Economic commentary

- *Inflation has edged up again in some of the major economies. Monetary policy has once again been tightened in the United States and continental Europe, but not Japan.*

- *Economic activity in the major industrial countries was stronger than expected last year.*

- *The adjustment of external imbalances has stalled since the end of last year and may even have gone into reverse.*

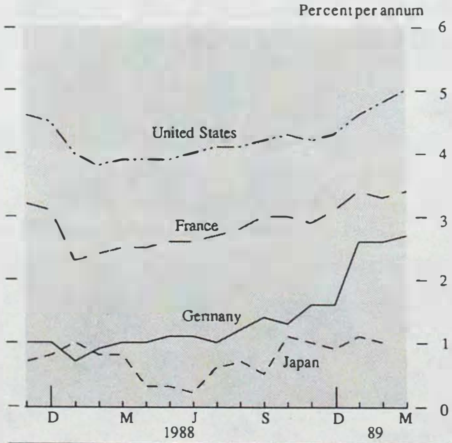
- *There was some indication in the fourth quarter of a slowdown in output growth in the United Kingdom. Nevertheless, non-oil growth in 1988 was exceptionally strong, for the second year running.*

- *There are continued indications that the rise in interest rates has moderated the growth of demand in recent months. The rate of increase in house prices has fallen in several areas and consumer spending was subdued in the first quarter.*

- *Labour market pressures have continued to intensify in recent months and labour costs are seen as a more significant factor in inflation than was thought earlier.*

- *The current account deficit fell in the first quarter. The growth of imports is expected to moderate as higher interest rates affect consumer spending.*

Consumer price inflation has picked up overseas



Inflation *in the major overseas economies continues to edge up . . .*

Inflationary pressures in the major overseas economies are greater now than they were six months ago, and the path of measured inflation has been stronger than had been forecast. The strength of economic activity in the industrial countries has also turned out stronger than originally expected. Whether further inflationary pressures resulting from the growth of output beyond potential rates are soon to appear, or whether the growth of productive potential has been underestimated, is a crucial question in assessing whether monetary policy has been tightened sufficiently to contain inflation. Inflationary concerns appear more justified in the United States than in Japan or Germany at present. In the major countries as a whole, wider profit margins on the back of strong demand are thought to have accounted for much of the rise in inflation in 1988. This is discussed further in the note on page 233.

Oil prices have strengthened over recent months, though temporary supply disruption has played an important part in this. North Sea and US benchmark crude prices have been affected by these disruptions but the price of Dubai crude has also firmed. At least part of the rise in price seems to reflect unexpectedly strong demand for OPEC crude as well as cutbacks in production as OPEC members moved closer to their quotas. However, with some members seeking higher quotas for the second half of this year and demand expected to ease back, prices are expected to weaken. Meanwhile, non-oil commodity prices have fallen in each of the first three months of this year. However, the Economist index of non-oil commodity prices fell by only 6% in SDR terms in the first quarter, when the average was higher than for any quarter of 1988.

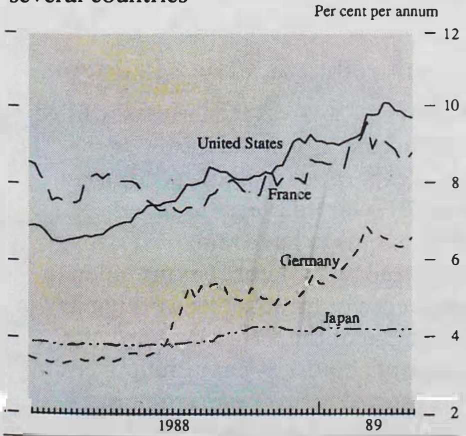
. . . particularly in the **United States** *and* **Germany**. . .

Inflationary pressures associated mainly with the continuing strength of the US economy do now appear to have resulted in a marked acceleration in the producer price index. It rose by 2% in the first quarter and the annual rate of increase is now 5½%—twice what it was six months ago. Although the increase in consumer price inflation has been much less dramatic it has nevertheless picked up noticeably. Labour market pressures are still evident; unemployment fell to its lowest rate in fifteen years in March and non-farm payroll employment continues to grow quite strongly. Despite this, there still seems to be little evidence of rising wage pressure; actual unit labour costs in manufacturing rose only slightly over the first three quarters of last year, with increases in earnings matched to a large degree by productivity gains.

Inflationary pressures in Japan are less obvious, although tensions are becoming evident. Consumer prices fell by 0.8% in the three months to February to stand 1% higher than a year earlier but the index of wholesale prices rose by nearly 1% in the first quarter, having fallen by a similar amount over the previous three months. Much of the recent increase seems to have been due to import prices, and the oil price in particular. There is also some evidence of moderately growing labour market pressure, with earnings creeping up—spring 1988 wage settlements averaged 4% and this year's average is expected to be above 5%. However, strong growth in productivity has helped to contain unit labour costs. The rate of unemployment fell to just over 2% (its lowest level for seven years) in December and has remained there in the early months of this year, while the ratio of job offers to job seekers recently reached its highest level since 1979.

Reported inflation in Germany has risen sharply, albeit from a low base. While some of this is attributable to special factors, there has nevertheless been an increase in the underlying rate. Consumer prices rose by 1½% in the first quarter, with much of the increase being caused by the rise in indirect taxes at the turn of the year. The twelve-monthly rate of inflation has doubled—to 3%—in the six months to April. Increases in hourly wage rates have been creeping up, although up to the fourth quarter of last year, increases in productivity had resulted in only a small rise in unit labour costs.

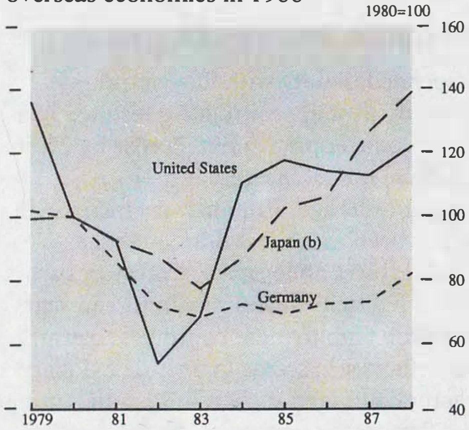
Money-market rates have risen further in several countries



. . . where **monetary policy** *has been tightened again*

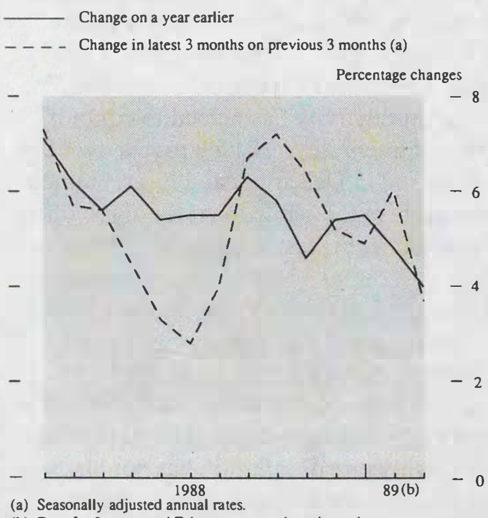
Monetary policy has been tightened again in the United States following the acceleration in producer and consumer prices in January. The discount rate was raised to 7% from 6½% on 24 February; economic growth has as yet shown only modest signs of a slowdown (the recent tightening having yet to work through), while inflation is seen as unacceptably high by the Federal Reserve. The German monetary authorities tightened

Real net investment increased in the major overseas economies in 1988[(a)]



(a) Gross fixed capital formation less capital consumption.
(b) Figures for Japan for 1988 are estimated.

