Economic commentary

- *The major overseas economies continued to grow strongly in the first quarter although there are tentative signs of a slowing in some countries more recently. Inflation rates remain generally subdued but domestic pressures may be a little stronger in the United States and, to a lesser extent, Japan as a result of the strength of activity. The rise in non-oil commodity prices, however, will have potential inflationary implications for all industrial countries. Several countries have tightened their monetary stance in response to higher inflation expectations.*

- *External imbalances in the three largest economies have tended to decline since the start of the year in dollar terms and relative to GNP. The higher interest differential between the United States and the rest of the world, as well as the fall in the US trade deficit, has contributed to the strength of the dollar since June.*

- *Growth in the United Kingdom slowed a little in the first quarter. Recorded output has behaved erratically in recent months, making it difficult to discern the trend. There is little firm evidence, however, that demand has slowed significantly and it continues to outpace domestic production, it being too early yet for the recent tightening of monetary policy to have a major effect.*

- *The prospects for inflation in the United Kingdom have worsened. Higher commodity prices have begun to feed through into input prices (though not yet into retail prices) while pressures in the labour market continue to be reflected in earnings and labour costs. House prices, meanwhile, continue to accelerate, with the rate of increase in several regions now outpacing that in London.*

- *The faster growth of demand than output, together with the loss of competitiveness last year and this, has been reflected in the very rapid deterioration in the current account deficit in the first half of the year.*

GNP/GDP growth in the major overseas economies

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

	1986	1987					1988
		Year	Q1	Q2	Q3	Q4	Q1
United States	2.8	3.4	4.6	5.0	4.5	6.1	3.4
Japan	2.4	4.2	6.1	—	8.4	7.5	11.3
Germany	2.5	1.7	-2.0	2.8	5.7	2.9	5.7
France	2.2	2.3	0.2	4.5	3.6	3.2	4.5
Italy	2.7	3.1	1.8	4.8	3.9	0.8	3.0(a)
Canada	3.3	3.9	6.3	5.1	7.2	6.5	3.4
Total	**2.6**	**3.2**	**3.4**	**3.7**	**5.4**	**5.3**	**5.3**

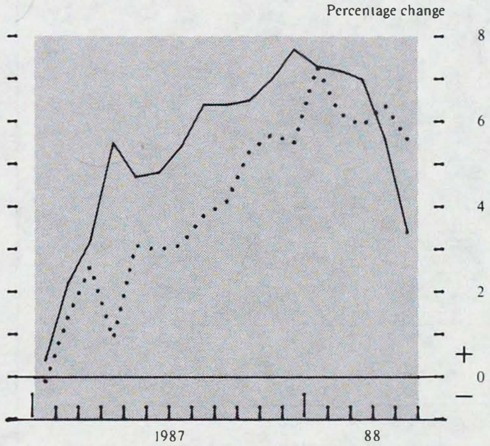
(a) Bank estimate.

Growth in the six major overseas economies remained buoyant in the first three months of 1988, despite earlier expectations that the stock market setback in October 1987 would lead to a slowdown. Output is provisionally estimated to have risen by 1.3%, the same rate as in the fourth quarter of 1987. Following a period of weakness in 1986 and the early part of 1987, output rose by some 5% over the year to the first quarter of 1988, partly as a result of continued strength in fixed investment. The reasons for this upturn in output growth were discussed in the May *Bulletin*. It may reflect in part a lagged response to the favourable terms of trade developments of 1986, as well as a reduction in saving ratios as a result of continued low inflation. Policy co-ordination following the Louvre accord has made a further contribution by providing a more stable planning environment; and an easing of monetary and fiscal policies in some countries will have stimulated activity. More recently, however, monthly data on industrial production indicate that growth may have eased in the second quarter in Japan and continental Europe, but the extent of any general slowdown is uncertain.

Although there are signs of a slightly faster rise in prices and wages in some countries, inflation rates have generally remained low. Nonetheless, the rapid increase in output may have increased incipient inflationary pressures associated with tight

Industrial production *suggests that* **growth in the major six** *may have slowed*

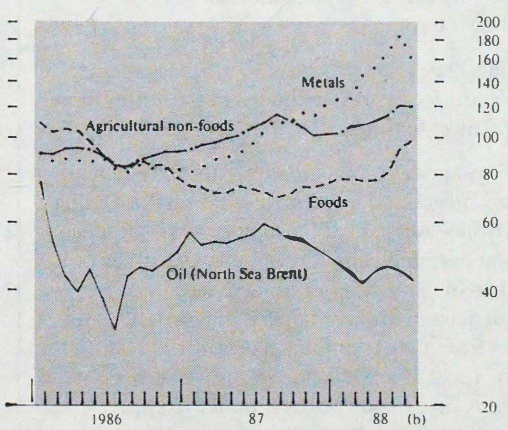
.... Change on a year earlier
——— Change in latest 3 months on previous 3 months(a)



(a) Seasonally adjusted annual rates.

Non-oil commodity prices[(a)] *have risen sharply in the first half of the year*

SDR indices
1985 = 100
Logarithmic scale



(a) Economist indices of spot commodity prices.
(b) July gives average of first two weeks.

labour markets and high levels of industrial capacity utilisation in some areas, notably the United States and, to a lesser extent, Japan. By contrast, such domestic pressures are less strong in the large continental European countries, with the possible exception of Italy. However, a more widespread source of inflationary pressure will have been the rise in non-oil commodity prices. Following its trough in January 1987, the Economist index of spot prices had risen by around 50% in SDR terms by mid-July, with about half of the rise occurring this year. Metals prices, which have almost doubled over the same period, have risen most strongly, although there has also been a substantial rise in the price of agricultural non-foods. In part, this reflects strong economic growth in the OECD area, as well as higher demand from some less developed countries, notably the Asian newly-industrialising economies. A low level of metal stocks has reduced the buffer to stronger demand, while producers have been slow to reopen capacity which was closed when prices were much lower, and to invest in new capacity. There has also been a series of disruptions to supply. However, between early June and mid-July metals prices fell back significantly, with rising market stocks suggesting that the supply situation may be easing. Food prices, which comprise about half the Economist index, had until recently been relatively subdued. However, they rose by over 20% between May and mid-July, mainly as a result of drought in parts of North America. The rise in non-oil commodity prices is discussed in more detail on page 308.

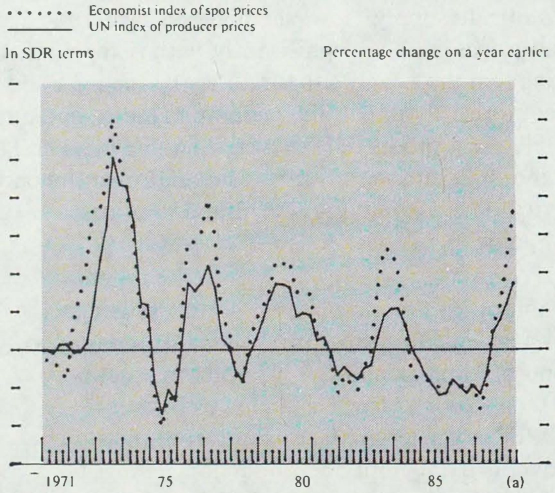
In contrast to non-oil commodity prices, oil prices drifted downwards for a period after end-April, when OPEC failed to agree on a proposal from six non-OPEC producers that both groups reduce their exports. This was followed by an inconclusive OPEC Ministerial Meeting in early June which simply rolled over existing notional production ceilings for a further six months. Production by most OPEC members, which was at or close to quota in the first three months of the year, rose significantly in the second quarter and the price-discounting that was already widespread was further extended. Prices have recovered more recently on prospects of a meeting of the OPEC price monitoring committee in August and a ceasefire in the Gulf. UK Brent, which stood at around \$16 per barrel in early May, was trading at or just below \$15 in mid-July, after slipping below that level for some time.

Inflation expectations appear to have increased in the second quarter, judging by the general rise in bond yields in the major overseas economies. The increase in yields was most pronounced in Japan and the United States, and less marked in the European economies. There have also been moves towards more restrictive monetary policies. In the United States the Federal Reserve has raised short-term rates gradually in recent months, by a total of more than 1%, and this tightening helped to steady the bond market, by confirming the authorities' anti-inflationary commitment. In Germany the Bundesbank increased the repurchase rate by a total of ¾% in a series of three steps in June and July and raised the discount rate and the Lombard rate by ½%. Japanese short-term controlled interest rates have edged up over the period, and there has been an increase of nearly ½% in some market interest rates. In France, short-term official interest rates were cut by ¼% in May, but with an increase in reserve requirements the stance of policy remained broadly unchanged.

Non-oil commodity prices: a comparison between 1986-88 and previous upswings

Although non-oil commodity prices have risen strongly over the past year, Chart 1[1] suggests that, to date, increases (particularly in producer prices) remain significantly less than those seen in 1972–74. Furthermore, oil prices, which were an important contributory factor to high rates of inflation during the 1970s, have remained depressed; they now stand just 8%[2] above the level of the second quarter of 1986. Nevertheless, it is estimated that, by the second quarter of this year, producer prices for non-oil industrial raw materials had risen to a greater extent than in 1983–84 and by almost as much as in 1976–77 and 1979–80, also periods of significant non-oil commodity price increases. More recently, food prices have also risen, although the increase in food producer prices is estimated to be still much less than those of previous cycles.[3]

Chart 1
Non-oil commodities: spot and producer prices

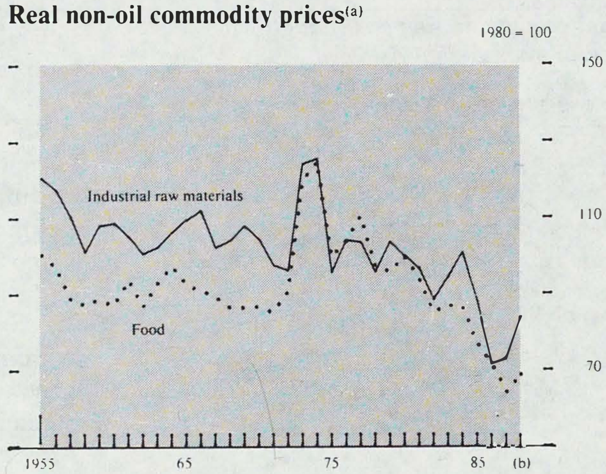


(a) Bank estimates of UN index for 1988 Q1 and 1988 Q2.

