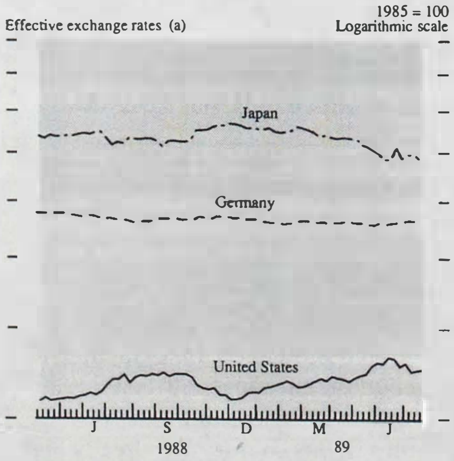
Economic commentary

- *The relative strength of the dollar so far this year has helped to restrain inflation in the United States while adding to inflationary pressures elsewhere.*
- *There are signs of a slowdown in the US economy, where monetary policy has now been eased, but in Germany and Japan output continues to grow strongly and monetary policy has been tightened in both countries.*
- *There has been some further adjustment of trade surpluses and deficits in the three major economies, though this may in part reflect the short-run effects of dollar strength.*
- *Consumer spending in the United Kingdom is subdued and the indications are that the increases in interest rates seen over the past year are delivering a better balance of output and demand.*
- *Inflation has edged up but is unlikely to rise much further. The authorities moved to forestall the inflationary consequences of a fall in the exchange rate by increasing interest rates in May.*
- *The trade deficit narrowed further in the second quarter, despite depressed oil production. There has been a significant improvement in the balance on manufactured trade.*

The dollar strengthened through the first half of the year



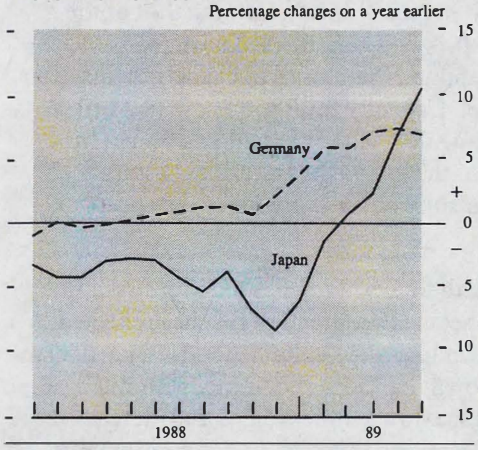
(a) Bank of England index.

The dollar's *strength may have added to* **inflation** *outside the United States . . .*

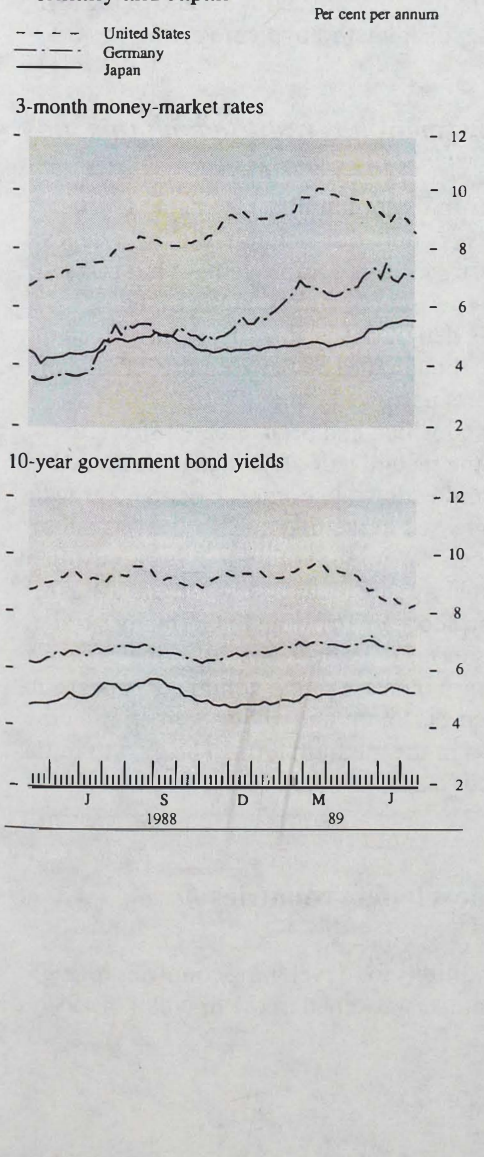
Despite the marked increase in interest rates in all the major overseas economies with the exception of Japan over the last eighteen months, firm evidence of a slowdown in economic activity has as yet emerged only in North America. Activity remains strong in Japan, where the official discount rate has been raised for the first time since 1980, and in continental Europe, where interest rates have been further increased. Inflation has continued to increase in the major overseas economies. The unexpected strength of the dollar in recent months has underpinned increases in import prices outside the United States, although it may have served to limit external pressure on inflation in the United States at a particularly difficult time. The rise in import prices, the strength of demand and the domestic expenditure tax increases earlier this year have combined to maintain upward pressure on inflation in Germany and Japan.

The dollar's unexpected strength in the second quarter has shown signs of unwinding recently. Demand for the currency this year seems to have been boosted by a favourable reassessment of US assets, stemming from a more optimistic view in some quarters of the sustainability of the budget and trade deficits and by political uncertainties elsewhere. However, it remains difficult to explain the dollar's strength earlier in the year and the subsequent downturn suggests that at least some of the appreciation may have been speculative in nature. Interest rate differentials are now tending to move in favour of other currencies and recent data on activity have been hinting at a more pronounced slowdown in the US economy than had previously been envisaged. These developments appear to have dampened demand for the dollar.

Import prices have risen sharply outside the United States



Short-term interest rates have risen in Germany and Japan



The rise in the dollar over the second quarter has helped to restrain inflation in the United States, but it has had unhelpful implications for inflation in other countries. In both Japan and Germany there has been concern over the weakness of their respective currencies and the implications of this for prices. There has been a marked increase in the price of imports in both countries in recent months, although in neither has there yet been any marked pick-up in wage inflation; unit labour costs have so far been rising only very moderately. However, the danger is that expectations of higher inflation will begin to affect the wage bargaining process. In Germany, there are already signs that higher inflation may feed through to wage demands this autumn.

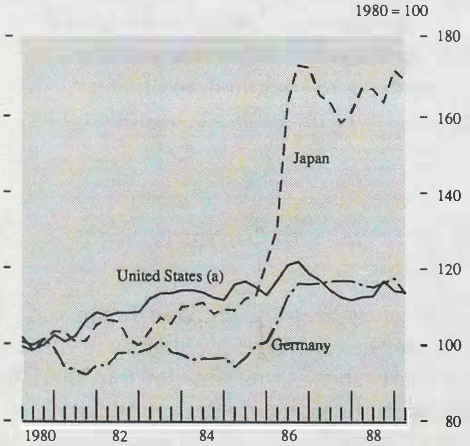
Although non-oil commodity prices were slightly higher on average in the first half of this year than in the second half of last, prices have fallen recently and now stand some 7% below the first half average in SDR terms. This largely reflects significant falls in metal prices, which are currently below average 1988 levels, and recently a sharp fall in the price of coffee. In contrast, prices in the agricultural non-food sectors have shown modest rises so far this year. OPEC's ministerial conference at the beginning of June reached agreement on a new quota ceiling of 19.5 million barrels a day. However, Kuwait has repudiated its quota, and, together with the UAE, is producing well above it. Nevertheless, the continuation of stronger than expected demand and further supply disruptions helped to sustain the oil price, although it has fallen back slightly in July.

. . . *and* interest rates *have risen in* Germany *and* Japan . . .

Monetary conditions have recently been tightened in Japan and Europe, while the United States has eased policy slightly in three stages. Activity indicators clearly show some slowdown in the US economy and this, together with sluggish growth in monetary aggregates and the strength of the dollar, led to the reduction in rates, although continued concern about inflation presents a conflicting pressure. The Bank of Japan raised its official discount rate in May in response to inflationary concerns arising from the strength of domestic demand and pressures on import prices from the weakness of the exchange rate. The rise brought the discount rate into line with market rates. The Bundesbank raised its Lombard and discount rates, by ½%, in late June for similar reasons, and was followed by some other European countries.