Major seven industrial production continues to grow strongly



(a) Seasonally adjusted annual rates.
(b) Data for January and February are partly estimated.

policy in mid-April, when the discount and Lombard rates rose by ½% to 4½% and 6½% respectively. Prior to this increase, the Bundesbank had shown signs of wishing to discourage expectations of further increases in official rates, which had arisen following a further weakening of the deutschemark against the dollar, an increase in import prices and the effects on the consumer price index of increases in indirect taxes. The upward movement of rates in other countries has also resulted in an edging up of short-term market rates in Japan, although the discount rate remained unchanged after the ½% rise in the US discount rate, despite the fears about inflation resulting from higher import prices associated with the weakness of the yen and rising oil prices.

Given the large amount of net investment in 1988, it is possible that productive capacity in the major countries may now have increased to a level greater than had been expected at the start of last year. However, with measured capacity remaining high, inflation edging up and no firm evidence, as yet, of a slowdown in world economic activity, it is questionable whether the recent rates of growth will prove to be sustainable, a crucial factor when considering whether there is a need for further policy measures to combat inflation.

Measured growth *in the* **United States** *picked up in the first quarter . . .*

GNP in the United States grew by 1.4% in the first quarter—double the fourth quarter rate. Much of the increase, however, represented a rebound from the effect of last year's drought. Excluding drought effects, growth was 0.7%, slightly down on the previous three months, reflecting weaker growth in consumer spending and housing investment, despite a pick-up in business investment. The external sector made a positive contribution with a marked slowdown in import growth. It is not yet clear whether the slowdown in consumption is more than a pause following a surge last autumn. The latest monthly data point to some easing in the pace of activity: industrial production was flat in February and March and the rate of capacity utilisation fell, albeit from a historically high level. Orders for durable goods have also fallen back to the levels of last November. However, the labour market remains very tight; non-farm payroll employment growth remains very strong with an average monthly increase of over 290,000 in the first quarter, only a little below that seen in the final three months of last year.

. . . and **underlying growth** *remains strong* **in Japan**

Japan's growth rate in 1988—at 5.7%—was the fastest for fifteen years, even though growth fell from 2¼% in the third quarter to ¾% in the fourth as exports, consumer spending and private investment all slowed. So far this year, however, underlying economic activity seems to have remained strong. Industrial production grew strongly in March, having fallen in February (partly as a consequence of the loss of a working day in that month because of the funeral of Emperor Hirohito); the index had risen by an average of about 1½% per month over the previous three months. The rate of capacity utilisation in manufacturing rose in the fourth quarter to the highest level since 1980. But although capacity is tight, the high levels of investment in 1987 and 1988 may well have helped provide the productive capacity for robust growth to continue in the near term without causing a significant exacerbation of inflationary pressures.

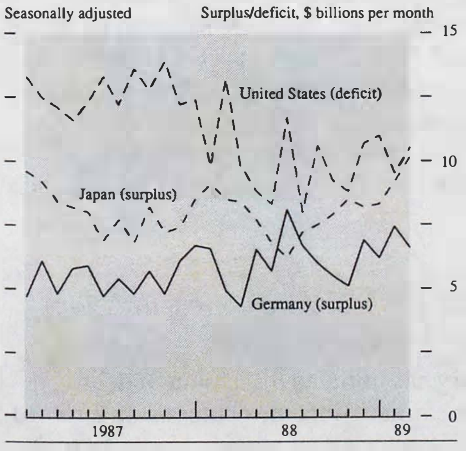
Real GNP in Germany grew by 3.4% in 1988—a much faster rate than had been expected at the start of last year, even though there was virtually no growth in the fourth quarter, with an easing in consumer and government spending more than offsetting a pick-up in investment. Although growth in 1989 is likely to slow as a result of the tightening of monetary policy and the indirect tax increases introduced at the beginning of the year, the latest indicators suggest a fair degree of momentum in the German economy. The twelve-monthly rate of growth of industrial production was just over 5% in the year to March. Orders for capital and consumer goods also remain strong. Seasonally adjusted unemployment edged down to just over 7% in February—1 percentage point lower than a year earlier.

There are, however, clear signs of capacity constraints in the German economy. Capacity utilisation in manufacturing in the fourth quarter rose to the highest rate recorded since the early 1970s. Net investment rose strongly in 1988 after virtually no growth the previous year, although the extent to which this may have helped avoid an even greater exacerbation of inflationary pressures is, as elsewhere, unclear.

The reduction of **external imbalances** *among the major economies has stalled . . .*

Movements in nominal trade imbalances in the three major economies proved uniformly disappointing in the final quarter of last year and the narrowing of current account imbalances seen in the middle of last year has halted. The fourth quarter US trade deficit totalled $32 billion compared with $29 billion for the third, largely reflecting a rise in the value of imports. The current account deficit for the fourth quarter was also $32 billion, slightly larger than in the third. Although the current account deficit for 1988 as a whole declined, the fourth quarter figure is only marginally better than the deficit for a year earlier. There is little sign of any narrowing in the nominal trade deficit in the first two months of this year, even though the external sector made a positive contribution to real GNP growth in the first quarter.

Progress in narrowing trade imbalances halted towards the end of last year



The Japanese seasonally adjusted trade surplus widened to over $25 billion in the fourth quarter. Although export growth eased in value terms, the value of imports fell, despite rising quite strongly in volume terms; a fall in import prices in the fourth quarter was associated partly with low oil prices seen towards the end of last year. The current account surplus did not widen to the same extent as the trade account in the second half of last year because of a sharp deterioration in the invisibles deficit, associated mainly with expenditure abroad by tourists. The latest monthly data (for March), however, do show the trade surplus below the level of a year earlier for the first time in eight months.

The German visible trade surplus rose slightly over the final months of last year, reaching $18½ billion in the fourth quarter, even though import volumes rose at twice the rate of export volumes, having hardly increased at all during the three previous months. Even so the current account surplus widened slightly over the fourth quarter to \$11½ billion as a result of a sharp narrowing of the invisibles deficit.

. . .*and* **external conditions** *are deteriorating for many* **developing countries**

Far Eastern developing countries, especially the newly industrialised economies, grew strongly in 1988, reflecting rapid growth of domestic demand and export volumes despite some losses in competitiveness. The three largest Latin American countries stagnated, and many African countries grew only marginally faster than their populations, despite adjustment efforts. Inflationary problems intensified, particularly in Latin America and China, inducing a variety of counter measures. Terms of trade movements varied widely, but the overall movement between 1987 and 1988 was small despite the strong performance of some commodities. This reflects the exposure of developing countries to weakening beverage and oil prices, and rising import prices. As export market growth and competitiveness improved, many countries achieved stronger current account positions: in some cases, however, liberalisation of import and domestic controls caused current accounts to weaken, owing to rapid growth of import volumes.

External conditions for developing countries deteriorated in the first quarter of 1989. Metal and beverage prices have fallen from their end-1988 levels, with no apparent reduction in the rate at which import prices are rising. Tightening monetary policy in the industrial countries in the course of 1988, and particularly the rise in dollar interest rates, has continued in the first quarter of 1989. Latin American countries are particularly affected by this, given the high share of non-concessional floating-rate debt in their obligations and their high ratios of debt service payments to exports. However, short-term factors have strengthened oil prices since the third quarter of 1988 and this is expected to relieve the severe external debt difficulties of some oil exporters, without causing equivalent deteriorations for oil importers. Concern about domestic and external developments induced some countries to begin reversing liberalisation measures towards the end of last year.

The United States has proposed new measures for dealing with **debt problems**

The US Treasury Secretary has initiated discussion of debt reduction proposals for the middle-income debtors with a record of strong adjustment efforts, which may ultimately relieve some of the debt burden. The proposals involve modifying the Baker Plan whose principles have guided the strategy toward debt problems over the last three years. Key elements of the Baker strategy, including the need for good adjustment policies and structural reforms supported by new financing, were re-emphasised. It is also proposed that a proportion of IMF and IBRD lending already earmarked for structural adjustment should be redeployed, either to replenish a debtor's reserves following a debt buyback or to provide collateral for debt exchanges at a discount. Debtor countries would be encouraged to open their doors to direct investment, to expand debt/equity swap programmes and to adopt policies that would encourage a repatriation of flight capital.