Although *metal* markets have been affected by short-term supply disruptions, stronger than expected OECD industrial production and growing demand from newly-industrialising economies have probably been the dominant factor in raising prices. The level of world metal stocks, which was particularly low in relation to demand at the end of last year, has added to the impact of this upturn. While improved monitoring and control and high real interest rates may mean that the desired level of stocks is now lower than in the 1970s, the low level of stocks also reflected the weakness of real prices in the mid-1980s, which led to a closure of much production capacity (see Chart 2). Therefore, unlike earlier periods there has been more scope for re-expanding production. Overall output has risen and between early June and mid-July spot prices fell 20%.

Growth in industrial demand may be slowing from the very rapid rates of the recent past (see pages 309–11). Real prices may not, however, fall back to previous lows since their level in 1986 may have been artificially depressed. This reflected the high rates of investment in production in the early 1980s and the subsequent start-up of new capacity at a time of unexpectedly weak demand.

Chart 2
Real non-oil commodity prices[a]



(a) Producer price indices deflated using UN index of world manufactured export prices.
(b) Bank estimate for 1988 H1.

Agricultural raw material prices have also risen, but to a significantly lesser extent. Industrial demand has caused timber, rubber, cotton and wool prices to stengthen, although forecasts for higher production this year have led, more recently, to a fall in cotton prices. Vegetable oil markets have been subject to numerous weather-related supply disturbances. Nevertheless, as with metals, some part of the real price increase may be sustained into the longer term.

Users of raw materials may, therefore, have to adapt to a higher level of prices than in the recent past, although in the longer term some substitution of lower for higher cost inputs is possible.

Recent increases in *food* prices have been concentrated in a few sectors: coffee, sugar and grains. Coffee prices rose on the signing of an International Coffee Agreement in October 1987 (although continued substantial oversupply has prevented any further price rises); spot prices of temperate grains have recently responded sharply to news of drought in parts of North America (stocks having fallen from the exceptional levels of 1984–86); and weather-related crop damage has caused sugar and rice prices to rise. Increases in real food prices caused by supply disruptions are unlikely to be sustained. Rising world food prices have, in many cases, still not affected consumers in most OECD countries since price support to producers had led to prices to consumers standing substantially above the world market levels before the recent upturn. It is estimated that world wheat and sugar spot prices would have to rise by 83% and 181% respectively from end-1987 levels before they exceeded June 1988 CAP intervention prices. By the end of June they had risen 34% and 44%.

Whether higher raw material costs feed through into consumer prices depends on the ability and willingness of firms to absorb higher input costs by reducing profit margins. The rise in the share of profits in GNP in the G7 (which may in part reflect the earlier weakness of commodity prices), coupled with the continuing low oil price, may mean that some of the increase in raw material costs will be absorbed. The counter-inflationary stance of present policies throughout the G7 will also limit the extent to which raw material prices can be passed on.

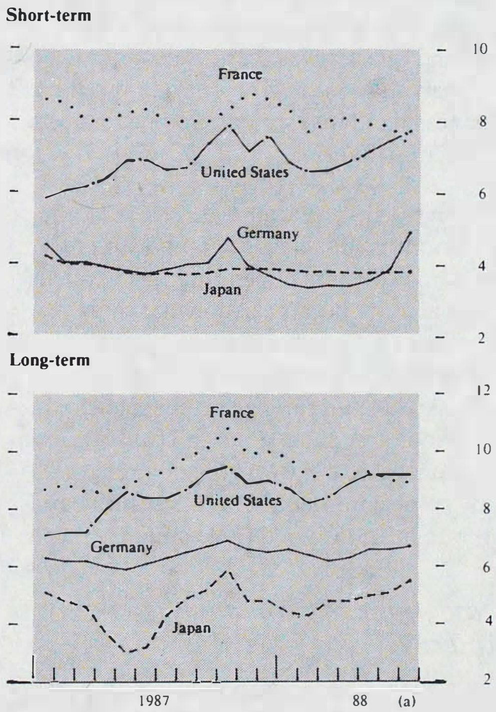
(1) Chart 1 compares movements in The Economist index (exclusively spot prices) and the UN index (largely producer prices) of non-oil commodities. Only a small percentage of any commodity is traded on spot markets and spot prices tend to be more volatile than producer prices, which reflect longer-term contractual arrangements and are less affected by speculation.

(2) All price changes are in SDR terms.

(3) See the chart on page 307 showing recent movements in spot prices of sub-groups.

Interest rates *have moved generally higher*

Per cent per annum



(a) Average of first three weeks.

Components of GNP/GDP growth in the major overseas economies

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

	1986	1987				
		Year	Q1	Q2	Q3	Q4
Private consumption	4.0	3.1	2.7	4.4	4.3	0.4
Private fixed investment	2.6	4.9	-1.4	11.9	11.9	8.3
Public expenditure	3.0	3.2	-3.7	1.5	4.7	5.0
Stockbuilding(a)	0.2	0.3	2.9	-0.6	-1.0	3.7
Domestic demand	**3.7**	**3.8**	**3.5**	**4.5**	**4.7**	**6.5**
Net trade(a)	-1.0	-0.6	-0.1	-0.7	0.6	-1.3
GNP/GDP	**2.6**	**3.2**	**3.4**	**3.7**	**5.4**	**5.3**

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

The money-market intervention rate was cut by a further ¼% in early July. However, several smaller countries in continental Europe have followed the change in the stance of German monetary policy and raised short-term interest rates. Growth in broad money has remained strong in both Japan, where M2 + CDs increased by 11.1% in the year to June, and Germany, where M3 remains above the top end of its target range of 3%–6%. In the United States, both M2 and M3 are rising at rates towards the top end of the target ranges of 4%–8%. Stock markets in the major foreign economies are generally at higher levels than three months ago.

Growth in **Japan** *was exceptionally strong in the first quarter but* **inflation** *remains subdued*

The marked strengthening in the rate of activity in Japan has continued. Having risen by 1.8% in the final three months of 1987, GNP increased by 2.7% in the first quarter (the largest quarterly rise in ten years) to a level some 6¾% higher than a year earlier. Personal consumption accelerated following its weakness at the end of 1987 and there were substantial increases in both public and private fixed investment. However, inventories fell, mainly in the retail sector, and the impetus from residential investment diminished. The external sector detracted only marginally from growth, despite the yen's appreciation and the increase in domestic demand. Imports of goods and services rose by 4½% but exports were also buoyant, rising by 3½%. More recent data indicate that some slowing in growth may have occurred in the second quarter. Industrial production fell in April and May, and there has also been a sharp decline in housing starts, albeit from a very high level. Nevertheless, the underlying position of the economy remains buoyant and industrial production rose strongly in June.

The rapid rate of growth in Japan has tightened labour market conditions. Both overtime working and the ratio of job offers to applicants are at exceptionally high levels. Earnings have accelerated in response, with industrial wage rates increasing by 3.5% in the year to April, a higher figure than in earlier months this year. The upturn in manufacturing earnings has been more pronounced. The increase, however, may to some extent reflect higher overtime, and the impact on unit labour costs has been more than offset by higher productivity. The spring wage negotiations produced increases in leading companies around 1% above last year's settlements. Final prices continue to rise slowly: consumer prices increased by 0.2% in the year to May while wholesale prices fell over the same period by 0.5%.

Strong export volumes have helped to sustain growth in the **United States . . .**

GNP in the United States rose by 0.8% in the first quarter, a slower rate than in the second half of 1987. Personal consumption recovered following its decline at the end of last year, and there was a very strong increase in fixed investment. However, a smaller contribution from stockbuilding detracted from the increase in domestic demand. The external sector made a very strong contribution to the rise in GNP. Imports rose by the smallest amount for a year in volume terms, and exports rose by 6%. Output growth continued to be quite buoyant in the second quarter. Industrial production rose somewhat more rapidly in the three months to June than earlier in the year, suggesting that the stock overhang which was evident at the start of the year has been worked off. In addition, capacity utilisation rose by three quarters of a percentage point between March and June, having moved little since December. The preliminary estimate for the increase in GNP in the second quarter was 0.8%. Personal consumption rose less strongly than in the first quarter, but there was a further surge in business fixed investment, and net exports also made a strong positive contribution.

Growth in Canadian GNP in the first quarter was 0.8%, half the rate of the preceding three months. Business fixed investment rose particularly strongly, while consumer spending was weaker. There were indications that activity became somewhat more buoyant towards the end of the first quarter, with industrial production rising by 0.8% in March, having been stable in January and falling in February. Retail sales growth also picked up in March following a period of weakness, but fell back again in April. In addition, housing starts have shown greater strength than had been expected by some commentators so far this year, while the unemployment rate has continued to decline.

