Economic commentary

- *Output growth in the major overseas economies slowed somewhat in the second quarter, although a number of special factors may have been at work.*

- *The authorities in the major economies tightened policy slightly in response to worries about potential inflation. Inflationary pressures arising from commodity prices have, however, eased and, while domestic pressures have become more of a preoccupation recently, inflation itself has remained subdued in the major overseas countries.*

- *There has been evidence of slower progress in reducing the external imbalances of the three major economies in recent months; Germany's merchandise trade surplus widened to a record level in the second quarter.*

- *Growth in the United Kingdom is recorded as having slowed in the second quarter, but problems with the measurement of GDP cast some doubt on this. Demand seems to have grown strongly in the first half of the year and concern about the potential inflationary consequences of this led the authorities to increase interest rates by a total of 4½ percentage points between May and September.*

- *According to the preliminary estimate, consumer spending rose by over 2% in the third quarter. This may, however, conceal some slowing in recent months; retail sales rose sharply in July but were unchanged in August and fell in September. This may owe something to the tightening of policy, as may the fall in turnover in the housing market in some areas.*

- *Inflationary pressures in the United Kingdom have intensified, even allowing for the effects on the RPI of recent mortgage rate rises. There are signs that profit margins have widened, and the labour market continues to tighten although the growth in labour costs has been subdued.*

- *The effects of rapid demand growth can be seen clearly in the deteriorating balance of trade in manufacturing. This was the main factor in the very sharp increase in the current account deficit in the third quarter. The current account deficit is forecast to reach £13 billion for the year as a whole.*

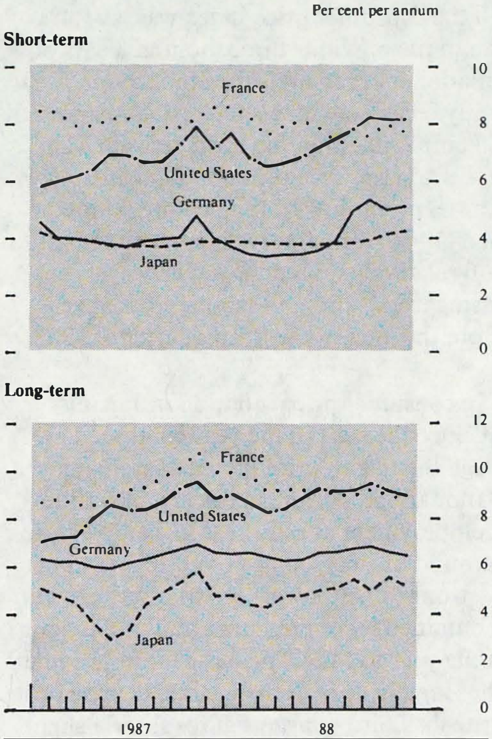
Growth *in the* **major overseas economies** *slowed in the second quarter and* **interest rates** *edged up overall in the third . . .*

Output growth in the six major overseas economies slowed to 0.3% in the second quarter of this year from the rapid growth attained in the three preceding quarters. The slowdown, however, reflects a number of special factors. The drought in the United States is estimated to have reduced GNP growth by 0.2% in the second quarter and the extent of the slowdown in Japan may well have been exaggerated by seasonal adjustment problems. The German first quarter performance was also affected by the unusually mild winter weather, which stimulated construction. While the composition of growth in the United States and Japan in the first half of the year continued to aid the correction of external imbalances, recent growth in Germany appears to have been sustained by the external sector. The main cause of the deceleration in aggregate output growth overseas appears to have been a deceleration in consumption and a negative contribution

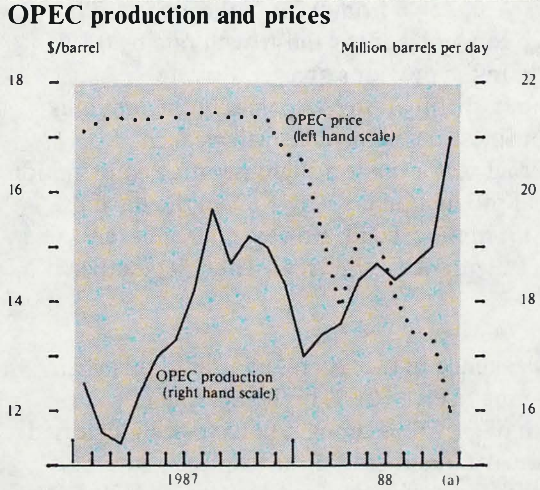
Contributions to GNP/GDP growth in the major overseas economies
Percentage points of GNP/GDP: at constant prices

	1986	1987				1988	
		Year	Q2	Q3	Q4	Q1	Q2
Private consumption	2.3	1.9	2.7	2.6	0.2	3.1	1.3
Private business investment	0.1	0.7	1.5	1.8	1.1	1.5	1.9
Private residential investment	0.4	0.3	0.6	0.4	0.5	0.3	-0.6
Public consumption	0.5	0.5	0.2	0.7	0.5	-0.6	0.5
Public investment	0.1	0.1	0.1	0.2	0.4	0.3	-0.2
Stockbuilding	0.2	0.3	-0.5	-1.0	3.2	0.5	-1.8
Domestic demand	**3.6**	**3.8**	**4.7**	**4.8**	**6.1**	**5.1**	**1.2**
Net trade	-1.0	-0.6	-1.1	0.5	-0.9	0.3	-0.1
GNP/GDP	**2.6**	**3.2**	**3.6**	**5.3**	**5.2**	**5.4**	**1.1**

Short-term **interest rates** *generally rose in the third quarter*



OPEC production and prices



(a) Latest monthly figures are estimates.

from stockbuilding; business fixed investment has remained very buoyant. To the extent that investment is easing pressures on capacity, it should help reduce inflationary forces over the longer run. Nevertheless, amid fears that the pace of growth might lead to an acceleration in prices, short-term interest rates rose from June onwards (from April in the United States), although in some countries they have since fallen back.

The widespread tightening of monetary policy reflects concern about the inflationary risks arising from stronger growth, as well as, in some cases, monetary overshooting or exchange rate weakness, allied earlier in the year with higher commodity prices. The Federal Reserve raised its discount rate in August by ½% to 6½%, and short-term market interest rates in the United States also rose before stabilising in September, after employment data for August tentatively suggested a slight easing of potential pressures in the labour market. Meanwhile, Japanese market rates rose by about ½% during August, largely in response to the weakness of the yen, but subsequently fell somewhat in the period to mid-October. The Bundesbank also raised key interest rates, largely because of the weakness of the deutschemark and the continued overshooting of M3, the monetary aggregate now targeted: the securities repurchase rate has risen by 1% since June to 4¼%, and the Lombard rate was raised ½% to 5%, while the discount rate was increased in two ½% stages to 3½%.

. . . *and* **concerns about inflation** *remain, even though external pressures have eased*

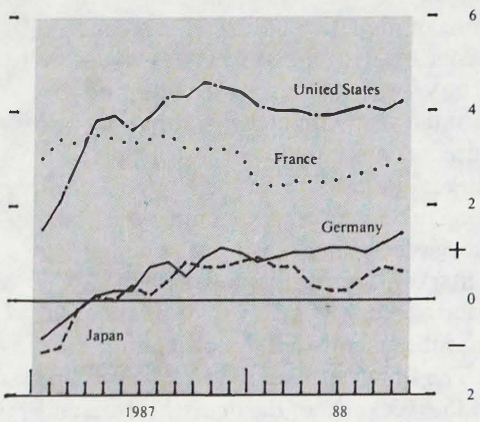
Concerns over external influences on inflation in the major economies have eased in the past few months, as oil and spot non-oil commodity prices have fallen. Oil prices have fallen markedly since the start of July; the prospects for a ceasefire in the Gulf, together with the announcement of a meeting of OPEC's price monitoring committee, appeared for a time to support prices. However, that meeting (and subsequent ones in September and October) were largely inconclusive, although there have been tentative indications of progress towards an agreement on output at the ministerial conference to be held in late November. With OPEC output well in excess of short-run demand and amid speculation that Iran and Iraq might be seeking to boost production in the coming months, oil prices have remained volatile. Brent crude was trading at $12.40 per barrel towards the end of October.

