Economic commentary

- *Output growth in the six major overseas economies was strong in the third quarter. The momentum continued into the fourth quarter in the United States and Japan, but not in Germany.*
- *Inflationary concerns continue to stem partly from the pace of economic expansion, which is above the rate thought consistent with non-inflationary growth in several countries. The recent recovery in commodity prices has added to these worries.*
- *Little progress has been made recently in the reduction of external imbalances.*
- *Economic activity in the United Kingdom remained strong in the third quarter, though problems with the most recent statistics make it hard to gauge the strength of domestic demand. In the first three quarters of 1988, domestic demand grew faster than output, which itself was growing at an unsustainably rapid rate. Consumer spending grew more slowly in the fourth quarter.*
- *Clear signs have now emerged of a slowdown in turnover in the housing market in several regions. Prices have stabilised in some areas and mortgage lending has fallen since the summer.*
- *Inflation has continued to increase in recent months. Much of the rise has stemmed from higher mortgage rates, but profit margins and unit wage costs are still significant influences on the underlying rate of price increases. Concerns about the continued momentum of domestic demand, and its potential inflationary consequences, led the authorities to signal a further rise in base rates—to 13%—on 25 November.*
- *The strength of domestic demand has continued to be reflected in the growth of imports and the current account deficit. There are tentative indications that the current account deficit may be stabilising.*

Contributions to growth in the three major countries

Percentage points of GNP: at constant prices

	1986	1987	1988(a)	1988(b) Q2	Q3	Q4(a)
United States						
GNP growth	2.8	3.4	3.8	3.0	2.5	2.0
of which:						
Domestic	*3.5*	*3.4*	*3.0*	*1.4*	*2.8*	*2.7*
External	*−0.7*	—	*0.8*	*1.6*	*−0.3*	*−0.7*
Japan						
GNP growth	2.5	4.2		−3.3	9.3	
of which:						
Domestic	*3.9*	*4.9*		*2.7*	*7.6*	..
External	*−1.4*	*−0.7*		*−6.0*	*1.7*	..
Germany						
GNP growth	2.3	1.8	3.4	−0.7	5.2	—
of which:						
Domestic	*3.4*		*3.6*	*−2.8*	*2.8*	*0.8*
External	*−1.1*	*−1.2*	*−0.2*	*2.1*	*2.1*	*−0.8*

.. not available.

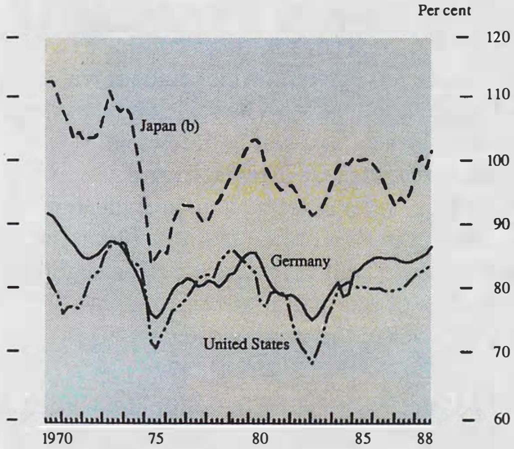
(a) Provisional.

(b) At annual rates.

There is little sign of an end to the **current upturn** . . .

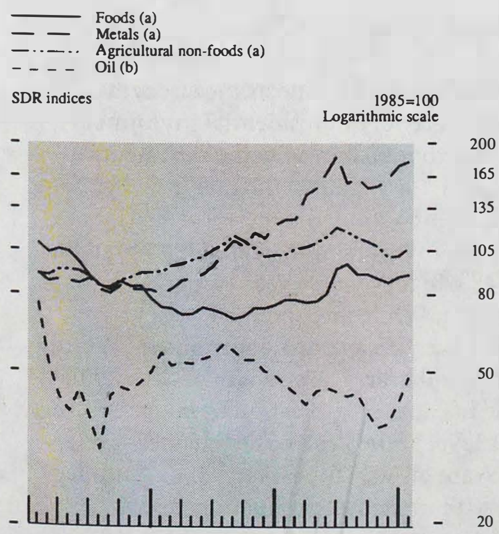
The current upturn in the major industrial countries as a group has now been in progress for around six years. Despite its longevity, there is no evidence of an imminent end to the recovery. Indeed, the pace of economic activity in the six major overseas economies, which had weakened in the second quarter, recovered in the third. Output rose by around 1%, compared with 0.3% over the previous three months, although the increase was less than the even stronger rates attained around the turn of the year. Output growth continues to be widespread across the major countries, although in the third quarter the momentum was greatest in Japan and Europe. In both Japan and Germany, however, it is possible that the third quarter data could overstate the actual strength of activity. The latest data seem to suggest that in the United States and Japan the strength of activity has been sustained in the fourth quarter, although it appears that growth in Germany may have eased.

Levels of capacity utilisation have been rising[a]



(a) Data are from national sources and are not strictly comparable.
(b) The figures for Japan can show levels above 100% but are a useful guide to changes in utilisation over time.

Commodity prices recovered at the end of last year



(a) Economist indices of spot commodity prices.
(b) North Sea Brent price.

. . . and concern about **inflation** *remains*

The continued strength of output has exacerbated inflationary concerns in a number of countries, in part because it is unclear to what extent there are spare productive resources available to meet what appears to be robust underlying demand. Although it is extremely difficult to assess precisely the rate of sustainable output growth—that consistent with no acceleration in inflation—it is possible that the widespread strength of activity in the past year or so has resulted in output growing above sustainable rates, especially in the United Kingdom, the United States, Japan and Canada.[1] This suggests that there is an increasing risk that continued strength in demand would be reflected more in higher inflation and less in output growth. The risks appear to be greater in North America, and (to a lesser extent) Japan, than in continental Europe. Manufacturing capacity utilisation data for the major overseas economies also show that current levels are close to or above those at previous cyclical peaks. However, these data are not easy to interpret and so far there has been sufficient spare capacity to support continued strong widespread growth in industrial production in recent months, with only a very moderate rise in inflation.

Another potential source of inflationary pressure re-emerged towards the end of last year, with commodity prices regaining some of the buoyancy seen in the first half of the year. In the two months to end-January the Economist index of spot non-oil commodity prices rose 8% (in SDR terms) to a level only 9% below its June 1988 peak. Industrial raw materials have performed particularly strongly. Metal and agricultural non-food prices rose by 11% and 8% respectively over this two-month period, with metal markets showing considerable volatility. Although supply-side disturbances continued, the strength of demand appears to have contributed significantly to the price increases. Oil prices remain below their level of early 1988, but have risen from their October trough. In late November, OPEC reached an agreement on output to which all thirteen members were signatories. An overall quota ceiling of 18.5 million barrels per day was established for the first half of 1989, well below the prevailing level of production. Market response to the agreement was an increase in prices, with UK Brent trading at $14–15 per barrel, compared with $12 per barrel prior to the conference. Prices have since remained firm and more recently the Brent price rose to well over $17 per barrel, before easing back, partly because of a temporary loss of some production facilities. More generally, even if OPEC members do produce at the new quota, high levels of stocks are likely to restrain prices in the near term.