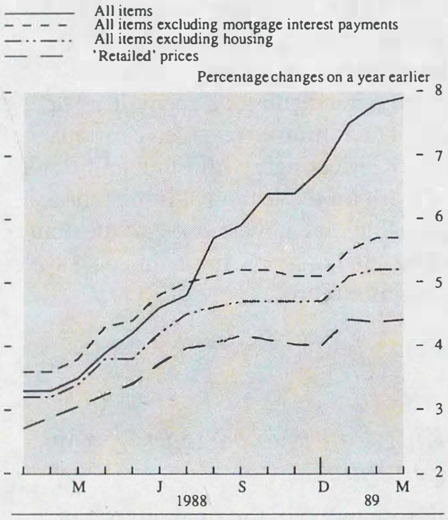
The element of the US initiative that has aroused most controversy is the proposal that, in return for partial interest guarantees financed by additional IMF and IBRD lending, commercial banks should consider reducing a portion of their claims, through either interest rate concessions or partial write-downs of their loans. In order to facilitate a medium-term programme of debt reduction, the United States suggested that banks might also consider waiving certain clauses in loan contracts. Creditor governments were also asked to examine whether there was scope for reducing regulatory, accounting or tax barriers to debt reduction. The initiative received cautious support at the IMF/IBRD Spring Meetings, with Fund and Bank staff being commissioned to work on the technical implications of the proposals. It seems probable that at least some of the debt reduction proposals will be included in a new financing package for Mexico currently under negotiation.

Output *in the United Kingdom is expected to grow more slowly in coming months . . .*

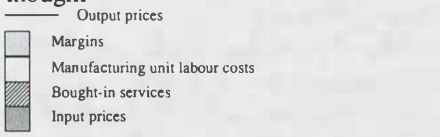
The output measure of GDP rose by ¼% in the final quarter of 1988—the smallest quarterly rise for over three years. The quarterly movements of the other two measures of GDP continue to present a confusing picture, however, with GDP(E) rising by 2% in the fourth quarter, while GDP(I) fell by ¾%. The rise in the output measure was mainly associated with a sharp increase in activity in the construction sector; services output was, surprisingly, recorded as having been flat. Industrial production was unchanged from the previous quarter, with a rise in manufacturing production offset by a further fall in energy and water supply. The growth rate of manufacturing output remains high, however—its fourth quarter level was nearly 7% above its level a year earlier—although some moderation in the growth rate is expected in the first half of this year. The latest CBI survey of manufacturing companies indicates that order books, while remaining relatively high, are closer to normal levels than they were throughout 1988, and the balance of companies expecting to expand output has also fallen (though it remains firmly positive). It is likely that industrial production will be subdued during the first half of this year. In particular, the reduction in oil and gas extraction, resulting from two incidents in the North Sea in December, will have depressed industrial production and GDP by about 1½% and ½% respectively in the first quarter of 1989.

There have recently been significant revisions to past data, which have had the effect of reducing discrepancies between the GDP measures. The most substantial revisions relate to the expenditure measure, which has been revised up by ½% in 1987 and by over 1% in the first three quarters of 1988. Most of the revision is accounted for by fixed investment, which is now estimated to have been around 7% higher in the first three quarters of 1988 than had been originally thought. In a separate exercise, the CSO has now published the results of an investigation into balancing the UK national and financial accounts to remove statistical discrepancies. The work was concerned with the period 1985–87, and is subject to a number of caveats; the data used are now slightly out of date and the results

The prices of goods sold in shops rose by less than the RPI last year



New data show manufacturing margins widened by less last year than had been thought



(a) Based on unit wage costs revised in line with employment estimates from the 1988 Labour Force Survey.

obtained are sensitive to assumptions made by the statisticians. For the period covered, some upward revision of capital expenditure and some downward revision of company profits together with a substantial disinvestment of the personal sector from securities were employed to resolve the main discrepancies. An updating of the exercise, taking into account data relating to 1988, is intended in due course in line with a recommendation in a recently published report on government economic statistics.

. . . and **inflation** *is likely to fall later in the year . . .*

The annual rate of increase of the all-items RPI has continued to rise in recent months, reaching 7.9% in March—the highest since the middle of 1982—compared with just 3.3% at the beginning of 1988. A significant proportion of the recent increase can be attributed to increased mortgage interest payments. Nevertheless, the annual growth in the RPI excluding mortgage interest payments stood at 5.7% in March and, although its growth rate has remained significantly below that of the all-items RPI, it, too, has risen significantly—by over 2 percentage points since January 1988. It seems likely that private sector services account for a substantial part of the increase. The twelve-month increase in prices charged by retailers has risen by only 1½ percentage points over the period and, while the rise in the rate of increase of nationalised industry prices has been substantially larger, these have a small weight (only around 5%). The implication is that the prices of privately produced services have accelerated markedly, which is not altogether surprising given rapid earnings growth and relatively low productivity growth outside manufacturing.

The annual inflation rate may show some variability over the next few months. The effects of last autumn's interest rate rises have now fed fully through to the level of the RPI, however, and this year's Budget measures will have almost no effect on the level of retail prices. It is unlikely, therefore, that inflation will rise much further and it should begin to fall back decisively in the late summer as the effect of last year's mortgage rate increases begins to depress the growth in the RPI from August. The expected slowdown in demand is also likely to be reflected in some narrowing of profit margins in the coming months, as well as some moderation of labour costs—provided earnings growth is restrained.

. . . although underlying **inflationary pressures** *remain strong*

Manufacturers' input prices have been accelerating since the early autumn and the annual growth rate reached 6.7% in March. This reflects, in large measure, the strong growth in commodity prices in recent months, though this has moderated somewhat since the beginning of the year. Much of the acceleration in input prices appears to have been passed on, so that the growth rate of output prices in manufacturing has continued its upward trend and was over 5% in March. This implies that, although the broad trend of rising margins in manufacturing may be continuing, there is some evidence of a narrowing towards the end of last year. The accompanying charts show that, in the third quarter, margins were still higher than a year earlier, thus continuing to give a positive contribution to output prices though the rate at which they were widening was lower than in most earlier quarters. Recent revisions to unit labour costs (as a result of changes to employment estimates) also indicate that margins were raised by less last year than was previously thought.

The evolution of domestic costs in the economy as a whole can also be seen from changes in the GDP deflator (see table). The rate of increase in the deflator was on an upward trend until the third quarter of 1988, but more recently has fallen. Labour costs have been a major factor behind the rise, with the recent slowing being mainly the result of a less buoyant profits contribution (from both oil and non-oil companies).

Increase in GDP deflator[a]

Percentage changes on same period of previous year

	Labour costs(b)	Profits(b)	Other income(b)	GDP deflator
1987 Q1	4.0	1.6	4.9	3.7
Q2	2.8	11.5	3.5	4.5
Q3	1.9	23.9	1.7	5.3
Q4	5.4	11.5	3.4	6.0
1988 Q1	3.7	13.9	0.3	4.9
Q2	7.1	5.4	4.3	6.3
Q3	7.1	10.4	4.4	7.2
Q4	7.5	5.8	5.2	6.8

(a) Constant-price output is derived by dividing the current-price income measure of GDP by the GDP deflator. The contribution of each component of 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.

The labour market *has tightened further . . .*

Unemployment (seasonally adjusted) fell to just over 1.9 million in March. There have now been 32 consecutive monthly falls since July 1986, when unemployment stood at over 3 million. Unemployment has fallen in every region in the last twelve months, but most rapidly in the West Midlands and Wales. The average monthly fall in the first quarter was a little under 40,000, less than in the fourth quarter of 1988, though it is too early to say whether the trend rate of decline is beginning to slow.