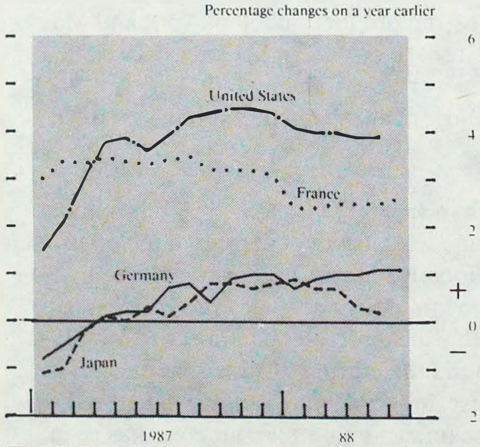
. . . and there are indications of a modest rise in **inflation** *in North America*

There is some evidence of a slight acceleration in prices in the United States. The average monthly rise in the consumer price index between March and June was somewhat higher than in the preceding four months, although the twelve-month increase declined. Producer prices have also risen slightly more rapidly. In the labour market there are tentative indications that wages growth may be reacting to the decline in unemployment in recent months to its lowest level for fourteen years. The twelve-month increase in whole-economy hourly earnings rose to almost $3\frac{1}{2}$% in May and June, about one percentage point higher than the average rates recorded in 1987. Import prices have continued to increase less rapidly than the rate of dollar depreciation. They rose by around 7% in the year to April, about one percentage point less than the twelve-month increases reported in the second half of last year.

So far this year, the twelve-month increase in consumer prices in Canada has been around 4%. Producer prices are also rising by just over 4%, compared with a little under 5% at the start of the year. However, inflationary pressures are more evident in the labour market. Hourly earnings growth has accelerated this year, and some wage settlements have also risen.

Consumer price inflation *remains low in most major overseas countries*

Percentage changes on a year earlier



In Europe, where **inflation** *remains low,* **growth** *seems to have slowed in the second quarter*

In Germany, GNP rose by 1.4% in the first quarter following an increase of 0.7% in the previous three months. The latest increase can be partly attributed to a rise in personal consumption, perhaps reflecting the tax cuts implemented at the start of the year, but half the rise was accounted for by a surge in construction expenditure. Some of the rise in construction spending, however, seems to reflect the effect of the unusually mild winter rather than more fundamental influences, and the growth rate in the whole economy is widely expected to be slower in the second quarter. Industrial production fell by about 1½% between February and May, while the volume of new orders rose only a little following a rise of 4½% between December and February. Domestic orders—which had accounted for most of the upturn—remained broadly unchanged in the later period, although export orders have continued to rise. Retail sales declined in April from March. Inflation in Germany has remained low. Consumer prices rose by a provisional 1% in the year to July, a similar annual inflation rate to that recorded in the six previous months. Unit labour costs have remained unchanged since the start of last year. The authorities' concern over inflation, which led to the rise in interest rates, relates more to the continued strong growth in M3, the rise in commodity prices and the depreciation of the deutschemark against the dollar.

Growth increased in France in the first quarter. Preliminary figures show GDP to have risen by 1.1%, with a particularly strong contribution from corporate fixed investment. Since then some slowdown appears to have occurred, with the level of industrial production in May still around December's level. Inflationary pressures are still muted, with wage behaviour restrained.

The growth of industrial production in Italy increased in the first quarter to 2.7%. Business sentiment also appeared to pick up. There is some evidence of inflationary pressures, notably in the labour market, where there was recently a large public sector pay settlement. Earnings growth in Italy is already higher than in most of the G7, with industrial earnings rising by 5.9% in the year to April. Nevertheless, in May the consumer price index was 4.9% above its level a year earlier, a slightly lower annual inflation rate than recorded in the previous half year.

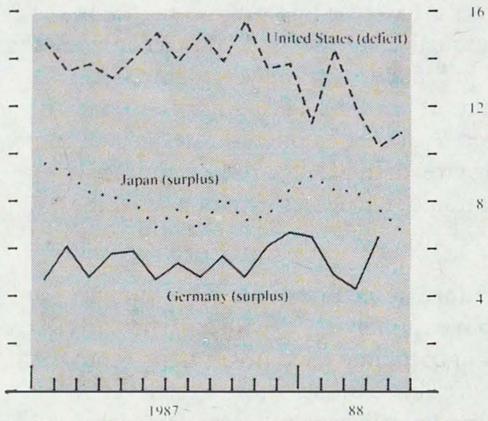
The dollar *has appreciated against other major currencies and* **current account imbalances** *between major economies are declining*

Following a period of stability earlier in the second quarter, the dollar strengthened substantially during June and early July. This partly reflected the tightening in monetary policy in the United States, which led to a widening of interest differentials with the rest of the world, and also the unexpectedly rapid improvement in the US trade deficit. Between its trough at the start of the year and the middle of July, the dollar rose by around 10% against the yen in nominal terms, and by almost 20% against the deutschemark. Since November, when co-ordinated moves between central banks alleviated the tensions which had built up in the system, the European exchange rate mechanism has been relatively stable. The uncertainty surrounding the French elections failed to have a major impact: although the French franc weakened within the system, after the elections it moved back towards the middle of the narrow band, despite a narrowing of the interest differential with Germany.

The pattern of demand in the three largest economies in the first quarter will have made some contribution to a reduction in the external imbalances between them. Domestic demand growth declined in the first quarter in the United States, where the external sector made a positive contribution to growth, while the reverse was true of Japan although the contractionary impact of

Some progress has been made in reducing **nominal trade imbalances**

Seasonally adjusted — Surplus/deficit, $ billions per month



net exports in Japan was very small. This general pattern of demand was, however, reflected to only a limited extent in a reduction in the scale of current account balances expressed in dollars. The US trade deficit in the first three months of the year fell to $36 billion from $41 billion in the fourth quarter, but this improvement was offset by a deterioration in the invisibles account owing mainly to a fall in investment income. Although the invisibles component is rather erratic on a quarterly basis, this led to a deterioration of $6 billion in the current account deficit from the fourth quarter, to almost $40 billion. This was equivalent to 3.4% of GNP, the same figure as a year earlier. The Japanese current account surplus rose in the first quarter by more than $2 billion to over $23 billion, mainly as a result of an increase in the trade surplus. Nevertheless, over the past year the surplus has fallen very significantly in relation to GNP—to 3.3% in the first quarter of 1988 from 4.6% a year earlier. Adjustment appears to have been more rapid in Germany so far this year, with the current account surplus falling to $9 billion in the first quarter, almost $1½ billion less than in the final quarter of 1987. As a percentage of GNP it has fallen from 4.4% in the first quarter of 1987 to 2.9% in the first quarter of 1988.

Monthly trade data covering the three major economies suggest that the quarterly figures may conceal a faster underlying rate of decline in the external imbalances, although month-to-month movements are erratic. In the United States, the trade deficit averaged just under $11 billion in the three months to May against an average of $13.2 billion in the three months to February. In addition, a downward trend has been apparent in the Japanese current account surplus since the start of the year; it fell from $8 billion in January to $7.3 billion in March and $6.0 billion in May. The German trade surplus fell in March to $4.3 billion, down from $6.6 billion in January and a monthly average of almost $6 billion in the fourth quarter, although, reversing this trend, the surplus rose sharply to $6.5 billion in April.

The larger continental European countries have announced **fiscal measures**

The German government announced in the draft budget for 1989 its aim to cut the Federal deficit to DM 32 billion from an estimated DM 39 billion this year. The main tightening measure is an increase in expenditure taxes. The deficit is expected to rise again in 1990 as the projected income tax cuts take effect, although only to DM 36 billion. The Italian government has adopted measures including tax increases and spending cuts which aim to reduce the 1988 state budget deficit by Lit 7 trillion to a projected Lit 115 trillion. The government has also adopted a five-year fiscal plan aimed at bringing the state sector deficit (excluding interest payments) into a slight surplus by 1992. The plan implies a discretionary tightening in fiscal policy equivalent to approximately ¾% of annual GDP each year over a five year period. The reductions would be achieved through a combination of indirect tax increases, cuts in welfare payments, measures to combat tax evasion, limitations on pubiic sector pay rises and the sale of public assets. The new French government is to maintain the fiscal target of the previous administration to reduce the central government deficit to Fr. Fc. 115 billion in 1988, and Fr. Fc. 100 billion in 1989.

A wide range of issues was discussed at the **Toronto summit,** *including* **debt relief** *for the poorest countries*

The Heads of State or Government of the seven major industrial nations and the President of the EC met in Toronto in June for the fourteenth annual economic summit. They stressed the need to maintain vigilance against any resurgence of inflation, and to continue to undertake fiscal, monetary and structural policies to foster the adjustment to more sustainable economic and financial positions. They also endorsed the conclusion of the earlier communiqué issued by the Group of Seven Finance Ministers and central bank Governors that either excessive fluctuations of exchange rates, a further decline of the dollar or a rise in the dollar that becomes destabilising to the adjustment process could damage growth prospects in the world economy; and called for countries to resist protectionism. The development of informal processes to facilitate discussions on issues of mutual concern with the newly-industrialising economies in the Asia-Pacific region was encouraged.

The participants welcomed proposals calling on Paris Club creditors to provide further debt relief to the poorest countries. Under the proposals, creditors would offer to reschedule official debt on concessional terms, in the form of lower interest rates, longer repayment periods at commercial rates, partial write-offs of principal, or some combination of the three. The summit participants also reaffirmed their commitment to a market-based, case-by-case approach to middle-income debtors and their rejection of any global debt forgiveness scheme which would effectively transfer the risk or costs to creditor governments.