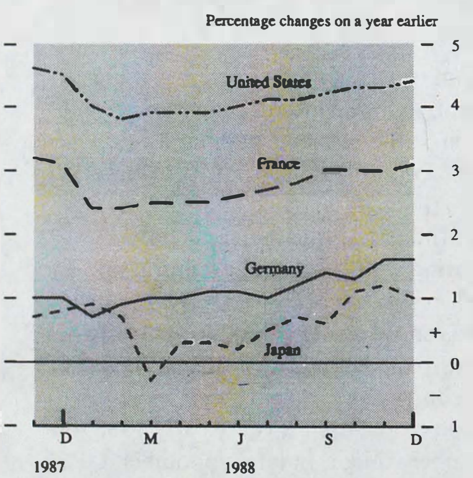
The dollar strengthened in December and January to end some 5% above end-November levels in effective terms. Short-term market interest rates have edged up in some of the major countries in recent months in response to heightened inflationary concerns. In the United States, long rates have also fallen slightly, leading to a flattening of the yield curve. The recent weakness of some European currencies against the dollar prompted a further ½% rise in official rates in Germany, France and the Netherlands in mid-January.

(1) This judgement is based on research which appeared in the IMF's *World Economic Outlook*, October 1988, pages 45–8.

Activity *remains strong in the* **United States and Japan . . .**

Excluding the effects of the drought, underlying GNP growth in the United States picked up very slightly in the fourth quarter from 0.7% to 0.8%, although, as the impact of the drought remained substantial, growth as measured slowed to 0.5%. The balance of demand continued to shift away from the external sector to domestic sources. Personal consumption continued to rise quite strongly but business investment, which had grown only slowly in the third quarter, fell back in the fourth but was, nevertheless, up over 9% in the year as a whole. Despite this robust investment performance, the rate of capacity utilisation rose slightly in the year to December and this may provide a further stimulus to investment in the coming months. Industrial production remains fairly buoyant, although growing at a slightly slower rate than in the middle of the year. In the fourth quarter it rose by 1%, compared with 1.7% in the third quarter.

Consumer price inflation overseas has crept upwards in the past twelve months



There has been a barely perceptible rise in inflation in the United States. On a twelve-month basis, the consumer price index was up by 4.4% in December, a rate of increase only marginally higher than at the start of 1988. This broad stability partly reflects the fact that inflationary pressures in the labour market remain more latent than real. The growth in earnings and unit labour costs has remained subdued, although the increase in non-farm payroll employment in recent months has been particularly rapid, averaging 307,000 in the fourth quarter (an increase of 0.3% of total employment per month). Import prices have been weak, partly reflecting the dollar's appreciation in mid-year; they rose by only 1% in the year to September.

Activity was strong in Japan in the third quarter; GNP grew by 2.2% after falling by 0.8% in the second. The resurgence of domestic demand in the third quarter reflects the strength of consumers' expenditure, a recovery in residential investment and another large contribution from business fixed investment. Consumer spending grew by 1.4%, double the rate in the previous three months, and retail sales continued to perform strongly in the fourth quarter. Business investment increased by 4½% in the third quarter to a level 18% higher than a year earlier. Net external demand was strong. While imports made a negative contribution to growth of over 1%, exports contributed 1½%, after having fallen in the second quarter. The strength of activity has led to a marked increase in capacity utilisation in manufacturing, which is now around its level at the peak of the business cycle that ended in 1980. Buoyant growth appears to have continued into the fourth quarter, with industrial production growing strongly in October and November.

The twelve-month rate of consumer price inflation in Japan fell back to 1.0% in December, much the same rate as at the beginning of last year, having picked up slightly in the autumn. Although earnings growth rose during last year, some of the rise in consumer prices in September and October was the result of an increase in food prices, caused by unseasonal weather conditions. Wholesale prices fell in the first two months of the fourth quarter, reflecting the weaker oil price and the renewed strength of the yen; import prices in December were 6.1% lower than a year earlier, compared with a decline of 2.8% in the year to May.

. . . *but* **growth in Germany** *appears to have eased*

German GNP increased by 1.3% in the third quarter, after falling slightly in the second. While the main impetus to growth came from the domestic sector, the external sector also made a substantial contribution. Much of the growth of domestic demand was accounted for by the growth in personal consumption, which rose by 0.9% after falling in the second quarter. The external sector's contribution stemmed largely from a rise in export volumes. However, GNP grew by 3.4% in 1988 according to preliminary estimates, implying a sluggish fourth quarter. Other recent data support the view that growth has slowed; orders for German goods both in the domestic economy and abroad have been showing some signs of easing following strong growth in the third quarter, and the volume of domestic orders fell back sharply in September and October across all industries. The slackening of foreign orders has been the result of weaker demand for consumer goods and basic goods. Orders for capital goods have remained high owing to the worldwide strength of investment, although they have not increased beyond the third quarter level. Industrial production fell by an average of 1.1% per month in the three months to November, although this may be partly seasonal.

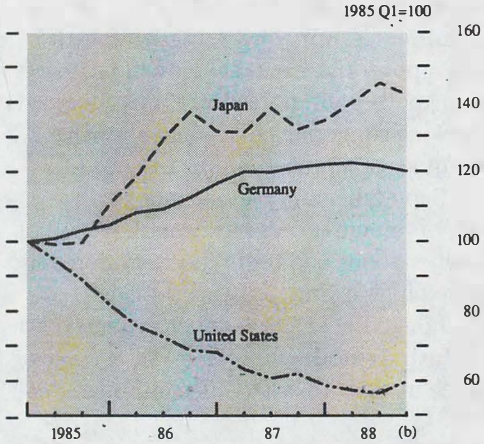
Although capacity utilisation rates remain high, recent inflationary pressure in Germany has been associated not so much with the strength of the economy as with external influences. The depreciation of the deutschemark earlier in the year together with rising non-oil commodity prices led to a 5% rise in import prices between the first and third quarters. This contributed to a rise in the twelve-month growth rate of consumer prices, to 1.6% in December, up from 1.1% six months earlier. A rise in expenditure taxes from January will since have added at least a further ½% to the price level. The growth in unit labour costs has, however, remained very weak.