Preliminary results from the 1988 Labour Force Survey show that the number of employees in employment has grown significantly faster than previously estimated. By the third quarter of 1988 the cumulative effect of revisions from early 1987 was to increase employment by some 500,000 and raise the growth rate of employment in 1988 by over 2%. The growth in employment is now shown to have exceeded the fall in unemployment. This does not necessarily imply a direct causal relationship between the two, however; much of the increase in employment could be the result of changes in the labour supply as a result, for example, of buoyant labour market conditions leading to an increase in participation rates among people not previously recorded as unemployed. Both this and the fall in unemployment, however, are clearly a reflection of the rapid rate at which the economy has been growing in the past two years. The revisions to employment figures are particularly significant in the manufacturing sector, where employment is now estimated to have risen by around 90,000 in the past two years, rather than falling as previous estimates had suggested. Although this revision was not expected, neither is it wholly surprising given the strength of manufacturing output.

Tight conditions in the labour market have been reflected in a continued edging up in the rate of earnings growth. The underlying rate of increase of whole-economy average earnings was 9¼% in the year to February—¾ of a percentage point higher than a year earlier. This reflects a rise in the underlying rate of increase in both manufacturing and service sector industries. According to the CBI, manufacturing settlements averaged 7.1% in the first quarter, while in the private services sector, average settlements for the second half of 1988 were running at 7.4%. Both of these figures represent substantial increases on a year earlier. Evidence on the distribution of manufacturing settlements from the CBI suggests that over a quarter were between 5½% and 6½% and about a half exceeded 6½%.

The cost of living and the need to recruit and retain labour, reflecting the strength of output, continue to be reported as the most important upward influences on settlements in manufacturing. The cost of living is of increasing significance, cited by almost half the firms covered by the survey as an important influence in the 1988/89 pay round compared with less than a quarter in the previous one. In the private service sector, skill shortages are deemed to be even more important, although the high level of profits and the increase in the cost of living are also important influences.

Wage drift in manufacturing, the gap between earnings and settlements, was still around 2¾% in the year to February, though this is slightly lower than a year earlier. The contribution of changes in overtime payments to earnings growth has fallen back to around ½ of a percentage point in manufacturing (and ¼ of a percentage point in the whole economy) compared with 1 percentage point at the same time last year. Although the level of overtime working remains high, its growth rate has fallen and this accounts for the decline of the contribution of overtime to earnings growth.

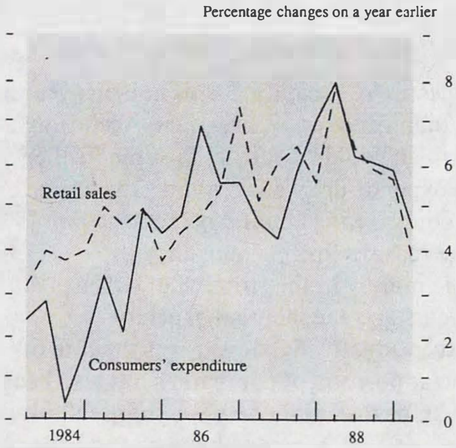
. . . and **labour costs** *have been rising faster than was thought*

In the absence of offsetting revisions to the data on aggregate output or earnings, the revisions to the employment figures have the effect of raising the growth rate of unit wage costs and reducing that of productivity. Whole-economy productivity growth in the year to the third quarter of 1988 has now been revised down from 2.6% to 1.0% and in the year to the fourth quarter it fell to 0.6%, reflecting the slowdown in output growth. The revisions to productivity figures for the whole economy have resulted in a higher estimated growth rate in wages and salaries per unit of output; 7.3% in the year to the third quarter with a further rise to 8.4% in the year to the fourth. Whole-economy productivity growth now appears to have slowed in 1988 compared with 1987, while labour costs have risen rather faster. The new employment figures have also altered the estimates of productivity and labour costs in manufacturing. In the year to the fourth quarter, productivity growth in manufacturing is now seen to have been just below 6%, while the rate of growth of unit wage costs has been revised up to just over 2½%. The momentum of earnings growth and the widening margin between it and productivity growth is therefore a serious problem and a more significant contributory factor to inflation than had been thought earlier.

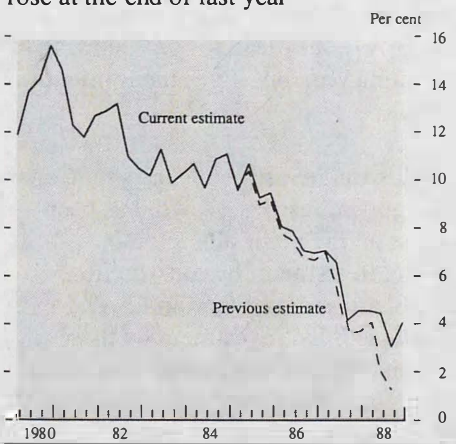
Consumption *grew more quickly than* **personal incomes** *last year but its growth has since slowed*

Personal incomes are estimated to have risen by 5% in the fourth quarter—twice the rate of the previous three months. Wages and salaries grew strongly but the largest increase (almost 13%) was in ‘other income’ which consists of rent, dividend and interest receipts. Within this item, dividend payments seem to have been particularly buoyant as companies’ dividend/payout ratio increased sharply. Total personal disposable income, after taking account of deductions, rose by 4¼% in the quarter and with a rise in the implied consumers' expenditure deflator of 1¼%, real personal disposable income (RPDI) increased by 3%.

The growth of consumers' expenditure and retail sales fell in the first quarter



The saving ratio has been revised up and rose at the end of last year



According to the preliminary estimate, real consumers' expenditure grew by around ½% in the first quarter, compared with 1¾% in the fourth. The weakness of durable goods—particularly those associated with housing—has been very noticeable in the past two quarters; spending on furniture and floor coverings has been flat since the third quarter of last year, while spending on other durable goods has fallen by over 5% over the same period. Expenditure on vehicles fell slightly in the first quarter and there was a sharp drop in spending on energy, largely as a consequence of the mild weather in the first quarter. The marked slowing in the growth of consumer spending so far this year was foreshadowed by the figures for retail sales (which account for around 40% of consumption) which showed no growth overall in the first quarter. This may overstate the degree of weakness to some degree as the fourth quarter's figures may have been buoyed up to some extent by retailers bringing forward traditional post-Christmas discounts into December. There are, nevertheless, clear indications of a fall in the growth rate of consumer spending.

As a consequence of the slowdown in consumption, the saving ratio increased from just over 3% in the third quarter to just over 4% in the fourth. The saving ratio has on average been revised up by 1½ percentage points in 1988 and ¾ of a percentage point in 1987, largely as a result of revisions to the estimates of income from wages and salaries arising out of the Labour Force Survey, though revisions to the other personal income series have also contributed. Despite the upward revisions and the recovery between the third and fourth quarters, the saving ratio still shows a marked decline through the 1980s. Considerable uncertainty about the true level of the saving ratio remains, however, given the size of the balancing item in the personal sector's financial accounts and the remaining differences between the various measures of GDP.

Higher **interest rates** *continued to have a dampening effect on* **house prices**

The annual rate of increase of house prices, according to the Halifax Building Society, slowed slightly in the first quarter of 1989 but remains above 30%. Correcting for seasonal influences, the Halifax index has shown a perceptibly smaller rate of monthly increase in the past six months than in the previous six and the annual rate of increase over this period has been around 18%. There continues to be considerable variation in the behaviour of house prices in different regions. The Halifax report that house prices fell in East Anglia and Greater London in the first quarter, while continuing to rise strongly in parts of the North. This pattern is much as expected; the housing market is likely to show the largest response to higher interest rates in areas where house prices are highest in absolute terms and mortgage holders are most highly geared.