The case-by-case strategy has been strengthened by the agreement reached between Brazil and its creditor banks' Advisory Committee on the terms sheet for the medium-term financing package. Acceptance of these terms by the wider group of creditor banks would bring to an end the moratorium on interest payments. This extends the 'menu' approach, with a mixture of new money in various forms, exit bonds and several debt-equity swap options.

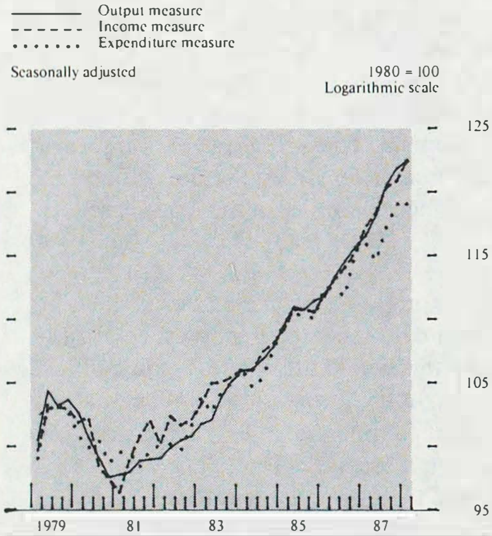
Prospects for **developing countries** *have improved this year, but the situation remains difficult*

The external economic environment faced by developing countries has continued to improve in general so far this year. Their export markets have recovered from relatively depressed growth in the first half of 1987 and have expanded rapidly in the past year. Non-oil exporters' terms of trade have improved substantially in aggregate, owing to the recent strength in most commodity prices, and dollar interest rates are below their peak of last autumn, even though the recent trend has been upwards. Developing countries' trade balances improved significantly last year, partly the result of substantial cutbacks in non-oil imports following major adjustment efforts in some countries, and a surplus is expected this year as export markets continue to grow strongly and terms of trade improve. The ratios of both gross debt and debt service to exports fell in aggregate last year thanks to the stronger export growth, and are projected to continue falling slowly over the next few years, although within the aggregate there are a number of exceptions. The outlook for developing countries is discussed in more detail in a separate note on pages 323–5.

Output growth *in the United Kingdom may have slowed, but* **demand** *remains strong . . .*

Activity in the United Kingdom slowed somewhat in the first quarter with a rise in the average estimate of GDP of ¾%. While this represents growth of 4% over a year earlier, there seems to have been a slowing compared with the very rapid growth seen in the second half of last year. As in previous quarters, the various measures of GDP diverged widely. The expenditure measure was virtually flat while a rise of nearly 1½% was recorded in the income measure. The output measure (usually regarded as the most reliable in the short term) grew by ½%. Services output remained strong, more than offsetting a fall in energy output, but recorded manufacturing output increased only marginally, with engineering and allied industries the area of greatest weakness. There is some evidence that the abrupt halt in manufacturing output growth apparent from the official figures may have overstated the weakness in this sector at the beginning of the year. Survey evidence gave a buoyant picture of orders and output throughout the first quarter (and continues to do so) while more recent figures suggest that manufacturing output has picked up strongly in the second quarter. The volatility of recorded output figures makes the assessment of trends particularly difficult, but it is likely that there has been some slowing in output growth compared with the second half of 1987.

GDP growth in the United Kingdom *slowed a little in the first quarter*

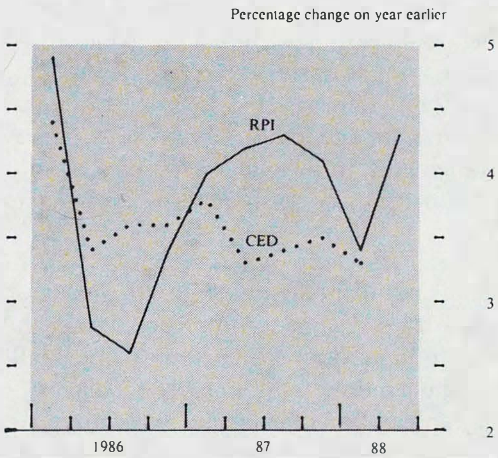


Domestic demand remained strong in the first quarter. Consumers' expenditure grew by 1¼% in real terms while gross domestic fixed capital formation grew by over 3½%. Net exports deteriorated, however, as domestic demand outpaced output. Preliminary figures suggest that the growth of consumer spending slowed in the second quarter, although this conflicts with other evidence (such as that on retail sales) which suggests that demand remained buoyant. The preliminary figures for consumer spending may, as in the past, be subject to substantial revision.

. . . and there are signs that **inflation** *is edging up, whereupon* **monetary policy** *has been tightened*

Inflationary pressures have increased in recent months. Despite a firm exchange rate, strong commodity prices have begun to force up costs of imported goods. The twelve-month increase in retail prices rose to 4.6% in June, the fourth successive monthly rise since February's trough of 3.3%. Around ¼ percentage point of the increase since February is due to the increase in excise duties announced in the Budget and a significant part of the remainder may be accounted for by increased charges for public utilities (water, electricity, etc), and local authority rates. While the overall increase since February has been sharp by recent standards, therefore, it is clear that a number of special factors have contributed to the rise. This can be seen more clearly from the recent growth in the consumers' expenditure deflator (CED) which, although broadly similar in content to the RPI, may be thought to be a more reliable indicator of consumer prices, partly owing to its treatment of housing costs. Since the beginning of 1986, the twelve-month growth in the CED has exhibited a more

Inflation *was subdued in the first quarter but has since risen*



Regional house prices[a]

	Average house prices (£)		House price increases per cent[b]	
	1987	1988	1987	1988
	Q2	Q2	Q2	Q2
Scotland	37,574	39,453	9.3	5.0
Northern Ireland	31,118	32,549	− 2.8	4.6
North West	33,680	38,665	6.4	14.8
West Midlands	35,917	48,631	12.7	35.4
Wales	31,902	38,219	10.6	19.8
South West	45,188	62,540	17.9	38.4
North	30,714	33,355	7.9	8.6
Yorkshire and Humberside	29,235	33,503	7.4	14.6
East Midlands	35,666	44,761	13.8	25.5
East Anglia	46,529	69,049	21.8	48.4
Greater London	71,166	88,388	25.2	24.2
South East	62,437	81,356	24.2	30.3
United Kingdom	**46,864**	**57,315**	**14.6**	**22.3**

(a) Source: Halifax Building Society mix-adjusted house price index.
(b) Percentage changes over the same period in the previous year.

stable pattern than the RPI (including or excluding mortgages) and it appears to have slowed a little in the first quarter of this year. This slowdown is partly explained by movements in import prices, which eased between the middle of last year and the first quarter of 1988, reflecting the strength of sterling, together with some reduction in non-oil commodity prices and the continuing stability of the prices of imported manufactures. More recently, however, some import prices have begun to increase, largely because of rising commodity prices. Input prices to the manufacturing sector (in which imported goods have a weight of 60%) rose by 3% in the second quarter and excluding inputs to the food, drink and tobacco industries the increase was over 4%. There has, therefore, been a growing tendency in recent months for external pressures on inflation to add to domestic ones and this may have a significant upward effect on inflation in the coming months.

Concern about the continued strength of demand and growing inflationary pressures has led to a tightening of monetary policy in the United Kingdom. This has been achieved through a series of rises in interest rates, totalling three percentage points, between the middle of May and mid-July.

House prices *continue to rise rapidly with especially sharp rises in some regions*

Investment in housing is estimated to have risen by nearly 22% in the first quarter. This high growth rate may well reflect the expectation that the value of houses will continue to appreciate in real terms, although the unseasonally good weather in the first quarter of this year also allowed an acceleration in completions and purchases of new houses. The indications are that, as expected, housing completions have declined slightly in the second quarter.

House prices rose by 22.3% in the year to the second quarter compared with 14.6% in the year to the second quarter of 1987 according to the Halifax Building Society mix-adjusted house price index. There continues to be significant regional dispersion in rates of increase in house prices. East Anglia, the West Midlands and the South West have seen particularly sharp increases and prices in these regions continue to rise more quickly than those in London and the South East. However, house price increases had been substantially lower in the regions so that the acceleration there represents a 'catching up', reinforced (in the case of East Anglia) by improved communications links.

Earnings *continue to grow strongly*

Wage settlements have continued to edge up in the manufacturing sector, averaging 6.0% in the first quarter compared with 5.5% in the fourth quarter of 1987, according to the latest estimates from the CBI. Private sector service settlements have also increased slightly to 6.9% in the first quarter compared with 6.7% in the second half of last year. The need to recruit or retain labour seems to have become an increasingly important influence on pay settlements, while the strength of the company sector's finances has allowed firms to accommodate the implications for earnings of tightening labour market conditions.

Contribution of overtime to earnings growth

Per cent per annum

	Manufacturing earnings			Whole economy earnings		
	Overtime contribution(a)	Underlying growth(b)	Adjusted underlying growth(c)	Overtime contribution(a)	Underlying growth(b)	Adjusted underlying growth(c)
1984						
Q3	½	8¾	8¼			
Q4	½	8½	8			
1985						
Q1	¼ to ½	8½	8 to 8¼	¼	7½	7¼
Q2	¼ to ½	9	8½ to 8¾	¼	7½	7¼
Q3	½	9	8½	¼	7½	7¼
Q4	¼	8¾	8½	nil	7½	7½
1986						
Q1	nil to –¼	8¼	8¼ to 8½	nil to –¼	7½	7½ to 7¾
Q2	–¼ to –½	7¾	8 to 8¼	–¼	7½	7¾
Q3	nil	7¾	7¾	nil	7½	7½
Q4	nil	7¾	7¾	nil	7¾	7¾
1987						
Q1	½	8	7½	¼ to ½	7½	7 to 7¼
Q2	¾	8	7¼	½ to ¾	7¾	7 to 7¼
Q3	½ to ¾	8½	7¾ to 8	½	7¾	7¼
Q4	1	8¼	7¼	¾	8¼	7½
1988						
Q1	1	8½	7½	¾	8½	7¾

(a) Source: *Employment Gazette*, published quarterly in *Topics*.
(b) Source: *Employment Gazette*, Table 5.1.
(c) (3) = (2) – (1).