Elsewhere, GDP in France rose by 1% in the third quarter, up from 0.4% in the second, and the rate of growth in Italy also picked up. In France, there was a mild acceleration in inflation through last year, with consumer prices rising by 3% in the year to November, compared with just over 2% at the start of 1988. The twelve-month rate of inflation in Italy in December was 5½%, very slightly higher than a year earlier. Canadian GDP growth slowed to 0.7% in the third quarter from 1% in the second, and rose only fractionally in October. The twelve-month increase in consumer prices remained around 4% through the year to December.

Little further reduction has occurred in **external imbalances** . . .

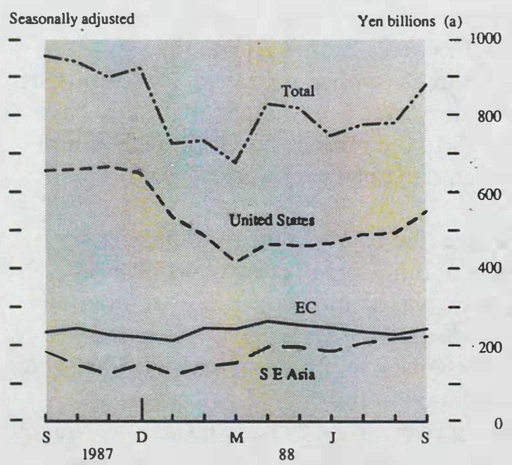
In contrast with the first few months of 1988, the remainder of the year saw generally slower progress in the reduction of external imbalances of the major economies. The average monthly US trade deficit in the three months to November was about $11 billion, the same as in the three previous months; and although the German current account surplus declined in the third quarter to $12½ billion, this was from the very high level of $15½ billion in the second (when growth in exports had been particularly buoyant). The Japanese current account surplus, which had fallen by $5 billion in the second quarter to

Recent changes in competitiveness have not helped the external adjustment process [(a)]



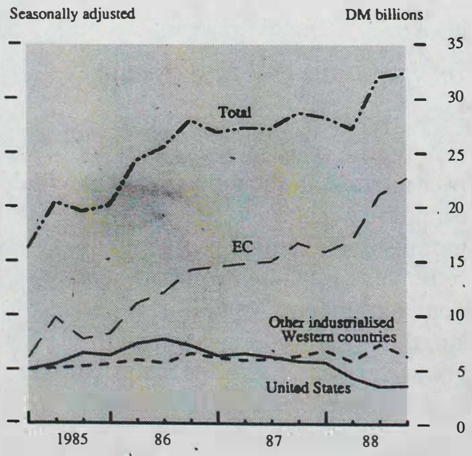
(a) Relative unit labour costs in a common currency; a rise in the index indicates a fall in competitiveness.
(b) Estimates for the third quarter.

The Japanese trade surplus vis-à-vis the US has picked up recently . . .



(a) Three-monthly averages.

. . . and the German trade surplus has gone on rising



$18 billion, increased slightly in the third, and in the fourth quarter probably rose above its level of a year earlier. However, imbalances relative to GNP have declined when viewed over a longer time horizon. In the third quarter, the Japanese current account surplus was around 3% of GNP (some two percentage points less than at the start of 1987), while the US current account deficit was equivalent to 2½% of GNP, one percentage point less than a year earlier. There has, however, been little adjustment in Germany; its current account surplus in the third quarter was over 4% of GNP, little changed from a year previously, although it had been lower in the intervening period.

This slowing in the adjustment process may prove to be only a pause, though most international forecasts envisage only modest further declines over at least the next year. For 1988 as a whole, changes in domestic demand among the G3 countries relative to that in their export markets will in general have made some contribution to the adjustment process, though to a declining extent as the year progressed. The exception to the trend for last year would appear to have been Germany, where domestic demand probably rose at either the same rate or more slowly than in a number of its main competitors. By contrast, domestic demand may have increased by as much as 8% in Japan in 1988, around double the average in the other G7 countries. In the United States, it increased more slowly than in other large industrial countries, with the difference being the largest for a number of years.

. . . *as* **competitive positions** *have tended to stabilise*

The slower rate of adjustment after the start of last year may owe more to trends in international competitiveness than to relative demand. For example, between the first quarters of 1985 and 1987, competitiveness as measured by relative unit labour costs improved by around 35% in the United States, while it declined by some 20% in Germany and 30% in Japan. In the following eighteen months, however, it increased by only 5% in the United States, while it was broadly unchanged in Germany and deteriorated by no more than 10% in Japan. Given the usual lags between changes in competitiveness and their effects on trade flows, these less marked changes in the recent past may have slowed the adjustment process. They mainly reflect the slower rate of dollar depreciation in the later period and very strong productivity growth in Japan, as well as, in the German case, the stability of the ERM since the last realignment at the start of 1987.

There have been certain notable developments among bilateral balances. There is of course no reason why bilateral trade flows between countries need balance, but changes in them do provide information about the nature of the adjustment process. In the twelve months to September, for example, there has been an overall decline in the Japanese surplus with the United States, partly offset by larger surpluses with the EC and the newly industrialising Asian economies. More recently, however, the downward movement of Japan's trade surplus with the United States appears to have been reversed. The increase in the German trade surplus reflects bigger bilateral surpluses with other European countries, notably France, Italy, the United Kingdom and the Netherlands. Both Japan and Germany appear to have benefited from their comparative advantage in producing capital goods at the time of an investment boom in many countries.

The strength of activity has done little to benefit **developing countries**

The strength of activity in the major economies has done little to improve the prospects of developing countries, given rising interest rates and the failure of stronger industrial country import demand to lead to commensurate growth in developing countries' export volumes. Import volumes in the developing countries have also failed to rise in line with the overall growth in world trade, in large part because of the continued cost imposed by debt service obligations. Stronger demand in the third quarter in the three largest industrial countries coincided with a general decline in non-oil commodity prices, although some metal and other commodity prices recovered late in the fourth quarter, and the upturn in oil prices following the OPEC agreement should relieve more debt pressures than it will create. At the end of 1988, non-oil commodity prices were above the average for the first half of the year, and the terms of trade are likely to have improved for many developing countries during 1988. Experiences will have varied widely, however, and tropical beverage exporters continue to face relatively low prices, while net grain importers have been adversely affected by rising prices. For many developing countries, the upward trend in dollar interest rates during 1988 will have offset any benefits of improved terms of trade and stronger export market growth. This is particularly true of the Latin American economies where a higher proportion of outstanding debt is contracted at non-concessionary floating interest rates. Indebted developing countries have also continued to suffer from the effects of cumulative low levels of investment on the responsiveness of their economies to faster export market growth.

