Economic commentary

- *World financial markets have been more stable so far this year than in the turbulent months in late 1987. From historic lows against the yen and the deutschemark at the start of January the dollar rebounded somewhat on co-ordinated intervention. Share prices in many countries rose, though not, except in Japan, back to their October levels.*

- *The resilience of economic activity in the face of the earlier fall in share prices was confirmed by the strong rise in output in the major overseas countries towards the end of 1987. The latest data suggest that some of this strength continued into the early months of this year, and was not associated with higher inflation.*

- *However, some tensions began to resurface, with the dollar weakening on fears that the US economy was growing too strongly for inflation to remain low or the trade deficit to narrow significantly. In addition US bond yields rose, and share prices fell back.*

- *In the United Kingdom there have been some signs of slower growth so far this year. The evidence has been conflicting but on balance suggests no greater slowdown than previously expected.*

- *Although UK earnings have tended to rise faster, with productivity growth high, unit labour cost increases have remained low. Profit margins and profitability rose in 1987 despite the strengthening exchange rate.*

- *Sterling's appreciation has made for a loss of competitiveness, which may now be affecting trade flows, although the latest statistics appear distorted. It has also made for very weak import prices.*

Output in the six major overseas economies is estimated to have risen by 1% in the fourth quarter of 1987, slightly less than the increase in the previous three months; and it was concentrated rather more in North America and Japan than in Europe. The rise in output in the year to the fourth quarter was almost 3¾%, the fastest rate since 1984, and a marked improvement on the 2¼% attained through 1986. Investment strengthened considerably; private fixed investment rose by over 7% between the fourth quarters of 1986 and 1987, and a higher rate of addition to stocks contributed about 1 percentage point to the increase in output over the same period. The faster rate of growth may have reflected in part a lagged response to the favourable terms of trade developments of 1986, as well as the wealth effects of rising equity prices in the first three quarters of the year and continued low inflation, both of which may have reduced saving ratios. Policy co-ordination following the Louvre accord, which provided a more stable planning environment, and an easing of monetary and fiscal policies in some countries, could have made a further contribution.

Output growth *was strong in the most recent period in* **North America** *and* **Japan** . . .

Despite the substantial appreciation of the yen, growth has continued to be most rapid in Japan, with GNP rising by about 5½% in the year to the fourth quarter of 1987, helped by an easing of monetary and fiscal policies. Activity accelerated during the

GNP/GDP growth in the major overseas economies

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

	1986	1987		
		Year	H1	H2(a)
United States	2.9	2.9	3.2	4.0
Japan	2.4	4.2	4.0	5.9
Germany	2.5	1.7	-0.4	4.3
France	2.0	1.9	0.9	3.4
Italy	2.7	3.1	1.8	2.9
Canada	3.3	3.9	4.3	5.6
Total	**2.7**	**2.9**	**2.6**	**4.3**

(a) Partly estimated.

Components of GNP/GDP growth in the major overseas economies

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

	1986	1987		
		Year	H1	H2(a)
Private consumption	3.9	2.6	1.7	3.1
Private fixed investment	3.4	4.0	1.3	10.8
Public expenditure	3.6	2.4	-0.4	4.7
Stockbuilding(b)	0.2	0.5	1.5	-0.2
Domestic demand	**3.9**	**3.3**	**2.7**	**4.5**
Net trade(b)	-1.1	-0.4	-0.1	-0.2
GNP/GDP	**2.7**	**2.9**	**2.6**	**4.3**

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

second half of the year, when there was a particularly pronounced rise in industrial production. In the fourth quarter, there was a further surge in private business investment and residential construction, which offset a moderation in the growth of personal consumption. In the third quarter, net exports had, against expectations, made a positive contribution to growth, but the continuing loss of competitiveness and growth in domestic demand induced a fall in exports and a sharp rise in imports in the last three months of the year. More recent data indicate that robust growth in demand and output has continued in the early months of 1988.

The US economy has been more difficult to evaluate in the months since the collapse in share prices. GNP grew by 1.2% in the fourth quarter, to stand 4% higher than a year earlier. However, personal consumption fell in the last three months of the year as the saving ratio rose. This increase may have been partly related to the stock market crash, but consumption had already weakened prior to October. Although the external sector made a positive contribution to growth, a rise in inventories, particularly in the retail sector, was responsible for around three quarters of the increase in output. Given the very weak rise in final sales, at least some of this increase may have been involuntary, raising fears of a correction to production this year. Recent data have, however, diminished worries that a recession is imminent. Indeed, the focus of market attention has switched to the possibility that inflationary pressures are building up. This has been due mainly to strong employment growth and the associated fall in the unemployment rate to 5.6% in March, its lowest level for nine years, while there has also been some recovery in both consumer confidence and retail sales. However, other evidence suggests the rate of output growth may be slowing. Industrial production rose by only 0.5% between December and March, significantly less than the rise in the previous three months; and although the level of capacity utilisation remains high, it fell in both February and March. The preliminary estimate for GNP growth in the first quarter was 0.6%. This reflected very buoyant fixed investment and a recovery in personal consumption, as well as a further rise in net exports. A smaller increase in business inventories was mainly responsible for the slower rise in GNP than in the fourth quarter of 1987.

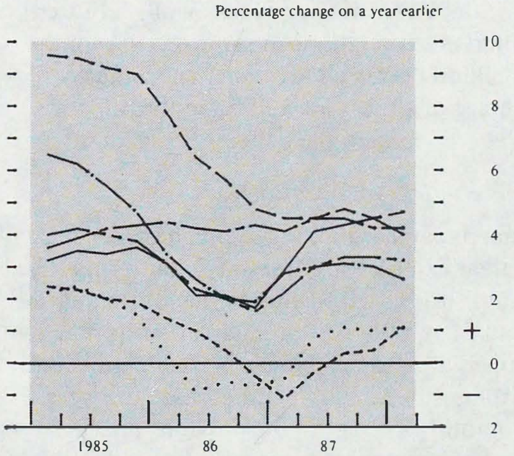
The performance of the Canadian economy has in many respects been similar to that of the United States, although growth has been rather quicker. A rise in inventories was partly responsible for the faster rise in GNP in the second half of the year, particularly in the final quarter. On the other hand, final sales in Canada have been rather more buoyant than in the United States, the result of continued strength in personal consumption and faster growth in business fixed investment. The rapid expansion in domestic demand at a time when export volume growth has been extremely muted has led to a significant rise in imports and a deterioration in the current account balance.

. . . *but* growth *was weaker in* Europe . . .

In the major European countries, growth slowed in the last quarter of the year, following a strong performance in the third quarter. It is unlikely that the wealth effect of the sharp decline in stock prices in October was directly responsible for the slowdown, given the limited extent of personal sector shareholdings. Indeed, consumption held up well, and it was investment that weakened. It seems more likely that the appreciation of European currencies in the last quarter of the year adversely affected business sentiment, which had already been dented by the crash. In Germany, GNP rose by ¾% in the fourth quarter, to stand 2¼% higher than a year earlier. Compared with the third quarter, there was a fall in business fixed investment and residential construction remained unchanged. Since the turn of the year, there have been some indications of continued growth. Industrial production and new orders rose in January and February, partly the result of favourable weather conditions, while unemployment fell. In addition, business sentiment appears to have improved, while personal consumption growth may have been supported by the tax cuts implemented at the start of the year. In France, growth in GNP slowed to 0.4% in the fourth quarter, down from about 1% in the third. There was a fall in residential investment and a slower rate of increase in personal consumption. Italian GDP rose by 0.2% in the final quarter of 1987, compared with 1% in the third. Personal consumption and fixed investment increased at moderate rates, but net exports detracted from growth.