Over the three months to end-September, the Economist index of spot non-oil commodity prices fell by 10.7% in SDR terms. Industrial raw material prices peaked in June and by mid-October metal and agricultural non-food prices had fallen by 22% and 10% respectively, mainly reflecting a slowing in OECD demand growth as well as improved supply prospects. Market stocks of metals have continued to rise, although supply disruptions have caused price volatility. Food prices have fallen 10% since their end-June peak. While no overall supply shortfalls are expected this year, the drought in North America, combined with poor rice harvests elsewhere, will lead to a substantial rundown in world wheat, maize and rice stocks.

Despite these signs of an easing of external influences on inflation, concern remains about rising domestic pressures in some major countries. This is perhaps most notable in the

Consumer price inflation

Percentage price changes on a year earlier



United States, where concern relates in particular to potential pressures from a tight labour market, the rise in intermediate goods prices and the current high rates of capacity utilisation, as well as the effects of the drought. Evidence of an acceleration in consumer prices in the United States is, however, limited. In the third quarter, the rise in the consumer price index was, at 1.4%, only slightly higher than in the previous three months. Fears of an intensification of inflationary pressures from the labour market have eased slightly recently, with a smaller-than-expected rise in non-farm payroll employment in the third quarter. The unemployment rate shows no clear recent trend, rising in July and August from the fourteen-year low in June before falling back again in September, but still remains well below the levels of a year ago. Although still relatively muted, however, wages growth has been on a rising trend, and unit labour costs have continued to edge up from the lows of the third quarter of 1987.

The mild upward drift in consumer price inflation in Japan which has been evident since the start of the year continued in the third quarter, although the rate of price increases remains very low. Potential inflationary pressures are discernible in the labour market, with unemployment at a six year low and nominal wage growth around one percentage point higher than a year ago. Nevertheless, strong (albeit lower) productivity growth has, so far, more than contained these pressures, and unit labour costs fell by over 5% in the year to May. The basis for inflationary concerns in Germany has largely been exchange rate depreciation and strong monetary growth. Third quarter figures show a slight pick-up in consumer price inflation, to 1.2% at a twelve-monthly rate compared with an average of 1.0% in the first half-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	Year	Q2	Q3	Q4	Q1	Q2
United States	2.8	3.4	5.0	4.5	6.1	3.4	3.0
Japan	2.4	4.2	0.0	8.4	7.5	11.2	−3.9
Germany	2.5	1.7	2.8	5.7	2.9	5.7	−0.7
France	2.1	2.3	3.7	3.2	2.9	4.6	1.7
Italy	2.7	3.1	4.8	3.9	0.8	5.3	2.4
Canada	3.2	4.0	5.1	6.2	6.5	3.2	3.9
Total	**2.6**	**3.2**	**3.6**	**5.3**	**5.2**	**5.4**	**1.1**

Growth in the United States *eased slightly in the third quarter*

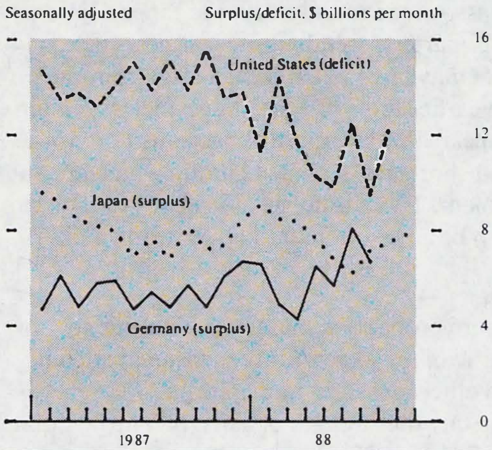
Preliminary estimates show that US GNP grew by 0.6% in the third quarter of this year, down from 0.7% in the second. The drought is estimated to have reduced the growth rate by 0.1% compared with 0.2% in the previous quarter. Private consumption grew at a slightly faster rate than in the previous three months but business investment growth weakened markedly. The external sector made a slight negative contribution to growth. Industrial production grew by 1.6% in the third quarter, up from 1.1% in the second. However, most of the increase came in July, with output in August and September virtually flat.

Activity in Japan weakened in the second quarter of this year. GNP fell by 1%, having risen by 2.7% in the first quarter, although the pattern of growth is thought to have been distorted by inadequate seasonal adjustment for the leap year. Recent indicators suggest that the economy remains strong but is slowing to a more sustainable rate of growth. The slowdown in the second quarter reflected a slower increase in domestic demand, attributable to lower consumption growth, a fall in residential investment and a lessening impact from the government's public works programme that was introduced in the middle of last year. Private business investment remains strong, rising by over 4½% in the second quarter, and there is tentative evidence of a pick-up in consumption in the third quarter. Net external demand made a strong negative contribution to growth in the second quarter.

GDP in Germany was unchanged in the second quarter from its level in the first. However, this apparent weakness probably reflects the unusually good performance in the first three months of the year, itself due partly to buoyant construction spending associated with unusually mild weather, and the position of the economy is still rather better than had been expected earlier. Domestic demand declined by ½% in the second quarter, as personal consumption and construction expenditure both fell, but the slowdown in domestic demand was offset by strong growth in the export sector—partly a reflection of the demand for German capital goods as a result of the buoyancy of investment in many countries. The strength of the economy appears to have been maintained in the third quarter, with industrial production and orders both rising strongly in August.

Progress in reducing **external imbalances** *has been patchy*

There is little evidence of a narrowing of **G3 nominal trade imbalances** *recently*



It appears that the rate of decline in the G3 external imbalances has slowed, even before the appreciation of the dollar earlier in the year has had time to have a significant effect. The US trade deficit for August widened to $12.2 billion from $9.5 billion in July, and three-monthly averages show that the fall in the deficit has halted for the time being. Japan's external surplus fell in the second quarter, even though domestic demand growth slowed. On the evidence available for the third quarter, however, the improvement appears to have paused. In Germany, the merchandise trade surplus widened in the second quarter to $20.4 billion from $15.8 billion in the first three months of the year. The main reason was the rapid growth of exports.

Stronger-than-expected industrial country growth during the first half of the year has had an uneven impact on developing countries. While countries in the Far East have benefited overall from stronger markets for their exports, the slower growth in North American markets has limited the gains to other developing countries and the recovery in commodity prices has been patchy. In particular, the prices of oil and tropical beverages, which form an important, and in some cases dominant, part of the exports of some heavily indebted countries, have been weak. While export prices of some non-oil exporters have recovered sharply, in aggregate the terms of trade of developing countries may have changed little year-on-year. The rise in interest rates through much of this year will also have offset part of the benefits of stronger industrial country growth. Nevertheless, the checking of inflationary pressures at an early stage should promote further growth in OECD countries and this should provide a more favourable environment for developing countries. The cumulative impact of low rates of investment in many ldcs since the onset of debt problems may, however, limit their capacity to respond.

Output *and* **demand** *in the* **United Kingdom** *continued to grow strongly in the first half of the year*

According to the average estimate, GDP grew by only 0.4% in the second quarter to a level 4% higher than in the second quarter of 1987. The latest Industry Act forecast is for growth in the average measure of GDP of 4½% for 1988 as a whole compared with a forecast of 3% at the time of the Budget. Growth is now expected to slow to 3% in 1989. As usual the three measures of GDP showed considerable dispersion in the second quarter, with the output measure showing growth of 1.1% (5.7% in the year) while the income and expenditure measures were both flat in the second quarter. The dispersion in the various measures of GDP, together with the growing problem of reconciling the estimated financial positions and identified changes in financial asset holdings of the various sectors, continues to impede the interpretation of economic developments. These discrepancies have been the subject of an official review of government economic statistics and the Central Statistical Office is investigating the production of a set of balanced and consistent accounts for recent years.