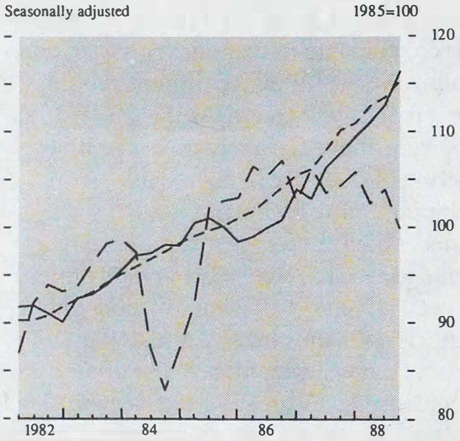
Activity in the UK economy *was very strong in the third quarter, though the statistics are more than usually uncertain*

The economy grew strongly in the first three quarters of 1988, with domestic demand (which is underestimated in the official figures) growing significantly faster than output and output itself growing well in in excess of any sustainable growth rate of productive potential. Successive rises in interest rates in the summer and autumn months had been directed at restraining demand, particularly consumer spending, and forestalling the potentially serious inflationary pressures arising from the unsustainable pace of activity. Interest rates were raised by a further 1%, to 13%, at the end of November in the light of indications, including those from the October trade figures, that the momentum of demand growth was even greater than had appeared earlier.

The provisional estimates of gross domestic product for the third quarter show a widening of the discrepancy between the expenditure and output measures. The output measure showed 1¼% growth in the third quarter (to a level 4¼% up on a year earlier). In contrast, the expenditure measure fell by 2¾% and was almost 1% lower than in the corresponding quarter in 1987. The income-based measure also rose by 1¼% in the latest quarter; its recent movements have been closer to those of the output measure than the expenditure one. For this and other reasons—such as the greater reliability of the initial output estimate and the substantial body of evidence indicating that growth has been strong in the last year—there is a very strong presumption that underrecording of the expenditure measure is the main explanation for the discrepancy. In particular, it seems likely that consumption and gross domestic fixed capital formation have been significantly higher than recorded in the last year.

Manufacturing and services output grew strongly last year

Manufacturing
Service industries
Energy and water supply



The disaggregated figures for output indicate that the non North Sea sectors continued to experience rapid growth in the third quarter, with their output rising by more than 2%. The overall output figure has, however, been depressed by recent developments in the North Sea sector; extraction of oil and gas was subdued in the first half of 1988, and fell by 11% in the third quarter on account of the Piper Alpha disaster. As a consequence, the sector made a negative contribution of about $\frac{3}{4}$% to the year-on-year growth rate. In contrast, manufacturing output grew significantly faster than output in the economy as a whole, and was just under 8% higher in the third quarter than in the same quarter a year earlier. Growth was not evenly distributed among manufacturing subsectors, however; in textiles, output fell slightly in the year to the third quarter, while metals output rose by almost 12%. In the engineering and allied industries sector, which accounts for almost a half of total manufacturing production, growth was nearly 10%. The services sector also grew strongly in the third quarter; total output increased to a level over $4\frac{1}{2}$% above that of a year earlier, with distribution, hotels and catering growing particularly strongly.

Figures for industrial production in October and November suggested that this component of output may have faltered in the fourth quarter. Energy production remained weak and manufacturing output showed no growth overall in the four months to November. In contrast, the latest CBI survey indicates that manufacturing output remained buoyant at the end of last year (although some weakening is expected in the coming months) and other indicators, notably the exceptionally high level of overtime working, tend to support this view. To the extent that the economy is operating close to the limit of its productive potential, some slowing in output growth from the exceptionally rapid rates seen during last year, as indicated in the CBI survey, would not be an unwelcome development. There are already some signs that concerns about capacity are easing a little.

Domestic demand, *in particular, grew faster in 1988 than the recorded figures suggest*

On the basis of the official figures, domestic demand fell slightly in the third quarter, and was just over 3% higher than a year earlier. This is certainly a considerable underestimate, however. A proxy measure, based on the figures for output and the current account, suggest that domestic demand may have grown by close to 3% in the third quarter to a level perhaps 8% higher than a year earlier. These orders of magnitude should be taken as approximations only, but they do give some idea of the possible shortfall in the official figures on expenditure.

Notwithstanding the statistical problems, consumers' expenditure is recorded as having grown by $2\frac{1}{4}$% in the third quarter—an exceptional rate of increase. Over a third of this was attributable to durable goods; spending on vehicles rose by $11\frac{3}{4}$%

in the third quarter (compared with 2¼% in the previous quarter) and expenditure on other durables rose by 6% over the second quarter. It nevertheless remains possible that consumers' expenditure (along with investment) has been underrecorded in recent months. The preliminary estimate of recorded consumers' expenditure in the fourth quarter shows a slowdown in the rate of growth to 1.4%—accounted for by lower spending on durable goods. This had been foreshadowed by a growing body of anecdotal and survey evidence that consumers had begun to retrench in the fourth quarter and by some indications of a slowing in the rate of growth of retail sales. The rises in interest rates during the second half of 1988 will have reduced the growth in consumers' expenditure both by encouraging saving and by reducing the growth of personal disposable income. The first of these effects may have been modest in the fourth quarter although it is likely to increase in importance over time. The effect on personal disposable income is more immediate; higher interest rates on the personal sector's net floating-rate liabilities may have reduced 'other income' (which includes net interest receipts) by about £0.4 billion. This is equivalent to about ½% of total pre-tax personal sector income. In the case of holders of mortgages on which payments are adjusted annually (about a third of the total mortgage stock) the income effect will be felt in the first half of this year, though the effect on the pattern of spending will depend on the extent to which such adjustments were anticipated by consumers in the fourth quarter.

Developments in the housing market may also have helped reduce the growth rate of consumers' expenditure. Although in the United Kingdom as a whole, house prices rose by 34% in 1988, the rate of increase moderated significantly in the fourth quarter, with prices rising (on an unadjusted basis) by 6½% compared with over 10% in the previous quarter, according to the Halifax Building Society house price index. There remain large regional variations in house price increases, however, with prices in the fourth quarter rising only 1½% in Greater London but 11½% in Yorkshire and Humberside and 10½% in the East Midlands. The decline in the overall rate of increase reflects the rise in mortgage interest rates, the ending of dual tax relief in August and, for first-time buyers in particular, the high level of the house price/earnings ratio. Borrowing for house purchase fell in the fourth quarter, with banks' and building societies' lending £8 billion (compared with nearly £10 billion in the third). The relationship between consumer spending and housing market developments is discussed in the article on pages 66–77.