Consumer price inflation[(a)] *remains moderate*

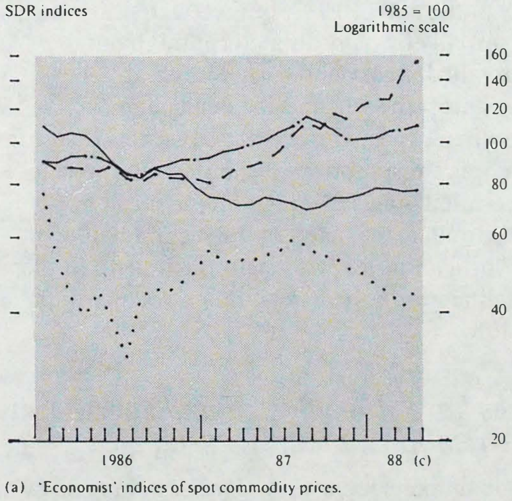
Italy
United States
France
Germany
Japan
Canada
Major six



(a) Consumers' expenditure deflator: 1988 Q1 partly estimated.

Commodity prices *have shown divergent trends*

Food(a)
Metals(a)
Agricultural non-foods(a)
Oil(b)



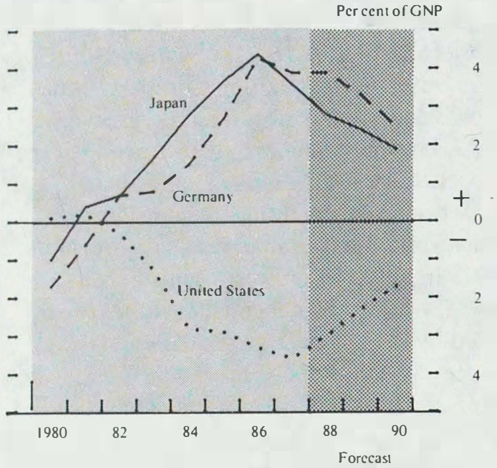
(a) 'Economist' indices of spot commodity prices.
(b) North Sea Brent price.
(c) April 1988 is average of first three weeks.

. . . *and was not accompanied by higher* inflation

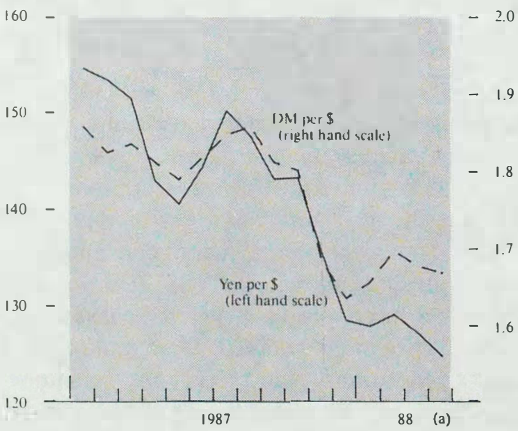
Despite the acceleration in output growth in the second half of last year, there was a decline in the annual rate of consumer price inflation, which was consolidated in the first quarter of 1988. Recent months have also seen some convergence in inflation rates across countries, even though significant differences persist. In Canada and the United States, the annual rate of consumer price inflation declined from some 4.5% in mid-1987 to around 4% in February and March respectively. However, the consumer price index in the United States rose by 0.5% in March, the largest increase for over a year. In Japan and Germany, consumer price inflation on a twelve-month basis rose through 1987, largely reflecting the progressively diminishing effect of the fall in oil and other commodity prices in 1986. However, in both countries the annual rate of inflation stabilised towards the end of the year, and in February was some 1% in Germany and ¾% in Japan.

The external influences on inflation have been mixed in recent months. Non-oil spot commodity prices rose by about 12½% in SDR terms between December and mid-April. This rise is attributable to exceptionally strong increases in metals prices; aluminium, copper and nickel prices have all been raised by supply disruptions as well as strong demand. With low levels of stocks, prices have been very volatile. By contrast, food prices rose by only 2% in SDR terms over this period. Oil prices weakened in the first quarter of 1988, with UK Brent averaging $15¾ per barrel, compared with $18 per barrel in the fourth quarter of 1987. The fall was largely caused by the effects of a significant stock overhang, a mild winter and, reportedly, an increase in non-OPEC production. However, there was a reduction in OPEC output in the first quarter, with most countries producing at, or near to, their quotas. At the end of April, OPEC ministers met to consider an offer from six non-OPEC producers to reduce exports by 5% in May and June, provided OPEC made similar commitments. However, no agreement was reached and prices, which had risen on news of the non-OPEC offer, fell back to around $16 per barrel after the meeting.

Current account imbalances *of the major industrial countries remain large, but may have peaked*

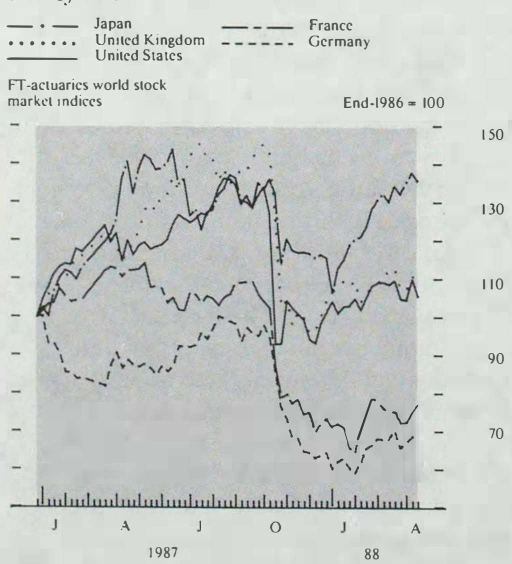


The **dollar** *fell again, following its recovery at the start of the year*



(a) April 1988 is average of first three weeks.

Share prices *in the major industrial countries have in general risen since the end of 1987*



External imbalances *have improved slightly but remain obstinately high, and the* **dollar** *has weakened further . . .*

In the fourth quarter of 1987, the process of real external adjustment—which had faltered in the previous three months—resumed. In volume terms, exports of goods and services by the United States rose by almost 4% in the fourth quarter, while import volumes increased by some 2½%. In the same period, Japanese exports fell, while import volumes rose by 2½%. In Germany, both exports and imports rose significantly in the fourth quarter, by 2½% and 4½% respectively. To a degree, these improvements have been evident in the nominal trade and current account positions of the major industrial countries. In particular, the US trade deficit (which is not seasonally adjusted) has been lower than market expectations in some recent months, averaging about $12½ billion between November and January, compared with an average of almost $16 billion in the previous three months. However, in February the deficit rose again, to nearly $14 billion.

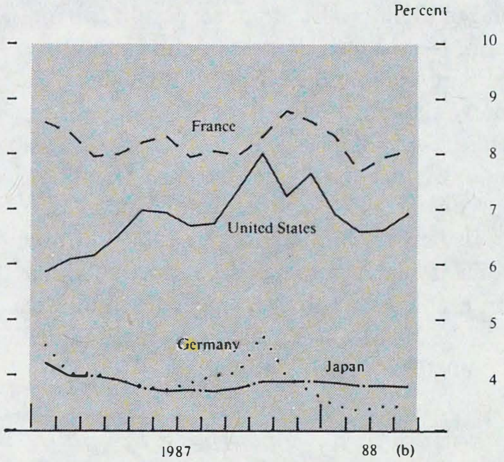
In neither Germany nor Japan has there been much evidence of a significant decline in their external surpluses in dollar terms. The German current account surplus fell slightly in the fourth quarter from the third, to about $10½ billion, but the Japanese current account surplus remained around $20 billion in each period, and the Japanese trade surpluses in January and February this year were higher than the monthly average in the previous quarter. However, the process of adjustment is more apparent if the current accounts of the surplus countries are measured relative to GNP. The Japanese surplus fell from about 4½% of GNP in 1986 to around 3½% last year, while the German surplus declined by about half a percentage point of GNP to just under 4%.