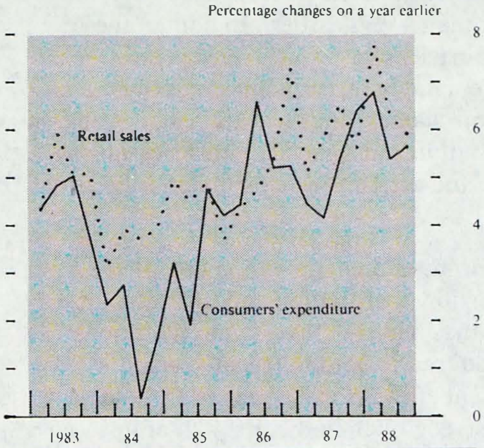
It continues to be the case that the output measure of GDP is probably the most reliable. GDP(O) grew by 2½% in the first half of the year compared with the second half of 1987. This partly reflects the strength of manufacturing output, the growth of which, on the basis of earlier figures, had been thought to be slowing but which has increased strongly through the second quarter and on through the summer months, more than offsetting a fall in energy output associated mainly with the Piper Alpha disaster. The latest CBI quarterly trends survey suggests that, while output and orders may have fallen back a little from the exceptional levels seen earlier this year, they nevertheless remain extremely strong. It appears that the main constraints to output growth are capacity and shortages of skilled labour, which are an increasingly acute problem. There is no sign, however, that orders or sales are perceived to be a reason for a likely slowdown in output growth.

While the output measure probably remains a good guide to GDP, the same is not true of the expenditure measure, which is more variable than the other measures and appears systematically to understate the strength of activity. The fact that recorded GDP(E) was unchanged in the second quarter cannot, therefore, in itself, be taken as evidence of a slowdown in activity. Consumer spending is recorded as having risen by less than ½% in the second quarter, a surprisingly small increase, although it recovered strongly in the third. Part of the fall in the growth rate in the three months to June seems to have been due to a decline in spending on energy products (following unseasonally mild weather) and food. But even if expenditure on these items had grown in line with their trend levels, recorded growth would still have been only around ¾%. Other indicators suggest that consumer spending remained strong throughout the second quarter; retail sales grew by 1% and borrowing by the personal sector remained very strong. Net advances for mortgage lending rose from £5.4 billion in the first quarter to £6.4 billion in the second, though this is likely to have been boosted by borrowers anticipating changes in the rules on mortgage tax relief. The amount of consumer credit outstanding (agreements with finance houses and other specialist credit grantors, building societies, retailers and on bank credit cards) rose more than £2 billion in the first half of the year and by a further £0.5 billion in August to stand at nearly £26 billion.

Consumer spending *is expected to respond to* **higher interest rates . . .**

Preliminary estimates suggests that consumer spending recovered strongly in the third quarter, rising by 2.2%—broadly in line with

Consumers' expenditure *and* **retail sales**
grew strongly in the first three quarters



the increase in retail sales. Within this quarterly rise, however, retail sales grew very strongly in July, but were unchanged in August and fell in September. July's sharp increase seems to have been associated with rapid turnover in the housing market ahead of the changes to the arrangements for taxation of mortgage tax relief, and the apparent faltering in the subsequent two months may have been a reaction to this. It is also possible that the 4½ percentage point increase in interest rates between May and September may have had an effect, either directly or as a result of lower turnover in the housing market.

The effect of the recent interest rate rises on personal sector spending depends on several factors, of which probably the most important is the effect on disposable incomes of the higher servicing costs of existing household debt. The stock of such debt may currently stand at around £250 billion, of which perhaps four fifths is accounted for by mortgages. Potential borrowers may also be deterred by the higher cost of servicing prospective debt. With mortgage rates at 12¾% the average debt service burden of mortgages for first-time buyers will have risen, perhaps to around a third of disposable income in the United Kingdom as a whole and to a level even higher than this for first-time buyers in Greater London and the South East. Set against higher borrowing costs is the boost to incomes from higher returns on variable-rate financial assets, of which households' holdings may be of the order of £200 billion.

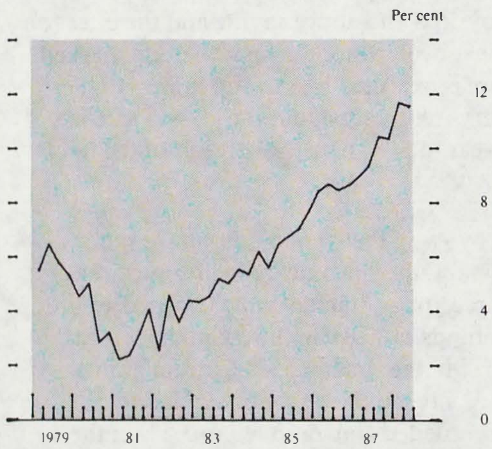
The precise implications of the rise in interest rates for consumers' expenditure are uncertain and depend on, among other things, savings behaviour, the distribution of income gains and the higher servicing burden of different sections of the population. The net effect will, however, be to depress personal sector disposable income and encourage saving and the effect on expenditure over the next twelve months may be quite marked. Consumers' expenditure is expected to grow by 5½% in 1988 according to the Industry Act forecast, but the growth rate is expected to slow next year to 3½%, partly as a result of the tighter stance of policy.

Personal incomes rose by ½% in the second quarter—a modest rise compared to the first. 'Other income' (which comprises rent, dividends and interest receipts—much of which accrues to life assurance and pension funds rather than households) fell back from its exceptional level in the first quarter. Current grants also fell slightly, partly as a result of the continued fall in unemployment. The recorded saving ratio fell to 3.5% in the second quarter from 4.9% in the first. A large proportion of 'other income' tends to be saved, at least in the short run, and it is likely that this effect unwound to some extent in the second quarter. The saving ratio averaged 4.2% in the first half of the year, much the same as in the second half of 1987, and is now forecast to be around 3½% for 1988 as a whole.

. . . but **investment** *is growing strongly and may continue to do so . . .*

Gross domestic fixed capital formation increased by almost 4% in the second quarter and, from the figures on industrial investment, it seems clear that the United Kingdom is at present experiencing an investment boom. Manufacturing investment (including assets leased to manufacturers) grew by 9.5% between

The pre-tax real **rate of return on capital** *remains very high*[a]



(a) Non North Sea ICCs.

the first and second quarters to stand over 13% higher than a year earlier, while investment by the construction, distribution and financial service industries grew by 5.5% to a level nearly 15% higher than the corresponding quarter in 1987. Within the manufacturing sector, investment activity has been widely spread among industries but the major growth has been in the vehicle production industry (23% up on the quarter and 46% higher than a year earlier) and paper, printing and publishing (39% up on the quarter and 56% higher than a year earlier). In both of these sectors it appears that capacity constraints have become more severe recently. There remain, however, some areas of notable weakness, particularly mechanical and electrical engineering. In the construction, distribution and financial industries, all categories except hotels and catering have exhibited substantial investment growth.

The forecast of 12.5% for investment growth in the manufacturing, construction, distribution and financial industries published in the June DTI investment intentions survey (which has a good track record in recent years in forecasting the investment growth for the year as a whole) is unlikely to prove excessive: growth in the first half of this year was around 5% (compared with the second half of 1987). A rise of 5½% in the second half of this year would be required to achieve the DTI's projected increase for the year as a whole. The latest official forecast suggests that manufacturing investment (including leased assets) may rise by 18% this year and non-oil industrial investment by 13%. Industrial investment in 1989 may rise by around 8%.