Real personal disposable income increased by 1¼% in the third quarter, nearly 1 percentage point less than the recorded rise in consumers' expenditure, reducing the saving ratio to 1¼%—the lowest figure since the quarterly series began in 1955. However, care needs to be taken in interpreting the level of the saving ratio because of the large balancing item in the personal sector financial accounts and the large statistical discrepancy in the GDP figures. The former may indicate that personal incomes are being underrecorded, while the latter may suggest that consumers' expenditure is underrecorded. The true level of the saving ratio depends upon the relative magnitude of these effects and may be either higher or lower than the recorded figure. Nevertheless, the downward direction of change since the early 1980s seems firmly based and reflects a number of factors,

The recorded saving r tio has f llen to its lowest ever quarterly level

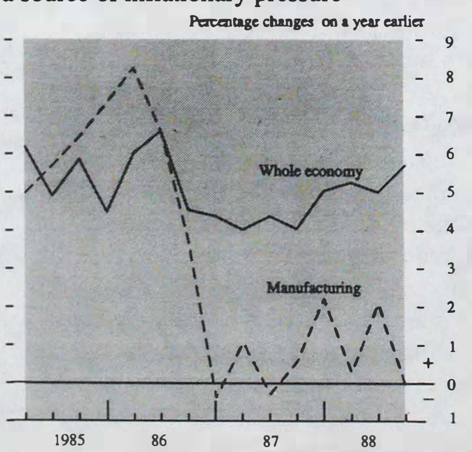
including lower inflation, employers' pension holidays, rising real wealth, increased consumer confidence and increased access to credit by the personal sector.

The strength of economic activity continues to be reflected in the **labour market**

Unemployment continued to fall strongly through the second half of last year, when the average monthly rate of decline was over 48,000, a markedly faster rate than in the first half. The seasonally adjusted measure has fallen continuously since July 1986 (by a total of 1.1 million) and as a percentage of the workforce now stands at 7.2% (compared with 11.2% in mid-1986). The number of employees in employment, meanwhile, increased by 160,000 in the first three quarters of 1988, somewhat less than in the same period in the previous year. The rise was more than accounted for by the services sector; in other sectors, notably manufacturing, numbers employed have continued to fall. At least part of the marked difference in rates of productivity growth between manufacturing and the rest of the economy is, therefore, associated with changes in employment.

The underlying rate of increase of whole-economy average earnings was $8\frac{3}{4}$% in the year to November, compared with $8\frac{1}{4}$% at the same time last year. In the service industries the underlying rate of increase was $8\frac{1}{2}$% and in manufacturing $8\frac{3}{4}$%. The most recent figures suggest that the rate of underlying earnings growth in services has slowed somewhat in recent months and this has been reflected in the figures for whole-economy earnings. This apparent slowing is, however, illusory, stemming from a sharp rise in earnings in the public sector at the end of 1987. There is no sign that earnings growth in any sector has moderated in recent months and the indications are that the trend remains firmly upward.

Unit wage costs in the whole economy are a source of inflationary pressure



Settlements have risen over the past year and this has continued so far in the 1988/89 pay round. According to the CBI, manufacturing settlements averaged 6.3% in the third quarter, compared with 5.8% in the same quarter a year earlier. This rise is broadly consistent with the increase in the underlying rate of growth of earnings. In the private service sector the first estimate of average settlements in the second half of the year was 7.8% (compared with 6.6% in the second half of 1987). CBI data show that the increase in inflation is being reflected in the percentage of manufacturing firms citing the cost of living as a very important upward influence on settlements. This percentage has almost doubled within the past year to 42% so far in the 1988/89 pay round. The need to recruit and retain labour has also become a more important influence, up to 31% in the 1988/89 pay round. It also appears that settlements in manufacturing, where productivity growth remains extremely high, may be having an impact on those in the rest of the economy—notably services, where the rise in productivity, though high by historical standards, is significantly lower. In consequence, a wide gap remains between the rates at which unit labour costs are rising in manufacturing and elsewhere.

In the third quarter, output per head in manufacturing was over 8% higher than a year earlier, compared with $2\frac{1}{2}$% in the whole economy. This disparity accounts for the difference in the behaviour of unit wage costs, which fell fractionally in manufacturing in the third quarter but increased by 5¾% in the economy as a whole. This implies that, outside manufacturing, labour costs were rising significantly faster than underlying inflation (excluding the effects of mortgage interest rates) during 1988.

Inflation *was on a rising trend through 1988, driven by* **interest rates, labour costs and profit margins**

Inflation, as measured by the RPI, rose consistently throughout 1988. The low inflation rates observed at the beginning of 1988 partly reflected reductions in mortgage interest rates a year earlier. (The table opposite shows that the twelve-month increase in the RPI excluding mortgages was above that of the all-items index until August.) However, by December, retail price inflation had risen to 6.8%—mainly as a result of higher mortgage rates, but underlying inflation had also picked up. This view of rising inflation is reinforced by the rise in the annual rate of increase of the consumers' expenditure deflator—from 3.7% to the first quarter of 1988 to 5.5% to the third quarter.

Components of retail price inflation

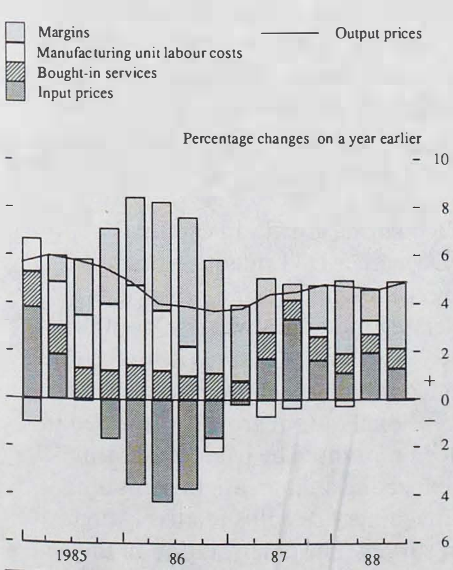
Percentage changes on a year earlier

	All items RPI	RPI excluding mortgages	RPI excluding all housing	Local authority rates	National-ised industries	'Retailed' prices(a)
1988						
Jan.	3.3	3.6	3.2	7.7	2.8	2.4
Feb.	3.3	3.6	3.2	7.7	3.1	2.5
Mar.	3.5	3.8	3.4	7.7	3.0	2.7
Apr.	3.9	4.3	3.8	8.4	4.1	2.9
May	4.2	4.4	3.8	8.4	5.3	3.1
June	4.6	4.8	4.2	8.4	6.6	3.8
July	4.8	5.0	4.5	8.4	7.2	4.0
Aug.	5.7	5.1	4.6	8.4	6.9	3.6
Sept.	5.9	5.2	4.7	8.4	7.5	3.7
Oct.	6.4	5.2	4.7	8.4	7.6	3.6
Nov.	6.4	5.1	4.7	8.4	7.3	3.7
Dec.	6.8	5.1	4.7	8.4	7.3	3.6

(a) Prices of goods actually sold by retailers, accounting for around 50% of the RPI and excluding other items in the table as well as with private services.

