subsequently the paths of the NICs' exchange rates have diverged. Between mid-1986 and the end of 1987 the New Taiwan dollar appreciated in nominal effective terms by some 20% and the Singapore dollar by 4%, while the South Korean won remained broadly stable and the Hong Kong dollar, linked to the US dollar through Hong Kong's note-issue rate, depreciated by a further 6%. Against the US dollar alone, however, the New Taiwan dollar has appreciated by 26%, the South Korean won by 6% and the Singapore dollar by 11% over the period March 1985 to December 1987.

Both Singapore and Hong Kong have tended to resist recent external pressure to allow their exchange rates to appreciate, on the grounds that while their bilateral imbalances with the United States may be large, the small size of their global current account positions does not justify significant change. In addition Singapore regards its modest effective depreciation over the last three years as only a partial reversal of a previous longer period of appreciation. In Hong Kong's case there is also the desire to maintain maximum exchange rate stability in the period up to 1997.

(1) Using the Hong Kong Government's index for the Hong Kong dollar, the Monetary Authority of Singapore's index for the Singapore dollar and indices produced by Phillips & Drew for the other two currencies.

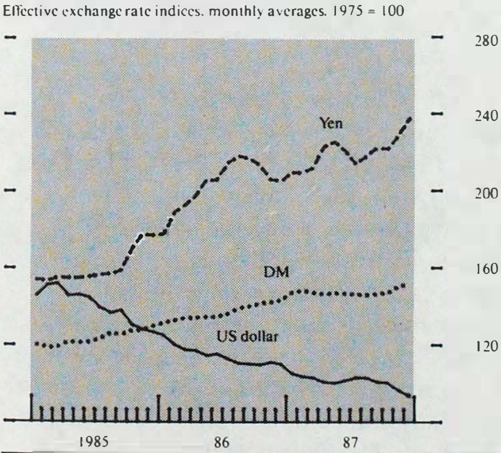
—Taiwan, South Korea, Hong Kong and Singapore. Policy makers in the major industrial countries have suggested that these countries should do more to allow their currencies to appreciate against the US dollar and to open their markets. Although some concern seems warranted in the case of Taiwan and South Korea, which may have accumulated current account surpluses of $20 billion and $10 billion, respectively, last year, both Singapore and Hong Kong are likely to have recorded current account positions much closer to balance in the past year and have continued to maintain extremely liberal trade regimes. (See the note on page 14.)

As well as threatening renewed turbulence in financial markets, the persistence of trade imbalances may raise protectionist pressures in the United States. Currently, an Omnibus Trade Bill is before a Congressional Conference. It contains provisions which would foster trade restrictions in the United States and might well provoke retaliatory actions elsewhere. Such a development would be unfortunate at a time when the Uruguay Round of GATT negotiations is aiming to reduce the existing barriers to trade in goods and services.

. . . and have led to considerable pressures on exchange rates

The **US dollar** *has fallen further*

Effective exchange rate indices, monthly averages, 1975 = 100



Following a period of relative stability between April and October, the US dollar depreciated sharply in the last quarter of the year. Between the end of September and the end of the year, the dollar's nominal effective index fell by 11½%. The initial decline may have been triggered by a reduction in the differential between US and foreign interest rates but the announcement of a record monthly US trade deficit gave further momentum to the decline in early December. At year-end, the dollar had fallen to record lows of ¥122 and DM1.57 following a period of considerable volatility around Christmas. It recovered in the New Year, initially through co-ordinated official intervention, in which the Federal Reserve took part, and subsequently with the announcement of better-than-expected US trade figures.

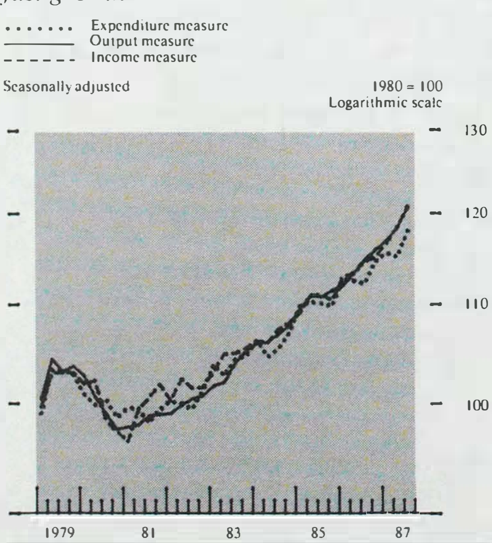
In the light of considerable uncertainties, the major industrial countries have found it necessary to reassert their commitment to continued policy co-ordination and to more stable exchange rates. In mid-December, the Finance Ministers and central bank Governors of the Group of Seven industrial countries reaffirmed their commitment to continued efforts to co-ordinate policy, with a view to reducing external imbalances while strengthening non-inflationary growth. Their statement emphasised that the major external imbalances in the world economy must be corrected. The policies which had been implemented were gradually showing the intended effects. In particular, the balance between domestic demand and output in the United States and in Japan and West Germany had shifted in a direction which promotes external adjustment, and in volume terms their trade imbalances were diminishing.