The dollar fell sharply at the end of 1987, but recovered subsequently, helped initially by co-ordinated central bank intervention. Between mid-January and early March, it appreciated modestly against the yen and the deutschemark, owing in part to better than expected trade data. It seems that, for a period at least, there was a resumption of spontaneous private capital flows into the United States from the major surplus countries. However, the dollar weakened in the second half of March, and again in April, amid renewed signs of strength in the US economy. This decline was, nonetheless, much smaller than in the last quarter of 1987.

. . . but **share prices** *have strengthened and* **short-term interest rates** *have remained broadly unchanged*

Prices in overseas stock markets have generally risen since the beginning of the year, although FT-Actuaries stock market indices in the major financial centres are still below their levels at the beginning of October, with the notable exception of Japan. The index there rose by almost 30% between end-December and mid-April. Having fallen sharply in the later months of 1987, short-term interest rates have also stabilised in most overseas economies, owing in part to diminished exchange rate pressures. There was a modest easing in Federal Reserve policy in late January, when short-term rates in the United States fell by ¼% to about 6¾%, though this was reversed around Easter. The Canadian authorities have maintained a high differential

Short-term interest rates[(a)] *have been relatively stable compared with late 1987*



(a) Three-month market rates.
(b) April 1988 is average of first three weeks.

between Canadian and US rates, as they have attempted to restrain incipient inflationary pressures. Japanese short-term rates have remained broadly unchanged in the past year at about 3¾%, while German rates were about 3½% through the first quarter of 1988 following their decline at the end of 1987. After a series of reductions between November and February, French short-term rates rose by about ½% to 8¼% in the middle of March, when the franc came under pressure within the exchange rate mechanism of the EMS. The earliest signs of financial tensions in 1987 had been evident in bond markets, and yields rose steadily in most countries ahead of the October crash. Since then, yields have generally fallen and price movements have become more subdued. However, bond yields in the United States rose by about ½% in March, but not back to their end-1987 level, as the perceived risks of higher inflation came to outweigh fears of a recession.

The **economic policy** *guidelines of the G7 communiqué are reaffirmed*

At a meeting in mid-April the Finance Ministers and central bank Governors of the countries in the Group of Seven reaffirmed their commitment to policies aimed at achieving a resolution of international imbalances in a co-operative way, so as to maintain order and stability in financial markets. They reiterated that either excessive fluctuations of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilising to the adjustment process, could be counter-productive by damaging growth prospects in the world economy.

Further policy measures consistent with those in the December G7 statement may be forthcoming. There is the prospect of a further easing in Japanese fiscal policy later this year, when direct tax cuts of ¥2.9 billion (0.8% of GNP) are expected to be implemented. These are part of a tax reform package which may entail the introduction of a sales tax in 1989. Following the reduction in the US federal deficit last year, further progress is unlikely until after the forthcoming Presidential and Congressional elections. The Administration, Senate and the House of Representatives have proposed similar budgets for fiscal year 1989 (beginning October 1988) with deficits of between $130 billion and $140 billion. These deficits are within $10 billion of the Gramm-Rudman target of $136 billion and, if realised, would avoid triggering the automatic sequestration process. However, the Congressional Budget Office has suggested that, without further measures, the eventual deficit for fiscal 1989 could exceed this trigger level.

In Europe, divergent budgetary trends are evident in France and Italy. In France, there has been a significant reduction in the central government deficit; this fell to Fr.Fc. 120 billion (2.3% of GDP) in 1987, compared with Fr.Fc. 141 billion in 1986. A further reduction, to Fr.Fc. 115 billion, is planned for 1988. By contrast, the Italian state budget deficit rose to Lit 114 trillion in 1987 (11.7% of GDP) up from Lit 110 trillion in 1986, and a further rise to Lit 122 trillion is currently expected in 1988.

Although interpretation of specific monetary aggregates has become more difficult, it is clear from a broad range of measures that monetary growth in the three largest industrial countries has

Growth in key monetary aggregates

Per cent

		1987 Target	1987 Outturn(a)	1988 Target
United States	M1	—	3.1	—
	M2	5.5–8.5	4.0	4–8
	M3	5.5–8.5	5.4	4–8
	Credit	8–11	9.6	7–11
Japan	M2+CDs	8–9(b)	11.8(c)	12(b)
Germany	CBM	3–6	8.0	—
	M3	—	6.0	3–6
France	M2	4–6	4.1	4–6
	M3	3–5	9.2	—
Italy	M2	6–9	8.3	6–9
Canada	M2	—	6.2	—

(a) Growth over target base or 12 months to December.
(b) Projection for Q1.
(c) Q4 on Q4.

accelerated recently. In the United States, the targeted aggregates, M2 and M3, both rose strongly in January and February and are now close to the top end of their 4%-8% target ranges. In Japan, the growth of broad money—M2 plus CDs—remains high, reflecting buoyant credit growth and the effects of financial deregulation. In Germany, the rate of growth of M3, now calculated as the annualised rate of change between the average stock of the current and previous month and the base period stock, increased in February to 8.4% (seasonally adjusted at an annual rate) from 7.2% in January but fell back to 7.6% in March. Growth in targeted monetary aggregates has been more subdued elsewhere in Europe. In France, M2 rose by almost 4% in the year to February, and in Italy the growth in M2 has moderated under the influence of direct controls on bank lending.

In the United Kingdom **activity** *continues to expand*

At home, GDP on the average measure grew a further ¾% in the final quarter of last year to stand 4¼% higher than a year earlier. Strongest growth was in the construction sector (up 9% on a year earlier), but manufacturing also remained vigorous. The service industries were more subdued than in earlier quarters and energy output was again little changed. In the early months of this year there have been some signs of weaker growth, which need, however, to be treated with caution. Some slowdown had been expected, and the balance of evidence does not suggest any more than that this expectation is being fulfilled. On the demand side, considered further below, consumers' expenditure slowed in the first quarter, but the main adverse news has been in the trade figures, which, however, appear distorted. On the supply side the main surprise has been the apparently sharp fall in manufacturing output estimated for February, of which only a small part could be attributed to problems in the motor industry. However, the CBI surveys of manufacturers give no sign of any such sharp contraction. Indeed, they showed strong order books and activity through the first quarter and into April. Nor is the recorded fall in manufacturing output consistent with the recent slower fall in manufacturing employment or with the prospective increase in such employment indicated by the CBI survey. Overall, although the economy may in some areas have been a little less buoyant recently than in the middle of last year, there seems no reason to abandon the view that activity remains strong.

. . . *while* **inflation** *remains stable* . . .

The inflation picture has not altered much recently. The twelve-month change in the retail price index rose a little in March, to 3.5%, but was still lower than at any time last year. Much of the variation in this measure has been attributable to the mortgage element. Although the twelve-month change in the index excluding mortgages also rose, to 3.8%, in March, it had been in the 3%–4% range for the previous two years. Other broad measures of the prices at which goods and services are sold in this country, such as the consumers' expenditure deflator, or the domestic demand deflator (given in the table on page 169) show similarly small variation in their rates of change.

The most comprehensive measure of *domestically-generated* inflation is the GDP deflator, which represents the price of domestic value added, and is thus determined by a combination

Costs and prices

Percentage changes over the same period a year earlier

	1986		1987	
	H1	H2	H1	H2
GDP deflator (at factor cost)	3.7	2.1	3.9	5.0
of which:				
Labour costs per unit of output	4.9	3.6	2.7	2.7
Profits and other income per unit of output	1.2	-1.0	5.9	9.6
Non-oil ICCs' profits per unit of output	20.2	16.4	14.6	18.0
Domestic demand deflator (at market prices)	4.8	4.5	4.2	4.0

of profits, the earnings of labour, and productivity. The table shows that, measured at factor cost, the GDP deflator has risen more rapidly through the past year and a half. This acceleration owes a considerable amount to the recovery in oil prices through the year. The non-oil GDP deflator has remained stable within a fairly broad band in 1987, averaging around 4%.