Compared with this fairly strong growth in underlying inflation, a constructed measure of 'retailed' prices shows rather less of an increase throughout 1988. This measure, shown in the table, accounts for around 50% of the RPI and is intended to include only the prices of goods actually sold by retailers (it therefore excludes items such as services). Although the measure shows an increase in the growth rate of just over a percentage point in the year, the fact that it accounts for a relatively small part of the total rise in RPI growth suggests that price rises among other items have been rather more significant. One important group of items excluded from 'retailed prices' are services, whose prices are likely to have risen sharply as a result of accelerating labour costs.

Profit margins in manufacturing have continued to widen



The rate at which manufacturers' input prices have been rising has shown some volatility in recent months. The twelve-month rate of increase was 5.0% in June but fell back before picking up strongly again at the end of the year—the rise in the twelve months to December was 4.7%. To a large extent this profile reflects the behaviour of world commodity prices which, after reaching a peak at mid-year, weakened in the second half, when the strength of sterling further restrained non-oil commodity prices in domestic currency terms, resulting in a fall of around 12%. As noted on page 9, prices, particularly of metals and oil, have recently increased quite sharply and, although further strong increases are not expected, the likelihood of continued volatility in these markets in particular makes prospects for input prices in coming months uncertain.

Output prices in manufacturing have been on an increasing trend since the beginning of 1988, the twelve-month rate of increase rising from 3.8% in January to 4.9% in December, suggesting that, for much of last year, manufacturing margins were widening rapidly. The recent sharp increases in manufacturing margins have been the more remarkable for having followed several years of almost uninterrupted expansion, and are probably attributable to a combination of strong demand and increasing capacity utilisation. Conditions in the domestic market may also have been sufficiently buoyant to encourage exporters to widen margins rather more than might normally be expected (given the strength of sterling), with a consequent switching of production towards home sales.

Contributions to growth in the GDP deflator give a clearer view of developments in domestic costs in the economy as a whole, although the most recent data are subject to rather greater uncertainty than usual, owing to the discrepancies in the national accounts data. The table shows the income flows per unit of output, from which it can be seen that the growth in the deflator has risen markedly since the beginning of 1987. In the first instance it appears to have been driven largely by buoyant profits (of both oil and non-oil companies). In 1988, the contribution of profits has eased (although for the non-oil deflator it remains significant) and, in the economy as a whole, labour costs have emerged as a more significant pressure.

Increase in the GDP deflator[a]

Percentage changes on same period of previous year

	Labour costs(b)	Profits(b)		Other income(b)	GDP deflator	
		Total	Non-oil		Total	Non-oil
1987 Q1	3.6	2.0	11.5	4.5	3.4	4.2
Q2	3.3	12.1	12.9	3.3	4.8	3.8
Q3	2.1	23.2	21.2	1.4	5.5	3.8
Q4	5.2	11.6	14.3	3.4	6.0	5.7
1988 Q1	4.6	9.8	17.0	2.5	5.2	5.4
Q2	5.8	6.0	11.0	5.3	5.7	5.9
Q3	6.3	6.8	13.6	5.4	6.3	6.4
Current share of GDP (per cent)	*63.2*	*19.9*	*18.1*	*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.

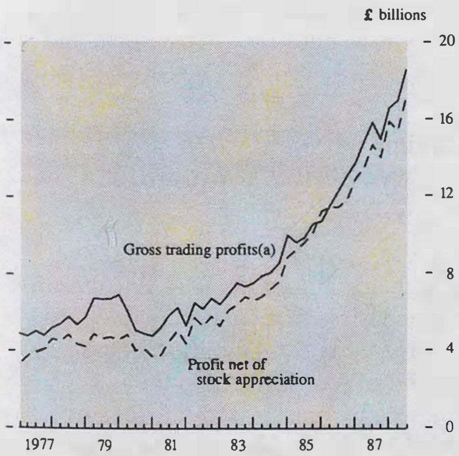
Investment *may have fallen in the third quarter but remains strong in underlying terms . . .*

Recorded gross domestic capital formation fell by 3¾% in the third quarter, although all the signs are that, in underlying terms, the growth of investment remains strong. The decline in the third quarter was particularly concentrated in the construction and distribution sectors. There was also a fall of 2¾% in manufacturing, associated with decreases in the textiles, vehicles, and paper, printing and publishing sectors. There is, however, a strong expectation that subsequent revisions to these figures will be upward, not only on account of the very substantial discrepancy between the output and expenditure estimates of gross domestic product, which may be associated with an underrecording of investment (as well as of consumer spending), but also because of the large unidentified outflow of funds which has been reported in company sector accounts in recent quarters. Revisions to capital expenditure figures in recent years have been predominantly upward. The underlying strength of investment expenditure has been clearly evident from statistics relating to the supply of investment goods from the United Kingdom and abroad (although it is difficult to draw precise conclusions because of definitional differences). Imports of capital goods in the third quarter were 23% higher, in volume terms, than in the same quarter of 1987 (though exports have also grown strongly) and output of investment goods rose significantly faster than that in the economy as a whole for much of last year.

The prospect is for continued strong growth in capital expenditure in 1989. The December DTI intentions survey suggests that investment by the manufacturing, construction, distribution and selected service industries will rise by 10% in the year as a whole, only slightly less than in 1988. Within the total, an increase of 11% is expected in manufacturing investment, probably reflecting the exceptional output growth witnessed in this sector in the last eighteen months. The balance of firms reported by the CBI to be expecting an increase in capital expenditure on plant and machinery remains relatively high, at 21% according to the latest survey. The deterioration in the net liquidity of industrial and commercial companies and the further rise in short-term interest rates towards the end of the year may have had some impact on firms' investment plans, although the real rate of return remains high and longer-term interest rates, to which firms may pay more attention when framing their investment intentions, have increased by less than, and remain below, short-term rates. There is little indication from surveys that the cost of finance is a significant factor inhibiting investment.