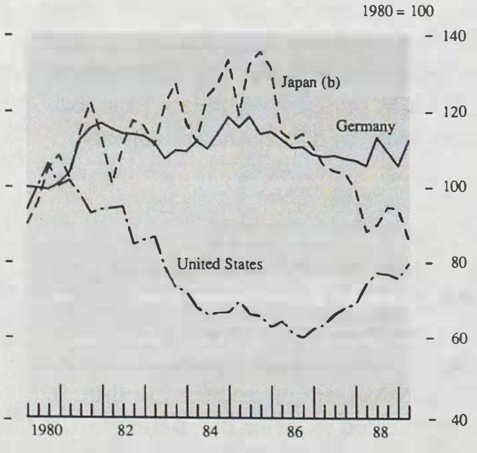
The signs of a slowdown in the US economy have been reinforced by the latest data although it is too early, as yet, to tell whether the economy is heading for a gradual or sharp slowdown. Second quarter GNP figures show a further easing in consumption and a smaller rise in inventory accumulation than in the first. The slowdown in consumption and the build-up in stocks is now starting to be reflected in an easing in the growth of industrial production, which in the first half of this year grew by a monthly average of less than 0.1%, compared with 0.5% for the previous six months. Although capacity remains tight by historical standards, utilisation has started to fall back in recent months. Indicators of future trends in industrial production seem to point to a further slowdown, with orders for durable goods showing little growth so far this year.

The terms of trade of the major countries have changed little in the past two years . . .



(a) Latest numbers for the United States are estimates.

. . . but trade volumes have moved in a broadly helpful direction(a)



(a) Ratio of index of exports to that of imports, both based on 1980 = 100.
(b) Japanese data are not seasonally adjusted.

. . . where **growth** *has been strong so far this year*

Japanese GNP grew by 2¼% in the first quarter, with consumption and business investment up strongly and a small negative contribution from the external sector. Other indicators in Japan also suggest continued robust growth once volatility in recent monthly data, associated in part with the introduction of the sales tax at the start of April, is taken into account. Signs of supply constraints remain, with high rates of capacity utilisation and a tight labour market. Capacity utilisation rose in April to its highest level since 1974, while unemployment has been a little over 2¼% since the turn of the year—the lowest level since 1982. Industrial production, in spite of these pressures, has been growing quite briskly.

As in Japan, output growth in Germany has held up strongly so far this year, although it seems that much of this has reflected external demand for German goods—capital goods in particular. Private consumption growth has been moderate, with retail sales flat so far this year. This may owe something to the increase in expenditure tax rates in January. Investment has continued to grow strongly, while construction output was sharply boosted by the mild winter weather. Meanwhile, industrial production continues to show steady growth, with a rise so far this year of around 5% on a year earlier. Orders from overseas, particularly for capital goods, have once again been rising strongly, suggesting that the trade gap between Germany and the rest of Europe may, for the time being, continue to widen. Growth in domestic orders has slowed, but remains quite strong, particularly in the capital goods sector. In volume terms, they are about 8% above the levels of a year ago. The rate at which unemployment is falling has picked up recently.

Current account adjustment *has restarted but this may be short-lived*

The strength of the dollar in recent months, if sustained, will not help longer-term current account adjustment in the three largest economies. Recent data suggest some improvement but this may be partly linked to short-run J-curve effects. Some of the reduction in the US trade deficit this year seems to have been due to such short-run effects, though the gap between the volume of exports and that of imports narrowed markedly in the first quarter, in line with a trend which had been apparent from the third quarter of 1986 to the second half of last year. This may be partly linked to a relative slowdown in domestic demand growth. Japan's trade surplus increased in the first quarter but has fallen back more recently (though the amount of underlying adjustment may have been exaggerated by short-run terms-of-trade losses). Recent monthly data also show a narrowing in Germany's trade surplus. This too reflects terms of trade losses following currency depreciation. Given a sharp increase in the volume of exports in the first quarter, the prospects for an underlying correction in the surplus do not seem good in the medium term. The growth in the surplus has been reflected in a worsening of trade positions elsewhere in Europe.

Prospects for many **developing countries** *have weakened this year*

After the favourable conditions for developing countries in 1988, the external environment has weakened in the first half of 1989.

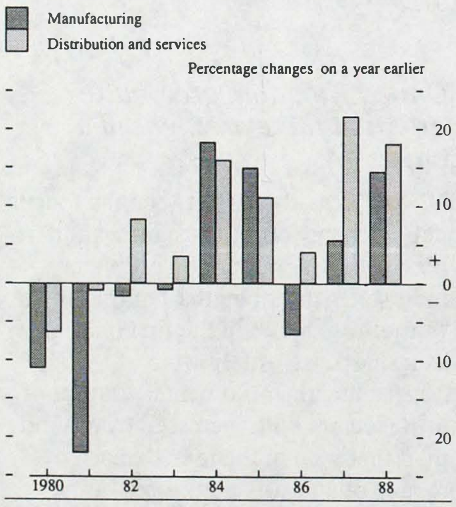
While their markets have continued to grow, notably in Europe and the Far East, growth has slowed and the non-oil exporters' terms of trade have fallen. Prices of many major export commodities have fallen back from their 1988 peaks as demand has weakened and some of the supply disruptions which underlay the strong performance of prices in 1988 have eased. Inflation has risen in the major economies which will add to developing country import prices. US interest rates have fallen recently, a development of particular benefit to the middle-income Latin American debtors, though rates remain above 1988 levels. These developments are reflected in a deterioration of the current account positions of many developing countries in early 1989.

Growth remains slow in the major Latin American countries and in Africa, in contrast to the much stronger performance in Asia. However inflationary difficulties, arising in some cases from rapid growth, and in others from more deep seated causes, persist in all three areas despite the measures adopted to control them. This is most notable in Brazil and Argentina, though also in China where inflationary problems have been compounded by some loss of creditor confidence following the disturbances there. The programme for reduction of commercial debt outlined by the US Treasury Secretary has been developed in subsequent discussions. A package involving new money, defeasance, and debt and interest rate reduction has been put to the major creditors by the advisory committee on Mexico recently. The eligibility of other countries for debt reduction under the scheme remains to be determined.

Non-oil output *in the United Kingdom grew quite strongly in the first quarter but there are signs of a slowdown in* **manufacturing** . . .

The output measure of GDP was virtually flat between the fourth and first quarters. A sharp fall in energy output, a significant part of which was associated with North Sea production problems, however, means that this understates the strength of output in an underlying sense. Non-oil output rose by ¾% in the first quarter. The increase was boosted by a sharp rise—of 3½%—in construction output, largely reflecting the mild winter. Output of the services and manufacturing sectors both increased by around ½%—rather slower growth than that seen in the fourth quarter. The impression is, therefore, one of a positive but moderating underlying rate of output growth, though this is less clear from the other measures of GDP. The income measure rose by 1¼% in the first quarter but this was chiefly associated with a rise in companies' profits, and initial estimates of these are known to be somewhat unreliable. The expenditure measure fell by more than ¼% in the first quarter, so that the discrepancy between it and the output measures widened further. There has now been a substantial—and fluctuating—discrepancy between the two measures since the end of 1987 and, as a consequence, the profile and precise extent of recent growth is particularly difficult to judge. It is nevertheless evident that domestic demand grew hardly at all in the first quarter, while during 1988 it grew at an average quarterly rate of almost 2%. It also seems likely that, once allowance is made for the effect of oil production difficulties, the balance between output and demand has improved. The trade figures and industrial surveys offer some support for this view.

Industrial investment was exceptionally strong last year



Industrial production fell by 1¼% in the first quarter, mainly reflecting developments in the energy sector. The mild winter resulted in a low level of electricity demand, while oil production was also depressed, following supply disruptions which developed at the end of last year. Extraction of oil and gas will have remained subdued in the second quarter, but is expected to recover in the second half of 1989, with GDP likely to be boosted by about ¾% in the third and fourth quarters as production resumes. Movements in manufacturing production have been less erratic and there are signs that output growth in this sector has moderated quite markedly in recent months. Manufacturing output was just over ½% higher in the first quarter than in the fourth and picked up in May, but has shown little overall rise in the first five months of the year. The latest CBI survey indicates that there has been a noticeable slackening of demand in the manufacturing sector since the autumn. The balance of respondents reporting that they are operating below a satisfactory level of output has risen to almost 40%, compared with just over 30% at the beginning of the year while those reporting higher orders and output have fallen sharply. The balance expecting to expand output in the coming months, though still firmly positive, has fallen back to levels last seen in 1986.

. . . and **investment expenditure** *is expected to slow somewhat*

Fixed investment by manufacturing, construction, distribution and financial industries was recorded as virtually unchanged in the first quarter from the fourth quarter's extremely buoyant level. However, the widening of the gap between the expenditure and output measures of GDP and the tendency towards large unidentified outflows of funds from the company sector make it difficult to judge how far the growth of investment did, in fact, moderate at the beginning of the year. The suggestion that some slowing occurred in the first quarter is supported by the production statistics, which show output of investment goods unchanged from the fourth quarter of 1988. Notwithstanding this apparent pause in the most recent period, the increase in investment expenditure over the past year has been remarkably rapid. In the twelve months to the end of the first quarter, manufacturing investment was nearly 11% above its level in the previous twelve months, while investment by construction, distribution and financial industries was over 19% higher.