Labour cost increases were lower last year than in 1986, although they may now no longer be falling. Wages and salaries outstripped output by just 4%, though when, as in the table, other slower-growing elements of labour costs are included (such as employers' pension contributions and redundancy payments) total labour costs per unit of output are estimated to have grown by less than 3%. Such costs may grow a little faster this year, with earnings growth tending to rise, while productivity growth will not have been so favourable if output is indeed rising more slowly. On the other hand, profit margins, which continued to expand last year, may be less buoyant, as the further exchange rate appreciation earlier this year has appreciably sharpened competition. Import costs, which have been falling over the last year, would also be restrained by continued strength in the exchange rate. These elements of costs are considered further below.

. . . as **productivity** *and* **earnings** *are still both rising fast*

Productivity in manufacturing continues to grow strongly, with an average of 6.9% recorded for 1987 as a whole. The presently estimated increase of 6% per annum in the three months to February over a year earlier continues this strong trend, and although it is at a slightly slower pace than in the early part of last year, it is subject to all the uncertainty associated with the latest estimate of output. Productivity growth in the whole economy continued strongly at 3.1% in the year to the fourth quarter. Current productivity growth and changes in working practices are, therefore, still offsetting much of the current growth in earnings.

In the economy at large the 'underlying' growth of average earnings (ie adjusted for strikes, back pay, etc) had increased to 8½% in the year to last December, and remained at that rate in the first two months of this year. Some of the increase was due to overtime and bonuses rather than settlements. Underlying earnings in the service sector grew faster than in manufacturing in the year to February.

Overtime working has remained high. The fall in February was from an exceptional level, and does not in itself suggest any slackening in activity. Although the total number of hours overtime per week in manufacturing remains below the level reached in the late 1970s, there are now fewer operatives, and a higher proportion are working, on average, one hour more overtime per week than at the previous peak. Latest estimates suggest that in the year to the fourth quarter of 1987, overtime earnings added 1 percentage point to the growth in manufacturing earnings and ¾ of a percentage point in the economy as a whole. Excluding the effect of overtime, the increase in underlying earnings remained little changed in manufacturing during 1987, but in the economy as a whole rose from 7% in the first half of the year to 7½% in the fourth quarter.

The strong output figures, combined with data on wages and salaries, imply that wages and salaries per unit of output in manufacturing increased on average by only 1.1% in 1987 as a whole, but will have risen by 2% in the three months to February over a year earlier if the present output estimate is correct. Productivity growth in the whole economy helped keep the increase in such costs to 4.0% in 1987. This is more than 1% lower than the rate of increase seen in 1986.

The general rate of pay settlements in manufacturing appears to be levelling out at around 5½%, some ½%–1% higher than at the same time last year. Settlements in this sector were 5.8% in February. Elsewhere in the economy, settlements may now be averaging around 6½%, with some in the public sector rather higher. This could imply some upward pressure on labour costs in the coming twelve months.

Regional unemployment: March 1988

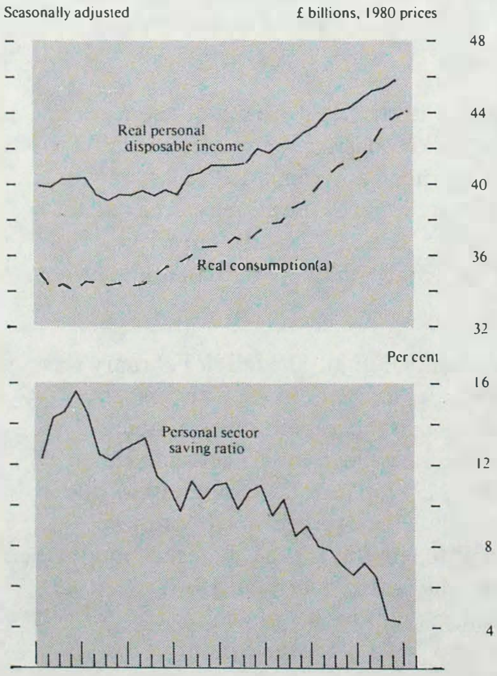
Seasonally adjusted

	Numbers unemployed (thousands, excluding school leavers)	Percentage change over twelve months	Unemployment rate, per cent of working population	Change in unemployment rate over twelve months (percentage points)
South East	557.1	-22.2	6.0	-1.7
Greater London(a)	*315.8*	*-16.3*	*7.4*	*-1.4*
East Anglia	57.0	-26.0	5.7	-2.0
South West	149.1	-20.7	7.2	-1.9
West Midlands	254.8	-19.4	9.8	-2.4
East Midlands	156.1	-17.6	8.1	-1.7
Yorkshire and Humberside	243.4	-17.1	10.4	-2.1
North West	347.8	-15.8	11.7	-2.2
North	187.0	-13.5	13.1	-2.0
Wales	135.9	-14.7	11.5	-2.0
Scotland	300.1	-12.6	12.3	-1.8
Northern Ireland	116.4	- 7.2	17.1	-1.3
United Kingdom	**2,504.8**	**-17.5**	**9.0**	**-1.9**

(a) Included in South East.

Claimant unemployment (adult, seasonally adjusted) continues to fall strongly and was 2.5 million in March, or 9.0% of the working population. The series has now fallen for twenty consecutive months, by over 700,000 in total since July 1986. The fall has been experienced across all regions (see table). In percentage points the fall over the last year has been greatest in the West Midlands and the North West. Although the rate at which unemployment is falling has slackened recently, no such slackening is apparent in the rate at which jobs are being created. Employment in the economy as a whole rose by an estimated 146,000 in the fourth quarter, while in manufacturing the downward trend in employment appears to have come to an end, with a small rise recorded in the three months to February.

The **personal saving ratio** *stabilised in the fourth quarter*



(a) Including expenditure on durables.

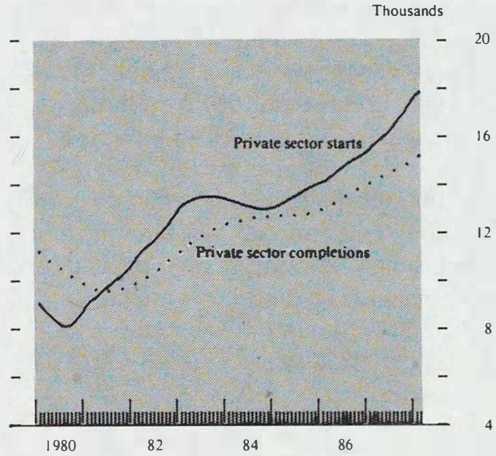
Personal **consumption** *and the* **housing market** *remain strong*

Strong employment and real earnings growth continue to underpin consumers' expenditure. It rose by 1% in real terms in the fourth quarter of 1987 and (on the preliminary estimate) by ½% in the first quarter of this year, to a level 6¼% higher than a year earlier. Quarter-by-quarter growth has been slower than in the middle of last year, when the personal saving ratio was falling rapidly. The ratio fell no further in the fourth quarter, and is unlikely to have done so since then, given what is known about personal income. Retail sales and consumer credit[1] have also grown more slowly in the latest months than during some periods last year, but these are volatile series and the underlying trend, at least in retail sales, still seems to be strongly upwards. The latest CBI Financial Times survey of the distributive trades does however suggest some moderation in the coming months.