The growth of average earnings has remained extremely strong over the past six months, with underlying whole-economy average earnings rising by 8½% in the year to May according to the Department of Employment's figures. The buoyancy of the economy in the past year has led to a rise in overtime working which contributed to the rise in earnings. Once adjusted for the rise in overtime, the acceleration in earnings has been less marked over the past year (growth has been close to 7½% in both manufacturing and the rest of the economy). Given the evidence pointing to increased settlements, this would suggest the contribution of bonus payments (other than overtime) may have fallen slightly.

More recently, however, the number of overtime hours worked by manufacturing operatives has declined. After reaching a peak of 14.48 million per week in January, overtime hours worked fell to 13.33 million in May (though this was still nearly 8% higher than a year earlier). The contribution of overtime to earnings in the second quarter is therefore likely to be less than in the three or four preceding ones.

Productivity growth *has held up in recent months*

The strong growth in recorded manufacturing output since its pause in February has been reflected in productivity growth. Output per head in manufacturing was over 6½% higher in the three months to May than a year earlier (output per hour has increased more slowly, because of the rise in overtime working). For the whole economy, growth in output per head slowed somewhat in the first quarter to 3% (compared with the rate of about 3¼% recorded in the second half of 1987).

The growth of unit wage costs has tended to increase this year. Wages and salaries per unit of output in the whole economy were almost 6% higher in the first quarter than a year earlier (compared with an annual rise of 4½% to the second half of last year). This mostly reflects higher earnings growth. In manufacturing too, unit wage costs have increased, notwithstanding the strong performance of productivity. In the three months to May, unit wage costs in manufacturing were nearly 2½% higher than a year earlier. This reflects the growth of earnings, although the pressure from overtime payments will have had its counterpart in higher output (or fewer workers employed). The contribution of accelerating earnings to unit labour costs will therefore be smaller when earnings are driven by overtime payments as opposed to higher settlements.

The most comprehensive measure of domestic costs (and thus of domestically generated inflation) is the GDP deflator, the recent growth of which, together with the primary cost components (expressed as income per unit of output), is presented in the table opposite. An important influence on the deflator in 1986 was the sharp fall in oil company profits—reflected in the differential growth of the GDP deflator including and excluding oil. In the early part of 1987, profits on North Sea activities recovered while other companies prospered as a result of widening margins: this was more than sufficient to offset the slowdown in the growth of unit labour costs and hence the deflator accelerated. More recently, a further fall in North Sea profits has been masked by a combination of the buoyancy of non North Sea companies' profits and an acceleration in unit labour costs.

Contributions to growth in the GDP deflator[a]

Percentage changes on same period a year earlier

	Labour costs(b)	Profits(b) Total	Profits(b) Non-oil	Other income(b)	GDP deflator Total	GDP deflator Non-oil
1986 Q1	4.1	4.8	22.4	3.7	4.1	6.7
Q2	5.5	-6.3	18.7	5.3	3.2	6.3
Q3	3.9	-3.1	22.0	5.4	2.8	5.6
Q4	3.2	-6.3	11.9	4.1	1.6	4.0
1987 Q1	3.2	2.2	14.1	5.1	3.3	4.0
Q2	2.8	13.9	16.8	4.7	5.1	4.4
Q3	2.6	15.7	14.2	4.3	5.2	4.0
Q4	4.1	11.3	16.8	4.8	5.5	5.2
1988 Q1	5.4	5.2	13.8	5.2	5.3	5.4
Current share of GDP (per cent)	*63.8*	*18.4*		*17.8*		

(a) Constant-price output is derived by dividing the current-price income measure of GDP by the GDP deflator. The contribution of each component to the growth of the deflator is calculated by multiplying its growth by the share of the relevant income flow.

(b) Per unit of output.

The outlook for inflation depends on **earnings** *and* **margins**

Part of the growth in productivity in the past year has been of a cyclical nature—a view supported by the evidence of high utilisation rates in CBI survey data and by high levels of overtime working. To the extent that productivity growth has been cyclically above trend it would now be expected to fall as employment responds with a lag to the rapid growth in output through last year and/or output slows. It might also be expected, however, that producers would be alert to the consequences of such a deterioration and that their willingness to accede to wage demands would be influenced by it, so that unit labour costs would not feel the full impact.

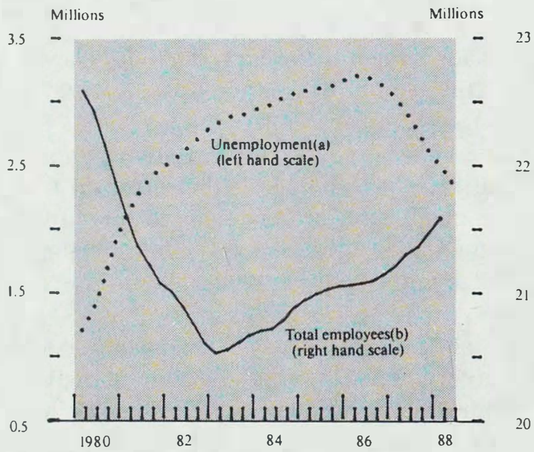
Alternatively, the main adjustment to lower productivity growth rates could come primarily from profits, and in particular profit margins, rather than wages. Profits per unit of output in non North Sea companies have expanded at a remarkably rapid rate in the past two years. However, it appears that, since the first half of 1987, margins in manufacturing have changed very little and may even, in recent months, have declined—for, while the growth of input prices and unit labour costs continues to rise, the growth in manufacturers' output prices (adjusted for changes in excise duties) has remained static. This may be owing in part to the impact of deteriorating competitiveness, given the strength of the exchange rate. Another factor, however, could be the pricing policy of manufacturers. If, as some believe, manufacturers price on the basis of some measure of normal (or trend) costs (rather than actual costs), then the rapid growth in productivity through last year would be expected to hold profit margins up, but only temporarily. If this is the case, then the deterioration in unit labour costs might imply a squeeze on margins, rather than a rise in inflation. Against this, however, is the fact that the fall in oil prices in 1986 permitted a rapid widening of non North Sea companies' profit margins, which was presumed to be temporary in nature (on the normal cost pricing argument), but which has still not been reversed.

Personal incomes *are growing strongly and the* **saving ratio** *has risen*

Real personal disposable income rose by 2¼% in the first quarter—the fastest growth since the second quarter of 1983. Despite the faster growth in income, consumers' expenditure rose by just 1¼% in the first quarter, the same rate as in the previous quarter. As a result the personal sector saving ratio increased from under 4½% in the second half of 1987 to over 5¼%. Part of the explanation for this rise is that a large proportion of disposable income growth was accounted for by the increase in the 'other income' category (reflecting mainly a sharp rise in dividend payments). The propensity to consume 'other income' is believed to be lower than for income from wages and salaries (or the adjustment to it slower).

Although the personal sector saving ratio has returned to the average level recorded in 1987, it still remains well below the levels witnessed through much of the last two decades. Part of the fall in the saving ratio during the 1980s has been due to the decline in the saving of life assurance and pension funds (LAPFs)—these institutions form part of the personal sector

The strength of the economy is reflected in the **labour market**



(a) Unemployment (UK) excluding school leavers, seasonally adjusted.
(b) Employees in employment (GB) seasonally adjusted.

Changes in employment and unemployment in Great Britain[(a)]

Thousands

	June 1985–June 1986	June 1986–June 1987	June 1987–Mar. 1988(b)
Estimated change in civilian labour force(c)	+95	+426	+377(d)
Changes in employment			
Manufacturing	-126	-90	-36
Services	+262	+355	+424
Other employees	-52	-35	-16
Self employment	+17	+234	+124
Total	**+101**	**+464**	**+496**
Change in registered unemployment	+92	-287	-557

Source: *Employment Gazette.*

(a) The figures for the civilian labour force are derived from the annual Labour Force Survey of households, whereas employment figures are based on monthly and quarterly surveys of employers. Unemployment figures are derived from records held at Unemployment Benefit Offices.

(b) At an annual rate.

(c) The civilian labour force includes those in employment (employees, employers and self-employed, but excluding members of the Armed Forces) and all those identified by censuses and surveys as seeking work.

(d) Projections beyond 1987 incorporate the latest (1985-based) population projections.

alongside households. Employers' contributions to LAPFs have fallen in real terms since 1981, as some companies have taken pension 'holidays'. However, there has also been a decline in the saving ratio of households. Perhaps the most important reason for this is the decline in inflation, although the rise in wealth (especially in owner-occupied dwellings) and the increasing ease with which it is possible to extract equity are also likely to have played a part.