The latest evidence on mortgage lending tentatively suggests some recovery in the housing market, calling into question the view that house prices may show significant falls this year, even in real terms, although the evidence is still hard to interpret. A period of relative stability in house prices nevertheless has a potentially important role in slowing consumer spending. A reduction in the growth of housing-related expenditure would play a part in this, together with a slowing in the growth of housing-related credit expansion.

Investment *was exceptionally strong last year . . .*

The increase in gross domestic fixed capital formation last year, at nearly 12%, was larger than for over twenty years. According to the expenditure figures (which could be subject to some further upward revision), capital expenditure was an important source of demand growth in 1988, contributing about 2 percentage points to the rise in GDP(E). The reasons for this buoyancy in investment expenditure lie mainly in the strength of output growth in the past three years and the fact that capacity utilisation is now at an exceptionally high level, as is the rate of return. The healthy financial position of companies has also been a contributory factor and helps to explain why the sharp fall in equity prices in the autumn of 1987 seems to have had so little effect on investment plans. It seems unlikely that the rise in short-term interest rates in the second half of last year will have a large direct effect in depressing capital expenditure; long-term interest rates are thought to be a more important influence on investment decisions, and these have risen by less than short-term rates in the past year and remain at a lower level. A general slowdown in output growth may lead to some slowing in capital expenditure in the coming year, but investment intentions nevertheless remain buoyant.

Analysis of the figures for industrial investment shows that, apart from the energy and water supply industries, growth has been fairly evenly distributed across all the main subsectors. Manufacturing investment and investment by construction, distribution and financial industries rose by 9½% and 11½% respectively in 1988, although recorded investment by these sectors did not rise very rapidly within the year, and was only a little higher in the second half than in the first. This may simply reflect an element of underrecording in the most recent figures, however, since the revisions made to the aggregate investment figures have not yet been reflected in those at the individual industry level. Statistics for the output of investment goods, which showed a rise of 9% between the first and fourth quarters, also suggest a rising quarterly profile for investment throughout 1988, although the full significance of this for domestic investment is hard to gauge as trade in capital goods was buoyant last year. Full-year figures for the transport and communication sector are not yet available, although it appears that investment in this sector may have been slightly less strong, while in the energy and water supply industries it is likely that capital expenditure fell, continuing a trend which has persisted since 1982.

The level of stocks held by UK industry rose by £1.5 billion (1985 prices) in the fourth quarter. This was an exceptionally large increase, and was one of the main factors underlying the rise of over 2% in GDP(E) in the quarter. It may have been a result of unexpected weakness in demand in some sectors in the last three months of 1988. Stockbuilding in the construction sector may have reflected the slowdown in the housing market, while a sharp reported rise in retailers' and distributors' stocks is consistent with slower than expected growth of retail sales in the fourth quarter. The rise in manufacturers' stocks, however, may be less related to demand factors; most of the increase occurred in the engineering sector, where the value of outstanding work in progress rose substantially.

. . . *and* **companies** *moved into* **financial deficit** *in the fourth quarter . . .*

Although, in an underlying sense, the company sector remains extremely buoyant, profitability actually fell somewhat towards the end of last year—partly as a reflection of the slowdown in the rate at which output was growing—and a financial deficit emerged as a consequence of a high level of outflows. The interpretation of company sector activity also continues to be hindered by deficiencies in the published data. The balancing item of the company sector totalled £14 billion over the first nine months of last year, although the fourth quarter figure, while not yet known precisely, appears to have been negligible. Recent revisions to the figures for profits and investment have reduced the size of the company sector balancing item in 1986 and 1987 and suggest that the financial surplus of the sector was more modest than previously indicated. In 1988 it apparently moved into financial deficit (see table).

Industrial and commercial companies' income and capital accounts

£ billions, *seasonally adjusted*

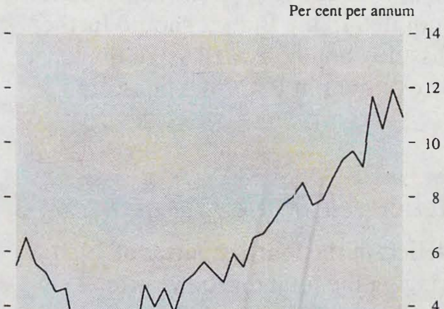
	1987	1988			
	Year	Year	H1	Q3	Q4
Total income (a)(b)	81.0	90.8	44.2	23.8	22.8
of which:					
Gross trading profits (b)	61.1	68.7	34.2	17.8	16.6
North Sea	9.5	6.9	3.8	1.7	1.4
non North Sea	51.6	61.8	30.4	16.1	15.2
Total allocations	43.4	54.1	24.7	13.9	15.5
of which:					
Dividend payments (c)	11.9	17.7	7.5	4.5	5.7
Other payments (d)	11.7	14.8	6.2	4.1	4.5
UK taxes	13.5	15.1	7.9	3.6	3.6
Undistributed income (b)	37.6	36.7	19.5	9.9	7.3
Less: expenditure on fixed					
capital	32.2	37.4	18.2	9.3	9.8
other	1.8	2.5	1.1	- 0.5	1.9
Financial surplus	**3.6**	**- 3.2**	**0.2**	**1.1**	**- 4.4**
Identified financial transactions (outflow/acquisition of assets-)					
Investment in UK company securities	- 3.2	-11.6	- 5.3	-3.3	- 3.0
Investment abroad	-15.2	- 9.0	- 3.9	-1.8	- 3.3
Liquid assets	- 9.8	- 5.0	- 1.9	-2.8	- 0.5
Borrowing from banks (e)	13.0	29.7	15.2	7.7	7.5
Other borrowing (f)	23.2	16.7	8.2	3.5	5.0
Other identified transactions	- 7.5	..	0.3	0.6	..
Unidentified financial transactions	**- 4.1**	..	**-10.1**	**-3.9**	..

.. not available.

(a) Including interest, other property income and income from abroad.
(b) Net of stock appreciation.
(c) Net of tax. ACT payments on dividends included in tax payments.
(d) Including North Sea royalties.
(e) Including Issue Department holdings of commercial bills.
(f) Mainly capital issues, including equities.

Industrial and commercial companies' (ICCs') gross trading profits (net of stock appreciation) fell in the fourth quarter. The gross trading profits of North Sea oil companies fell by 19%, largely as a result of a number of supply disruptions (and associated falls in production) though profits in this sector have been falling since mid-1987. The trading profits of non North Sea ICCs also fell, but by much less (6%), as output growth slowed and margins may have been trimmed back. Quarterly profits figures tend to be erratic and too much should not be made of a single quarter's fall; underlying profitability remained high, with the real rate of return on non North Sea companies' assets standing at nearly 11%, only slightly less than the peak reached earlier in the year which was the highest figure since 1964.

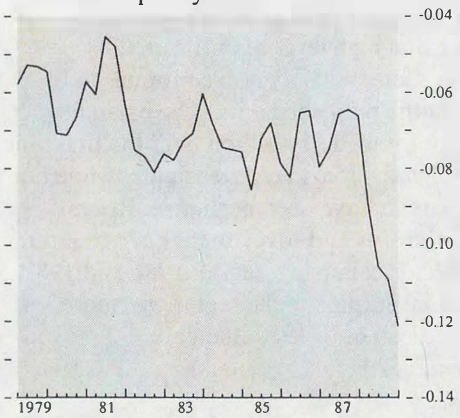
Non North Sea ICCs' real rate of return fell in the fourth quarter but remains high



Notwithstanding some reduction in gross profitability, all of the main components of ICCs' outgoings increased in the fourth quarter; interest payments rose as a consequence of both the increase in interest rates and continued high levels of bank borrowing, although income gearing remained relatively low (at 17%), reflecting the high level of profitability. Dividend payments also rose, leading to a sharp increase in the dividend/payout ratio to just over 43%, as did ICCs' tax payments, reflecting the recent sustained growth of profits. These increases in interest, dividend and tax payments led to a contraction in undistributed income which, together with a rise in investment and a sharp increase in stocks, led to a £4½ billion financial deficit in the quarter.