Rising employment and real earnings have also made for continued strong growth in demand for housing. This has been reflected in house prices, building activity and mortgage lending. In March the Halifax mix-adjusted house price index was 18.2% above the same month of 1987, against 16.4% in January and 14.3% in mid-1987. Quarterly data show that not all regions have experienced the same rise in house prices; in Greater London increases have slowed for the fourth consecutive quarter and the annual rate of increase (22.7%) is below that recorded in East Anglia (39.3%), the South West (27.7%) or the South East (26%);

(1) Agreements with retailers, finance houses, specialist credit investors, building societies and lending on bank credit cards.

Housebuilding[a] *has been buoyant*



(a) Bank estimate of underlying trends.

much lower increases continue to be recorded in the North of England, Scotland and Wales. The increase in house prices is running considerably ahead of construction costs. In the year to the third quarter, the construction material costs of new housing increased by 6¾% while employees' earnings increased by 7¾%. However, land prices per plot in the first half of the year increased by 25% compared with a year earlier. Nevertheless, the rise in house prices appears to have encouraged extra building. Private sector completions in January were at the highest level since early 1973. However, even if this rate were maintained throughout the year, the stock of dwellings would rise by only about 1%, which would in itself have only a small effect in moderating house price increases. Furthermore, although private sector completions are likely to remain buoyant—reflecting the strong increase in private starts since early 1985—some of the current level of completions reflects companies bringing forward completion dates to take advantage of the unusually good weather.

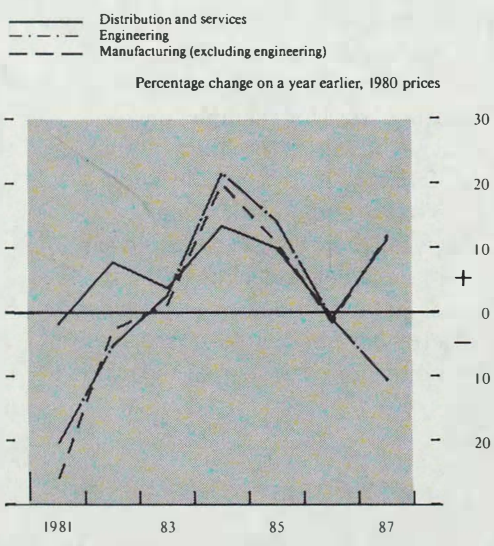
Lending by banks and building societies for house purchase totalled £25¼ billion last year, only slightly higher than in 1986. However, lending increased through the year, and was very high in the first quarter of 1988. Banks increased their share of the mortgage market significantly during 1987, at the expense of building societies. In the third quarter, for example, they provided nearly 40% of total net advances for house purchase, compared with an average of under 20% in 1986. Building societies lost market share to banks and other lending institutions. Net retail inflows into building societies increased sharply in the fourth quarter following the decline in the stock market, and were again strong in the first quarter of this year. As a consequence building societies have been able to take an increasing share of the expanding mortgage market so far this year.

Companies *continue to enjoy fast* **growth** *and high* **profits . . .**

Companies are at present going through a buoyant phase; in terms of profitability, productivity and growth, the last couple of years bear more resemblance to the late 1960s and early 1970s than to anything observed subsequently. Latest Bank estimates show that the pre-tax rate of return for non North Sea companies rose above 10½% in the second half of 1987. Manufacturers' profit margins and rates of return both appear to have fallen in the fourth quarter, but since the turn of the year margins have made a small recovery. Despite the strength of their situation, ICCs have so far remained cautious with regard to investment expenditure, which grew rapidly in 1984 and 1985 but has been subdued in the last couple of years. At the same time, the financial markets have substantially revised their valuation of the underlying assets of the corporate sector. The market value of ICCs' ordinary and preference shares rose from just over £180 billion at the end of 1984 to (probably) over £300 billion at the end of 1987. Companies responded to this revaluation by issuing substantial quantities of both fixed-interest debt and (especially before October) equity. These outturns, combined with their substantial financial surplus, and increasing use of short-term debt instruments such as commercial paper, resulted in their amassing liquid assets. ICCs' deposits with the monetary sector have risen from £38 billion at the end of 1985 to £56 billion at the end of March this year.

Strong company profits are contributing to rising corporation tax payments. Other influences tending to boost tax receipts include privatisations—which increase the corporation tax base—the fall in the proportion of tax-exhausted companies as a result of the sustained rise in profits and the effects of the 1984 corporation tax reforms, and the abolition of stock relief in 1984. Dividend payments on ordinary shares were 40% higher in 1987 than in 1986. Rising profitability is an important factor here too, as is the substantial increase in the number of shares in issue over the past couple of years, which reflects both privatisations and the issue of new equity capital by companies. The substantial growth in dividends paid on existing shares no doubt owes something to the level of takeover activity.

Fixed investment[a] *recovered last year, but not in engineering*



(a) Excluding leased assets.

. . .*and* **investment** *is becoming more buoyant*

In aggregate, investment expenditure rose modestly in 1987, despite the buoyant performance of the corporate sector and a higher degree of capacity utilisation. In January 1988 and again in April the percentage of firms working below capacity in the CBI industrial trends survey was the lowest ever reported. The pattern of investment was in fact uneven between industries. In the construction, distribution and financial industries investment rose 12% in 1987 (excluding assets leased to manufacturers), and was particuarly strong, especially in the financial industries, in the final quarter. In manufacturing, by contrast, investment rose in 1987 as a whole by less than 4% and fell in the final two quarters. It is clear that the weakness has been concentrated in the engineering industries, especially mechanical engineering, even though they have shared in the recent growth of output. Outside engineering, manufacturing investment was buoyant last year. Surveys by the CBI and DTI suggest that investment generally will rise more this year than last.

The strong growth in output together with only a small increase in stocks meant that the manufacturing stock/output ratio continued to decline throughout 1987. The low rate of stockbuilding in the 1980s seems to reflect the higher cost of stockholding associated with positive real interest rates and the abolition of stock relief. Improvements in efficiency which have enabled companies to meet demand quicker, and fewer interruptions to production through labour unrest, also appear to have reduced companies' need for stocks.

Companies' financial behaviour *has been affected by the stock market fall*

Since the fall in the equity markets in October there has been a significant reduction in the issue of ordinary shares by ICCs—not surprisingly, now that equity capital is more expensive. This, together with low gearing levels, might have led firms to switch to long-term debt financing. However, issues of preference shares and debentures have not exhibited much growth. It appears that companies had already raised enough capital before October and have not felt any need to raise more while market conditions are relatively unfavourable. However, eurobond issues by ICCs have been strong so far in 1988 and a trend away from equity towards long-term debt financing still seems likely. The October crash has also had an effect on corporate mergers, with a significant swing towards cash deals, as the slump in equity prices has made share swaps relatively more expensive.

The level of borrowing by ICCs from UK banks was high before the stock market crash, and has been even higher since. £4½ billion was borrowed in the fourth quarter and £8 billion in the first, with companies apparently preferring to incur short-term rather than long-term debt until developments on the markets became clearer. The high level of borrowing before the crash is harder to explain. Two factors may be important. Bank lending to property companies over the last two years has amounted to over £6 billion, or nearly double their outstanding stock of borrowing at the end of 1985. Second, more than 60% of non-property company borrowing has been to industries associated with high levels of merger activity.

Investment in overseas securities by ICCs fell slightly in the fourth quarter. ICCs deposited £9¼ billion with the banking sector, during the year and a further £1½ billion in the first quarter of 1988.