Unemployment *continues to fall rapidly*

The strength of the economy has also been reflected in the labour market. Registered unemployment (seasonally adjusted, excluding school leavers) has continued to fall sharply, reaching 2.38 million in June—8.4% of the workforce. In total, unemployment has fallen by over 800,000 in 23 months. The table shows contributions to the changes in employment between June 1985 and March 1988, a period in which registered unemployment rose during the first year by a little under 100,000 before falling rapidly over the subsequent 21 months. This decline occurred despite growth in the civilian labour force (ie those in employment plus those seeking work). Changes in the labour force will have resulted from changes both in the population (and its age distribution) and in activity rates (which tend to increase when the economy is buoyant).

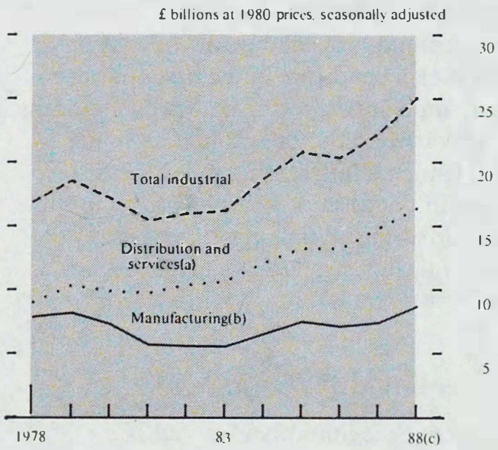
One reason for the fall in unemployment since mid-1986 has been strong growth in employment, which is a reflection of the underlying strength of the economy. These gains have been concentrated in the service sector and in self-employment, while losses have continued in manufacturing (though at a declining rate). Between June 1986 and March 1988 the increase in employment exceeded the fall in registered unemployment by over 100,000. However, it is not possible to say with certainty whether the fall in registered unemployment has mirrored the increase in employment. One factor which suggests that this may not have been the case is the growth in service employment, which has been concentrated to a large extent amongst females and part-timers, many of whom will not previously have been registered as unemployed.

If the rise in employment over the past two years has to a significant extent reflected the taking on of workers not previously registered as unemployed, this would imply that some proportion of the fall in registered unemployment since July 1986 will have been due to other factors. The most important factor during 1987 may have been the role played by claimant advisers and Restart interviews. One result of these measures has been to remove some individuals from the register but not necessarily by placing them in employment. The number of Restart interviews conducted last year exceeded 3 million and they are currently running at just under 200,000 per month.

Investment *seems set to continue growing strongly*

Industrial investment expenditure is now seen to have grown by around 10% last year. Manufacturing investment (including leased assets) grew by over 4% while investment in construction, distribution and financial industries grew by over 13%—much of this concentrated in the fourth quarter. In the first quarter of this year manufacturing investment was particularly strong, while

Industrial investment *is expected to grow strongly this year*



(a) Excluding leased assets.
(b) Including leased assets.
(c) Bank projections based on DTI investment intentions survey.

that in construction distribution and financial services fell back from the very high rate seen in the previous three months.

A strengthening in manufacturing investment has been expected for some time, given the high real rate of return and high level of capacity utilisation revealed by surveys. Forecasts published by the DTI in their June investment intentions survey suggest that manufacturing investment may grow by 16% this year while that by the distribution and services sector will also remain strong. Total industrial investment is expected to grow 12% this year with a further, though smaller, rise next year. It is not yet clear, however, whether the recent (and expected) growth in investment will be sufficient significantly to ease potential capacity constraints and there remains the risk that companies' ability to respond to rapid demand growth could be restricted.

Stocks remained virtually flat in the first quarter of 1988; those in the manufacturing sector and in energy and water supply fell, while those in the wholesaling, retailing and 'other' sectors showed a modest rise. The weakness of stockbuilding despite the highly liquid position of companies is something of a puzzle. Since the early 1980s, the abolition of stock relief, together with the emergence of positive real interest rates, has tended to discourage the holding of stocks and encourage a switch towards financial assets. Greater efficiency and continuity of supply have also enabled companies to operate at lower stock levels and, consequently, stock/output ratios have shown a significant decline. However, recent survey evidence has suggested that manufacturers are becoming increasingly unhappy with their stock levels (especially of finished goods). Given this and the current strength of company sector finances, there is a possibility that stocks may be increased in the near future.

Profits *grew strongly in the first quarter*

Industrial and commercial companies' gross trading profits (net of stock appreciation) were again buoyant in the first quarter. Growth of nearly 5% was more than accounted for by profits of the non North Sea sector, where demand and margins remained strong: the profits of North Sea companies fell as oil prices weakened. The strong growth of profits, the large amount of equity which now needs to be serviced and lower associated ACT payments resulting from reduced income tax rates, all led to an increase in dividend payments of nearly 21% in the first quarter, with the dividend-payout ratio at its highest level since the early 1970s. ICCs' tax payments also grew strongly in the first quarter—a response to the strong income growth at the beginning of last year.

Companies have been unwilling to raise equity finance given the depressed state of the market. ICCs' issues of ordinary shares in the first half of the year totalled little over £1 billion (over £12½ billion was raised in this form in 1987). The loss of the equity market as a significant source of finance, however, seems to have been little more than a minor inconvenience: the eurobond markets, bank borrowing and syndicated credits have all provided a ready source of funds. Nearly £2 billion was raised via sterling and foreign currency bond issues (in roughly equal amounts) in the first quarter. Estimates for the second quarter indicate that sterling bond issues remained very strong though issues in other currencies fell back somewhat. Bank borrowing in sterling and foreign currencies totalled around £7½ billion in each of the first two quarters of this year. Syndicated credits continue to be a popular form of banking finance, the main advantages being the competitiveness of the market, which ensures low margins and the fact that large sums can be raised quickly on the market and that credits can be arranged and drawn when needed. It seems that a significant amount of bank borrowing may have been directed towards capital expenditure in the first quarter. Bank borrowing by the manufacturing sector in the three months to the end of February grew by £1.5 billion (more than in the previous twelve months) while manufacturing investment grew by 3¾% in the first quarter. Initial estimates for the three months to end-May suggest that borrowing by manufacturers rose even further, while borrowing by the construction, distribution and financial sectors remained strong.

. . . but companies' **net liquidity** *has fallen . . .*

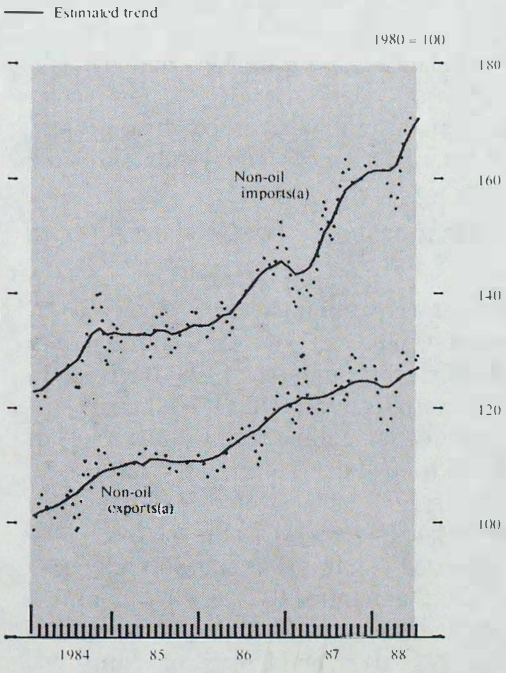
According to the DTI's survey, the liquidity of large ICCs (measured by total current assets as a percentage of total current liabilities) fell during the first quarter, with high corporation tax settlements and record cash expenditure on acquisitions making heavy demands on companies' finances. The survey results suggest that large companies responded by running down their bank deposits and increasing their bank advances, which has contributed significantly to the fall in liquidity. The gross liquidity of all companies (on a seasonally adjusted basis), however, has continued to increase (having risen steadily since 1980) and measured relative to capital base now stands at an all-time peak. The causes of this sustained rise are not entirely clear, but appear to be linked to a decline in the cost of liquidity, or a narrowing of the spread between the rate earned by companies on their deposits and the rate paid on their borrowing. It may also be related to the abolition of stock relief and the switch towards positive real interest rates, both of which have tended to discourage the holding of inventories and encourage a switch towards financial assets. Finally, especially in recent years, it appears that companies have been able to draw on readily (and inexpensively) available funds from a variety of sources, and have been tempted to take advantage of these funding opportunities as they arose, holding the funds as financial assets until such time as they could be put to more appropriate use. The picture of companies' financial transactions is, however, obscured by the persistence of large unidentified transactions, casting doubt on any conclusions that might be drawn from the data. The unidentified component was over £16 billion in 1987. It is not clear whether this is mainly due to the underrecording of expenditure or overrecording of income.

. . . partly because **acquisition activity** *has continued apace*

Despite the stock market crash, acquisitions by ICCs within the United Kingdom have continued at a high level though, as expected, conditions in the equity market have affected the financing of this. In the first quarter, acquisitions were valued at just over £6 billion (including the acquisition of Britoil by British Petroleum for £2.3 billion). Over 70% of total expenditure was in the form of cash, and as noted above, acquiring companies have reduced their bank deposits or increased their bank borrowing in order to take advantage of the fall in share prices to acquire companies inexpensively.

The level of cross-border merger activity has escalated since 1987, and with the approach of the single European market in 1992 this trend may be expected to continue. UK companies have been particularly active in the United States. Total direct investment in overseas securities is estimated by the DTI to have been £5.8 billion in 1987 (compared with £5.6 billion in 1986 and £3.8 billion in 1985) though some unofficial estimates have put the figure much higher than this. Acquisitions have remained high so far this year. Expenditure on inward acquisitions has also increased rapidly. The DTI estimate that the value of inward acquisitions in 1987 was £1.6 billion (compared with £0.6 billion in 1986 and £0.1 billion in 1985) though other unofficial sources suggest the 1987 figure could be as high as £4 billion, the discrepancies being attributable to problems of distinguishing between direct and portfolio investment and to data collection problems. Estimates for 1988 suggest expenditure has accelerated further to about £1 billion by the end of May. It would seem that the approach of 1992 can only further encourage both outward and inward acquisitions.