The high level of acquisition activity witnessed in the recent past continued into the fourth quarter, with domestic expenditure on acquisitions and mergers standing at £5 billion which, while lower than the peak of over £8 billion (recorded for the third quarter) remains comfortably above the quarterly average for 1987. Domestic merger activity in 1988 as a whole reached a

The fourth quarter saw a further fall in ICCs' net liquidity ratio [(a)]



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

record £22 billion and, in contrast to 1987, was predominantly cash financed. Accordingly, ICCs' investment in UK company securities was high—£11½ billion in 1988—more than three times the previous year's level—and their expenditure on cross-border acquisitions also remained high. The DTI estimate this to have been £2.8 billion in the fourth quarter, taking the total for 1988 as a whole to nearly £6 billion.

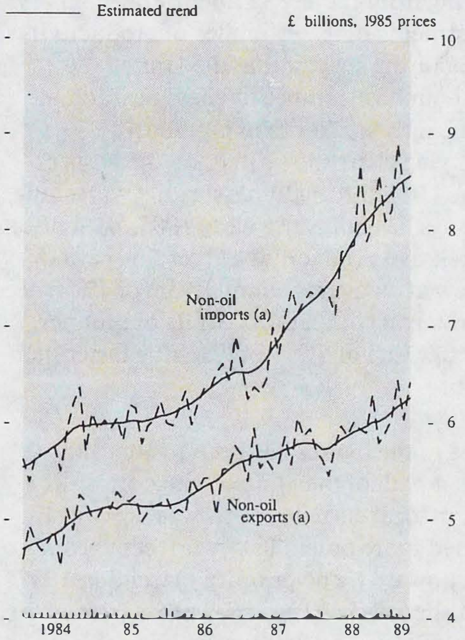
. . . while their net **liquidity** *deteriorated further*

ICCs continued to acquire liquid assets in the fourth quarter and this, together with buoyant investment both in UK company securities and abroad and the £4½ billion financial deficit, led to the development of a considerable net borrowing requirement. The manner in which this was financed continued to reflect the influence of the stock market crash in October 1987, with issues of ordinary shares at only about half of the average 1987 level. The main source of company funding was therefore bank borrowing, which accounted for approximately 70% of all external funding (almost double the proportion in 1987) with ICCs borrowing £7½ billion from banks in the fourth quarter alone. In line with this, net liquidity continued to deteriorate. The DTI survey of company liquidity indicated that the ratio of large companies' current assets to current liabilities fell from 117% at the end of 1987 to 73% at the end of 1988. There are a number of encouraging indications, however, that companies have been exploring the possibilities of longer-term sources of finance. The main sustained emphasis has been in the domestic bond market. Issues of debentures and preference shares in the fourth quarter, at nearly £600 million, were buoyant by historical standards, and followed equally strong issues in the third quarter. These figures compare, for example, with an equivalent figure of around £400 million for the whole of 1987. The latest data suggest that such buoyancy has continued into the early part of 1989. Although weak in the fourth quarter, eurobond issues have also increased this year. The growth in issuing activity has occurred for a number of reasons. On the demand side, the shortage of gilts implied by the government's net repayment of public sector debt has encouraged increased institutional demand for long-dated company securities. On the supply side, downward pressure on long rates, which reflects the authorities' transactions in bond markets, together with the markets' confidence in the anti-inflationary stance of policy, has led to a sharply inverted yield curve and corresponding incentives to issue longer-maturity debt. Policy changes incorporated in the Budget should further enhance the attractions of issuing bonds, as well as, in the longer run, bringing about an improvement in ICCs' net liquidity position.

The **current account deficit** *fell in the first quarter. . .*

The UK current account deficit in the fourth quarter of 1988 widened to £5.5 billion, bringing the total for the year to £14.7 billion. The fourth quarter visible trade deficit was £6.3 billion and widened by less than the current account deficit, since the latter partly reflected a weak performance of invisibles, mainly as a consequence of a temporary shift in the timing of EC transfer payments. For 1988 as a whole, the invisibles surplus was £5.9 billion, compared with £7.3 billion in 1987, with an increase in net IPD receipts more than offset by a sharp fall in the

Non-oil import volumes have grown more slowly in recent months



(a) Including erratics.

Contributions to change in the visible balance(a)

£ billions

	1988 compared with 1987	1989 Q1 compared with 1988 Q4
Total change	**-10.4**	**0.3**
of which:		
Oil	-1.8	-0.2
Non-manufactures	-1.6	0.3
Manufactures	-6.9	0.2
of which:		
Erratics	*-1.0*	*0.1*
Semi-manufactures	*-1.7*	*-0.2*
Cars	*-1.6*	*0.1*
Other consumer goods	*-1.2*	*0.2*
Intermediate goods	*-1.7*	*0.2*
Capital goods	*0.1*	*-0.1*

(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.

surplus in services. The fall in the services balance reflected a doubling of the deficit on travel to some £2 billion (reflecting strong growth in disposable income and adverse exchange rate movements), and a fall in the surplus on financial and other services as a result of falls in insurance underwriting earnings.

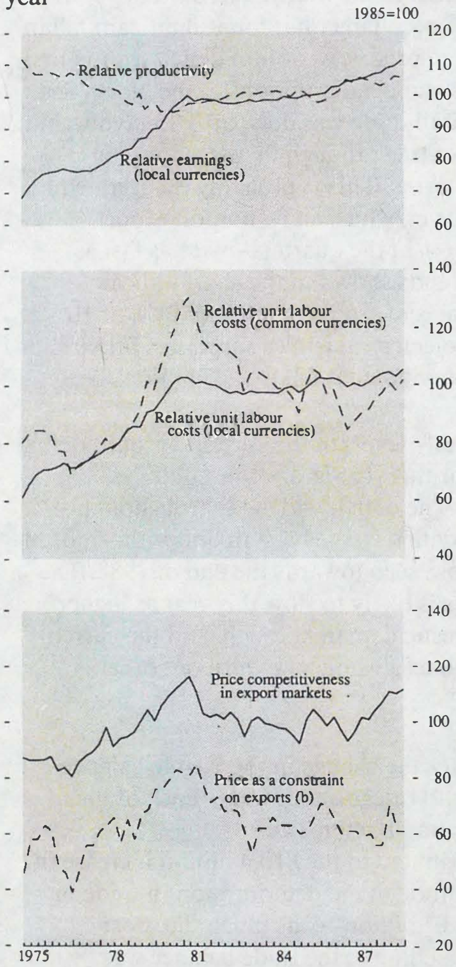
In the first quarter of 1989 the visible trade deficit was £6 billion, slightly lower than in the fourth quarter. The improvement would have been larger but for a significant fall in the oil balance (which, in February, went into deficit for the first time since 1980), owing to supply disruptions in the North Sea. The improvement in non-oil trade was due partly to favourable movements in the terms of trade though there was also an improvement in volume terms. This is probably exaggerated by the recorded figures, however, which show non-oil export volumes growing at over 6% in the quarter—twice as fast as imports. The estimated trends shown in the chart indicate roughly equal quarterly rates of growth of around 2½%, or 10% at an annual rate. With a projected invisibles surplus of £1.5 billion, the estimated current account deficit fell to £4.5 billion.

Projection of recent monthly levels of the current account deficit to arrive at an estimate for this year as a whole could be misleadingly pessimistic. The deficit widened throughout last year and recent monthly deficits have been in line with—indeed slightly smaller than—those seen towards the end of 1988. The growth of import volumes is likely to slow this year as higher interest rates reduce domestic demand growth, and the current account deficit for the year as a whole may turn out broadly similar to last year's.