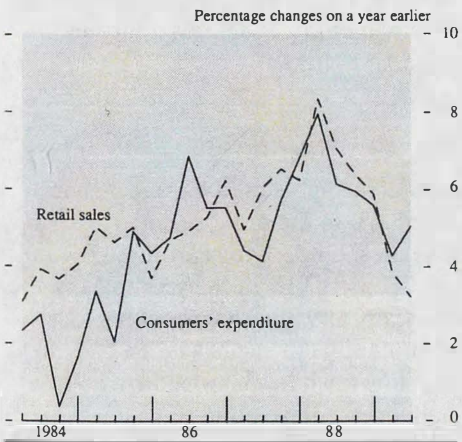
The CBI survey of investment intentions published in July was less optimistic than earlier surveys, which had suggested that investment expenditure would remain strong during 1989 as a whole. Some further growth in investment seems likely, especially in view of the strong upward trend in output last year, though the rise this year is unlikely to match the 14% growth seen in 1988. Beyond this year, the outlook for investment is more uncertain. There has been a marked deterioration in the financial position of the company sector in the past twelve months and the means by which a further large increase in capital expenditure would be financed is yet to be resolved. Companies' net liquidity and income gearing may deteriorate further during the remainder of this year and this, together with uncertainty about the prospects for demand, may introduce an additional element of caution into investment plans. It is notable that, according to the CBI, the proportion of respondents reporting that the cost of finance is a constraint on capital expenditure has increased in recent months. These considerations may lie behind the finding of the latest DTI survey that investment growth is likely to slow in 1990.

The fall in the expenditure measure of GDP recorded in the first quarter mainly reflected a sharp fall in stockbuilding, after the exceptionally large accumulation in the fourth quarter of last year. Total stocks rose by only £½ billion in the first quarter. The aggregate figure conceals two distinct developments: wholesalers and retailers destocked by about £600 million, while production and other industries increased stocks by over £1 billion in total. There is some suggestion in the figures that manufacturers may have been taken by surprise by the weakness of demand, having accumulated £750 million of stocks in two quarters.

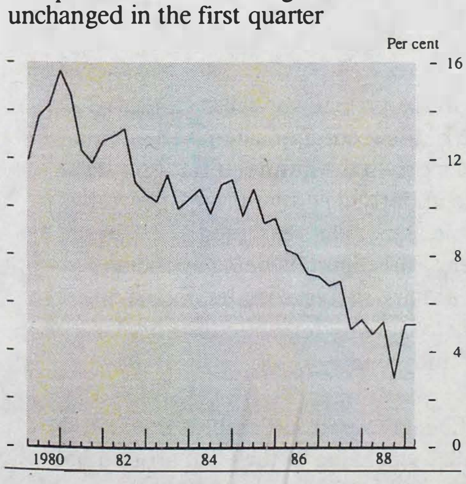
Consumers' expenditure—*particularly on durable goods—has slowed*

Personal incomes are estimated to have risen by 2% in the first quarter—half as fast as in the fourth. Wages and salaries and 'other income' (which consists mainly of rents, dividends and interest payments) both grew quite strongly but less so than in the previous quarter, when the rise in dividend payments in particular was exceptionally large. Growth in employers' contributions exceeded that in wages and salaries in the first quarter, which may suggest that some employers' pension fund contribution holidays may be coming to an end—a development which would boost the measured personal sector saving ratio. Total personal disposable income, after taking account of deductions,.rose by 2% in the quarter and, with a rise in the consumers' expenditure deflator of 1½%, real personal disposable income (RPDI) increased by only ½% (compared with a rise of 4% in the fourth quarter).

Consumers' expenditure and retail sales are growing much more slowly than last year



The personal sector saving ratio was unchanged in the first quarter



With consumption up around ½% in the quarter, the saving ratio was unchanged at just over 5%. Recent revisions to the figures from which the saving ratio is compiled have resulted in its having been revised up by almost 2 percentage points in 1988 and 1 percentage point in 1987. Although this does not change the general picture of a decline in the saving ratio since 1980, it does suggest a much flatter profile in the most recent years.

According to the preliminary estimate, real consumers' expenditure grew by around ¾% in the second quarter, a marginally higher rate than in the first. Expenditure on durable goods remains subdued reflecting reduced activity in the housing market. In contrast, expenditure on services seems to have remained extremely buoyant so far this year.

There are some indications that conditions in the **labour market** *may be easing somewhat . . .*

Seasonally-adjusted unemployment in the United Kingdom has now fallen every month since July 1986 and in June stood at 1.8 million—around 6¼% of the workforce. Long-term unemployment has fallen particularly rapidly—by around a quarter to just below 750,000—in the twelve months to April. The sustained fall in unemployment in the past three years owes a good deal to the strength of economic activity and the implications of this for employment creation, particularly in the service sector. There has recently been some modest slowing in the rate at which unemployment is falling, however, to a rate a little over 35,000 per month. It is too early to say whether this presages a lasting slowdown, though this would be consistent with the moderation in output growth seen so far this year. Vacancies at Jobcentres showed a recovery from recent falls in June to rise by 8,000. However, the increased activity appears to be mainly due to an unexpected increase in seasonal work arising from the recent good weather. With the exception of June's figures, vacancies at Jobcentres have been on a downward trend since October 1988, with the largest falls seen in the South East.

There is, however, little indication of a slowdown in the figures for the workforce in employment, which increased by almost 600,000 in the year to the first quarter and by 177,000 in the first quarter itself. Employment in manufacturing, which had been roughly stable in the last three quarters of 1988, fell by 5,000 in the first quarter and by a total of over 30,000 in April and May. This series has exhibited considerable volatility in the past but it now seems possible that the gains in employment seen in this sector, mainly during 1987, may be reversed as manufacturing output growth slows. The service sector, which had accounted for most of the strong rise in employment in 1988, saw a further sharp rise—of 114,000—in the first quarter.

. . . *but* **wage settlements** *are continuing to rise*

Wage settlements in the manufacturing sector averaged 7¼% in the first quarter, compared with 6% in the same period a year earlier, according to CBI estimates. Underlying earnings growth in manufacturing picked up slightly to 9¼% in the year to May, the rate of increase having been steady at 9% in the preceding four months. Overtime working in manufacturing has fallen back in recent months (reflecting the slowdown in manufacturing output) and contributed less than half a percentage point to manufacturing earnings growth in the first half of 1989 compared with almost one percentage point at the end of last year. This will have partially offset the effect of higher settlements.

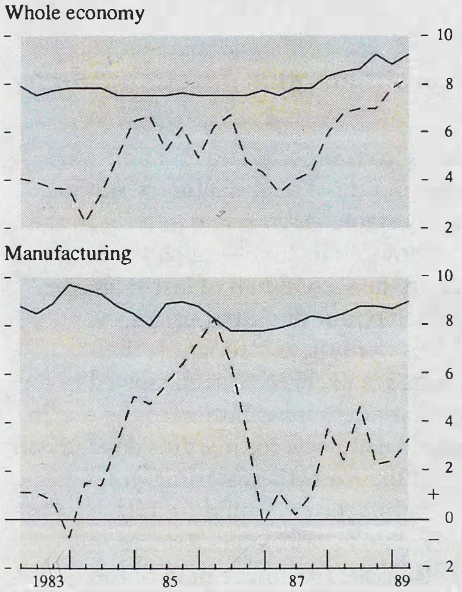
Settlements and earnings in the private service sector have also been on an upward trend. In the second quarter, settlements were probably running at a rate close to the annual inflation rate as measured by the RPI. The underlying growth rate of earnings in the service sector as a whole , however, remained at 9% in the first five months of the year. This figure is being artificially depressed by the effect of a sharp increase in the underlying series in the second quarter of last year which resulted from a large settlement for nurses and midwives.

The main factor behind the increase in settlements seems to be the rise in the cost of living. According to the CBI, around half of firms in the manufacturing and service sectors are reporting this as an important upward influence on settlements, this percentage having risen sharply in recent months. The next most important factor is said to be the need to recruit and retain labour; around one third of manufacturing firms and over half of private service sector firms regard this as an important influence, though the percentage of firms citing this as a factor has fallen in recent months.