Despite the recent increases in interest rates, therefore, any marked slowdown in investment growth in the remainder of the year seems unlikely. Output growth continues to be buoyant and, according to the latest CBI survey, firms are optimistic about the prospects for continued growth in demand. The return on productive activity continues to outstrip that on financial assets (the real rate of return on non North Sea ICCs' assets remained above 11% in the second quarter) and capacity constraints continue to feature strongly in survey responses. Most studies also find that investment decisions are generally relatively insensitive to interest rates. One indirect channel through which interest rates might affect investment, however, is through their effect on company sector finances. Industrial and commercial companies have recently built up their holdings of short-term debt and thereby increased their exposure to changes in short-term interest rates. Bank estimates suggest that a 1% rise in interest rates will now, over the span of a year, impose a net cost on ICCs (allowing for higher interest receipts on their asset holdings) of about £400 million (just over ½% of their 1987 gross trading profits)—around half as much again as a year ago. This would reduce the amount of finance available for investment projects, since nearly three quarters of investment is financed from retained earnings. Overall, however, the effect on investment is not likely to be great. The strong growth in the output of the investment goods industry (up over 11% in the year to August) and in imports of capital goods (up 18% in the year to August) suggests that domestic and foreign suppliers of such goods can respond to increased demand. Evidence from the CBI survey for the domestic capital goods industry suggests that the capacity is available to meet increased demand, though here, too, skilled labour shortages are a growing problem.

Private sector investment in housing increased by 17½% in the second quarter, having risen by 6½% in the first. The rate of increase was broadly similar for both new investment (despite a small decline in the number of private sector completions in the second quarter) and home improvements. Housing investment seems to have remained strong, with private sector completions averaging over 15,000 per month—only a little less than in the first half of the year.

In the first half of the year the level of stocks held by UK industry rose by over £500 million (at 1985 prices), of which the bulk was accumulated in the second quarter. This increase in stock levels has mainly occurred in manufacturing (up £250 million in the first half) and retailing (up £220 million). The build-up of stocks, especially in the second quarter, is perhaps surprising given the current strength of demand in the economy and the apparent inability of domestic output to meet it. This is especially true for manufacturers' stocks of finished goods, which rose by £150 million in the second quarter. Evidence from CBI surveys suggests that the build-up of stocks was unplanned: respondents to recent surveys, including the most recent, have indicated that their stock levels in all categories (raw materials, work in progress and finished goods) were expected to fall in the succeeding four months. Despite the build-up of stocks, however, it seems likely that the stock/output ratio fell again in the second quarter. Given the survey evidence and the recent rise in interest rates (which will increase the opportunity cost of holding stocks), it seems unlikely that the decline in the stock/output ratio will be arrested this year.

There are indications of a further **tightening in the labour market** . . .

All the indications are that conditions in the labour market have continued to tighten in recent months. Unemployment continued to decline in the third quarter and has now fallen by nearly 1 million since the middle of 1986. On the seasonally adjusted basis (excluding school leavers), unemployment in September stood at 2.3 million—the lowest figure since May 1981, while measured unemployment as a percentage of the workforce was 8%. The recorded fall in unemployment in September was only 6,000 because the postal strike resulted in an underrecording of the numbers ceasing to be unemployed. There is no reason, however, to suppose that the trend reduction in unemployment of 40,000 per month seen prior to September has altered.

Employment in manufacturing industry has continued to decline, falling below 5 million in August, but total employees in employment increased by 8,000 between the first and second quarters to 21.6 million—the highest level since 1981. The increase in employment since 1983, however, has been largely accounted for by the service sector and, since the proportion of part-time employees in the economy is now higher than in 1979, the growth in full-time equivalents will not have been as large as the growth in total employment.

The underlying rate of increase of whole-economy average earnings, having remained close to 8½% throughout the first half of the year, increased in each of the three months to August to 9¼%. The underlying rate of increase in service industries in

August was 9% and in manufacturing 9¼%. Most of the increase is due to higher settlements, which tended to increase throughout the 1987/88 pay round. The latest evidence from the CBI shows that the twelve-month moving average of manufacturing settlements was 5.9% in June compared with 5.1% at the same time last year, and the provisional third quarter average of 6.3% suggests that awards in the pay round just beginning will turn out higher than in the last. In the private service sector, settlements averaged 6.9% in the year to the second quarter, compared with 6.0% in the same period a year earlier. However, the average for the second quarter alone was, at 7.2%, the highest since the fourth quarter of 1985. This figure is in broad agreement with the Industrial Relations Services settlement register, which shows the median settlement level for all monitored settlements to be at its highest level since early 1986. Some public service settlements (notably that of the nurses) will also have contributed to the rise in whole-economy earnings growth.

One of the reasons for the rise in settlements may be the rise in the inflation rate. There is also considerable evidence, however, that skill shortages in some industries and regions and for particular types of labour have become increasingly important. According to the CBI, the percentage of firms in manufacturing citing recruitment and retention as an important upward influence on settlements is 21%. However, in the service sector the corresponding figure is 56%, more than twice that observed in the last pay round.

Wage drift (the gap between earnings growth and settlements) was probably around 2% for the whole economy in the year to the third quarter, much the same as a year earlier. In manufacturing, drift has also remained steady, but at around 3%. The contribution of overtime to drift (which depends mainly on the level of overtime working compared with a year earlier) has not increased in either case and, for the whole economy was about ¼–½ percentage point in the third quarter—a little less than a year earlier. It is not possible to say what proportion of the remaining element of drift is accounted for by factors such as productivity and output bonuses which, in principle, are cyclical, but there are no compelling reasons for thinking it to be very great. If this were the case, the effect on earnings of a slowing in output growth might not be much greater than that owing to the reduction in overtime working.

Productivity and real unit wage costs

Percentage changes on a year earlier

	Manufacturing			Whole economy		
	Output per head	Wages and salaries per unit of output	Real wages and salaries per unit of output(a)	Output per head	Wages and salaries per unit of output	Real wages and salaries per unit of output
1987 Q1	6.5	1.1	−2.5	2.7	4.1	0.4
Q2	8.0	−0.3	−4.7	2.7	4.4	−0.2
Q3	8.3	0.2	−4.9	3.3	4.2	−1.1
Q4	6.3	1.9	−3.6	3.1	5.0	−0.7
1988 Q1	7.6	0.5	−4.6	4.1	4.7	−0.7
Q2	6.5	2.1	−3.7	3.8	4.4	−1.5

(a) Deflated by the GDP deflator.

. . . *but* labour costs *remain subdued because of rapid* productivity growth

At present, productivity gains are offsetting at least part of the rapid growth in earnings. Any slowdown in productivity growth, however, would be reflected in unit labour costs to a degree which depends on the flexibility of earnings. If the cyclical element in earnings growth is indeed small, a reduction in productivity growth would lead to an acceleration in unit wage costs which, unless absorbed in margins, would have potentially serious implications for inflation. Productivity growth in the whole economy was 3.9% in the year to the second quarter—slightly below the first quarter figure but well above the increase in 1987, reflecting the strength of output this year. The strength of productivity growth meant that, notwithstanding the acceleration in earnings, wages and salaries per unit of output rose by only around 4½% in the year to the second quarter, much the same as the average rate of increase recorded in 1987. Within the manufacturing sector the picture is rather different, reflecting the more rapid growth of productivity—currently around 7½%. This has largely offset the increase in the rate of growth of wages and salaries so that unit wage costs increased only 1% in the year to August. The table shows that 'real' unit wage and salary costs were negative throughout most of 1987 and the first half of 1988, even for the whole economy, ie productivity growth has held labour costs below the inflation rate during this period.