The table opposite allocates the change in the visible balance between 1987 and 1988 into categories of trade. Each of the principal categories—oil, manufactures and non-manufactures—contributed to the £10.4 billion increase in the visible trade deficit, although the deterioration in trade in manufactures—at almost £7 billion—was much the most important element. A worsening of the trade balance was recorded for each of the main manufacturing sub-categories. Proportionally, the largest deterioration was in trade in cars, though this item represents only around 3% of manufactured exports and around 8% of imports (and, during the fourth quarter, car exports recovered strongly). By contrast, trade in capital goods made little impact on the deficit for the year as a whole (although there was some weakening through the course of the year) since exports of capital goods grew almost in line with imports. The oil surplus showed a significant deterioration in 1988, falling to just over half its 1987 value. This fall was due in almost equal measure to movements in the sterling oil price and a fall in net trade volumes. Around half of the latter effect was a consequence of the Piper Alpha disaster. Continued disruption in the North Sea may, in itself, increase the current account deficit for the year as a whole by around £1 billion.

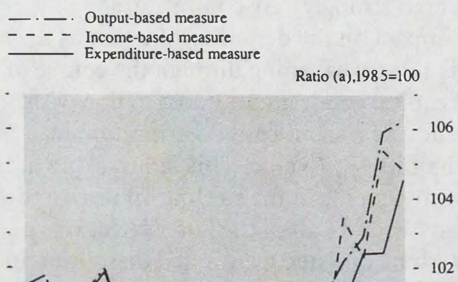
The table also shows the changes to the trade balance between the fourth quarter of 1988 and the first quarter of 1989. The further deterioration in the oil balance was more than offset by an improvement in non-oil trade. Developments within trade in manufactures offer some corroborative evidence for the slowdown in consumer spending: consumer goods and cars made

UK competitiveness deteriorated last year (a)



(a) A fall in the index represents an improvement in UK competitiveness.
(b) Percentage of firms in the CBI industrial trends survey reporting relative prices as a factor limiting export orders over the next four months.

Domestic demand in the United Kingdom grew faster than that abroad last year



(a) Ratio of domestic demand in the United Kingdom to the average in the major overseas economies.

a positive contribution to the change in the balance while that of trade in capital goods and semi-manufactures was negative.

. . . *although* **manufacturing competitiveness** *has been weaker than was previously thought*

The data revisions resulting from the 1988 Labour Force Survey and the consequent adjustments to the estimates of productivity and wage costs in manufacturing suggest that the United Kingdom's underlying labour cost competitiveness position in 1987 and 1988 was significantly weaker than previously estimated. The accompanying chart shows that, on the basis of the latest information, the United Kingdom's steadily worsening position on relative earnings has not, since early 1987, been offset by any improvement in relative productivity. Over this period, UK earnings per hour grew at an average annual rate of 7%, twice the average rate in our principal competitors, while output per man hour grew at an average rate of 5½%—only a little faster than in competing countries.

The effect of the revisions to the figures has been to alter the general profile of the recent path of the United Kingdom's relative unit labour costs in local currency. This was previously estimated to have remained more or less flat over recent years, but now shows a distinct upward (ie deteriorating) trend in 1987 and 1988. The latest data show only a very modest improvement (of ½%) in 1987 as a whole relative to 1986 compared with an earlier estimate of 1¼%. The effects of revisions on data for 1988 are considerably more marked: a worsening of 3½% between the first three quarters of 1987 and the same period of 1988, compared with the earlier estimate of a deterioration of less than 1%.

Despite the revisions to estimates of relative labour costs, movements in competitiveness continue to be dominated by changes in the exchange rate. The effective exchange rate in 1988 was some 6% higher than in 1987, while relative unit labour costs (adjusted for exchange rate changes) showed a deterioration of 9%. Competitiveness measured on this basis deteriorated by 3% between the third and fourth quarters alone.

Although the worsening in competitiveness may have had some adverse impact on the current account, and in particular on export performance, it is not possible to attribute more than a relatively small part of the overall deterioration to this cause. The main factor has been the rapid growth of domestic demand in the United Kingdom relative to overseas. The strength of UK demand may, however, be only imperfectly captured in the recorded measure of expenditure, which may still be underrecorded to some extent (despite substantial revisions to the figures). This was particularly evident in the third quarter, when recorded domestic demand in the United Kingdom showed year-on-year growth of 4½%—only a little faster than the average for the six major overseas economies, despite a growth rate of imports of non-oil goods and services of around 13%. The fourth quarter figures showed a rapid rise in recorded domestic demand, but even so the growth rate of just over 7% for the year as a whole (around 3% faster than demand growth overseas) may well understate the extent of the shift in the United Kingdom's relative cyclical position. Alternative measures of domestic demand can be constructed from the output and income measures of GDP, adjusted for movements in trade volumes. The output and income-based measures (see chart) show a more marked differential in growth rates of domestic demand, with the output-based measure showing demand growth nearly 5 percentage points faster in the United Kingdom than overseas.

The public sector *is forecast to remain in substantial* **surplus** *this year*

In the financial year 1988/89 the public sector debt repayment (PSDR) was £14.3 billion (£7.3 billion excluding privatisation proceeds). This can be compared with forecasts of just over £3 billion in the 1988 Budget and £9.8 billion in the 1988 Autumn Statement. Higher revenues and lower general government expenditure have both contributed to the higher than expected PSDR. Compared with the forecast made in the 1988 Budget, general government revenues are likely to have been nearly £6 billion higher, with over two thirds of the extra revenue attributable to higher receipts of income tax and VAT, together with national insurance and other contributions associated with the strong growth of earnings, employment and consumers' expenditure in the past year. The high level of activity in the housing market also contributed to buoyant tax receipts in 1988/89. General government expenditure was nearly £4 billion below the forecast made in last year's Budget. Reduced expenditure by the Department of Social Security, in part because of lower unemployment, and increased privatisation proceeds (which are regarded as reductions in expenditure) accounted for three quarters of the undershoot. Both general government expenditure (excluding privatisation proceeds) and non-oil taxes and national insurance contributions are expected to decline as a proportion of money GDP in the medium term. Even disregarding privatisation proceeds, the stance of fiscal policy tightened substantially last year as rapid economic growth raised the effective burden of taxation. This tightness is maintained in the fiscal stance implied by the latest Budget which envisages a PSDR largely unchanged at £14 billion. In the medium-term financial strategy the PSDR is forecast to decline as a percentage of GDP both because of the growth in money GDP and because the PSDR itself is expected to decline as the government pursues its long-term objective of achieving a balanced budget.

World economic prospects—latest Bank forecasts[1]

The world economy enjoyed a year of strong growth in 1988, with GNP in the six major overseas economies rising more strongly than in any year since 1984. This vigorous performance was widely spread through the industrial economies, with many European countries recording their strongest growth this decade, and Japan its strongest for fifteen years: encouragingly, investment was particularly robust. Modest wage increases combined with healthy increases in productivity to keep domestic costs under control, while lower oil prices helped to counteract quite sharp increases in non-oil commodity prices, so that strong growth was achieved with only a limited increase in inflation.

As the year progressed, however, evidence of less welcome developments began to emerge. Inflationary pressures became more apparent and adjustment of current account imbalances showed signs of stalling as the effect of earlier competitiveness changes worked through. Recent changes in the composition of demand have been unhelpful: in the United States consumption growth has led to renewed strength of imports and a possible crowding out of exports, while export growth recovered in Japan and Germany, helped by a relatively strong dollar and strong overseas demand for capital goods. A further disquieting feature in 1988 was that, although developing countries gained from (and contributed to) the strength in world trade, performance remained very uneven: the most substantial benefits accrued to the swiftly growing Asian economies. Despite higher commodity prices, healthy growth in world trade and relatively low interest rates, the most heavily indebted countries saw falls in per capita living standards.