Unit wage costs rose further in the first quarter

——— Underlying earnings
– – – – Unit wage costs

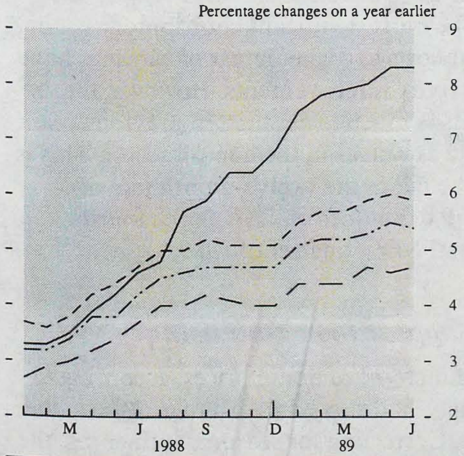
Percentage changes on a year earlier



Inflation on the RPI measure may be at its peak

——— All items
– – – – – All items excludung mortgage interest payments
—·–·— All items excluding housing
— — — 'Retailed' prices

Percentage changes on a year earlier



. . . *along with* unit wage costs

Although underlying earnings growth in the economy as a whole has been stable through most of the first half of the year, unit wage costs have accelerated as productivity growth has slowed. This has not been particularly marked in manufacturing, where employment has fallen in recent months and output per head grew by over 6% in the year to May. In the economy as a whole, however, recorded productivity growth has slowed considerably, although the past three quarters' figures have been depressed to an increasing extent by the effects of lost production of North Sea oil. The output implications of these have been substantial, while the associated employment effects are likely to have been small. Once this is allowed for, it seems likely that whole economy productivity growth in the year to the first quarter was between 1% and 1½% and that the rise in unit wage costs over the same period was around 7½%—a smaller rise than that suggested by the recorded figures but nevertheless a substantial increase over the beginning of 1988. Unit wage costs in private services probably increased by around 8½% in the year to the first quarter, as output growth weakened but employment continued to rise and earnings grew strongly.

Wage pressures have played a major, though not exclusive part in the recent wave of industrial unrest. The number of working days lost through industrial action in May was 170,000—a substantial rise over April but below the monthly average for the past year. Major disputes involving NALGO and the NUR are likely to have raised substantially the number of days lost in June and July. Most of these disputes are in the public sector, and involve not only reluctance to accept pay offers below the rate of inflation but resistance to changes in collective bargaining procedures.

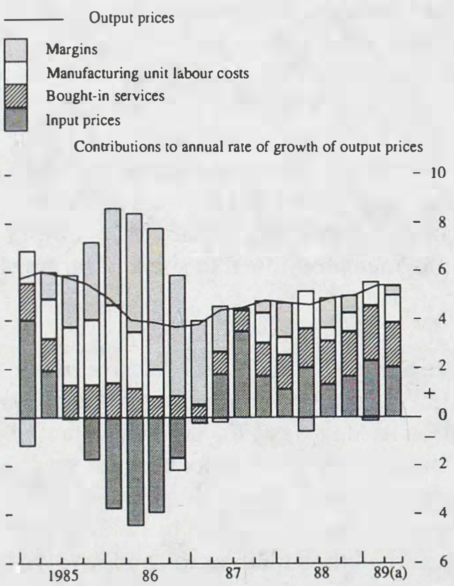
Inflation *may nevertheless have reached its peak . . .*

The upward trend in inflation (as measured by the all-items RPI) which has been evident since the beginning of 1988 continued in the first half of the year, with the twelve-month rate of increase rising from 7.5% in January to 8.3% in May and June. The gap between the all-items RPI and that of the RPI excluding mortgage interest payments has widened as a result of the increase in mortgage interest payments over the past year; on the latter measure inflation in the year to June was 5.9%.

The twelve-month rate of increase of 'retailed' prices—the prices of goods actually sold in shops—has edged up a little in recent months, and is estimated to have reached 4.7% in June; the rise has been fuelled mainly by higher prices for food, clothing and footwear. The difference—of around one percentage point—between the twelve-month increase of 'retailed' prices and that of the RPI excluding housing costs is accounted for largely by movements in the prices of private services which, in turn, are being driven by the acceleration of unit labour costs in that sector. The price rises for petrol and oil seen in the first half of the year also helped to explain the divergence though these have since fallen back. It seems unlikely that inflation will rise further—especially in view of the recent fall in petrol prices. The effect of last year's rises in mortgage rates should begin to depress the twelve-month rate of increase in the RPI from August onwards, although the extent of this depends on whether, and to what extent, May's base rate rise leads to an increase in building society mortgage interest rates.

The twelve-month rate of increase of manufacturers' input prices rose sharply in the early months of this year, reaching the highest rate for nearly two years at 7.9% in April, before falling back to 5.3% in June. The earlier rise partially reflected the strong recovery in oil prices. Excluding petroleum products, imports have contributed over a third of the rise in this measure of inflation (not seasonally adjusted) since March.

Margins came under some pressure in the first half



(a) Estimated.

... *as* **manufacturers' profit margins** *have come under pressure ...*

Despite the upward pressures from input prices and unit wage costs, the twelve-month growth rate of manufacturers' output prices has remained relatively stable. After rising to 5.2% in the first quarter, it fell back to below 5% in June—much the same rate of increase as that seen in the second half of last year. The implication of the subdued behaviour of output prices, particularly when input prices were rising strongly, is that manufacturers' profit margins are likely to have narrowed in the first quarter and made only a modest contribution to the rise in output prices in the second. The outlook for margins depends on that for demand as well as on the strength of sterling. If the exchange rate were to fall, manufacturers would find it easier to restore margins through increases in prices, since prices of competing imports would also rise. The future path of the exchange rate is therefore of considerable importance to the outlook for inflation. A sharp fall in the exchange rate would not only have a direct effect on prices but would also relieve competitive pressure on wage bargainers to contain settlements. It was these considerations which led the authorities to increase interest rates by 1% on 24 May in the face of downward pressure on sterling.

Increase in the GDP deflator(a)

Percentage changes on same period of previous year

	Labour costs(b)(c)	Profits(b)	Other income(b)	Total GDP deflator
Whole economy				
1987 Q1	3.9	0.9	4.2	3.3
Q2	3.0	11.0	3.8	4.5
Q3	2.3	23.9	2.2	5.7
Q4	5.7	10.9	3.8	6.3
1988 Q1	4.1	14.2	0.8	5.3
Q2	6.9	5.9	4.3	6.3
Q3	7.3	8.6	4.8	7.1
Q4	7.6	6.8	5.5	7.1
1989 Q1	9.1	6.0	7.8	8.4
Current share of GDP	*64.3*	*18.8*	*16.9*	
Non-oil economy				
1987 Q1	3.9	7.6	4.2	4.4
Q2	3.0	7.8	3.8	3.9
Q3	1.8	20.2	1.6	4.3
Q4	5.4	11.1	3.5	5.9
1988 Q1	3.5	21.2	0.1	5.5
Q2	6.5	10.9	3.9	6.8
Q3	6.6	15.6	4.1	7.6
Q4	6.8	13.0	4.7	7.4
1989 Q1	6.9	9.2	5.5	7.1
Current share of GDP	*65.1*	*17.8*	*17.1*	

(a) Constant price GDP is derived by dividing the current-price income measure of GDP by the GDP deflator.

(b) Per unit of constant price GDP.

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

A decomposition of domestically generated costs, as measured by the GDP deflator, is presented in the table opposite. It can be seen that the twelve-month growth rate of the deflator increased to 8.4% in the first quarter of 1989 compared with 7.1% in the fourth quarter of 1988. The most significant contributory factor has been the rise in labour costs as higher levels of earnings have not been offset by productivity improvements. However, the growth of corporate profits is much lower than in previous years, in the economy as a whole as well as in the non-oil sector. This is the main component of the fall in the twelve-month rate of growth of the non-oil GDP deflator from 7.4% in the fourth quarter of 1988 to 7.1% in the first quarter of 1989.

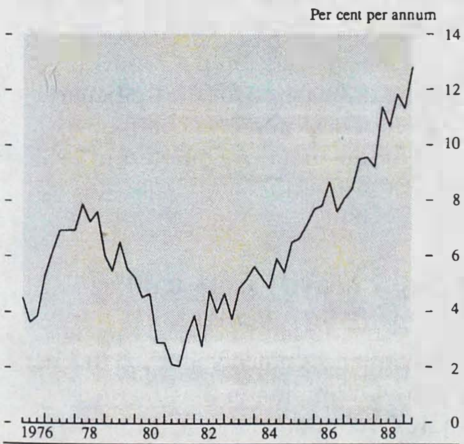
... *and* **house prices** *appear to be stabilising*

The twelve-month rate of increase of house prices, according to the Halifax Building Society, had slowed to just over 23% by the end of the second quarter. Correcting for seasonal influences, the average increase has been just under 1% per month during the past six months and the index was flat in June. There has been little or no increase in prices in the South East in the first half of this year. The slowing of the rate of increase of house prices together with continued growth of average earnings suggests that the ratio of house prices to earnings has stabilised.