A large surplus has been earned on the **invisibles** *account . . .*

Following revisions published with the 1987 balance of payments figures for the fourth quarter, the surplus on the invisibles account is now shown to have been significantly larger in the last three years than was previously thought. The revisions reflect mainly correction of reporting errors in overseas earnings of insurance companies and improved estimates of earnings by the non-bank sector on deposits held with banks abroad. As a consequence of these revisions, the current account is now shown to have been in balance in 1986 and the deficit in 1987, at £1.7 billion, to have been £1 billion less than previously believed. Provisional estimates indicate an invisibles surplus in 1987 of around £2 billion per quarter. The surplus fell in the fourth quarter, largely owing to erratic items in the oil IPD account. There is no evidence yet that dividend flows (to or from the United Kingdom) have been affected by the stock market crash, as underlying profitability has been maintained.

The surplus on service earnings has remained stable since 1985, though at a higher level than previously estimated, with substantial growth in earnings from financial services being offset by deterioration in the balances on civil aviation and tourism. Despite a stronger exchange rate in 1987 than 1986, credits from civil aviation and tourism grew substantially, but debits grew more rapidly, especially for tourism, where the growth in UK disposable incomes probably gave a stimulus to UK travel abroad. Exports of financial services have continued to grow in 1987, but more slowly than in the previous two years, mainly reflecting longer-term financial developments in insurance, rather than reduced earnings from lower levels of activity in securities markets since the crash.

Earnings from interest, profits and dividends continued to grow during 1987, although not matching the rapid growth seen in 1986. The oil IPD account has improved markedly from a deficit of £1½ billion in 1985 to a surplus of £½ billion in 1987. This improvement has been due to lower debits, with North Sea profits having fallen with the oil price, and strong growth in credits in 1987. Net earnings from non-oil direct investment have also been buoyant, having doubled since 1985, whereas the surplus on portfolio earnings fell in 1987, with debits rising faster than credits, reflecting stronger growth in activity in this country than abroad. The surplus on banks' eurocurrency earnings also fell, as margins on inter-bank lending were squeezed.

. . . while the **non-oil trade balance** *has deteriorated, but to an uncertain extent*

Revised figures show that in the year to the fourth quarter of 1987, non-oil import volumes grew by just under 10% compared with 4% for non-oil exports, but after revisions to the seasonal factors, growth on each side of the account in the fourth quarter itself appears to have been almost identical, at just over 1%. Given the faster growth of the United Kingdom than our main competitors and the appreciation of sterling during much of 1987, such a difference in the growth of exports and imports over the year was not surprising, and the apparent attenuation of the rapid growth in imports was moderately encouraging.

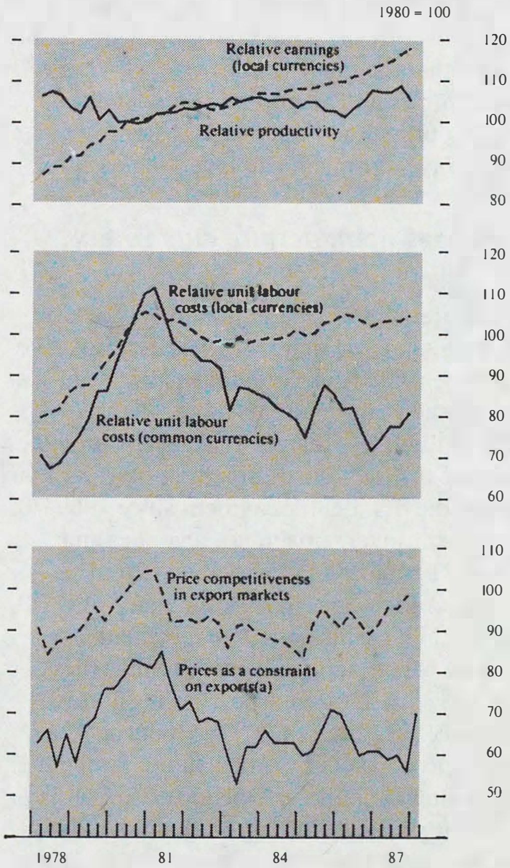
Even allowing for the well-known volatility of the monthly trade figures, those for exports in January and February appear exceptionally depressed, the size of the fall in January being particularly marked, as was the concentration of the recent weakness in exports to the European Community. Two possible explanations are the revised documentation procedures for trade and the industrial action at Dover, but it may be several months before the impact of these can be properly assessed. The recovery in exports in March suggests strongly that a large part of the earlier fall was indeed temporary, but it was not sufficient entirely to offset the adverse effects of the first two months. Given the scale of recent changes, any assessment of the underlying trend is necessarily extremely tentative. There may have been some genuine deterioration in export performance reflecting the growing impact from the loss of competitiveness last year, but it is certainly not apparent from the April CBI survey, which suggests little or no change over the past three months in export order books, or in the actual or expected growth of export volumes.

The recorded weakness in imports throughout the first quarter has provided some offset to the collapse in exports but it is difficult to reconcile this with the apparently continued strength of domestic demand; it should be recognised that the exceptional factors which are thought to have depressed recorded exports may also have had some impact on imports.

Cost competitiveness *has worsened . . .*

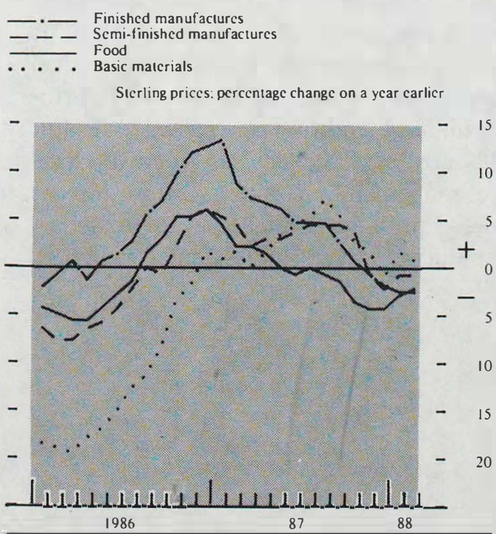
Provisional estimates indicate that the underlying competitiveness of UK manufacturing industry (as measured by relative unit labour costs *before* taking account of exchange rate changes) improved slightly in 1987, the first improvement over a year as a whole since 1983. While such a performance is in sharp contrast to the 5½% deterioration between 1983 and 1986, underlying earnings growth in the United Kingdom of over 8% per annum has meant that, even with the most rapid and sustained growth in UK manufacturing output and productivity for over a decade, only a very limited improvement in

UK competitiveness in manufacturing



(a) Percentage of firms in the CBI industrial trends survey reporting relative prices as a factor limiting export orders over the next four months.

Import prices *have generally fallen*



competitiveness was achieved. Indeed local currency relative unit labour costs worsened by 2½% in the year to the fourth quarter of 1987.

The worsening is sharper when movements in the exchange rate are taken into account. With the exception of the third quarter, sterling appreciated steadily during 1987 and was almost 10% higher in the fourth quarter than a year earlier; common currency relative unit labour costs rose by 12½% in this period and were 4% higher in the fourth quarter than in the year as a whole (see chart). Even if output and productivity continue to grow strongly, with underlying earnings growth now at 8½% per annum, some further gradual loss in local currency competitiveness seems likely, and this will have been reinforced by the further appreciation of the effective exchange rate so far this year.

. . . but **profit margins** *have increased further . . .*

Profit margins on exports as well as on domestic sales appear to have remained strong in 1987, after the sharp rise in 1986 following the oil price fall and sterling's depreciation. Measured price competitiveness in export markets deteriorated by 10% in the year to the fourth quarter of 1987 and for 1987 as a whole was 4% worse than in 1986. Despite this, manufacturers did not, during 1987, see relative prices as an increasing constraint on their ability to sell abroad. That they felt able to raise profit margins on exports at a time when the exchange rate was rising no doubt reflects improved non-price competitiveness (the quality of UK exports, delivery times etc). However, after the recent exchange rate appreciation, the April CBI survey suggests a sharp rise in the proportion of manufacturers whose exports are contrained by relative prices.