Inflationary pressures *have intensified, however, and* **retail prices** *have accelerated . . .*

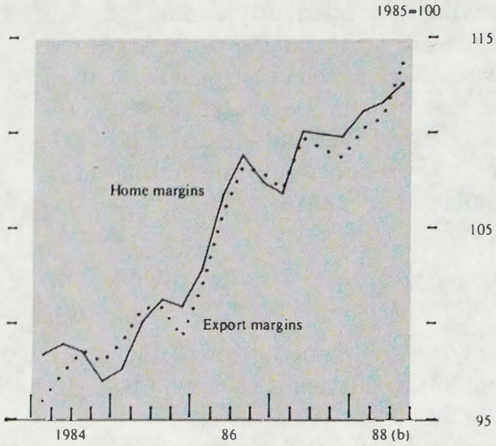
There has been a clear increase in inflationary pressures since the beginning of the year and this is reflected in the recent behaviour of retail prices, even after the effect of the increase in mortgage rates is excluded. As measured by the RPI, inflation edged up from 3¼% at the beginning of the year to just below 5% in July. The consumers' expenditure deflator (an alternative measure of consumer prices which does not include a mortgage interest component) accelerated sharply in the second quarter to stand 4.8% higher than a year earlier (compared with 3.5% in the first quarter). Since the second quarter, the rise in retail prices has increased sharply, to 5.9% in September. The rise in the third quarter was due mainly to the higher mortgage interest rates which came into effect for most borrowers on 1 August. The further increase which took effect in October will have an additional impact on the index; a one percentage point increase in mortgage rates raises retail prices by about 0.4 percentage points. Even excluding mortgage interest payments, however, retail prices rose by 5.2% in the year to September, compared with an annual rate of increase of just over 3½% at the beginning of the year. Inflation is now expected to rise further—to around 6¼% by the end of 1988 and on to the middle of next year. Some slowing is expected after this, according to the Industry Act forecast, with inflation falling back to 5% by the end of 1989.

While unit labour costs are a contributory element in inflation at present, they are not the main driving force—as is apparent from the fact that they are falling in real terms. Manufacturers' input prices rose sharply in the second quarter to a level 3.8% above that of a year earlier (compared with 1.7% in the first quarter), largely reflecting the rapid rise in commodity prices on world markets. The rate of increase over the year to the third quarter, however, has fallen back a little to around 3½% (on the basis of provisional figures) as commodity prices have weakened and sterling has remained strong. Output prices of manufactures have accelerated throughout the year so that the rise in the year to the third quarter was almost 5% (compared with less than 4% in the year to the first quarter). But much of this is explained by the increase in output prices of the food, drink and tobacco industries (which were temporarily depressed by subdued food commodity prices last year). The twelve-month growth rate of output prices excluding these items has been held within a narrow band (4¾%–5%) since the beginning of the year.

. . . as **margins** *have widened*

Although output prices in manufacturing have not accelerated in underlying terms, their persistent strength, given the slow growth of labour costs and only a modest rise in input costs, suggests that

. . . and **manufacturers' margins** *have continued to widen*[(a)]



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

(b) Bank estimate for 1988 Q3.

Contributions to growth in the GDP deflator[(a)]

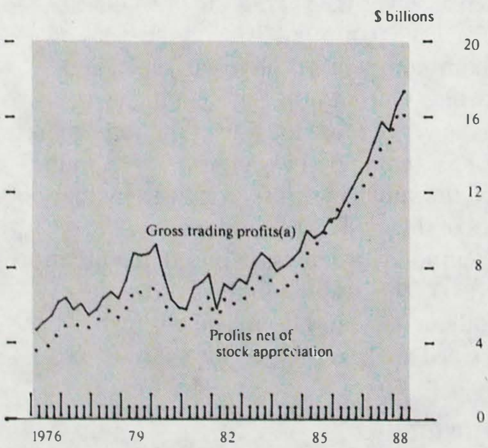
Percentage changes on same period a year earlier

	Labour costs(b)	Profits(b) Total	Profits(b) Non-oil	Other income(b)	GDP deflator Total	GDP deflator Non-oil
1986 Q1	3.4	4.8	21.1	2.3	3.5	8.9
Q2	5.2	-6.7	20.5	4.5	2.7	9.1
Q3	4.7	-8.7	15.4	6.0	2.4	7.9
Q4	3.4	-5.7	12.0	4.0	1.9	7.2
1987 Q1	4.0	0.4	10.9	4.8	3.4	4.8
Q2	3.5	11.1	11.8	3.4	4.8	3.6
Q3	2.4	23.1	21.1	1.4	5.7	3.7
Q4	4.4	15.4	16.4	2.2	5.9	5.6
1988 Q1	4.9	10.1	20.9	2.2	5.4	6.0
Q2	5.0	8.7	16.8	3.6	5.4	6.1
Current share of GDP (per cent)	*63.5*	*19.6*		*16.9*		

(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. Because they are based on the income measure of GDP, the figures for unit labour costs do not correspond precisely with the more usually quoted ones based on output data.

(b) Per unit of output.

Companies' **profits** *remain high . . .*



(a) Profits of non North Sea ICCs.

manufacturers' profit margins have remained extremely strong. There are signs that, after rising throughout 1987, margins have continued to edge up this year—probably in response to the strength of domestic demand, though pricing policies based on some concept of 'normal' unit labour costs may also be playing some part. Exporters' margins have also expanded so far this year, perhaps indicating that producers are currently content to switch supply towards the relatively more buoyant domestic market. For the whole economy, Bank estimates suggest that margins fell slightly in the second quarter but remained at a high level, having apparently changed very little between 1985 and the present. Profits, however, remain extremely strong. The table shows the contributions of a variety of income components to the growth of the GDP deflator and serves, in particular, to emphasise the continued strength of non North Sea profitability. It also shows that, while the growth in the GDP deflator was unchanged between the first and second quarters, once the effects of oil are excluded, there was an underlying rise.

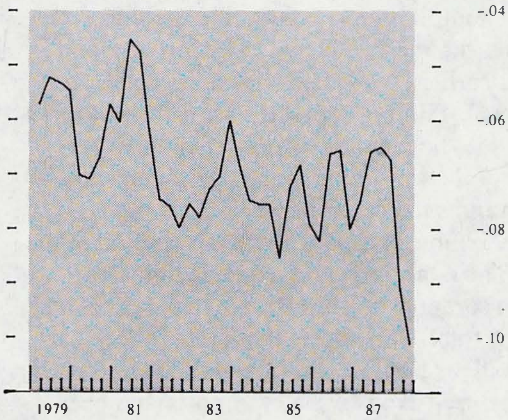
The annual rate of increase of house prices rose in the third quarter to just over 30%, compared with an annual increase of 22% in the second quarter, according to the Halifax mix-adjusted house price index. Average prices of all dwellings rose by around £5,000 to £62,000 over this period. More recently, there may have been some slowdown in the rate of increase in London and the South East, following the exceptionally high demand in the months prior to the implementation of the Budget changes to tax relief on mortgage interest. The recent interest rate rises may have contibuted to this. House prices in the South East rose by just under 9% during the third quarter and those in London rose by 7% (not seasonally adjusted). This compares with increases of around 10% and 8% respectively in the second quarter. It is too early, however, to distinguish the effects of the tightening of policy from those of the changed arrangements for mortgage tax relief and the seasonal slowing which is to be expected in the summer months. According to the Halifax index, annual increases in house prices in London and the South East have fallen from being the fastest, in 1987 as a whole, to only the eighth and fifth fastest respectively. House prices are still strongest in regions bordering the South East, with the rate of increase in the West Midlands and East Anglia close to 55%.

Company profits *remained strong in the second quarter . . .*

Industrial and commercial companies' gross trading profits (net of stock appreciation) were almost unchanged in the second quarter. Within the total, North Sea companies' profits fell by some 3½%, while the non North Sea component rose by ½%—a modest rise in view of the combination of strong margins and rapid output growth. The underlying growth rate of profits is still high; ICCs' gross trading profits were over 15% higher in the second quarter than in the same quarter in 1987, and for non North Sea companies the rise was almost 22% (although these figures are slightly inflated by the effects of privatisation). The real rate of return on non North Sea ICCs' assets may have fallen a little in the second quarter but remains over 11%.

ICCs' dividends, tax payments and capital expenditure all rose in the second quarter. Dividends on ordinary shares grew by 1%, and were nearly 40% higher than a year earlier, reflecting the strong and sustained growth in companies' profits, together with lower associated ACT payments resulting from lower income tax rates. The growth in profits is also having an impact on ICCs' tax payments, which rose nearly 8% in the quarter to a level 19% higher than a year earlier. Capital expenditure rose, and there was an increase in stocks. The only major item of expenditure reported in ICCs' appropriation and capital accounts which showed a fall in the second quarter was interest payments, reflecting the fact that interest rates reached a trough during the period. The total effect of the changes in income and expenditure was to depress ICCs' financial surplus by £600 million. Given recent higher levels of interest rates, and the fact that the surplus was only £3 billion in the first half of 1988, the surplus is likely to be significantly lower this year than the £9 billion recorded in 1987.