There remain distinct regional variations in house prices, with average prices in the South East (the highest priced region) almost three times those in Northern Ireland (the lowest). These regional patterns have been a feature throughout the 1970s and 1980s. There have, however, been cycles in the relative price of houses in the regions compared with those in Greater London and/or the South East more generally. The cycles are most marked in regions furthest from the South East. In the North, North West, and Yorkshire and Humberside, for example, prices ranged from 0.4 to 0.8 of those in Greater London between 1970 and 1985 with an average of around 0.6. The strong growth in house prices in the South East pushed the ratio down to around 0.4 in 1988. The ratio recovered fractionally in the first quarter of 1989, owing to a relative acceleration in prices in the northern regions but remains some way below the average for the past twenty years. This suggests that considerable further adjustment in relative house price may be in prospect.

Company profits *and* **dividends** *were recorded as strong in the first quarter . . .*

Non North Sea ICCs' real rate of return rose further in the first quarter



Industrial and commercial companies' profits are recorded as having risen sharply in the first quarter. The trend growth rate of gross trading profits over the past year has been approximately 3% per quarter, while the real rate of return for non North Sea ICCs rose to almost 13% in the first quarter, its highest level for twenty-five years. The factors contributing to continued strength in the first quarter are unclear, however; margins were apparently trimmed back a little, as firms sought to preserve market share, while the growth of output also slowed. It seems appropriate, therefore, to regard the profits figures with some circumspection. This increase cannot be explained by reference to the profits of North Sea oil companies since these fell by 7%, reflecting recent supply disruptions.

Between the fourth quarter of last year and the first quarter of this, ICCs' outgoings increased less rapidly than recorded profits, although there were some significant differences in the various components. Most surprisingly, recorded dividend payments rose substantially, on this occasion by nearly 12%. This came on top of a 26% increase between the third and fourth quarters of 1988 and maintained the level of the dividend-payout ratio at a record 42% (more than double the average for the 1980s as a whole). There is no obvious reason for such a development since, given a fairly efficient capital market, there is normally no advantage in firms raising money to pay current, at the expense of future, dividends (which is what, on the surface, companies appear to be doing) if shareholders can themselves borrow against future receipts should they wish to do so. Here too, therefore, the figures need to be treated with some caution, particularly as it is difficult to identify more than a few individual companies which increased their dividends by the amount suggested by the aggregate figures.

. . . but companies remained **in financial deficit** . . .

Interest payments also rose in the first quarter, by over 7%, mainly reflecting further increases in the level of bank borrowing. The movements in profits, dividends and interest payments, together with a modest fall in tax payments, led to a rise in undistributed income of 11½%. In addition, ICCs' investment expenditure rose by a modest 1½% and stockbuilding increased by only £½ billion—considerably less than in the fourth quarter of last year. As a consequence, the company sector's recorded financial deficit fell from £4 billion to £2½ billion.

It is likely that the deficit will continue for some time. The underlying growth of profits is expected to slow, while on the basis of the latest CBI and DTI surveys, investment should hold up fairly well for the rest of the year. The presence of a large unidentified outflow from companies, however, makes the financial position of the sector difficult to interpret, and it may be—if income is being overrecorded or expenditure underrecorded—that the financial deficit is larger than the existing figures indicate.

In the first half of this year, the emphasis of merger and acquisition activity shifted significantly from the domestic to the overseas stage. Although total domestic expenditure on acquisitions was £3½ billion in the first quarter, a high figure by historical standards, this nevertheless represented a further fall from the record £8 billion spent during the third quarter of last year. Correspondingly, ICCs' investment in UK company securities fell to £1½ billion. Figures for the second quarter should indicate a further easing in the pace of domestic acquisitions. In contrast, expenditure on cross-border acquisitions has been extremely buoyant; the DTI estimates that UK companies spent a record amount—over £8 billion—on cross-border acquisitions in the final quarter of last year and the figure for the first quarter may have been around £5 billion. These numbers compare with an average of below £3 billion for the first three quarters of 1988. Partly confirming this trend, ICCs' investment abroad rose by over 25% in the first quarter.

. . . and continued to **borrow heavily from banks,** *though longer-term borrowing has picked up*

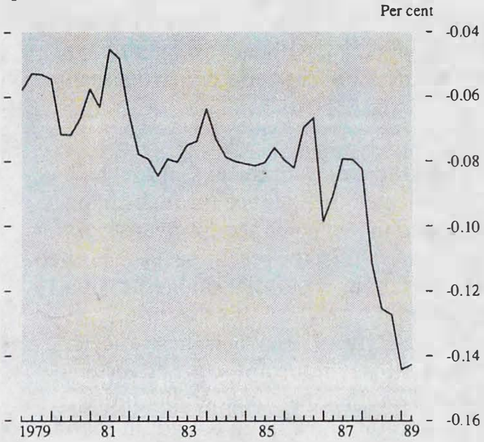
The developments in company finances noted above led to a net borrowing requirement of nearly £12 billion in the first quarter, similar to that in the fourth. ICCs continued to borrow heavily from banks, raising over £7 billion (seasonally adjusted) from this source. This figure is very much in line with experience during 1988, but is over twice the quarterly average during 1987.

There are, however, growing indications that companies are looking towards longer-term modes of finance. This has been most apparent recently in the bond markets. Domestic issues of debentures and preference shares in the first quarter were high by historical standards and followed buoyant issuing activity throughout the second half of 1988. Companies have also had substantial recourse to the eurobond market in the early part of this year, with issues of over £2 billion in the first quarter, half the amount raised in the whole of 1988. This increase in longer-term issues has occurred for a number of reasons. The shortage of gilts implied by the Government's full unfunding policy has increased institutional demand for long-dated company securities, while downward pressure on long rates has led to a sharply inverted yield curve and, given a growing perception that short-term rates are unlikely to fall in the near future, corresponding incentives to issue long-term debt. Policy changes announced at the time of the Budget are likely further to increase the attractions of bond finance. Activity in the equity market during the first quarter

Industrial and commercial companies' borrowing
£ billions, *not seasonally adjusted*

	1987	1988					1989
	Year	Year	Q1	Q2	Q3	Q4	Q1
Bank borrowing and domestic capital issues							
Bank borrowing	13.0	29.6	9.1	6.2	6.8	7.4	8.5
Ordinary shares	13.2	4.6	0.3	0.9	1.5	1.9	0.4
Preference shares	0.7	0.5	0.1	-0.1	0.3	0.1	0.1
Loan capital	- 0.3	0.6	—	-0.1	0.2	0.4	0.7
Gross eurobond issues							
Sterling	2.7	2.4	0.9	0.8	0.4	0.3	1.3
Other currencies	0.9	2.2	0.9	0.3	0.6	0.4	0.9

ICCs' net liquidity was stable in the first quarter [(a)]



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

was dominated by BP buying in almost £2 billion of shares from the Kuwait Investment Office. Overall, however, issuing activity remained weak.

ICCs' net liquidity in the first quarter remained broadly stable as their accumulation of bank deposits and increases in bank borrowing were of approximately the same order of magnitude. It remains unclear whether this represents a conscious move to arrest the recent pronounced decline in net liquidity or merely a brief interlude in an otherwise downward underlying trend.

The **current account deficit** *has narrowed . . .*

The current account deficit in the first quarter of this year is now estimated to have been £4.8 billion—an improvement of £0.8 billion compared with the final quarter of last year, but still over £1 billion higher than the average quarterly deficit in 1988. The visible trade balance improved by £0.5 billion, with a significant improvement in non-oil trade more than offsetting a continued deterioration in the oil balance stemming from North Sea supply disruptions. The surplus on invisibles increased by £0.3 billion in the first quarter, to £1 billion, the improvement marking a rebound from an exceptionally large deficit on transfers (associated with the timing of EC payments) towards the end of last year. The remaining components of invisibles showed no improvement, however; net IPD worsened as recent large sterling capital inflows and the high level of UK interest rates increased the cost of the United Kingdom's net sterling liabilities, while the balance on services remained unchanged.

The visible trade deficit showed a further slight improvement in the second quarter to stand at £5.8 billion. This left the deficit for the first half of 1989 somewhat less than that in the second half of last year, suggesting that the visible deficit has not only stabilised but may be improving, in spite of an oil balance which continued to deteriorate in the second quarter under the impact of the Cormorant Alpha production losses. Non-oil export volumes grew by 6% between the second half of last year and the first half of this, while non-oil imports increased by less than 5%. The non-oil balance was also buoyed up by an improvement in the terms of trade, however.