The communiqué followed the passage through Congress, and endorsement by the Administration, of an agreement on a two-year package of measures to reduce the US budget deficit. This agreement provides for total budget savings, through a combination of spending restraint and increased revenues, in fiscal years 1988 and 1989 (October 1987-September 1989) of approximately $76 billion. Within this total, about $32 billion will come from lower spending, $23 billion will accrue from taxation measures and about $21 billion will come from asset sales and other adjustments. The package replaces the cuts mandated under the Balanced Budget Law and will reinforce the progress already achieved in reducing the structural federal budget deficit.

Early in December, the German authorities announced the provision between 1988 and 1990 of subsidised credits at a cost to the government, over the ten-year life of the loans, of DM 2.6 billion. In addition, they promised to accelerate investment in telecommunication infrastructure and to take initiatives for further deregulation of markets, and subsequently undertook not to offset the effect of slower economic growth on the Federal deficit through a discretionary tightening in policy this year. The officially projected deficit for 1988 has increased to DM 40 billion, from under DM 30 billion estimated last November. However, the government plans to reduce the 1989 deficit by DM 10 billion through a combination of cuts in subsidies and other expenditures and increases in consumer taxes. The Japanese economy has responded strongly to the package of measures announced in May and the government has recently maintained the momentum of public works expenditure in its draft budget for the fiscal year beginning 1 April 1988.

In the United Kingdom, **growth** *was also particularly strong in the third quarter . . .*

The alternative measures of **GDP** *all show fast growth*



At home, it is now clear that the economy was growing particularly fast up to the third quarter of last year, at a rate not seen since the early 1970s. In recent months observers have been watching for signs of two possible but opposing tendencies. On the one hand, the indicators of inflation and the balance of payments have been monitored to see whether demand might be outstripping the economy's capacity to supply. On the other hand, the sharp fall in stock markets around the world in October, and since, might be expected to reduce demand through its effect on the wealth of consumers, on the cost of capital for businesses, and more generally and cumulatively by reducing confidence in future prosperity. The picture of the economy in the latest period is far from clear, but the initial signs are that growth is continuing.

Revisions to the UK national income statistics have reduced the discrepancies between the three measures of gross domestic product, and they all suggest real growth of as much as 5% between the third quarters of 1986 and 1987, with 2% growth in the third quarter of last year alone. With North Sea oil production now falling, there have been strong rates of expansion in manufacturing and construction (following a pause in the recovery for much of 1985 and into 1986) and accelerated growth in a wide range of services. Growth in the third quarter almost certainly exceeded the underlying trend, and there are some signs of slower, but still buoyant growth later in the year. Manufacturing output grew by 1½% in the three months to November compared with the previous three, not as fast as the 2¾% rate seen in the third quarter. CBI surveys and the Bank's own contacts with industry suggest that orders and output remained buoyant into the new year. Retail sales growth slackened to 1¼% in the fourth quarter after an exceptional 2¾% in the third, suggesting that the output of the distribution sector will also have eased somewhat.

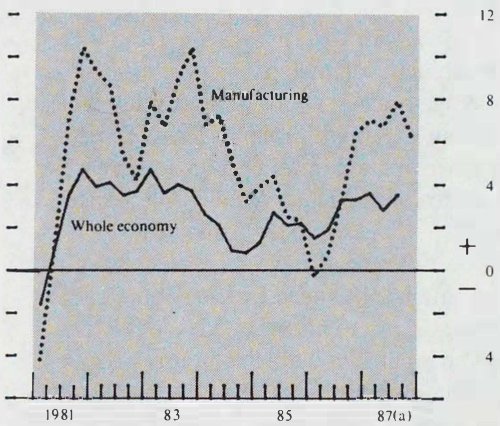
. . . *further improving* **productivity** . . .

Increased output requires either a more intensive and productive use of existing capital or of the currently employed labour force, or increases in the capital stock and in employment. So far in the present recovery, the productivity of both labour and capital has increased apace. For example, between the third quarters of 1986 and 1987 while output grew 5%, the employed labour force rose by about 1½% and although business investment rose by 4% over this period it is unlikely that any of the relevant measures of the capital stock grew by more than about 2% (perhaps even less in manufacturing).

As has been the case for a number of years, the service industries more than accounted for the increase in the number of employees in the latest period (up 2½% in the year to the third quarter). Nevertheless, labour productivity growth in this sector (3½% in the year to the third quarter) has been high by historic standards. In manufacturing, faster growth of output has slowed the decline in employment, to less than 1% in the year to November. Indeed, employment in manufacturing did not fall at all on balance over the latest six months. Output per head rose by as much as 8% in the year to the third quarter, and 3% in the third quarter alone, but has since slowed, with output growth, to 1½% in the three months to November compared with the previous three months. Overtime working has increased to the highest level since the beginning of the decade and average hours worked by operatives in manufacturing (taking account of both overtime and further reductions in short-time working) rose by 1% in the year to November. Output per hour rose by 4½% over the same period.