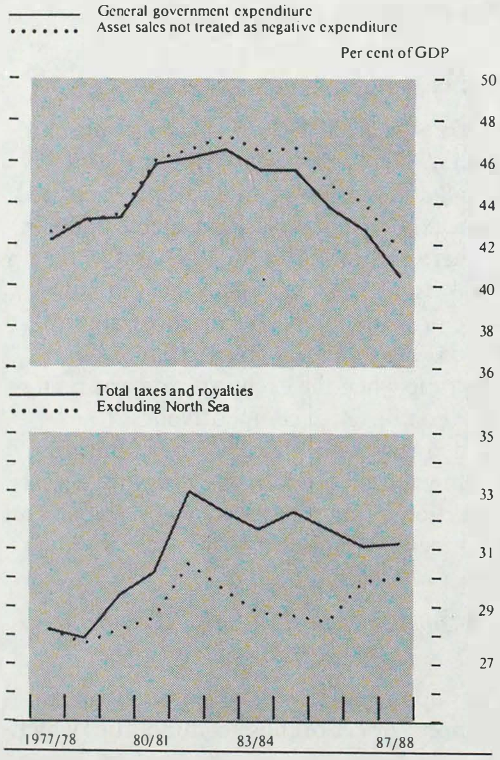
. . . and a strong **exchange rate** *has helped to hold down prices*

The initial impact of any appreciation will be felt most rapidly and most fully on the import prices of those commodities which are priced in world markets. Simulations on the Bank of England quarterly model of the UK economy suggest that, within six months, an appreciation in the effective exchange rate would have reduced the import prices of fuel and basic materials by an almost equivalent amount. The period since the beginning of 1987 has seen a marked increase in world commodity prices, after several years of virtually uninterrupted decline. The Economist all-items index rose 28% in SDR terms between the beginning of 1987 and mid-April this year. Such indices of spot market prices are more volatile than the average of prices charged in international trade, but these will also have risen markedly. In sterling terms, however, as the chart shows, UK import prices of raw materials have risen only modestly, and have fallen over some recent periods. This weakness has also been evident for some time in manufacturers' buying prices.

The Bank model suggests that the sterling price of manufactured imports will also reflect the bulk of any change in the exchange rate (with the remainder representing adjustments in the foreign currency price of exports to this country). As the chart shows, manufactured import prices have also fallen over the most recent twelve-month period. The price of domestically produced manufactures will also be influenced, to the extent of perhaps one third of any change in the exchange rate, through lower raw material costs, and through keener competition from manufactured imports. This suggests that the widening of UK profit margins through most of 1987 would have been greater but for the appreciation, and that the most recent rise in sterling will tend to hold down domestic as well as import prices, and thus exert some countervailing pressure to the rise in margins which might otherwise accompany continued high levels of demand.

The **public sector repays debt,** *despite cuts in* **tax rates**

Public expenditure *has fallen as a share of GDP*



Despite a borrowing requirement of £3.8 billion provisionally estimated for March, it is estimated that there was a cumulative public sector debt repayment of £3.6 billion for the financial year 1987/88. The outturn for the year represents a borrowing requirement around £7½ billion less than forecast at the time of the 1987 Budget. This was the third successive year of lower than expected borrowing, and the first debt repayment since 1969/70. These developments reflect movements in tax revenues and government expenditure. The charts show total taxes and royalties and general government expenditure as shares of GDP since 1977/78. In the first half of this period government revenues and expenditure rose roughly in parallel. Since then both have declined, but the fall in expenditure has been much greater than that of tax receipts. Asset sales have reduced government expenditure, as measured, and by an increasing amount, but, even excluding their effect, expenditure remains marginally lower as a share of GDP in 1987/88 than in 1977/78. During this period, revenue from North Sea taxes rose and then declined, reaching a peak in 1984/85. Excluding North Sea tax receipts, revenue remains higher as a share of GDP. Tax revenues have been particularly stable, despite reductions in tax rates and increases in allowances. Thus, while tax rates were cut in both the 1987 and 1988 Budgets, tax revenue as a share of GDP changed little in the last financial year, and is expected to remain stable in 1988/89. Income tax is expected to fall slightly in relation to GDP, with the double indexation of allowances, the cut in the basic rate and the abolition of rates above 40% more than offsetting the 'real fiscal drag' that would arise in an indexed system when earnings are rising faster than prices. However, other taxes are forecast to rise slightly as a proportion of GDP, almost entirely because corporation tax receipts are again likely to be very strong, while oil tax revenues are likely to fall further. The planning total of public expenditure is expected to decline as a proportion of GDP, but by less than last year. Interest payments are also expected to be smaller, and the public sector is forecast to continue in surplus, or—if privatisation receipts are treated as financing rather than reducing expenditure—a small deficit.

World economic prospects—latest Bank forecasts

The Bank's latest forecast of world economic prospects suggests that the rate of growth in the major industrial countries will slow this year, following a significant acceleration in the second half of 1987. At the same time, inflationary pressures seem likely to remain subdued. The process of current account adjustment is projected to continue, helped by the shifts in competitiveness of recent years and forecast developments in the pattern of domestic demand in the major economies. Following a period of adjustment and consolidation, the prospects for developing countries have improved, although the performance of the group as a whole is heavily influenced by the success of the newly-industrialising countries (NICs) of South-East Asia, which seem likely to make further gains in export market share.

Output in the major industrial countries is forecast to be about 2¾% higher in 1988, a fractionally slower growth rate than estimated for 1987 (see Table A). However, the year-on-year comparisons of rates of growth disguise the extent of the projected slowdown through 1988. In the year to the fourth quarter of 1987, output in the major overseas economies rose by about 3¾%. In contrast, it is projected to rise by only 1¾% in the year to the fourth quarter of 1988. In the short term, this weakening reflects to some extent the composition of demand in 1987, when there was a large rise in inventories, part of which may have been involuntary, leading to a likely correction in production in 1988. Consumption may also weaken, partly because of the fall in share prices, which is likely to raise saving ratios, especially in North America. The recent strong growth in private fixed investment is forecast to be more durable, although the impetus of the strong terms of trade gains in 1986, which appear to have stimulated investment in the past year, is expected to fade. No substantial acceleration in output is envisaged in 1989–90, when domestic demand and output are both projected to rise at rates of about 2% per annum. This subdued pace of growth reflects in part a general tightening in fiscal policies, associated variously with continued external adjustment and increasing concern over levels of public debt. The slowdown in domestic demand in the major economies is likely to reduce their demand for imports, and net external demand is projected to be neutral for them as a group over the forecast horizon, following significant negative contributions in 1986 and 1987.

Table A
Demand and output in the major overseas economies[(a)]
Percentage changes

	Estimate	Forecast		
	1987	1988	1989	1990
Domestic demand	**3.3**	**2.8**	**1.9**	**2.1**
of which:				
Private consumption	2.6	2.4	2.0	1.5
Private fixed investment	4.0	5.2	2.2	3.1
Public expenditure	2.4	2.8	1.9	2.1
Stockbuilding(b)	0.5	−0.3	−0.1	0.1
Net external demand(b)	−0.4	−0.1	0.1	—
GNP(c)	2.9	2.7	2.0	2.1

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

A small rise in the average rate of consumer price inflation in the major overseas economies is projected for the period 1988–90 (see Table B). The pronounced decline in oil and some other primary commodity prices in 1986 temporarily pushed inflation rates to very low levels, while also allowing some widening in profit margins. Subsequently, inflation rates have risen, as oil and commodity prices have recovered somewhat. In general, oil and non-oil primary commodity prices are expected to exert a restraining influence on prices through the forecast period, although no precipitate decline is expected. Import price inflation, expressed in local currency terms, in the major foreign economies in aggregate is envisaged as rising slightly in each of the forecast years. Some upward drift is also expected in the growth of trend unit labour costs, as tighter labour markets and higher import price inflation in some countries generate slightly faster growth in nominal earnings. Consumer prices would also be affected by any shifts towards indirect taxation that countries might implement to strengthen their fiscal positions. Some allowance has been made for this in the projections. Although such moves would raise the level of consumer prices, they may be less likely to lead to a sustained increase in inflation.