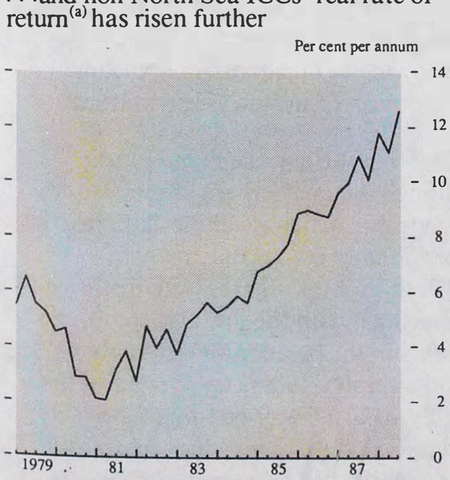
The level of industrial stocks fell by just over £100 million (at 1985 prices) in the third quarter of 1988, following a rise of £875 million in the first half of the year. Stocks held by manufacturers fell by around £150 million, while in the wholesaling and retailing sectors stocks continued to rise. These figures, together with the latest output statistics, indicate a further fall—of 1¼%—in the stock/output ratio in the economy as a whole. For some time firms have been reporting that stock levels of finished goods are lower than they would like and a period of more subdued growth in domestic demand might permit some rebuilding. Higher real interest rates and continued improvements in stock control techniques, however, may have led to some downward revision in desired levels.

Companies' profits remain high . . .



(a) Profits of non North Sea ICCs.

. . .and non North Sea ICCs' real rate of return[(a)] has risen further



(a) Non North Sea ICCs' real rate of return on capital employed.

. . . *and* **profitability** *remained high, though companies'* **net liquidity** *deteriorated*

The company sector enjoyed extremely buoyant trading conditions during 1988 and this was reflected in their financial position. Industrial and commercial companies' gross trading profits (net of stock appreciation) grew by 9½% in the third quarter. North Sea companies' profits fell but the non North Sea component rose by 11%, reflecting strong demand growth which permitted both an expansion of output and a widening of margins. Correspondingly, the real rate of return on capital employed in the latter sector rose sharply, to a record 12½%. ICCs' interest and dividend payments both increased. Interest payments rose by around a quarter, reflecting both the increase in interest rates in the third quarter and continued high levels of bank borrowing, although the continued high level of profitability meant that income gearing rose only a little, to just over 19%. Dividends on ordinary shares rose to a level 42% higher than in the third quarter of 1987, and the dividend payout ratio rose further.

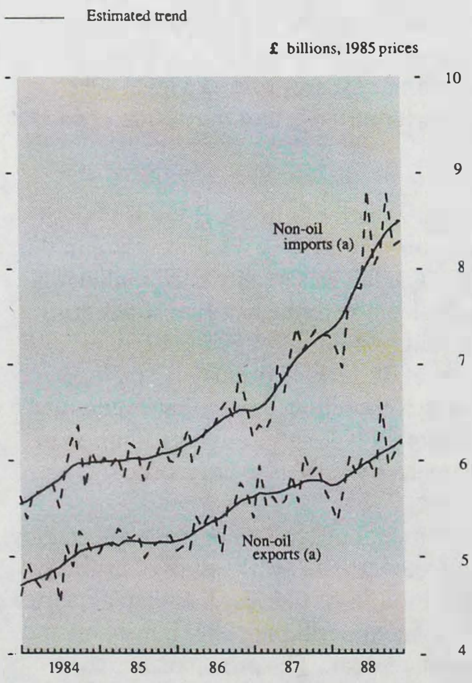
Despite the recent sustained growth of profits, ICCs' tax payments fell in the third quarter and were 4% lower than in the equivalent period of 1987. The fall was wholly attributable to lower net payments of petroleum revenue tax. Investment (in current prices) fell by 4% (but remains strong in underlying terms) and a small amount of destocking occurred. The buoyancy of profits, coupled with relatively subdued outgoings, generated a recorded financial surplus for all ICCs of just over £3 billion in the quarter—the highest quarterly surplus ever recorded.

ICCs' financial decisions throughout 1988 were much affected by the stock market crash in October 1987, with issues of ordinary shares during the first nine months of the year less than a quarter of the level seen in the equivalent period of 1987. Eurobond and debenture issues also remained weak. The principal source of company funding has been bank borrowing: in the first three quarters of 1988, this accounted for around two thirds of all external finance, compared with 38% in 1987 as a whole. This development is partly due to the increased flexibility afforded by new syndicated credit instruments as well as the perceived problems surrounding other forms of financing.

ICCs' gross liquidity has not been adversely affected by these developments—quite the reverse; in the third quarter, companies acquired £4 billion of liquid assets. In contrast, however, net liquidity has deteriorated sharply. The high level of acquisition activity continued into the third quarter; acquisitions by ICCs within the United Kingdom were valued at over £8 billion, taking total expenditure in the first three quarters of 1988 to more than £17 billion, higher than the record annual total for 1987. Acquisitions were, moreover, predominantly cash financed—over 70% of total expenditure by ICCs within the United Kingdom. Accordingly, the flow of funds out of the ICC sector on their investment in UK company securities has been high: £8 billion in the first three quarters of 1988. ICCs' expenditure on cross-border acquisitions has also remained high; the DTI estimate that UK ICCs spent £1.4 billion on such acquisitions in the third quarter, bringing total expenditure in the first three quarters to £3.3 billion.

Interpretation of company sector activity continues to be made difficult by shortcomings in the statistics. The balancing item in the first half of last year alone was nearly £12 billion—nearly as large as in the whole of 1987. In the third quarter, it may have been as high as £4-5 billion. It is thought that this is more indicative of some underrecording of expenditure than an overrecording of income, given the buoyancy of dividend and tax payments.

Non-oil import volumes rose sharply in 1988



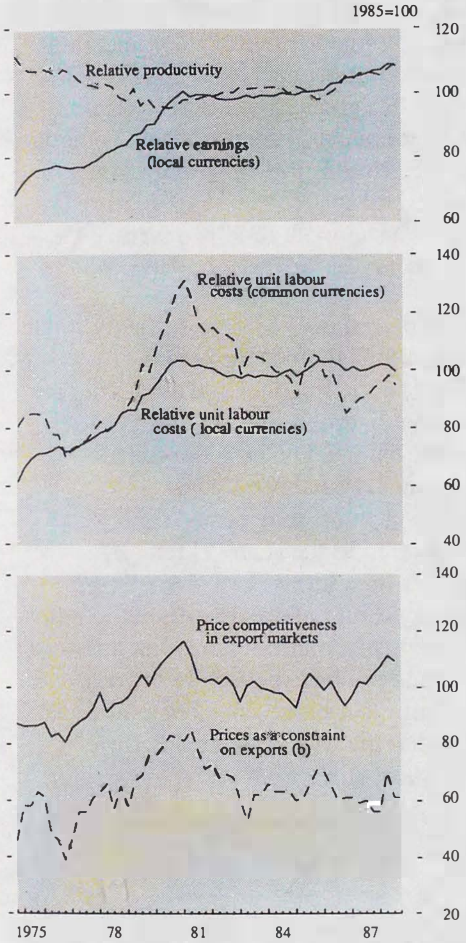
(a) Including erratics.