Net liquidity ratio[(a)]



(a) ICCs' net liquid assets as a proportion of their capital base.

Among factors affecting ICCs' financial transactions, equity market conditions have been radically altered by last year's stock market crash and issues of ordinary shares by ICCs (£0.3 billion and £1.0 billion in the first and second quarters respectively) were less than a third of the levels seen in the comparable periods in 1987. Companies have responded to equity market conditions by having greater recourse to bank borrowing; outstanding bank advances rose by 20% (£16 billion) in the first half of 1988, a larger increase than in the whole of 1987 (when they rose by £11 billion). Eurobond issues have also been higher than last year; £1.8 billion was raised in this form in the first quarter and £1.2 billion in the second, compared with a quarterly average of £0.9 billion in 1987. ICCs' gross liquidity has not, as yet, been affected by these developments; companies acquired a further £1.6 billion of liquid assets in the second quarter. Net liquidity, however, has deteriorated rapidly and has consequently increased companies' exposure to changes in short-term interest rates.

Although equity issues fell after the crash, takeovers did not. In the first half of 1988, expenditure on domestic acquisitions by UK firms was over £9 billion, and the DTI estimates that a further £3 billion was spent on UK acquisitions of foreign firms. However, the financing of acquisitions has changed markedly, with the proportion of cash used rising to over 50%. As a consequence, ICCs' investment in UK company securities has been high this year—£6 billion in the first half compared with £3.2 billion in the whole of 1987.

. . . but **the current account** *has deteriorated sharply, reflecting the strength of domestic demand*

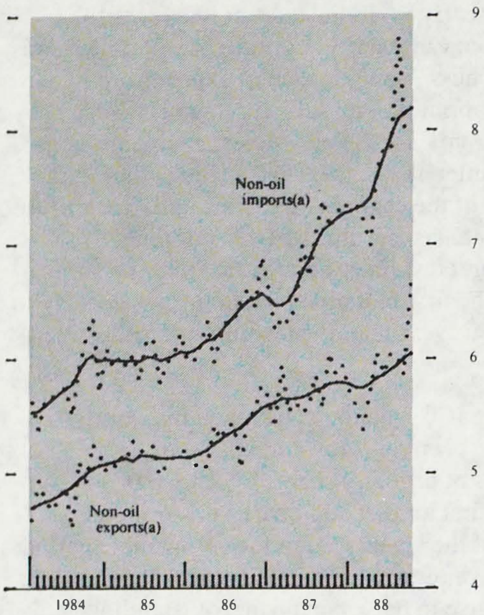
The current account deficit in the second quarter of this year was £2.9 billion, virtually unchanged from the first, giving a deficit of almost £6 billion in the first half of the year. The visible deficit in the second quarter was £4.4 billion, an increase of £0.5 billion on a quarter earlier. The increase in the visible deficit was accounted for in roughly equal parts by a fall in the oil surplus and an increase in the non-oil visible deficit. Almost offsetting movements in the visible balance, the surplus on invisibles recovered to £1.5 billion in the second quarter, owing to a slight improvement in the transfers balance and higher IPD earnings. The surplus on services remained unchanged from its first quarter level.

The third quarter saw a further deterioration in the visible balance. July's visible deficit of £2.7 billion was a record in both

Non-oil imports *have risen sharply*

—— Estimated trend

£ billions, 1985 prices



(a) Including erratics.

Contributions to change in the visible balance[a]

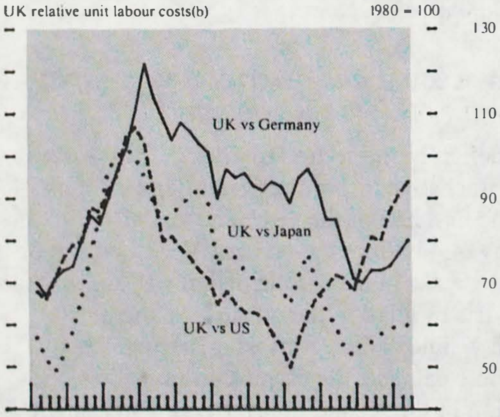
£ billions

	1988 Q3 compared with 1988 Q2	1988 Q3 compared with 1987 Q2	1988 Q1–Q3 compared with 1987 Q1–Q3
Total change	**-1.1**	**-2.3**	**-7.0**
of which:			
Oil	-0.3	-0.6	-1.2
Non-oil	-0.8	-1.7	-5.8
of which:			
Non-manufactures	-0.3	-0.3	-0.9
Manufactures	-0.5	-1.5	-4.9
of which:			
Erratics	*-0.1*	*-0.2*	*-0.8*
Semi-manufactures	*+0.2*	*-0.2*	*-1.1*
Cars	*-0.2*	*-0.5*	*-1.3*
Other consumer goods	*-0.1*	*-0.3*	*-0.7*
Intermediate goods	*-0.2*	*-0.3*	*-1.0*
Capital goods	*+0.2*	*+0.2*	*+0.2*

(a) Individual components may not sum to total change because of rounding. Within manufactures there is also a small discrepancy due to approximations used in converting data to a balance of payments basis.

Competitiveness *has deteriorated against the major overseas economies*[a]

UK relative unit labour costs(b) 1980 = 100



(a) A fall in the index represents an improvement in UK competitiveness.
(b) Common currency: not adjusted (or normalised) for cyclical movements in productivity.

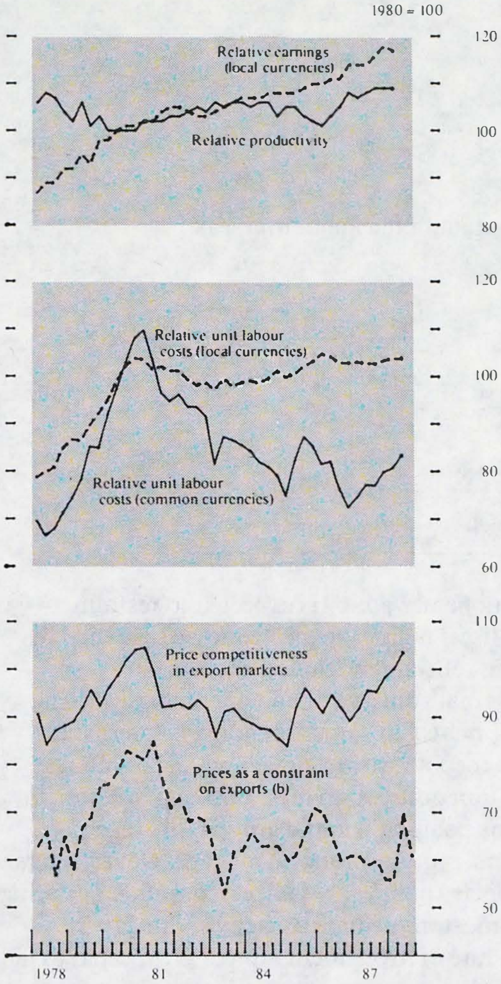
nominal and real terms. Past experience has generally shown that very rapid movements in the visible balance have tended to be at least partially reversed the following month, so that the recovery of the visible deficit in August was not entirely surprising. Nonetheless, even the August figures would—but for July—themselves have represented a record deficit. The further improvement in the recorded deficit in September was distorted by exceptional movements in 'erratics' and some probable overrecording of exports in the wake of the postal dispute. Even after these relatively good figures, the deficit in the third quarter as a whole was still significantly higher than in the first or second. The current account deficit for the year as a whole is now officially forecast to be £13 billion—around 2¾% of GDP. The deficit is expected to fall in 1989, but only to around £11 billion.