Table B
Prices in the major overseas economies

Percentage changes

	Estimate	Forecast		
	1987	1988	1989	1990
Import prices (a)	2.2	3.9	4.0	4.1
Unit labour costs in manufacturing	−0.9	0.4	2.2	2.2
Consumer prices (b)	3.0	3.2	3.7	4.4

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

At the present juncture, prospects for the United States appear particularly uncertain. No significant adjustments to policies are projected in the short run, reflecting in part the constraints imposed by the Presidential election. The rise in the saving ratio in the fourth quarter of 1987 may have brought private saving to a more normal underlying level. This was perhaps partly induced by the fall in equity prices and associated wealth losses—although there had been signs of a rise prior to the crash. With real disposable income growth remaining weak, private consumption is expected to be subdued, rising on average by only ¾% per annum in the period 1988–90. In contrast, the growth of business fixed investment may strengthen to about 5% in 1988, helped by improved external competitiveness. Some moderation in the rate of stockbuilding is projected in 1988, and this may exert a dampening effect on domestic output, although it is also likely to reduce the level of import volumes. Overall, domestic demand is expected to rise by about 1% in each of the years 1988–90. The growth of GNP may be about one percentage point higher, reflecting the substantial positive contribution to growth from net external demand. The volume of exports could rise by an average of about 10% per annum in the period 1988–90 and, in the light of the projected weakness of private consumption and stockbuilding, import volumes may fall during the forecast period.

The recent strength in the Japanese economy is projected to continue for much of 1988. A substantial increase in domestic demand has been fuelled by expansionary fiscal and monetary policies, and a further rise of 6½% is forecast for 1988. This reflects buoyancy in both consumption and investment, particularly in the construction sector. With import volumes rising strongly and export volumes rising only marginally, a significant negative contribution from external demand is likely, and GNP is forecast to rise by about 4½% in 1988. In 1989–90, some moderation in the pace of expansion may occur. Fiscal policy may become contractionary as the authorities shift their concerns to the control of public debt. Residential investment is also forecast to slow. Nevertheless, domestic demand may still rise briskly, at an average of about 4% per annum in 1989–90. Japanese producers are likely to suffer further losses in both domestic and export market shares and, consequently, GNP growth is expected to be slightly lower than in 1987–88, averaging about 3% per annum in 1989–90.

The economies of continental Europe have been far less successful than Japan in adjusting to the falling dollar, and this relative weakness is projected to continue. In Germany, the recent tax cuts should stimulate personal consumption, although domestic demand is forecast to rise by only 2¾% this year, slightly down from about 3% in 1987. Business investment is likely to remain sluggish, reflecting the persistence of high long-term interest rates and supply-side rigidities. With demand in European export markets remaining weak, export volumes are unlikely to rise significantly, and an expected negative contribution from net external demand of about three quarters of a percentage point reduces GNP growth to about 2% in 1988. No significant upturn in growth appears likely in 1989–90. On current plans, fiscal policy may be contractionary in 1989, but expansionary in 1990. Under these assumptions, domestic demand growth could slow to about 2¼% in 1989, before accelerating to about 3% in 1990. With external adjustment continuing, GNP is forecast to rise by less than domestic demand: growth of about 1½% is forecast for 1989 and 1¾% for 1990.

While France has succeeded in eliminating much of the inflation differential against Germany, this has been achieved by a very tight policy stance which seems likely to continue. Domestic demand is forecast to rise by about 2½% in 1988, and about 2% per annum in 1989–90. However, the depressing impact on growth associated with the external sector is expected to become less pronounced, reflecting in part improved cost competitiveness. Overall, GDP growth is forecast to be in the range 1½%–2% in each of the years 1988–90. A mildly contractionary fiscal policy may exert a dampening influence on activity in Italy in 1988–89. The problem of financing the very large budget deficit, particularly as liberalisation of exchange controls will reduce the degree of captivity of domestic savings, may crowd out the interest-sensitive components of domestic demand. Consequently, both domestic demand and GDP are expected to rise by an average of 2½% per annum in 1988–90.

World trade, as measured by import volumes, is projected to rise by about 4% in 1988, much the same increase as in 1987 (see the chart and Table C). The growth in industrial countries' import volumes is expected to fall slightly, largely accounted for by the United States. This modest decline may be broadly offset by a rise in non-OECD imports. OPEC economies are likely to continue to compress import volumes, reflecting the low level of economic activity in those countries, the fact that much of the costly infrastructure is now in place in many Gulf states, and the desire to protect reserves. However, the import volumes of non-OPEC developing countries may rise significantly through the forecast period. This growth is envisaged as being heavily concentrated in the

World import volumes

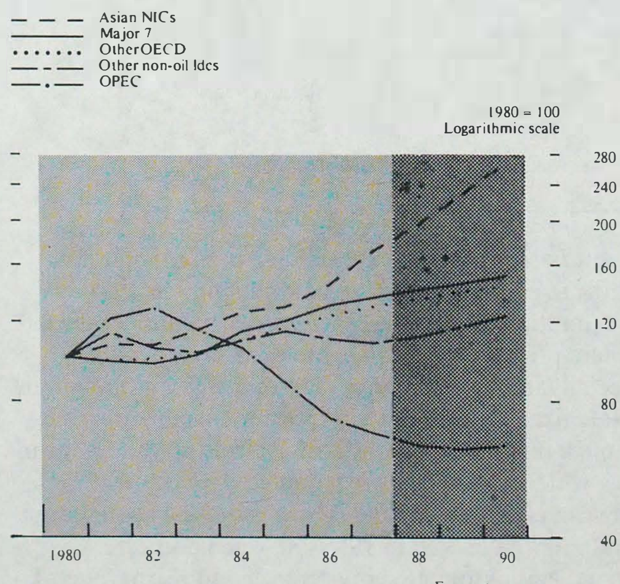


Table C
World trade and UK markets

Percentage changes

	Estimate	Forecast		
	1987	1988	1989	1990
World import volumes	**3.9**	**4.0**	**3.9**	**4.8**
of which:				
Major 7	4.1	3.9	3.3	4.0
Smaller OECD	4.7	4.4	3.2	3.5
Non-OPEC developing countries	6.0	8.5	9.8	10.7
OPEC	-7.2	-6.4	-2.2	1.9
UK markets(a)	**3.8**	**3.8**	**4.0**	**4.8**

(a) Import volumes weighted according to each countries' importance to UK exports.

newly-industrialising countries of South-East Asia, which seem set to increase both import and export volumes sharply. Heavily indebted middle-income countries are likely to remain constrained by limited net capital inflows, although the implementation of more effective domestic policies and more stable terms of trade may allow these countries to expand import volumes at a significantly faster rate in the period 1988-90 than in 1986-87.

The gradual unwinding of current account imbalances is expected to continue in the three largest industrial countries through the forecast period (see the chart on page 166). Large imbalances are expected to decline only slowly in dollar terms, but more rapidly as a share of GNP: for example, the US current account deficit is forecast to fall from 3.6% of GNP in 1987 to 1.7% of GNP in 1990, and the Japanese current account surplus is forecast to fall from 3.8% of GNP in 1987 to 2.0% of GNP in 1990. The German surplus is expected to fall less rapidly, since the growth in domestic demand may be more subdued. The combined surplus of the Asian NICs, which rose to about $35 billion in 1987 may rise further in 1988, before declining to about $30 billion in 1990 under the influence of strong import volume growth.