The volume of non-oil imports *has risen twice as fast as that of* **non-oil exports** *in the past year*



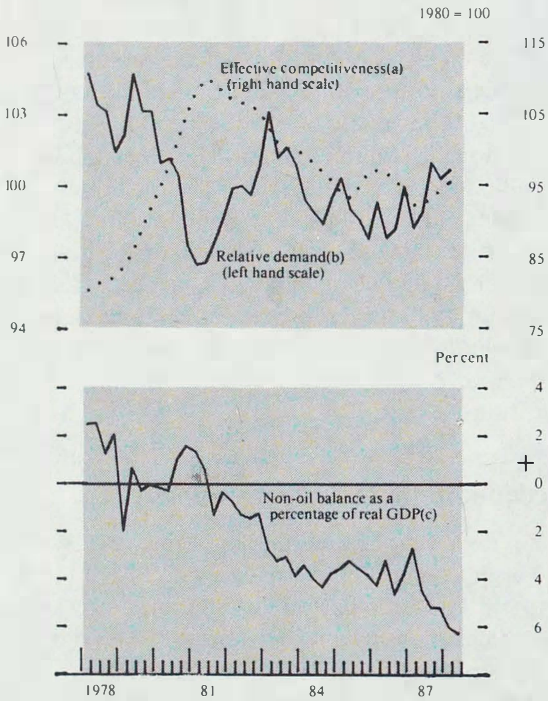
(a) Including erratics.

The current account deficit *has risen sharply*

The current account deficit in the first quarter of this year is now estimated to have been £2.8 billion (compared with £1.6 billion for the whole of 1987). The main part of the deterioration was in the visible deficit which, after upward revisions to the level of non-oil imports, is now put at £4.0 billion, an increase of £1.0 billion on the fourth quarter of 1987. But the surplus on invisibles also fell by £0.4 billion to £1.2 billion in the first quarter. This in turn was largely owing to a fall in the surplus on services, reflecting a significant rise in the travel deficit (debits rising strongly, while credits fell back); the other services balances were in the main flat. The deterioration in the travel account reflects rising real incomes in the United Kingdom and an increased preference by the British public for overseas holidays (further encouraged by the appreciation of sterling in 1987 which also held down overseas tourists' spending in the United Kingdom). It is possible that the initial estimate of the surplus on services may prove too pessimistic but it seems probable that there has been an underlying deterioration which is not likely to be entirely revised away. Continued weakness in the services surplus during the rest of the year is to be expected as the effects of the high exchange rate and strong home demand are likely to persist.

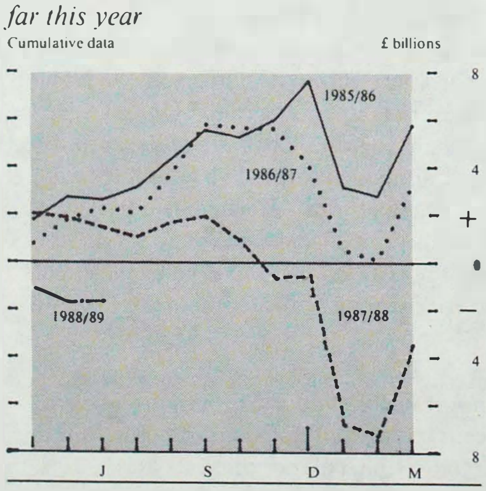
The revised level of non-oil visible imports is perhaps not surprising given the recent strength of domestic demand; but the overall deterioration in the visible balance presents an unexpectedly pessimistic picture. A fall in the oil balance contributed £0.2 billion to the increase in the deficit in the first quarter. Non-oil import volumes in the first quarter were nearly 13% higher than a year earlier, while non-oil export volumes were slightly lower. It is now thought that some non-oil exports were brought forward from the early months of 1988 to December 1987 in anticipation of new customs documentation procedures. Despite this (together with the effects of the ferry strike and problems of seasonal adjustment of the recorded figures) it is

The non-oil balance *is responding to* **relative demand and competitiveness**



(a) Bank estimates in 1988 Q1.
(b) Ratio of domestic demand in the United Kingdom to average domestic demand in the major six (Bank estimate for 1988 Q1).
(c) Bank estimate of GDP in 1988 Q2.

The **public sector** *has been in* **surplus** *so far this year*



clear that there has been some slowdown in the underlying trend growth of non-oil exports.

The visible trade deficit increased by a further £0.3 billion in the second quarter although the picture was clouded by an unusually low contribution from oil (as net export volumes fell) and the erratic components of manufactures. Seasonal adjustment problems may also have depressed the recorded level of exports in May. The deficit on trade in manufactures increased by £0.3 billion. Manufactured export volumes (excluding erratics) rose by 6% in the second quarter which compares quite favourably with 8% growth for imports. But despite this encouraging recovery, export volumes were still 1% below their level in the fourth quarter of 1987, whereas imports have risen by 4½%. Over the year to the second quarter manufactured export volumes (excluding erratics) grew by 8% while import volumes rose by 16½%.

The speed with which the current account has deteriorated so far this year has been surprising, notwithstanding the strength of domestic demand and the loss of competitiveness through 1987. In national currency terms (ie before allowing for exchange rate movements) relative unit labour costs in the United Kingdom rose by around 3% in the year to the first quarter. With an appreciation in the effective exchange rate of almost 8% over this period, relative unit labour costs expressed in common currencies increased by around 11%. It is possible that competitiveness effects may be operating more quickly and strongly than previous experience would suggest. The divergence between the expenditure and other measures of GDP in the first quarter may also imply that exports or domestic demand grew faster than recorded. On balance it seems unlikely that visible exports have been systematically underrecorded. If, however, domestic demand grew even faster than recorded, the speed of the deterioration in the external balance would be less surprising.

The **public sector's finances** *have begun the financial year in surplus*

The public sector's finances were estimated to be roughly in balance in June, following surpluses in both April and May. The cumulative PSBR for the first three months of 1988/89 is estimated to have been in surplus by around £1.6 billion, compared with a deficit in the same three months of 1987/88 of around £1.5 billion. At the time of the Budget the PSBR was projected to be in surplus in 1988/89 by around £3 billion (the same as the outturn in the last financial year) though the Chancellor has since indicated that this year's surplus may be larger. Privatisation proceeds amounted to £2.8 billion for the first three months of the financial year, £0.4 billion higher than in the same three months a year earlier, and largely reflecting receipts from the final payment for British Gas shares and the second payment for British Airports Authority shares. The surplus on the PSBR is almost certainly a result of the continued buoyancy of receipts from income tax, corporation tax and VAT.

The economic outlook for a selection of developing countries

This note summarises the Bank's latest forecast of the economic prospects facing a selection of developing economies. The forecast, completed in June 1988, considered the balance of payments and debt prospects of twenty-one developing countries.[1] (In a departure from previous practice none of the four main Asian NIEs[2] is included.) As in past years the basic approach to determining import demand is to assume that a country is either constrained or unconstrained by the availability of external finance. In this year's forecast only some Asian countries are unconstrained.

The sample countries differ markedly in size, per capita income, indebtedness and openness (the size of the export sector in relation to total GNP). The sample's aggregate exports of goods and services comprise about 44% of those of the 162 capital-importing developing countries identified in the IMF's world economic outlook (WEO) and over 64% of total debt. Ten of the Baker-15 countries are included. The group least represented in the sample (if only numerically) is sub-Saharan Africa, where only three of the 43 countries listed in the WEO are included. The dominance of India and China in the sample should also be noted. These two countries account for a third of the sample's total GNP and two thirds of its combined population, but less than 20% of exports and little more than 10% of medium and long-term debt. Together with Turkey and Yugoslavia, they make up the four countries in the sample whose exports are predominantly of manufactured goods.

Background to the forecast

External economic developments have an important influence on the shape of the forecast. In general, these suggest a more buoyant outlook than underlay the forecast last year. Assumptions regarding export market growth, interest rates and commodity prices have been taken from the Bank's latest world economy forecast (WEF), extrapolated to 1992.[3] The sample is assumed to face a reasonably benign world economic environment over the next five years, in that no major downside shocks—eg sharply higher interest rates—are projected, and the recent recovery in real non-oil commodity prices is broadly maintained. Overseas markets for their exports, while initially sluggish overall, are assumed to be growing quite healthily by the early 1990s. The initial sluggishness is partly a reflection of the relative success of the United States in adjusting its trade balance: for many of the sample, the impact of modest US import growth outweighs that of very rapid market growth in Japan and the NIEs. World activity, commodity prices and interest rates so far this year have proved to be higher than expected at the time the forecast was prepared and, on balance, these developments have tended to strengthen further the external position of the countries considered here.

Another important influence on the forecast is a conservative working assumption made regarding the willingness of creditors to provide new funds. In general, it has been assumed that, in the case of the heavily indebted countries, private creditors continue to reschedule most maturing debt but do not, overall, increase their net exposure significantly. This leads to a need for continuing adjustment by the debtors (who also draw on their reserves) and to a higher demand for official sources of credit (Table A).