The current account deficit *widened further in the second half of the year, reflecting the* **pressure of demand** . . .

The current account deficit rose sharply to £3.7 billion in the third quarter of 1988, taking the deficit for the first nine months of the year to £9.2 billion. The visible trade deficit in the third quarter was £5.8 billion (compared with £4.4 billion in the second). Both oil and non-oil trade contributed to the deterioration relative to the second quarter, with the oil surplus falling, owing mainly to the Piper Alpha disaster, while the non-oil deficit increased by £0.8 billion. The invisibles surplus, however, increased to over £2 billion in the third quarter because of a temporary change in timing of EC payments. IPD net earnings fell to £1.3 billion, owing to higher direct investment debits and higher payments on banks' net sterling liabilities.

The visible trade deficit showed a further rise in the fourth quarter to £6.3 billion, although the quarterly figure was exaggerated by the record monthly deficit of £2.5 billion in October, following the exceptionally favourable figure of £0.5 billion in September. Both months' figures were distorted by measurement problems associated with the postal dispute, and particularly sharp movements in the balance on erratic items (mainly precious stones and aircraft). Taking an average of the two months' figures probably gives a better picture of the underlying deficit, and suggests that there may have been little if any deterioration in the underlying deficit over the last five months of the year. The preliminary estimate of the current account balance for the whole of 1988 (including a projected invisibles surplus of only £1.2 billion in the fourth quarter) shows a deficit of £14.3 billion, equal to over 3% of GDP at current market prices. This compares with a deficit of £2.7 billion in 1987 (0.6% of GDP). While the most recent figures offer the

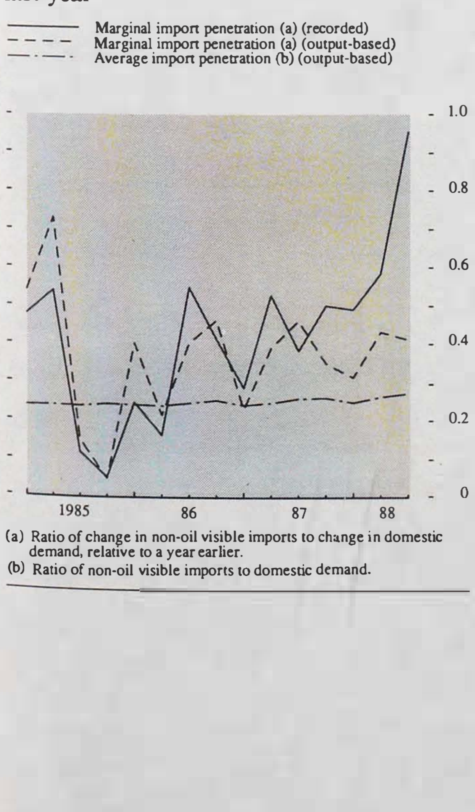
Relative unit labour costs have remained fairly stable [(a)]



(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.

Marginal import penetration rose sharply last year



(a) Ratio of change in non-oil visible imports to change in domestic demand, relative to a year earlier.

(b) Ratio of non-oil visible imports to domestic demand.

tentative suggestion that, after widening rapidly through the year, the monthly current account deficit may be stabilising, the rate of deterioration during 1988 was such that comparisons between 1989 and equivalent periods in the previous year will remain adverse for some time.

The third quarter saw some improvement in all measures of UK manufacturing competitiveness in quarterly terms: labour cost competitiveness (in a common currency) is estimated to have improved by between 3% and 4% relative to the second quarter. This reflects the short-term weakening of sterling's effective exchange rate, but also some estimated improvement in the United Kingdom's underlying position, with faster growth of productivity and (more unusually) slower growth in earnings than in our main competitors. However, over the longer term, although the United Kingdom's underlying competitive position has remained relatively stable, the rise in the exchange rate has meant a worsening in common currency terms—by around 4% in the year to the third quarter, and by around 10% since the end of 1986. The sharp downturn in export volumes at the end of last year revealed by the latest CBI survey looks rather surprising in this context.

The problems in measuring domestic demand need to be borne in mind when examining the recent course of import penetration of the UK domestic market. Based on recorded domestic demand, non-oil import penetration increased by 10½% in the year to the third quarter, but the same measure based on output and trade statistics increased by only 5%. Since some trend rise in import penetration is normal, this difference is very significant. This is illustrated by the accompanying chart, which shows the course of marginal import penetration (the ratio of the change in non-oil imports to the change in domestic demand). The recorded domestic demand figures show this ratio rising steadily to around a half in the second quarter, and then jumping to nearly one in the third quarter of 1988. In contrast, the same ratio based on output and trade statistics has remained roughly stable at around 0.4 for the past two years.

. . . which, together with continued restraint in public spending is also reflected in the strength of the **public sector's finances**

The cumulative public sector surplus for the first nine months of the financial year was £8.1 billion; privatisation proceeds accounted for around three quarters of this, including around £1 billion in December from the sale of British Steel. This compares with a surplus of £0.6 billion over the same period in the previous financial year, when receipts from privatisation contributed £5 billion to the total. The latest official forecast of the PSDR for the financial year as a whole is around £10 billion (according to the Chancellor's Autumn Statement) instead of the £3 billion surplus expected at the time of the Budget; the revision is due in almost equal measure to higher tax revenues and lower public expenditure.

Receipts from VAT, income tax and corporation tax (together accounting for around 75% of all tax revenues) have remained buoyant, reflecting the rapid pace of activity. Strong growth in personal incomes and high profit margins account for higher than expected income tax and corporation tax receipts, but the strongest growth has been in VAT receipts, reflecting the strength of consumer spending. Government expenditure in the current financial year now looks likely to undershoot the planning total by around £3¼ billion. The most important saving has been in social security benefits (owing to a greater than expected fall in unemployment), but asset sales have also been higher. The public expenditure planning total for 1989/90, at £167 billion, remains the same as in the Budget. General government expenditure is projected to continue to fall as a share of GDP by a further 1%, from 39¾% in the current financial year to 38¾% by 1991/92.

The large size of the PSDR expected in 1988/89 represents a tight fiscal stance on any measure, although once the effects of exceptionally rapid growth on public finances and asset sales are taken into account, the nominal figure for the PSDR overstates the degree of tightness to some extent. The medium-term financial strategy envisages roughly balanced budgets in the medium term, but significant surpluses may persist for several years. Fiscal policy remains geared to the achievement of medium-term objectives rather than for use as a short-term instrument. Tax rates and expenditure plans are difficult to adjust immediately in response to new information; many tax rates can be changed only once a year and public expenditure programmes are difficult to reverse. In addition, a supply-side response to tax changes depends on the fact that the fiscal framework, once established, is not subject to short-run variations.