Productivity *growth has been high*

Percentage increase in output per head on a year earlier

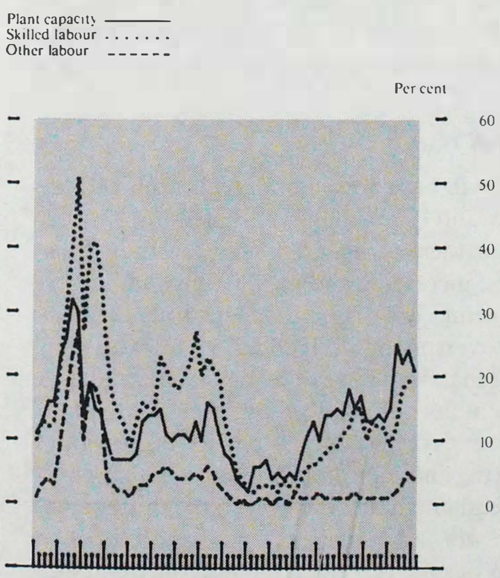


(a) Manufacturing productivity in the fourth quarter of 1987 partly estimated.

. . . *but raising questions of* **sustainability**

Recent rates of output growth will become unsustainable if productivity growth cannot be maintained, or if the capital stock or employed labour force do not expand sufficiently rapidly. There is evidence that the underlying productivity performance of both labour and capital has improved in recent years in the UK economy (unlike those of most OECD countries). Nevertheless, and tentative as they are, estimates of 'underlying' productivity growth fall short of those which have been actually achieved over the last year or so.(1) The implication is that some of the recent productivity growth reflects the more intensive use of labour and capital (through, for example, increased overtime working or the extension of multiple-shift working) and that only part results from technical and other progress. As more of the existing work force and the existing capital stock comes to be fully employed, it would be expected that output would become increasingly supply constrained and that firms would take on more labour and increase investment. There is some evidence of such constraints; respondents to the CBI's manufacturing survey have pointed to plant capacity as a significant constraint on output for the past year, although not to any increasing extent. Compared with previous cycles, plant capacity seems a more serious constraint than in 1979, but less serious than in 1973. There seems to be a wider diversity of experience than in 1973,

Percentages of respondents to CBI industrial trend surveys reporting **output constrained** *by:*



(1) See 'The underlying growth of manufacturing productivity' in the August 1987 *Bulletin*, page 336, and 'Total factor productivity' in *OECD Economic Outlook*, December 1987, pages 39–47.

with only a few sectors (chemicals, textiles and electrical engineering) operating closer to capacity than in 1973. Skilled labour is increasingly quoted as a constraint on output, but less so than in either 1973 or 1979.

Inflation *remains stable . . .*

Despite the growing pressure of demand, price inflation in the United Kingdom has shown few signs of acceleration. Cost increases in recent quarters have been low, with a strong exchange rate keeping down world prices in sterling terms, while labour productivity growth has restrained the rise in unit labour costs.

As will be seen from the table, the change in the domestic demand deflator (the average price at which goods and services are provided within the United Kingdom) has been declining very slowly over the past two years. Unit labour cost increases have tended to decline somewhat faster, as broadly unchanged earnings increases have been offset by faster growth in productivity. Profits per unit of output have increased sharply, though the path has been much influenced by the course of oil prices. Through 1986 when oil prices plummeted, the fall in North Sea oil profits was so great that whole economy profits per unit of output fell and total domestic costs (the GDP deflator, including North Sea profits) rose only slowly. In 1987 as oil prices recovered, whole economy profits rose once more (and the GDP deflator accelerated). A similar path is seen in the price of imports (including imported oil). Profit margins outside the North Sea have widened throughout. One interpretation of these developments would be that businesses have based their prices on a longer-term view of costs, with abnormal increases in productivity and fluctuations in the prices of oil and other commodity inputs being absorbed in profit margins. This might suggest that if productivity growth has begun to slow, along with output, profit margins may also rise more slowly. In the latest months, however, oil and other commodity input prices have begun to fall once more. The (seasonally adjusted) price of materials and fuel purchased by manufacturing industry was 2% lower in December than in August 1987. On this account there may be scope for continued widening of non North Sea margins.

Costs and prices

Percentage changes over the same period a year earlier

	1986		1987	
	H1	H2	H1	Q3
GDP deflator (factor cost)	3.5	2.0	4.1	4.9
of which:				
Labour costs per unit of output	5.4	4.3	3.8	3.4
ICCs' profits per unit of output	- 5.4	- 6.3	7.9	16.5
Non-oil ICCs' profits per unit of output	20.7	15.3	10.3	12.7
Domestic demand deflator	4.7	4.4	4.3	4.0
GDP deflator (market prices)	4.4	2.7	4.2	4.8
Import deflator	- 6.7	-0.1	2.1	4.6

. . . and **real incomes** *rise*

Strong productivity growth has allowed both real earnings and real profitability to rise, and has perhaps facilitated the settlement of pay claims, there being, up to now, few industrial disputes. With overtime increasing and productivity and other bonuses being paid, earnings have risen independently of settlements. Increased overtime in itself added ½% to ¾% to earnings growth in manufacturing in the year to the third quarter, and ½% in the economy as a whole. Indeed overtime more than accounted for the apparent acceleration in 'underlying' earnings growth[1] in manufacturing and the whole economy in that period compared with a year earlier. Taking the year to the third quarter as a whole, pay settlements had a smaller effect than in the previous year. This was despite the turnaround in the trend of unemployment since mid-1986, including a particularly sharp fall in short-term unemployment, often considered to have the

(1) Earnings growth adjusted for the timing of settlements and for industrial disputes.