As the accompanying table shows, the increase in the visible deficit in the third quarter partly reflected a fall in the oil surplus (largely due to the effects of the Piper Alpha explosion) but the greater part of the deterioration was due to strong growth of non-oil imports. Total non-oil import volumes in the third quarter were 6½% higher than in the second (15% higher than in the same period a year earlier), while non-oil export volumes were only 3% higher (6%). Taking the first three quarters of the year together, increases in the manufacturing deficit have been the major component of the worsening in the overall visible balance. In the nine months to September the deficit in manufactures was £9.9 billion, compared with £5.0 billion in the same period of 1987. The table also gives a detailed breakdown of the contribution of the components of the manufactures balance to recent changes in the total. This shows that trade in cars, though a relatively small proportion of total manufactured trade (around 3% of manufactured exports, 8% of imports) has been a major factor in the overall deterioration, comparable to the effect of worsening trade in semi-manufactures (around one third of both exports and imports). By contrast, trade in capital goods (18%–20% of both exports and imports) has been a fairly limited factor, despite the strength of domestic investment.

Latest figures show that in the first half of 1988 there was a slight deterioration in the underlying competitive position of UK manufacturing industry compared with the first half of 1987. Unit labour costs in the United Kingdom grew faster than those overseas in local currency terms (abstracting from exchange rate movements). While UK productivity growth, at around 7% over this period, was significantly above that of our competitors, movements in relative earnings more than outweighed the beneficial effects of this. The deterioration in labour cost competitiveness was, moreover, considerably more marked in common currency terms (allowing for exchange rate changes): on this basis there was an 8% deterioration between the first half of 1987 and the first half of 1988.

Recent movements in competitiveness against our major competitors taken together reflect considerable differences in individual exchange rate movements, as well as markedly different movements in productivity and earnings growth between individual countries. Comparing the first quarter of 1988 with a year earlier, most of the substantial deterioration in cost competitiveness against the United States, for example, has been caused by the appreciation of sterling against the dollar, and currency movements also account for most of the (smaller)

The United Kingdom's **competitive position** *has deteriorated so far this year*[(a)]



(a) A fall in the index represents an improvement in the UK competitive position.

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

deterioration against Germany. Against Japan, by contrast, there has been a slight depreciation of sterling against the yen; but this has been more than offset by a large deterioration in cost competitiveness in local currency terms. Underlying these figures is the fact that, whereas earnings growth has kept pace with productivity growth in the United Kingdom, the United States and Germany, earnings growth in Japan has been at only around half the rate of productivity growth. This contrasts sharply with the United Kingdom's recent failure to make any competitive gains from historically high productivity growth by restraining earnings. The strength of margins in the United Kingdom has meant that measures of price competitiveness, both in domestic and export markets, have worsened at least as rapidly as cost competitiveness. In the first half of 1988, price competitiveness in export markets is estimated to have worsened by 9%, a somewhat faster deterioration than in cost competitiveness.

Public sector finances *have been strong in the current financial year*

The cumulative PSBR for the first six months of the current financial year was in surplus by an estimated £3.7 billion, compared with a deficit in the same six months of 1987/88 of around £1.9 billion. The Budget forecast for the PSBR in 1988/89 was for a surplus of around £3.0 billion, but the outturn is now expected to be a surplus of £10 billion—around 2% of GDP. Receipts from privatisation proceeds have been higher so far this year than last—around £4.9 billion, compared with £4.0 billion over the same period last year. Excluding these, the PSBR for the six months to September has been in deficit by around £1.2 billion, compared with a deficit of £5.9 billion in the same period a year ago.

The stronger outturn in the public sector's finances for the financial year than was expected at the time of the Budget partly reflects the fact that general government expenditure is likely to turn out £2 billion less than allowed for in the last Public Expenditure White Paper. In addition, there has been stronger-then-expected growth in income tax, VAT and corporation tax receipts. Together, these are expected to exceed the FSBR forecast by around £3.5 billion. Thus the buoyancy of the economy, stemming from burgeoning domestic demand, together with strict control of government spending, has more than compensated for the effects of tax cuts on the public sector's finances.

World economic prospects—latest Bank forecasts

The recent performance of the world economy has been much better than had been expected by most forecasters, including those within the Bank, in the early part of the year. Growth in the OECD area has held up more strongly than expected, fuelled by a surge in private business investment. The US external account has improved more rapidly than generally envisaged and this, together with a widening of interest differentials in favour of dollar assets in the spring and early summer, has been associated with a stronger dollar, at least until recently, and a resurgence of private sector capital flows into the United States. The focus of concern among policymakers has shifted towards potential inflationary threats, even though oil prices have eased and the upward trend in non-oil commodity prices since early 1987 has recently abated. Inflationary fears are associated with the tightness of labour markets and pressures on capacity in some countries, fears about the cumulative impact of rapid monetary growth, and in some cases exchange rate depreciation. Interest rates have risen through the year in most countries as monetary policy has been tightened to combat this threat.

The stronger than expected performance of the major industrial economies has been attributed to a number of factors, including continued delayed effects from the strong terms of trade gains in 1986 which boosted profitability and real incomes; an overestimate of the adverse effect of the stock market crash on economic activity, which now appears to have been minimal; relatively accommodative monetary policy, particularly to restore confidence following the stock market crash; fiscal easing in some countries; improved business confidence resulting from a more stable policy background in many countries, a period of low inflation and greater certainty about exchange rates; and, in Europe, unseasonally mild weather, which raised construction output in particular in the first quarter. Growth has also been stronger than expected because of an underestimate of the momentum in the world economy in the second half of last year. This has helped sustain activity this year, as rising employment has boosted income and consumption, and profitability and output growth have boosted investment.

Taking account of these recent developments, the Bank's latest forecast projects that growth in the major overseas economies will reach 4% this year, over 1 percentage point higher than suggested in the spring. A slowdown is expected into 1989 and 1990, to some 2¾% and 2½% respectively (Table A), as some of the factors promoting the recent strength in activity are likely to be transient. For example, the impact of the large terms of trade gains in 1986 is projected to fade. In addition, the recent

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

		Forecast		
	1987	1988	1989	1990
Domestic demand	**3.7**	**4.0**	**3.0**	**2.5**
of which:				
Private consumption	3.2	2.9	2.3	2.1
Private fixed investment	4.8	9.1	6.1	4.4
Public expenditure	3.2	1.7	1.9	2.0
Stockbuilding(b)	0.3	0.1	—	—
Net external demand(b)	-0.5	-0.1	-0.2	-0.1
GNP/GDP	**3.2**	**3.9**	**2.8**	**2.4**

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

tightening of monetary policy is expected to restrain growth, while fiscal policy is expected to be tightened in some countries, reflecting variously the aims of supporting external adjustment and of combating rising levels of public debt. Consumer spending is forecast to weaken as real income growth slows and higher interest rates and inflation buttress savings. Business investment, the main engine behind the rapid growth this year, is expected to remain quite strong on average. Nevertheless, as tighter monetary policy takes effect, consumer spending slows and the most immediate capacity shortages are alleviated, the rate of investment growth is expected to fall back. Stockbuilding may have a broadly neutral influence on GNP growth. With hindsight, the judgement in the spring that much of the increase in inventories at the end of 1987, particularly in the United States, was the result of an involuntary increase on the part of domestic producers and would lead to a correction in production in 1988 has proved exaggerated. Net external demand is expected to have a slightly negative impact on growth in the major overseas economies as a group, although, reflecting recent developments and the better growth prospects for the world economy, the growth of both exports and imports is expected to be higher than forecast in the spring.