Contributions to change in the visible balance[(a)]
£ billions

	1989 Q2 compared with 1988 Q2	1989 Q2 compared with 1989 Q1
Total change	**-1.2**	**0.1**
of which:		
Oil	-0.7	—
Non-manufactures	—	-0.2
Manufactures	-0.5	0.3
of which:		
Erratics	*0.3*	*0.1*
Semi-manufactures	*-0.2*	*0.3*
Cars	—	*0.1*
Other consumer goods	*-0.2*	*-0.1*
Intermediate goods	*-0.3*	—
Capital goods	*-0.2*	—

(a) Individual components may not sum to the total change because of rounding.

The table opposite shows the composition of recent changes in the visible trade balance. In the year to the second quarter, there was a roughly equal deterioration in both the manufactures and oil balances. To the extent that the latter is temporarily depressed, it represents less source for concern. All categories of manufactures contributed to the worsening, except the balance on cars which remained at the same level as a year earlier.

Recent changes in manufactured imports[(a)]
Percentage changes

	1988 H2 on H1	1989 H1 on 1988 H2
Total change	**11.5**	**5.9**
of which:		
Semi-manufactures	6.2	7.1
Cars	15.9	-1.8
Other consumer goods	14.6	4.5
Intermediate goods	16.1	5.3
Capital goods	11.7	8.9

(a) Excluding erratics.

However, recent developments in manufactures trade show a rather more encouraging trend, with the improvement in the balance witnessed in the first quarter continuing in the second. The profile of imports of various categories of manufactured imports shows a more marked weakening in imports of cars and other consumer goods than of capital goods in recent quarters, while imports of semi-manufactures have actually grown more rapidly (see table). This tends to bear out the evidence from other indicators that the increases in interest rates over the past year have had a greater impact on consumer spending than on investment and output.

Explaining changes in the UK manufactures balance

Last year's sharp adverse movement in the current account of the UK balance of payments raises a number of questions about the roles of relative demand growth, competitiveness, and other factors in this deterioration. Some light may be shed on these questions by making use of the relevant sectors of the Bank's model of the UK economy, concentrating the analysis on trade in manufactures, which has dominated recent movements in the non-oil goods and services balance. The table first strips out that part of a given change in the balance which was due to movements in trade prices; the rest of the table uses the model to decompose volume movements into effects due to demand, competitiveness, etc.(1) Since the model is inevitably only an imprecise representation of the real world, the table also shows how much of the change remained unexplained in any year.

The manufactures balance has deteriorated almost continuously since 1980. The deterioration in 1988 was the largest over this period, but there was also quite a large worsening in 1983. Movements in *trade volumes* have dominated changes in the balance in most years, although 1988 saw quite a sizable beneficial impact from changes in *trade prices* (essentially a reverse 'J-curve' effect).

Perhaps the most interesting feature of the table is the interaction of *demand* and *competitiveness* effects. The former was the dominant element in last year's deterioration; but in some earlier years (including the recession of 1980–81) demand effects were strongly beneficial to the balance, as UK demand for manufactures weakened relative to world trade. Competitiveness effects up until 1988 improved the balance in five successive years, but this followed on from significantly larger negative effects in the early 1980s. The very small effect of competitiveness last year was the sum of a negative effect of around £¾ billion on exports (in response to the steady worsening in competitiveness since mid-1987), offset by an almost equal positive effect (ie improving the balance) from a reduction in imports. This reflects the slower response of imports in the model to competitiveness changes, with earlier gains still having a lagged beneficial effect in 1988. This year is likely to see a reversal of this beneficial effect, with a consequently significantly larger negative effect of competitiveness on the balance.

The table also gives an indication of the extent to which competitiveness has affected the balance through changes in the *exchange rate* and through changes in *relative unit labour costs in local currency.* In the recent past the United Kingdom's differential labour cost inflation has only had a small adverse impact on the balance; this was not, however, the case in the early 1980s, when these effects were very much larger. More importantly, the adverse effects in 1980 and 1981, reflecting considerably more rapid labour cost inflation in the United Kingdom than in competing countries up until the end of 1980 (see the chart on page 333), were only reversed to a very limited extent in later years. In contrast the (smaller) adverse effects of the appreciation of 1979–80 on trade volumes were fully reversed within three years.

Finally, the table shows the extent to which recent changes in the manufactures balance cannot be explained by the Bank model. The overall profile of changes has generally been correctly predicted, but for six years in succession the unexplained part of the change has been negative—indicating that the balance has been worse than the model would have predicted. Such 'over-optimism' is not however a permanent feature: in the early 1980s the model was 'over-pessimistic'. One possible explanation for this is that the unexplained element in trade volume movements is partly due to supply-switching between the overseas and domestic markets, which is not explicitly allowed for in the model. Such an effect might be expected to improve trade performance relative to the model's prediction at times when the domestic market is particularly depressed (as in the early 1980s), but to worsen the balance when there is strong growth of domestic demand, as in more recent years. Another possibility is that either the size or speed of the competitiveness response is overstated in the current model, since there is a fairly marked negative correlation between competitiveness and residual effects.

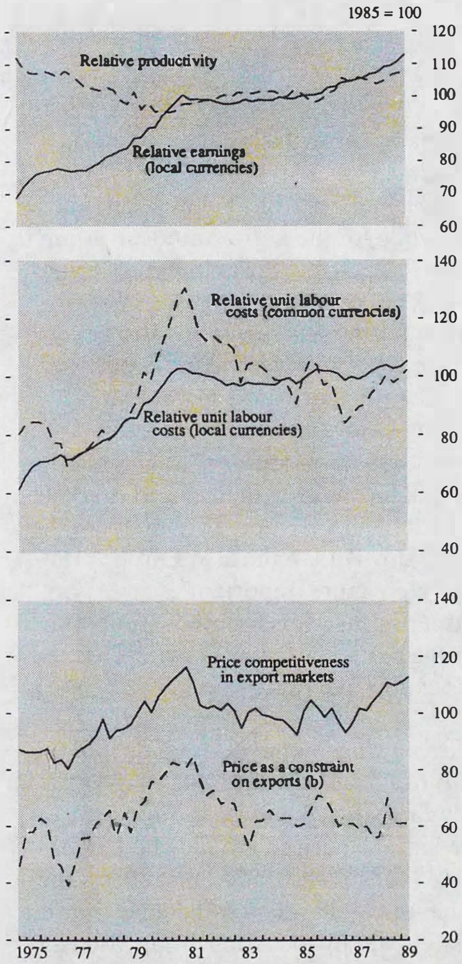
Explaining changes in the manufactures balance

£ billions

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Total change	**2.8**	**–0.9**	**–2.3**	**–4.7**	**–1.6**	**0.9**	**–2.6**	**–1.8**	**–6.9**
of which, due to movements in:									
Trade prices	2.0	0.5	0.2	0.4	–0.5	0.3	–0.9	–0.1	1.9
Trade volumes	0.8	–1.3	–2.5	–5.1	–1.1	0.6	–1.6	–1.7	–8.8
of which due to:									
Demand	4.9	2.9	–0.9	–3.0	0.7	1.2	0.7	–1.6	–5.6
Competitiveness	–5.2	–5.9	–1.7	1.6	2.5	2.2	0.4	2.8	–0.1
of which, due to changes in:									
Exchange rate	–1.8	–2.6	–0.4	1.3	2.0	2.3	1.2	3.1	0.4
Relative unit labour costs in local currency	–3.5	–3.3	–1.1	0.3	0.4	–0.2	–0.9	–0.3	–0.5
Trend rise in import penetration	–1.2	–1.0	–1.0	–1.0	–1.1	–1.2	–1.2	–1.3	–1.4
Pressure on capacity	1.1	1.4	–0.3	–1.2	–1.2	–0.5	0.4	–0.2	–0.8
Unexplained volume change	1.2	1.2	1.5	–1.5	–2.1	–1.1	–1.9	–1.4	–0.9

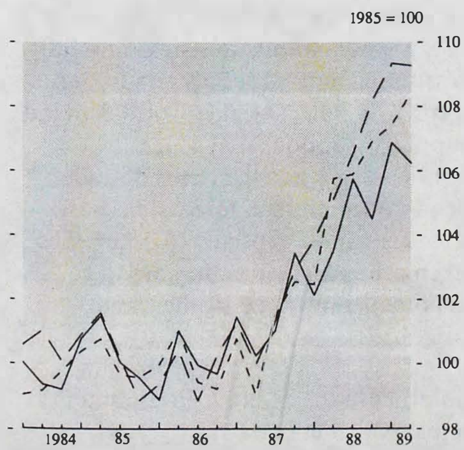
(1) In the Bank model both import and export volumes of manufactures respond to changes in demand (UK demand in the case of imports, world trade in the case of exports) and competitiveness (relative unit labour costs in manufacturing). In addition, imports are affected by a proxy measure of pressure on capacity (if UK output increases more rapidly than in the recent past, the proportion of home demand met through imports increases); the model also allows for a trend increase in import penetration of around 2% per annum. This latter effect is largely seen as proxying for increasing international specialisation. A trend rise of around this size is common to most developed countries, hence world trade tends to grow more rapidly than world domestic demand. Since UK exports grow in line with world trade in the model this results in a similar *implicit* trend to that for imports. Thus in a situation of normal growth in the United Kingdom and overseas, and starting from a position of balanced trade, demand effects *plus* import penetration effects on the balance will be broadly neutral, other things being equal.