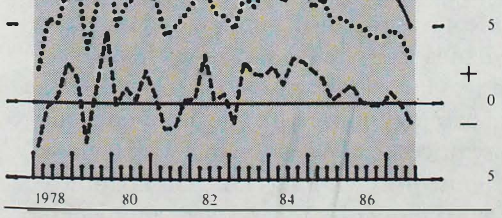
largest effect on pay. There have been relatively few settlements in recent months, but it is unlikely that the trend is still downwards. Settlements in manufacturing averaged below 5% in the spring of 1987, rose sharply in the summer and were still 5.7% in November. In private sector services, there was an even sharper fall, followed by a sharper rise, to 7.1%, in the third quarter, followed by 7.0% in the fourth. In the public sector, the second stage of the teachers' settlement and the local authority manual workers' agreement have added to earnings. Underlying earnings were growing faster in the service sector as a whole than in manufacturing in the year to November (by 8½% against 8¼%).

Profits and productivity and the need to recruit or retain labour have all become more important as upward pressures on settlements. Skill shortages in the South East have led to increases in both the level and the geographical coverage of London allowances, and some firms well outside the South East are offering similar terms for the skilled labour they need.

Consumption *remains buoyant*

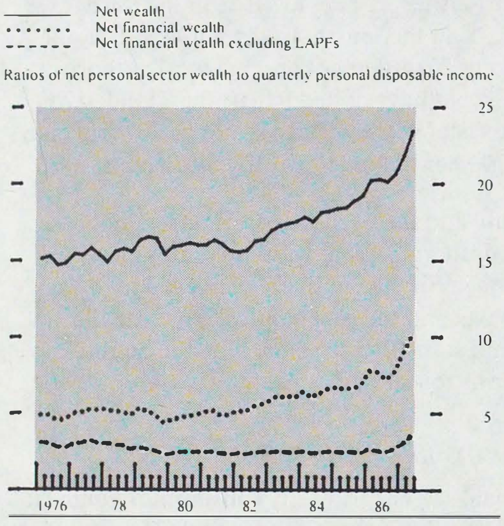
Spending by the personal sector (primarily consumption but also on new housing) has been a mainstay of the growth of demand. Personal real income has been growing strongly, though not as strongly as real national income in total. Income from employment has fallen as a share of the total (as profits have recovered) and, despite cuts in tax rates, the net effect of the income tax and social security systems has been to take a higher proportion of personal income, as the economy has expanded and as unemployment has fallen. Despite growing interest and dividend income and slow growth in consumer prices (relative to the price of total output), real personal disposable income grew a modest 3.4% in the year to the third quarter of 1987, compared with growth of 5.5% in gross real national disposable income over the same period. Consumption growth of 5.7% has thus required a further sharp fall in the personal saving ratio. Indeed revisions to past data (downward for disposable income and upward for consumers' expenditure) have produced a picture of a much steeper decline in the saving ratio since 1980 than was previously apparent, and the level estimated for the third quarter of 1987, at 5%, is lower than for any period since 1959. In the fourth quarter, consumption, on the preliminary estimate, was unchanged from the third, but still more than 5% higher than a year earlier. Retail sales have fluctuated in recent months, although the trend appears to be still strongly upward. Although information on personal income in the fourth quarter is still very incomplete, strong earnings growth in October and November makes it unlikely that the saving ratio will have fallen further.

Personal saving ratios *have fallen*



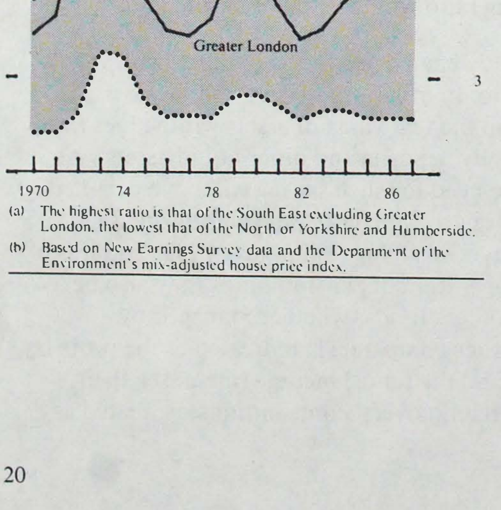
A number of factors may have contributed to the downward trend in the saving ratio. In inflationary times, some saving is needed just to maintain the real value of assets with values fixed in money terms (typically deposits and other liquid assets). As inflation has fallen, the need for such saving will have declined. The middle line in the chart, which excludes this effect, does indeed show a lower level of saving in the early 1980s and less of a fall since then. The operation of pension funds may also be a factor. Conventionally these funds (whether managed by employers or by insurance companies) are treated as the property of the personal sector and the funds' income (including their investment income and employers' contributions) is treated as