A very moderate rise in consumer price inflation in the major overseas economies is expected in the next two years (see Table B). Although this picture is broadly similar to that projected in the spring, the balance of influences between external and domestic factors has altered somewhat. Externally, non-oil commodity prices continued to grow very rapidly in the first half of 1988, reflecting mainly the strength of industrial demand, but also the effects of the North American drought on the prices of some agricultural products. Spot prices have fallen back in recent months from their peak levels, and it is expected that, as the rate of activity growth slows, real commodity prices will decline further, although the desire to replenish agricultural stocks, which have fallen as a

Table B
Prices in the major overseas economies
Percentage changes

	1987	Forecast 1988	1989	1990
Import prices (a)	−0.6	3.1	1.4	2.5
Unit labour costs in manufacturing	−0.4	—	1.9	2.6
Wholesale prices	0.2	3.2	2.3	2.7
Consumer prices (b)	3.2	3.4	3.8	3.9

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

result of the drought, may underpin prices next year. Recent developments in the oil market have led to a weaker prospect for oil prices, although it is expected that any period of very weak prices would be limited by renewed cohesion between OPEC producers. These lesser inflationary influences on consumer prices from raw materials are, however, expected to be partly offset towards the end of the forecast period by stronger domestic pressures associated with faster growth of activity than in the spring forecast. After falling in 1987 and remaining flat in 1988 because of strong productivity growth and relatively subdued earnings, unit labour costs are projected to rise over the forecast as tight labour markets in some countries and rising import prices, particularly in 1988, put upward pressure on earnings and as productivity growth slows, partly for cyclical reasons. Measured consumer prices are also raised by the assumption that in some countries there may be a shift towards higher indirect taxation. This raises the price level, and although it may lead to some extent to a higher level of earnings, a sustained rise in inflation is not expected from this source.

Activity in the United States has continued to grow strongly this year, the result of very strong growth in exports and private business investment. As there is little slack in the labour market, with unemployment around fifteen-year lows, and as plant utilisation is high in some sectors, the Federal Reserve has raised interest rates in several stages to dampen potential inflationary pressures. This tightening, together with some assumed eventual fiscal support from the new Administration, will tend to reduce domestic demand growth, while the fading of the marked improvement in US competitiveness between 1985 and 1987 is expected to reduce the degree of stimulus from the external sector. Consumer spending is forecast to grow at around 1¼% per annum on average in 1989 and 1990, following an increase of 2½% in 1988, as real personal disposable income growth weakens and the saving ratio is projected to rise. Business investment may increase by almost 12% this year, before slowing to 7% per annum on average in 1989 and 1990, while stockbuilding may give a small boost to growth through next year, partly as agricultural inventories are replenished. Domestic demand growth is projected to slow to around 1¾% per annum in 1989–90, while GNP growth may be around ¾ of a percentage point higher, as the external contribution to growth declines from around 1 percentage point this year.

The Japanese economy has slowed down recently from the exceptional pace of the second half of 1987 and the first quarter of 1988, but the underlying performance remains strong. As the effects of last year's sharp increase in public spending have worn off, there has been a substantial leap in business investment, which may rise by an exceptional 15% this year, and a pick-up in private consumption. Domestic demand may increase by 7½% in 1988, although, with import volumes rising rapidly, the net external contribution to growth is expected to be strongly negative, despite the continued resilience of exports. GNP growth is expected to be around 5¼%. Slower growth is expected in 1989–90, as a more contractionary fiscal stance limits the increase in public spending and reduces the growth of personal income. Growth in consumer spending may slow to some 4¼% per annum. While remaining quite strong, the increase of business investment is expected to fall to around half this year's rate as rising unit labour costs reduce profits and immediate capacity constraints are alleviated. Residential investment is expected to be subdued. Nevertheless, domestic demand is likely to continue to grow at almost 5% per annum, although, with Japanese producers continuing to lose market share in both foreign and domestic markets, GNP may rise by only around 3½% per annum.

Contrary to most expectations, economic growth in continental Europe has been robust so far in 1988, and projections of the likely outturn for the year have been steadily revised upwards as the year has progressed. In Germany improved business confidence has been associated with a pick-up in investment, which might increase by some 7% this year, although to a large extent this seems to be related to the renewed strength of exports. This in turn reflects the strength of demand for investment goods in the other industrial countries and continuing improvements in competitiveness, against other European countries in particular. Consumer spending has remained fairly sluggish this year, despite the tax cuts at the start of the year, and may increase by only 2%. Domestic demand may grow by around 3% and GNP may rise slightly faster. In 1989 output growth is expected to slow to around 2% as the increase in expenditure taxes limits consumer spending, and as the investment-led export boom loses momentum. This is expected to lower the growth of domestic capital spending, which may also be affected by declining profitability. In 1990 the proposed DM 20 billion net tax cuts may lead to a pick-up in domestic demand to over 3% from some 2% in 1989, with GNP rising by some 2½%.

Consistent anti-inflationary policies over a number of years in France have been associated with a reduction in inflation and a steadily rising growth rate. The latter has been due recently to a strong acceleration in business investment, which may grow by some 10% this year, reflecting partly the containment of labour costs and associated gains in profitability over a number of years. In 1989–90, the growth of business investment may slow to around 7% per annum, and as consumer spending remains fairly depressed, reflecting modest growth of wages and employment, domestic demand growth may slow from 3¼% in 1988 to 2¾% in 1990. Improving cost competitiveness has reduced the size of the adverse external influence on activity, and GNP growth is likely to be only slightly below the increase in domestic demand. The Italian economy has been very buoyant this year, and growth may be around 3¾%, although, in contrast to Germany and France, this reflects strong consumer spending as well as buoyant investment. Strong domestic demand coupled with declining competitiveness may be associated with a deteriorating external account. Policy is assumed to be tightened gradually in the future to contain the growth of public debt and to dampen domestic demand. Growth is expected to slow to around 2¾% per annum on average in 1989 and 1990.

World trade is forecast to grow more rapidly than previously projected, largely reflecting the stronger growth of domestic demand. As measured by import volumes, growth of over 7% is expected this year, well up on the 1987 figure, although these measures disguise a marked slowdown from the rates of over 10% in the second half of last year. As world activity slows in 1989–90, world trade may rise at just under 5% a year. Quite buoyant growth is expected in imports into the industrial countries as a group, although, reflecting the pattern of domestic demand and the continued adjustment to previous movements in competitiveness, import growth is especially strong in Japan, and quite weak in the United States. Imports are expected to continue rising very rapidly in the Asian newly industrialising economies. However, as growth in these economies slows and previous losses of competitiveness in Taiwan and Korea continue to take effect, the rate of import growth is projected to decline. Other non-OPEC developing

Table C
World trade and UK markets

Percentage changes

		Forecast		
	1987	1988	1989	1990
World import volumes	**5.8**	**7.4**	**5.0**	**4.2**
of which:				
Major seven	7.2	8.1	4.7	4.4
Smaller OECD	7.1	5.4	4.2	3.8
Newly industrialising economies(a)	24.9	23.6	17.5	14.3
Other non-OPEC developing countries	-2.0	8.0	7.3	5.4
OPEC	-9.1	-4.4	-1.7	-1.9
UK markets(b)	**5.1**	**5.8**	**5.2**	**3.8**

(a) Taiwan, South Korea, Hong Kong and Singapore.
(b) Import volumes weighted according to each country's importance to UK exports.

countries are forecast to achieve import growth averaging almost 7% per annum in 1988–90, although the group is extremely heterogeneous. In countries not affected by debt problems, such as China, imports are likely to rise rather faster than in most of the middle-income indebted countries, some of which may be adversely affected by terms of trade changes. Countries quite reliant on oil exports may be particularly vulnerable. In the OPEC countries, which depend almost exclusively on oil revenues, continued import compression is likely.

The US current account deficit and the Japanese surplus are expected to continue falling as a proportion of GNP, although in dollar terms progress may be slower, and much of the counterpart to the improving US position may arise in other countries. The US current account deficit may fall to under 2% of GNP by 1990, compared with 3½% in 1987, while the Japanese surplus may be around 2% (also 3½% in 1987). There may be little progress in reducing the German surplus which may still be around 4% of GNP in 1990. The combined surplus of the Asian NIEs may fall by only some $5 billion or so between 1987 and 1990, but relative to GNP the reduction is marked, from some 11% to around 7%.