UK competitiveness deteriorated in the first quarter but will since have improved[(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.

Measures of relative domestic demand



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

. . . *and* **competitiveness** *worsened in the first quarter, but will have since recovered somewhat*

The recent trend of deteriorating relative unit labour costs resumed in the first quarter, when they worsened by 2% compared with the fourth quarter of 1988, resulting in a similar deterioration relative to a year earlier. Although manufacturing productivity in the United Kingdom grew by 6½% over the year to the first quarter—over 3 percentage points faster than in our major competitors—this gain was more than outweighed by growth in earnings of nearly 9%, about 5 percentage points faster than that in our competitors. As the chart illustrates, recent quarters have seen a widening of the gap between earnings growth in United Kingdom and in competing countries, while relative productivity growth has levelled off. Relative unit labour costs and export price competitiveness *in a common currency* have continued to exhibit a similar profile, since both series are dominated by movements in the nominal exchange rate. The 6% deterioration in common currency labour cost competitiveness between the first quarter of 1989 and a year earlier largely reflects the 4% appreciation of sterling's effective exchange rate over that period. The more recent weakening of sterling, however, will have reversed part of this loss.

Despite the recent deterioration in competitiveness, a slowdown in domestic demand growth relative to that overseas has helped stabilise the current account deficit. This is a reflection of the fact that last year's deterioration was associated predominantly with the strength of demand in the United Kingdom rather than any weakness of UK output. Domestic demand growth in the United Kingdom between the fourth quarter of 1988 and the first quarter of 1989 (of less than ½% on the output-based measure) was almost certainly slower than overseas. While output growth has also slowed, export performance has remained reasonably strong, so that the apparent slowdown in relative demand has been translated into some improvement in the trade balance. As domestic demand growth slows further in response to the policy tightening seen in the past year, this should result in a continued narrowing of the current account deficit in coming months.

The **public sector** *was in deficit in the first quarter*

The public sector is estimated to have been in deficit in June to the extent of £0.7 billion, taking the cumulative PSBR for the first quarter of 1989/90 to around £0.2 billion. This compares with a surplus of £1.6 billion in the same period of 1988/89. The reduction in the surplus is due to a £2.4 billion increase in the central government's own borrowing requirement, which was only partly offset by reductions in the borrowing requirements of public corporations and local authorities. Privatisation proceeds in the first quarter were £1 billion lower than in the first quarter last year, while supply expenditure was 11½% higher and revenue receipts only 6% higher. National insurance contributions have also been depressed by the subsidy given to those taking out personal pensions and, as the number of personal pensions now in existence considerably exceeds expectations, the PSDR for 1989–90 may turn out to be lower than the £14 billion forecast in the FSBR.

Economic prospects for a selection of developing economies

This note summarises the Bank's assessment, completed in June 1989, of the balance of payments and debt prospects for a group of twenty-seven developing economies.[1]

This group, which includes the largest developing economies, accounts for over 60% of the visible trade and over 70% of the gross external debt of all developing countries excluding the newly industrialised economies (NIEs);[2] it includes twelve of the Baker-15 countries. However, sub-Saharan African economies are under-represented in numerical terms, and the dominance of India, China, Brazil, South Africa, Nigeria, and Mexico in the group should also be noted. These six countries account for 48% of the trade, and 40% of the external debt, of the group.

Background to the forecast

All but five of the country forecasts were prepared on the assumption that access to external finance is limited, so that import volumes are largely determined by the external financing constraint. Private creditors are assumed to continue rescheduling most maturing debt for countries in debt servicing difficulties, but not to increase their overall exposure to these countries markedly. No allowance has been made for debt reduction under the auspices of the Brady plan, though some forecasts incorporate reduction under existing arrangements (eg debt/equity schemes).

Export market growth, interest rates and forecasts for aggregate commodity indices are taken from the Bank's latest world economy forecast (WEF) extended to 1993.[3] However, terms of trade forecasts take detailed account of each country's commodity composition of trade, including up to five individual commodity forecasts, as well as the five WEF aggregate indices.

The WEF projected that interest rate policy would form the main instrument for slowing demand in Europe and North America in response to rapid growth in 1988. Growth was projected to remain relatively rapid in Japan and the NIEs.

Consequently, the forecast external environment is most favourable for the Asian group, and poorest for the highly indebted middle-income Latin American group. For the whole group, export market growth is forecast to slow sharply, from 11% in 1988 to 5% in 1992, before rising to 6% in 1993. Export market growth slows for the Asian group as well, but from a higher level; it is estimated to have been 15% in 1988, and only falls below 6% in one year of the forecast, while for the Latin American group it falls from 8% in 1988 to 2.5% in 1992 before recovering.

Export market growth for the Asian group is strong because Japan and the NIEs are its principal export markets. Europe is the principal export market for all other groups, including Latin America. Hence, it is relatively slow forecast growth in Europe which underlies the pessimistic outlook for the growth of export markets in these groups, even though US import volumes are forecast to grow more slowly than those in Europe. The United States is relatively more important as an export market for Latin America than it is for other groups, which accounts for the particularly low growth projected for Latin America's export markets.

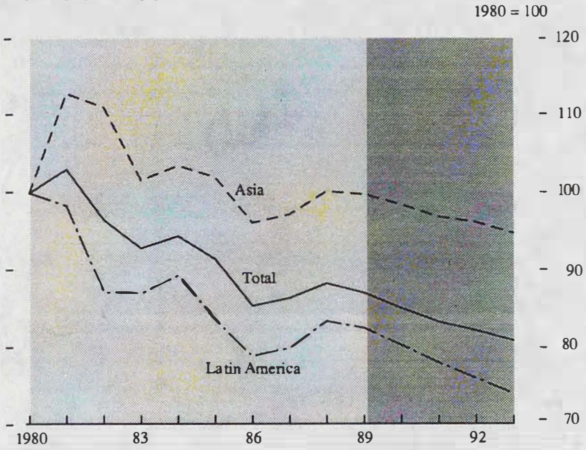
Average interest rates payable on the external debt of the group are forecast to rise from 7.2% in 1988, to over 8% in 1989, falling slightly thereafter. This rise is most pronounced for the Latin American group, where rates rise from 8.4% in 1988 to 9.6% in 1989. This reflects the high share of variable-rate dollar-denominated claims on this group. While rates paid by the Asian group also rise, they increase only from 5.9% in 1988 to 6.2% in 1989.

All groups, with the exception of the European group, are forecast to experience further declines in their terms of trade (see Chart 1). Oil exporters[4] and exporters of agricultural primary products[5] are expected to be particularly affected. This reflects forecasts that commodity prices will fall from their 1988 peaks, while manufactured import prices continue to rise. Commodity prices are forecast assuming normal supply conditions, and consequently primarily reflect weaker world demand and the easing of supply disruptions that generally supported prices in 1988–89. While the terms of trade movements may be more varied than forecast because some supply disturbances can be expected to occur, these are as likely to weaken prices further as they are to support them. This point is illustrated by the recent collapse of coffee prices.

The forecast deterioration in the external environment is more marked than that which underlay last year's

(1) A *sub-Saharan African* group—the Côte d'Ivoire, Ghana, Tanzania, and Zimbabwe; *Other Africans*—Nigeria, and South Africa; a *Latin American* group—Argentina,,Brazil, Chile, Colombia, Mexico, Peru, and Venezuela; an *Asian* group—China, India, Indonesia, Malaysia, Pakistan, the Philippines,,and Thailand; a *European* group--Poland, Turkey, and Yugoslavia; and a *Middle Eastern* group—Algeria, Egypt, Jordan, and Morocco.
(2) Hong Kong, Singapore, Taiwan, and South Korea.
(3) A summary of the WEF was given in the May 1989 *Bulletin*, pages 198–9.
(4) Algeria, Indonesia, Mexico, Nigeria, and Venezuela.
(5) Argentina, Colombia, the Côte d'Ivoire, and Ghana.

Chart 1
Terms of trade



forecast,[1] particularly from 1990 onwards, though the starting point is more favourable than was forecast then. The deterioration partly reflects policy tightening in the OECD countries in response to the unexpectedly strong performance in 1988.