Capital gains increased **personal wealth** *in the first part of 1987*



part of personal income. Movements in such income are not thought to influence consumption, but are for that reason likely to affect the saving ratio. As earnings on the funds' assets rose from the low levels seen in the 1970s, the saving ratio will have risen on that account. But then, as it became apparent that the value of the funds was becoming greater than needed to meet pension liabilities, employers' contributions stopped rising (from 1981) and in the last two years have fallen, even in nominal terms. This reduction in contributions (which counts as personal income) and in saving via the funds will have tended to bring down the conventional saving ratio. The bottom line in the chart on page 19, which adjusts for these effects as well as inflation effects, shows no decline through the 1980s as a whole, but even on this basis the saving ratio has been declining over the past three years. Over this period, the real wealth of the personal sector has been rising strongly, only to a limited extent as a result of saving, and much more importantly through real capital gains. If these capital gains had been an important stimulus to consumption, the fall in the stock market since October last might have been thought to have had a significantly restraining effect. Bank research has found real financial wealth to have an influence on consumption, but one which takes very many years to come through. Although the rise in asset prices over the past few years may have a long-term effect on the saving ratio, the exceptionally large rise in asset prices in the first part of 1987, followed by a sharp fall of equal size, would be expected to have little net effect. Moreover, the influence of wealth appears to have become much less significant in the 1980s, perhaps because consumers have been gaining access to many more sources of credit. But this increased availability of credit may well itself be a factor explaining the falling saving ratios of the last three years, together with greater confidence in the personal sector associated with the improvements in employment and employment prospects.

House price/earnings *ratios have risen, but not in all regions*



(a) The highest ratio is that of the South East excluding Greater London, the lowest that of the North or Yorkshire and Humberside.
(b) Based on New Earnings Survey data and the Department of the Environment's mix-adjusted house price index.

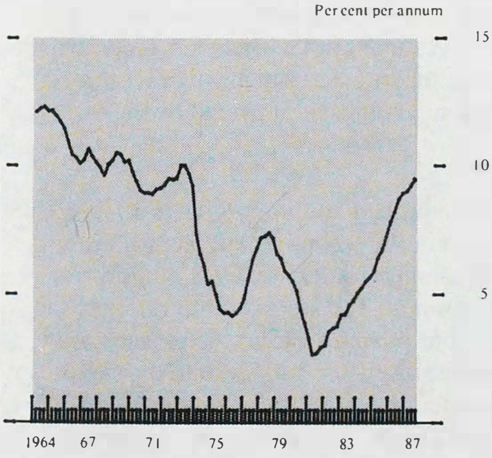
Housing investment *has recovered, and* **house prices** *continue to rise rapidly*

Capital expenditure by the personal sector continues to grow. The greatest part is on housing (although fixed investment and stockbuilding by unincorporated businesses are also included). Housing investment was sharply down early in 1987, perhaps because of bad weather, but recovered strongly in the third quarter. House prices continue to rise rapidly. The Halifax mix-adjusted index rose 14.6% in the year to the third quarter of 1987 and 15.5% in the year to the fourth. In the Greater London area the rate of increase in house prices was declining (slowly) throughout the year while it was increasing in East Anglia, the South West and the Midlands. Despite the slowdown in the Greater London area, prices increased by 22.9% in the year to the fourth quarter. Regional earnings indices are less up-to-date but, comparing average house prices in 1987 as a whole with regional earnings in April 1987, house price/earnings ratios in London and the South East exceeded those of 1979 and were approaching those of 1973. The spread of house price/earnings ratios between regions is now much wider than in previous years.

Continued growth in capital spending, coupled with the downward revised and downward moving estimate of personal saving, suggests that the personal sector was in sizable financial deficit in the year to the third quarter, for the first time since the late 1950s. The financing of this deficit is only partially revealed in the statistics of identified financial transactions. The latter do, however, suggest a continued fast rate of growth on both sides of the balance sheet. Borrowing for consumption continues to grow much faster than personal disposable income. This high trend rate of growth reflects to some degree changes in payments mechanisms, for example the more widespread use of credit cards to finance transactions, as well as longer-term adjustment of personal sector portfolios to the removal of constraints on borrowing. Trends established over the last few years have also continued on the asset side of the personal sector's balance sheet, and the twelve-month growth rates of persons' deposits with banks and with building societies have changed little during 1987.

Companies are highly **profitable** *. . .*

Profitability[a] *is higher than for many years*



(a) Pre-tax real rate of return of non North Sea industrial and commercial companies: average over four quarters.

Strong output growth, widening margins and a recovery in the oil price have made for strong growth in total company profits. In the third quarter of last year, industrial and commercial companies' (ICCs') gross trading profits (net of stock appreciation) were some 23% higher than a year earlier. Profits of North Sea companies rose 53% in the year to the third quarter, while those of the non-oil sector grew by 19% over the same period (although it should be noted that the comparisons made on a year earlier are distorted by the privatisations of British Gas, British Airways and the British Airports Authority). Estimates suggest that, with capital stock growing only slowly, the real pre-tax rate of return for non North Sea companies stood at around 10% in the third quarter, its highest level since 1973.