Recent indicators suggest that activity has remained robust, while signs of rising inflation have become more apparent in several countries. Monetary authorities abroad have reacted to the inflationary threat by further increasing interest rates. Compared with the second quarter of 1988, increases range from below 1 percentage point (Japan) to over 3 percentage points (Canada).

It is expected that the effects of this and earlier tightening, along with further fiscal restraint in some countries, will be sufficient to produce a slowdown in GNP growth in the six major overseas economies from just over 4% in 1988 to some 3¼% in 1989, and to 2½% in 1990 and 1991 (Table A). World trade is expected to slow in line with this profile. The outlook for inflation has deteriorated: oil prices and non-oil commodity prices are significantly stronger than forecast in the autumn, and domestic pressures on inflation are also likely to have intensified,

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

	Estimate	Forecast		
	1988	1989	1990	1991
Domestic demand	**4.1**	**3.2**	**2.6**	**2.7**
of which:				
Private consumption	3.3	2.9	2.7	2.7
Business fixed investment	9.9	6.6	5.9	3.4
Public expenditure(b)	1.3	2.2	1.8	1.6
Stockbuilding(b)	0.2	—	−0.2	—
Net external demand	0.1	0.1	—	−0.1
GNP/GDP	**4.2**	**3.3**	**2.6**	**2.6**

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

reflecting high growth rates, which have put additional pressures on capacity and labour and also led to a widening of profit margins. Consumer price inflation in the major overseas economies on the consumers' expenditure deflator (CED) measure is projected to rise from around 3% in 1988 to 4½% in 1989 before falling back to 4% in 1990 and 3¾% in 1991 (Table B). On the external front, the outlook is for some continued, albeit limited, reduction of the US current account deficit as a proportion of GNP: this is not matched by a fall in the German and Japanese surpluses.

Table B: Prices in the major overseas economies
Percentage changes

	Estimate	Forecast		
	1988	1989	1990	1991
Import prices (a)	0.9	6.1	0.9	2.1
Unit labour costs in manufacturing	−0.8	1.7	2.4	2.0
Consumer prices (b)	3.0	4.4	3.9	3.7

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

Increases in interest rates reduce the disposable income of consumers with net floating-rate debt, although consumers with corresponding net assets gain income from higher rates. The additional incentive to save, combined with the effects on indebted consumers and fiscal restraint, implies a reduction in the rate of growth of consumer spending. The tightening of monetary policy also has an influence on investment, one of the main engines of GNP growth in 1988, although the flattening (and in some cases inversion) of yield curves may limit its impact. Investment is projected to slow following the reduction in the pace of activity, though high profitability and continuing capacity pressures mean that business investment grows more rapidly than GNP thoughout the forecast. Net external demand is forecast to make no overall contribution to GNP growth in these countries taken together over the period of the forecast.

Inflation is forecast to be higher than was projected in the autumn, partly as a consequence of the higher path for oil

(1) These forecasts have been produced by the Bank's world economic forecasting team and country analysts using the Global Econometric Model supplied by the National Institute of Economic and Social Research.

and non-oil commodity prices (although both are expected to weaken during the forecast period). A shift towards indirect taxation in Japan, Germany and Canada will also contribute to a temporary increase in measured consumer price inflation.

Strong growth in exports and business investment produced growth of 4% in US GNP in 1988 (even more if the effects of the drought are excluded), but both are expected to grow at much lower rates during the forecast. It is assumed that the tightening of monetary policy instigated by the Federal Reserve is supported by some fiscal restraint in 1990. As a consequence of a slowdown in the growth of real personal disposable income, consumption growth slows from 2¾% in 1988 and 1989 to 1¾% in 1990. Business investment also slows, though the main part of the slowdown occurs in 1991 as the slowdown in economic activity and the effect of previous investment reduce capacity constraints. Domestic demand slows in 1989 (excluding drought effects) and 1990 before rallying in 1991. Improving competitiveness means that the United States is expected to increase its share of export markets throughout the forecast, so that net external demand helps to offset some of the domestically generated slowdown in 1989 and 1990, raising GNP growth by about half a percentage point in each year to 3¼% in 1989 and 2% in 1990. Inflation on the CED measure is expected to be higher during the forecast than in the recent past, with higher rates of increase in unit labour costs and import prices producing an inflation rate averaging around 5¼% per annum through the forecast.

1988 was a particularly successful year for the Japanese economy, with GNP growing more rapidly than at any time in the past fifteen years, led by an exceptional surge in business investment. Over the forecast period the economy is expected to slow along with the other major countries, though GNP growth is still projected to be higher in Japan than in any of the other majors: from a 1988 rate of 5¾%, GNP growth is forecast to slow to 4½% in 1989, then to an average of 3½% in 1990 and 1991. The net external contribution to the GNP increase was negative in 1988 as a result of strong import growth: a smaller negative contribution to growth is expected from the external sector in the forecast years. Consumer demand is expected to become increasingly important as a source of growth, while business investment growth falls from over 15% in 1988 to 6% on average in the three forecast years. Export volume growth slows significantly during the forecast as worsening Japanese competitiveness reduces export market shares. Inflation increases to over 2% in 1989, driven by increasing import prices and the imposition of a sales tax in April. Thereafter the rate declines through the forecast period to 1% in 1991.

In Germany, projected cuts in direct taxes boost real personal disposable income, and hence consumption, in 1990. Signs of capacity constraints mean that investment growth is expected to increase in 1989, in contrast to the other majors, but to fall gradually thereafter. As a consequence, domestic demand rises by an average of over 3% per annum during the forecast, only a little down on recent trends. However, slow export volume growth and rapid import growth—associated with the strength of consumer demand—result in a negative contribution to GNP growth from the external sector, amounting to a full percentage point in 1990. GNP growth is expected to fall from 3½% in 1988 to an average of 2½% per annum in the forecast. As in Japan, higher import prices and a rise in expenditure taxes in 1989 produce an increase in inflation to 2½% in 1989. Following a fall in the rate in 1990 to under 2%, rising unit labour costs in 1991 push the rate back over this level.

France recorded GNP growth of 3½% in 1988. Growth is forecast to slow by rather less than in the other majors, despite the expectation that net external demand will switch from making a positive contribution to growth in 1989 to a negative one in 1990 and 1991 as strong growth in real personal disposable income stimulates import growth. The outlook for inflation remains good, with moderate wage increases and a healthy productivity performance. Italy shows signs of overheating: rapid growth in unit labour costs produces a forecast of consumer price inflation of over 7% this year, compared with around 5% in 1988: the continuing strength of domestic demand produces a current account deficit of over $7 billion in each year of the forecast. There are tentative signs that growth in Canada may be beginning to slow as the result of the monetary tightening. Consumption is expected to rise by less than 2% per annum and GNP by an average of 2½% per annum. However, rising unit labour costs help to raise inflation to almost 5% in 1989, though it then falls back.

Growth in world trade is forecast to fall back somewhat from the estimated rate of around 7½% in 1988, but remains above the average for the 1980s as a whole. As in previous forecasts, the Asian newly industrialising economies are projected to make significant further gains in market share, although very rapid import growth associated with a loss of competitiveness and some capacity constraints leads to a marked fall in their combined current account surplus. The external environment for non-oil developing countries deteriorates in the forecast, with export market growth and non-oil commodity prices falling, and higher interest rates increasing debt servicing costs. Prospects for oil exporters depend crucially on oil market developments: increased production and export capacity in 1990 and 1991 are expected to result in some downward pressure on prices: import compression is forecast to end, though growth in import volumes is very small.

1988 saw some improvements in the process of adjusting the external imbalances of the three major industrial nations. Further progress in this area is forecast to be mixed: the US current account falls to around 2% of GNP by the end of the forecast from its 1988 level of 2¾%, but this improvement is not expected to be matched by a similar contraction in the surpluses of Japan and Germany, which remain at around the same proportion of GNP as in 1988, 2¾% and 4% respectively.