Table A
Outstanding gross debt claims[a]
$ billions, *percentage shares in italics*

	1980	1987	1992
Official (including IMF)	101	229	309
	25	*31*	*37*
Commercial	301	480	508
	75	*66*	*61*
of which, banks	205	351	364
	51	*48*	*44*
Total	**402**	**709**	**817**

(a) Excluding arrears.

The degree of commitment by the debtor countries to adjustment policies is another major area of uncertainty. In terms of their impact on creditor attitudes, developments in the main Latin American countries are likely to continue to have a pervasive influence.

It has been assumed that this year the Brazilian authorities, as a result of their adoption of an IMF programme, complete a new money/rescheduling agreement with the banks, as well as gaining considerable support from official creditors. In contrast to Brazil, continuing economic problems in a number of other debtors are assumed to aggravate external financing constaints.

The poorest sub-Saharan African countries are now likely to qualify for concessional rescheduling of official credits as a result of the consensus agreed at the Toronto summit. Their scope for increasing import volumes may thus now be somewhat higher than was assumed at the time of the forecast.

(1) Algeria, Argentina, Brazil, Chile, China, Colombia, Côte d'Ivoire, Egypt, India, Indonesia, Jordan, Malaysia, Mexico, Nigeria, Philippines, South Africa, Tanzania, Turkey, Venezuela, Yugoslavia and Zaire.

(2) Hong Kong, Singapore, South Korea and Taiwan.

(3) A summary of the WEF was given in the May 1988 *Bulletin*, pages 177–9.

Current account prospects

In 1987 the combined *merchandise trade balance* of the sample countries showed a significant improvement, despite a slowdown in export market growth. Their combined surplus rose from $8 billion to $33.7 billion, twice the average of the first half of the decade. This partly reflected some recovery in oil prices, but tighter controls of imports in China and a recession in Brazil were also important. The surplus is expected to be broadly maintained in 1988, despite a deterioration in the terms of trade (mainly attributable to weaker oil prices). Export market growth is somewhat stronger and many countries are expected to continue to reap the rewards of recent exchange rate depreciation and higher non-oil commodity prices. These gains permit a brisker growth in imports. In 1989, domestic pressures for expansion are likely to lead to a moderation of export volume growth and a further rise in imports. Assumed subsequent tightening of domestic policy in a number of the larger countries, coupled with little further movement in the terms of trade, averts a further significant deterioration in trade balances and leaves the trade surplus broadly stable over the remainder of the forecast period.

Table B
Selected economic indicators: total sample

	1980-85 (annual averages)	1986	1987	1988	1989-92 (annual averages)
					Percentage changes
Export markets	3.9	6.0	4.1	4.5	5.6
Non-oil export volume	4.9	− 1.3	11.2	7.6	5.2
Non-oil import volume	1.7	−10.0	− 4.0	6.2	5.8
Terms of trade (change)	− 1.5	−14.1	1.6	− 1.9	− 0.2
Real effective exchange rate	− 1.2	−20.0	− 9.1	− 3.2	− 2.1
	Percentages of exports of goods and services				
Trade balance	6.0	3.4	12.0	10.7	7.2
Current account balance	−13.2	−15.1	− 4.4	− 4.2	− 6.8
					$ billions
Selected capital flows:					
Net direct investment	7	8	10	10	12
Official borrowing	10	16	18	18	18
Commercial borrowing	26	6	5	11	4
Reserve change(a)	− 1	6	− 14	− 9	− 1
IMF borrowing	− 3	− 1	—	− 1	− 3

(a) Increase represented by a minus sign.

The main influence on the *invisibles* account—apart from a steady rise in insurance and freight payments on imports—is an increase in interest payments. Net interest payments of the sample remained little changed between 1984 and 1987 as the current account deficit of the group, and hence their net borrowing, fell sharply and interest rates declined. Over the forecast period, interest payments begin to rise again—to over $50 billion by the early 1990s. However, in relation to earnings, the trend remains favourable: the ratio of net interest accruals to exports of goods and services[1] falls from 17.6% in 1986 to 11.7% by 1992, little above the level recorded in 1981. (The total figure conceals a wide variation between countries but for most the trend is favourable.)

The combined *current account* deficit of the sample has fluctuated considerably since the onset of the debt crisis. From a peak of nearly $63 billion in 1982 it fell to less than $10 billion in 1984 but then rose again as pressures to expand domestic demand intensified and oil prices collapsed. Last year the deficit narrowed from $36 billion to $12 billion. Over the forecast period, the deficit steadily grows, reflecting the influences on trade and invisible accounts described above. Even so, in relation to exports of goods and services, the deficit is little more than half that of the early 1980s.

Capital flows

On *capital account* the main assumption is a dominance of *official lending* over private credits and, within the latter, a negligible amount of new lending by the banks. Nevertheless, adjustment efforts will have to be sustained if a significant volume of new official credits is to be available. The increasing reliance on official medium-term financing rather than shorter-term adjustment support is evidenced by continuing net repayments to the IMF.

The total figure for *commercial borrowing,* particularly from the banks, conceals some marked differences between countries. Some countries—China, India and Turkey—are assumed to borrow significant sums from the banks throughout the forecast. In contrast, by assumption the heavily indebted countries continue to make net repayments.

Net inflows of *direct investment* are assumed to increase steadily over the forecast, partly reflecting rising debt conversions. In countries adopting realistic exchange rate policies and positive interest rates as a result of domestic financial liberalisation, and where the debt burden is easing, debt-equity conversions offer some attractions to multinational companies.

Sounder financial policies in many countries mean that *capital flight* is forecast to be moderate.

Table C
Selected economic indicators: total less exporters of manufactures(a)

	1980-85 (annual averages)	1986	1987	1988	1989-92 (annual averages)
					Percentage changes
Export markets	4.1	6.6	3.5	3.8	4.8
Non-oil export volume	3.4	− 2.7	7.0	7.0	3.8
Non-oil import volume	− 3.1	−11.3	− 3.2	3.0	4.4
Terms of trade (change)	− 2.8	−16.5	2.2	− 4.0	− 0.8
Real effective exchange rate	0.1	−19.6	−10.0	− 2.1	− 0.8
	Percentages of exports of goods and services				
Trade balance	13.6	15.8	21.2	20.3	16.5
Current account balance	−14.5	−12.9	− 3.9	− 2.8	− 5.1
					$ billions
Selected capital flows:					
Net direct investment	6	6	8	8	9
Official borrowing	7	13	14	13	13
Commercial borrowing	24	− 1	− 1	5	− 5
Reserve change(b)	1	6	− 10	− 6	1
IMF borrowing	2	1	1	—	− 1

(a) China, India, Turkey and Yugoslavia.
(b) Increase represented by a minus sign.

(1) Including, in the case of some countries, workers' remittances and other private transfers.

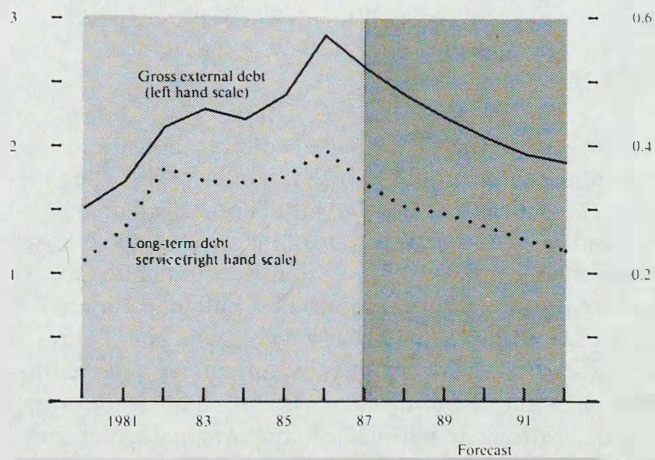
Implications for the debt strategy

Like most recent forecasts—for example the IMF's WEO—the Bank forecast shows a steady improvement in the aggregate ratios of debt service to exports and of debt to exports (see the chart). These trends are common to most of the currently heavily indebted countries in the sample. Even the comparatively successful countries are assumed to have only restricted access to world financial markets. However, import volume growth is significantly higher than recent experience, and should provide a more satisfactory background against which both development aspirations and international financial obligations can be met.

As mentioned above, much of the new commercial borrowing identified in the forecast is by China, India and Turkey, whose trade and current account deficits rise steadily over the forecast period. Export growth is likely to be strong, which in turn will require a rapid expansion of imports. The strength of exports will underpin buoyant domestic demand while keeping the external position manageable: while trade deficits grow in absolute terms, they are constant in relation to exports.

Debt ratios: total sample

Ratios to exports of goods and services



Risks to the forecast

External risks are finely balanced. While inflationary pressures could lead to higher nominal world interest rates than have been assumed, recent commodity price developments suggest that export earnings could be higher than forecast. A simple sensitivity analysis makes the stylised assumption that any adjustment to external shocks is borne entirely by non-oil import volumes. On this basis, the effect of a sustained one percentage point rise in interest rates is to reduce the non-oil import volume of the sample by 0.9% by 1992 (by 1.3% if the sample's four exporters of manufactures are excluded). Heavily-indebted countries with a high proportion of their external debt at floating rather than fixed interest rates fare worst. Argentina would have to contract imports by nearly 6% by 1992, and Brazil and Côte d'Ivoire by more than 3%, to adjust to the rise. By contrast, a sustained 10% rise in commodity prices over 1988–92 would permit a higher volume of non-oil imports by 1992 (2% per annun for the sample as a whole; 4% per annum for countries excluding manufacturing exporters). The effect is not uniformly beneficial: the countries that are most heavily dependent on exports of oil or manufactures, or on service receipts or workers' remittances, would suffer a small fall in import volumes.