Dividends grew strongly in the year to the third quarter, although the level of payments has fluctuated from quarter to quarter. Much of this growth is simply due to the strong performance of company profitability. The dividend pay out ratio is, however, higher now than in the early 1980s. The rise in the ratio can be attributed in part to companies' desire to signal high expected future profits. However, the reform of corporation tax in 1984, which reduced investment allowances, coupled with the rise in profits, has reduced the number of 'tax exhausted' companies (whose allowances exceeded their taxable income). Such companies previously had more incentive to retain earnings than to distribute them as dividends. Profits due abroad have also been high as a result of the high levels of company profitability and the increased number of companies with overseas parents.

The slump in the profits of North Sea companies in 1986 led to a sharp decline in receipts from petroleum revenue tax in late 1986 and the first three quarters of 1987. However, the performance of the non North Sea sector coupled with the reduction in the incidence of tax exhaustion has provided buoyant corporation tax revenues, which has meant that UK taxes paid by ICCs are approaching the levels witnessed in 1985.

. . . but their **capital spending** *has risen only a little so far*

Given the level of profitability and the apparently high degree of capacity utilisation, it may appear surprising that business investment has not been growing more strongly. After a strong second quarter, investment fell back in the third, when investment by manufacturing industry (including leased assets) was less than 5% higher than a year earlier and that by the distribution and services sector only 3½% higher. Although the estimated rate of return on real assets now clearly exceeds that on financial assets, a high proportion of manufacturers still quote 'inadequate returns' as a factor inhibiting investment, indicating perhaps that since the reform of corporation tax and the reduction in investment allowances a higher pre-tax return is required. Uncertainty about future demand is also a factor; firms which doubt that new capacity will be utilised may be adopting a policy of raising margins in response to higher current demand. Nevertheless, the survey evidence suggests that investment will continue to grow, with expansion of capacity and replacement increasingly important motives. The DTI's October investment intentions survey, taken before the stock market fall, suggested that investment growth in manufacturing would accelerate from 6% in 1987 to 11% in 1988, while that in distribution and services would remain at 6%. It appears that investment plans have not so far been seriously altered after the stock market fall. The CBI's January survey showed continued strength in manufacturers' investment intentions. Investment in the transport sector will be swollen by the Channel tunnel project, which will have added about £2 billion to investment (at current prices) by the early 1990s.

Total stockbuilding was about £900 million in the third quarter after a modest £18 million in the second. Manufacturing stocks rose by £268 million, wholesaling stocks by £108 million and retailing stocks by £335 million. The stock/output ratios of the manufacturing and distribution and services sectors have now fallen almost continuously since 1982 and, despite the significant build-up in the third quarter, the ratios are again likely to have fallen. The retail stock/sales ratio, by contrast, has shown an upward trend in 1987.

The falling ratios experienced in recent years may be due to a number of factors: the strong growth in output, the high cost of stockholding (reflecting high real interest rates, and also tax changes which have removed some of the incentives to stockholding), and greater flexibility of production processes, which makes companies more confident of their ability to respond to changes in demand and therefore reduces the need for stocks. However, this downward trend may come to an end if output growth slows while stockbuilding continues. (The continued high level of bank borrowing and imports in the fourth quarter would be compatible with continued stockbuilding.)

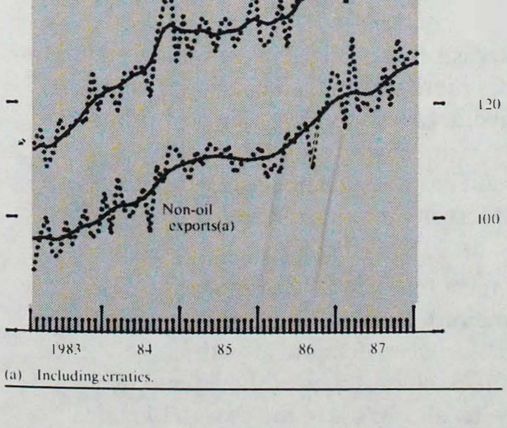
Despite generally rising expenditure on physical assets, industrial and commercial companies continue to run sizable financial surpluses, amounting to some £2 billion in the third quarter. In addition, the buoyant market conditions that prevailed before 19 October led firms to raise record amounts of capital on the equity markets. Capital issues by ICCs exceeded £13 billion in 1987, with those in the third quarter alone worth over £6 billion. Capital issues overseas were also high in the first half of the year with £2.5 billion raised. Bank borrowing was also high, which may be regarded as surprising given the large amounts of finance raised on the equity markets. However, net gearing ratios are at exceptionally low levels and companies may consider themselves to be under-borrowed at present. If current uncertainties diminish, the incentives for companies to issue long-term debt will be strong.

A striking feature of companies' financial behaviour before the stock market fall was the issue of new equity either as consideration for acquisitions or to raise new funds. These funds have often been used for cash acquisitions or to build up liquid assets. The causes of the acquisition boom are unclear, although it seems likely that companies have been finding it cheaper or less risky to acquire other companies than to increase their own capital expenditure. At this stage it is difficult to tell how the level of acquisition activity will be affected by the stock market fall; but it is already clear that with lower equity prices the emphasis has shifted from acquisitions paid for or funded by equity to acquisitions for cash.