Current account prospects

The deteriorating external environment contributes to a further widening of the group's current account deficit, from US$22.4 billion in 1988 to a peak of US$37.7 billion in 1990 (see the table). It narrows thereafter, first reflecting an improvement in the invisibles accounts, but subsequently also reflecting the forecast growth of exports because of the recovery of export market growth. Over half of the increase in the overall current account deficit of the group between 1988 and 1990 is accounted for by China, India, and Argentina. In China and India this reflects the relatively rapid growth of domestic demand in conjunction with domestic supply constraints and some liberalisation of import controls. In Argentina, it reflects a deterioration in the terms of trade, as well as rising interest payments on its external debt.

Selected economic indicators: total sample

	1981-86 (annual averages)	1987	1988	1990	1992
					Percentage changes
Export markets	4.0	7.4	11.0	5.9	4.7
Non-oil export volume	6.8	11.5	11.4	6.5	6.7
Non-oil import volume	2.5	7.5	11.6	6.3	5.7
Terms of trade (change)	- 2.5	- 1.1	2.2	- 2.3	- 1.3
Real effective exchange rate	106.0	77.0	75.8	73.6	71.7
					$ billions
Trade balance	9.3	25.8	23.3	16.1	16.9
Invisibles	-50.1	-40.6	-45.8	-53.9	-52.8
of which, interest payments	*-54.1*	*-58.8*	*-64.2*	*-76.3*	*-72.5*
Current account	-40.9	-14.8	-22.4	-37.7	-35.9
Selected capital flows:					
Net direct investment	7.6	9.8	16.4	15.6	18.5
Net official multilateral borrowing	..	0.3	6.2	7.3	8.6
Net bilateral official borrowing	..	7.4	6.3	6.9	4.5
Net commercial bank borrowing	7.7	7.9	2.7	9.9	9.1
Reserve change(a)	- 0.2	-14.9	5.1	0.5	- 5.9
Months import cover	*5.1*	*5.9*	*4.9*	*4.2*	*3.8*
Debt projection					
Gross external debt	635.2	885.2	890.5	965.1	1,030.8
Interest payments as a percentage of export earnings	*23.9*	*21.8*	*20.6*	*22.0*	*18.1*

.. not available.

(a) Increase represented by a minus sign.

The forecast for a widening of the group's current account deficit may be understated. The individual country forecasts generally project considerable adjustment effort, and consequently further steady gains in external competitiveness alongside slow growth of domestic demand. This could be optimistic, as the risks associated with forecasts for domestic policy stance have increased. Several countries, notably China and some of the oil exporters, have experienced domestic unrest recently, and several administrations have changed following elections, more of which are due. Furthermore, the effectiveness of the instruments available to policymakers to control demand is sometimes limited. These factors may be increasingly reflected in the external accounts owing to the import liberalisation measures implemented widely in the group in 1988 and those projected in the forecast. These may increase the sensitivity of import volumes to domestic demand.

Despite the assumed tightening of domestic policies, there remains scope for increases in import volumes, though not at the rate seen last year. This is so even for the twelve Baker-15 countries in the sample. In the countries for which further import compression is forecast, compression only weakly reflects the impact of adverse external conditions. This generally encouraging outlook for import volumes reflects three factors:

- First, except in 1989, the group is forecast to increase its share of export markets, notably in the later years of the forecast. Market share is forecast to fall only for the sub-Saharan African countries, though this group is dominated by the poor performance of Côte d'Ivoire, and the others increase market share. The Latin American group's market share is forecast to recover strongly from 1991 onwards. Increased market share partly reflects the diversion of output to export markets in response to the forecast slow growth of domestic demand, and gains in competitiveness in the group as a whole.

- Second, the forecast projects that net inward direct investment (NDI), which is estimated to have risen by 70% in 1988,[2] will remain high. The increase in 1988 was a counterpart to the high levels of investment in the industrial countries in 1988, though debt/equity schemes also contributed. Japanese investment in Asia was particularly strong. Thus, although NDI is forecast to fall in 1989, it is expected to remain high by historical standards, reflecting these favourable external factors as well as a generally improving environment for direct investment in many recipient countries.

(1) See the August 1988 *Bulletin*, pages 323–5.
(2) It more than doubled in the twelve Baker-15 countries in the group in 1988.

- Third, net lending by the World Bank and regional multilateral development banks is forecast to rise to almost US$9 billion in the later years of the forecast (up from US$6 billion in 1988), with just under half going to the Asian group. Net commercial bank lending is also forecast to rise, although, unlike multilateral bank lending, Asian exporters of manufactures(1) are forecast to absorb almost all of the increase. For other groups, net commercial bank lending is projected to remain stable at current low levels, after falling sharply in the mid-1980s. Further increases in arrears are expected in several countries. Import cover also falls.

These factors are forecast to permit imports to rise throughout, including 1989 and 1990 when the external environment deteriorates. Subsequently, as interest rates fall, the growth of import volumes increases still further.

Risks to the forecast

As noted, the individual country forecasts generally assume that adjustment efforts are considerable. This may be over-optimistic.

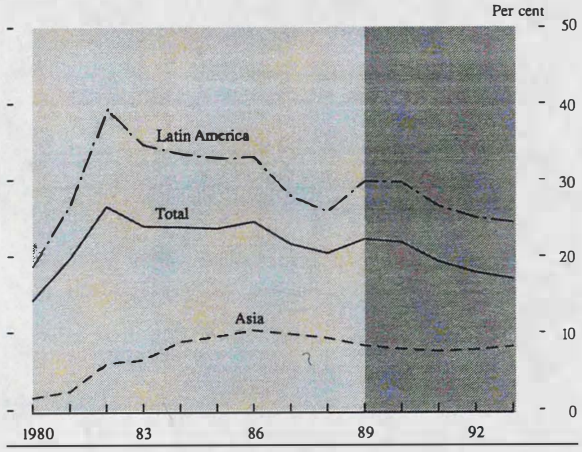
The external environment may be stronger than forecast. The risk of a 'hard landing' for the world economy, with inflation slowing with a major recession, may be receding. US interest rates have been lower than forecast in the WEF in the first half of 1989, while European growth has been stronger in the same period. Thus, the forecast may be a little pessimistic on interest servicing, and on export market growth for 1989, particularly for the Latin American group.

Against this, the group could face protectionist pressures in its major markets, despite some measures to reduce protection implemented in 1988, notably affecting agricultural products. Brazil and India have already been named under article 301 of the US trade bill. Concern is also sometimes expressed by developing countries about their access to European markets, as the development of the EC internal market proceeds. Should exports be affected by additional protection, this would impair prospects for the group and its external creditors.

Implications for the debt strategy

While external conditions lead to a rise in the ratio of net interest payments to exports in 1989, the increase is significant only in the Latin American group—where it is temporary, with the ratio remaining well below its 1982 peak—and in the African group (see Chart 2). Debt reduction under the Brady plan may improve this picture further. However, the forecast is pessimistic about the prospects for indebted countries achieving normal relations with international financial markets. Adjustment efforts may have to be sustained for some time and debt

Chart 2
Net interest service/exports



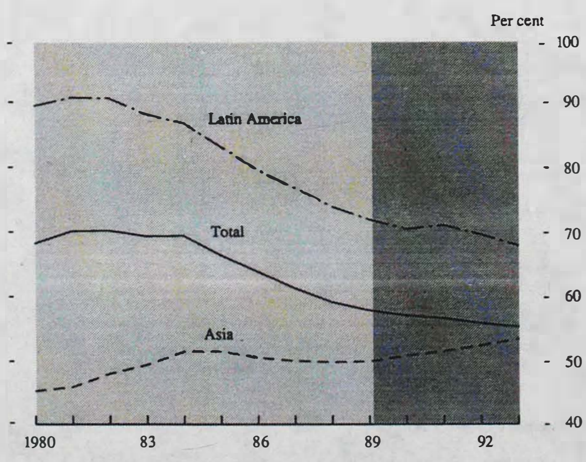
ratios may have to fall further before voluntary credits become available on a significant scale.

An important factor behind the relatively strong performance of import volumes is the projected level of lending by official creditors. This is reflected in the declining share of commercial to total debt, notably in Latin America (see Chart 3).

Among the sample countries, oil exporters and exporters of primary agricultural products appear to face the most severe external constraints, mainly reflecting forecasts for adverse movements in their terms of trade. Oil exporters have little scope for increasing export volumes despite production rates assumed to exceed OPEC quotas, while downward pressures on agricultural prices are expected to persist. These trends may place the adjustment programmes under way in some of these countries under considerable strain.

A small number of countries which currently enjoy relatively unconstrained access to international capital markets may find that access becoming more limited as their external obligations rise, unless the new borrowing is supported by appropriate structural reform.

Chart 3
Commercial debt/total debt



(1) China, India and Thailand.