ICCs' accumulation of liquid financial assets continued in 1987 with £7.8 billion acquired in the year as a whole. This reflected the substantial financial surpluses noted earlier and the large amount of capital that has been raised on the markets. In the second half, ICCs borrowed £9½ billion from the banks while placing £6½ billion on deposit. This behaviour is hard to explain, but it may be the case that small companies, whose financing alternatives are limited, are doing the borrowing, while the larger companies are raising cheap equity finance and placing the funds on deposit. But there is also evidence that individual companies are matching a higher proportion of their borrowing with liquid assets, perhaps because the margin between the two has fallen. (See pages 75–82.) However, the divergence that has occurred between the rates of return on physical and financial assets may moderate the desire to hold liquid assets.

Investment abroad rose to record levels in 1987 as UK companies took advantage of the weak dollar to acquire US companies. UK companies made some 250 acquisitions in the United States worth $27.2 billion (gross) in 1987. Any slowdown in the US economy in 1988 might deter acquisitions there, although American companies which are large exporters and may benefit from the declining dollar could become targets.

Export volumes *have risen strongly,* **import volumes** *even more strongly*



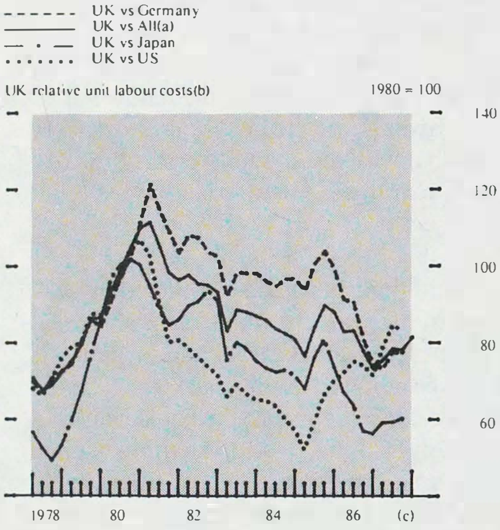
(a) Including erratics.

The **current account** *deteriorates, despite improved supply performance*

Industry's improved supply capability is having an influence on the balance of payments. Exports have been high even when world trade was weak, and firms have been able to widen their profit margins, on both exports and domestic sales. Nevertheless, very fast growth in domestic demand and sustained growth in import volume have resulted in a steady deterioration on the visible trade account since the first quarter of 1987.

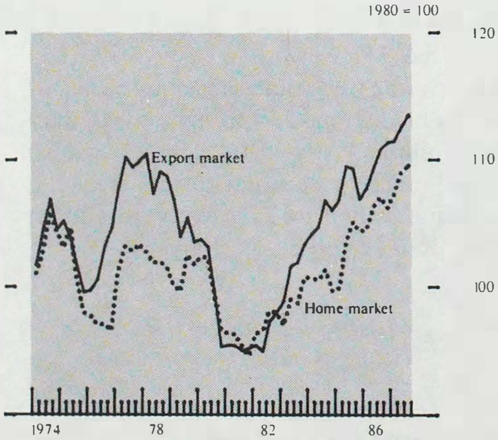
The deterioration on the visible trade account, of over £1¼ billion in 1987, was more than accounted for by trade in manufactures. The volume of exports of manufactured goods was 8½% higher in 1987 than in 1986. But imports of such goods in 1987 were 11% higher. Although the terms of trade rose slightly, the deficit on trade in manufactures was £7¼ billion compared with £5½ billion in 1986. But in view of the faster domestic demand growth in the United Kingdom than overseas and also the deterioration in competitiveness during 1987, some worsening was to be expected. Indeed there is evidence that, given the pattern of competitiveness and relative activity in the United Kingdom and overseas, the increase in the deficit in visible trade has not been as large as historical experience might have suggested.

Competitiveness *has worsened in recent quarters*



(a) Weighted average of 16 countries.
(b) Common currency: not adjusted (or normalised) for cyclical movements in productivity.
(c) Bank estimates for 1987 Q3 and Q4.

Manufacturers' margins[(a)]



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

Latest figures show that UK manufacturing industry's costs relative to those of competitors (in local currencies) were little changed between the end of 1986 and the third quarter of 1987, after deteriorating steadily between 1983 and the first half of 1986. Although UK manufacturing output and productivity have shown the most rapid and sustained growth for over a decade, underlying earnings growth has also been high, at around 8% per annum.

With the appreciation in sterling's effective exchange rate, cost competitiveness deteriorated sharply in the first half of 1987, although it remained substantially better than at the beginning of 1986. The effective exchange rate was little changed in the third quarter of 1987 and so the improvement relative to 1986 was maintained, but there was further appreciation of 3% in the fourth quarter. There have been considerable differences in the pattern of competitiveness against our major competitors; such has been the extent of the appreciation against the dollar that provisional estimates suggest that competitiveness against the United States was 13½% worse in the third quarter of 1987 than the average for 1986 as a whole. In contrast, some of the gain in competitiveness against Germany and Japan has been maintained; provisional estimates indicate that, in the third quarter of 1987, competitiveness against Germany and Japan was respectively 8% and 1% better than the average for 1986.

The loss of *price* competitiveness of UK output in both export and domestic markets during 1987 has been more marked than that of cost competitiveness, and price competitiveness in both markets was little changed from its level in the middle of 1985. The deterioration in both markets is reflected in the current strength of the non-oil terms of trade, which are at record levels. The difference in the behaviour of price and cost competitiveness reflects changes in profit margins. It would normally be expected that, in response to an appreciation, UK producers would narrow their profit margins in order to limit the loss of price competitiveness. However, overall, margins continued to increase in the first three quarters of 1987 and this has reinforced the loss of price competitiveness associated with sterling's appreciation.

Empirical evidence suggests that changes in competitiveness influence trade volumes more slowly than changes in demand. While changes in competitiveness do have a limited immediate effect, it takes around a year before even half of the full effect is seen. Changes in demand have a much more rapid influence, with almost all the effect seen after one quarter.

With only a limited impact likely so far from the loss of competitiveness, the major influence on the visible trade account has been the differential between demand growth in the United Kingdom and that overseas. Latest figures show that UK domestic demand grew by almost 6% in the year to the third quarter of 1987 (of which over a quarter reflected stockbuilding), compared with only 3% in major economies overseas. Despite the steady deterioration, there is evidence that improved supply conditions have allowed UK producers to capture a larger share of both export and domestic markets than would otherwise have been the case. Certainly the increase in the UK share of export markets at the end of 1986 was encouraging, even allowing for the possibility that some of it may have reflected a faster-than-expected response to improved competitiveness. Improvements in non-price competitiveness and an increased incentive to supply arising from wider profit margins have probably been important here.

The rapid growth of imports during 1987 has been at least in part associated with the need to import capital goods to maintain the growth of output. Furthermore, the growth of imports has occurred at a time when domestic production has been expanding rapidly. A significant part of the demand growth in the year to the third quarter was due to substantial stockbuilding and the latest import figures suggest that this may have continued into the fourth quarter. If this is the case, some of the growth in imports may prove to have been only temporary.

Overall, prospects for the visible trade account appear mixed. Bank estimates suggest some pick-up in the growth of export markets from the second half of 1987. However, while not all of the gains in cost competitiveness during 1986 have been eroded, much of the impact of the loss in competitiveness during 1987 has yet to be seen.

The **public finances** *move into surplus*

In the first nine months of the financial year the PSBR amounted to a surplus (ie net repayment) of £0.4 billion, compared with cumulative borrowing of £4.2 billion over the same period in the previous year. A significant factor in the decline in the PSBR has been the increase in privatisation proceeds, £5.1 billion compared with £3.3 billion in the previous period. But excluding their contribution, the PSBR is still nearly £3 billion lower. This can be traced to the effects of higher profitability in the corporate sector, higher oil prices, and continued strong economic growth. This has led to continued buoyant tax receipts (corporation tax receipts in the first eight months of the financial year were over 20% higher and inland revenue total net receipts over 11% higher than a year earlier). The pattern of petroleum revenue tax (PRT) payments has been reversed. Last year's PSBR was reduced by high PRT payments until August, with lower receipts in the remainder of the year following a rebate in September. In the current year, PRT receipts were low until September when a further payment of £0.9 billion was made, with expected revenues being higher for the rest of the year. Total tax revenues for 1987/88 are expected to exceed the forecast made at the time of the 1987 Budget.

The public expenditure planning total in 1987/88 is expected to undershoot the 1987 White Paper forecast of £148.6 billion by about £1 billion, according to the Chancellor's Autumn Statement. As confirmed in the 1988 White Paper, planning totals for 1988/89 and 1989/90 have been revised up by £2.5 billion and £5.5 billion respectively, but even after taking

Sectoral wealth and financial surpluses

£ billions

	Net wealth end–1986		Financial surplus/deficit	
	Total net wealth	Net financial wealth	1986	1987 (a)
Personal sector	1348.7	500.8	0.5	–4.9
Industrial and commercial companies	160.3	–268.9	5.8	10.0
Financial institutions	77.9	3.1	4.4	7.0
Public sector	222.8	–123.9	–8.8	–6.6
Total domestic sectors	1809.6 (b)	111.1 (c)	–0.9 (d)	–1.6 (d)

(a) First three quarters, seasonally adjusted at an annual rate.
(b) Net national wealth.
(c) Net claims on overseas.
(d) Surplus/deficit on current account; differs from the sum of sector surpluses/deficits by the residual error in the national accounts.

into account some slowdown in economic growth, Government expenditure is still set to fall as a percentage of GDP.

Sectoral **surpluses** *and* **deficits** *are small in relation to* **wealth**

The emerging pattern of financial surpluses and deficits is an unusual one, in which the personal sector is in deficit and the company sector in strong surplus, while the public sector financial deficit is much reduced. But because the pattern runs against past trends there are large stocks of accumulated assets or liabilities with which the deficits and surpluses might be financed, just as for the country as a whole the emerging current account deficit comes after a period in which net external assets have risen strongly.