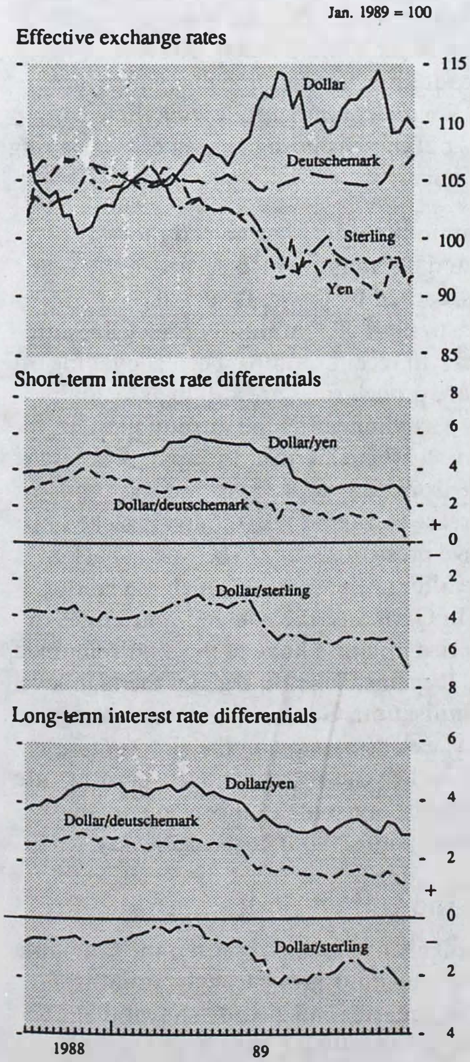
Economic commentary

- *The strength of the dollar has been a major feature of the international economy in recent months.*
- *Inflation seems to have stopped rising in the major industrial countries. Nevertheless it still seems too early to say with confidence that it is established on a downward path.*
- *Activity remains strong except in the United States, where there have been signs of a slowing.*
- *Output in the United Kingdom was little changed in the second quarter while domestic demand fell. Consumer spending remains subdued as a consequence of the successive increases in interest rates.*
- *Wage costs remain a cause for concern and the increase in interest rates in the United Kingdom in October demonstrated the authorities' determination not to allow the firmness of the monetary stance to be undermined by further exchange rate depreciation.*
- *The current account deficit widened in the third quarter, despite the slowdown in demand.*

The dollar has generally remained strong



The dollar's strength *has been a major feature in the international economy . . .*

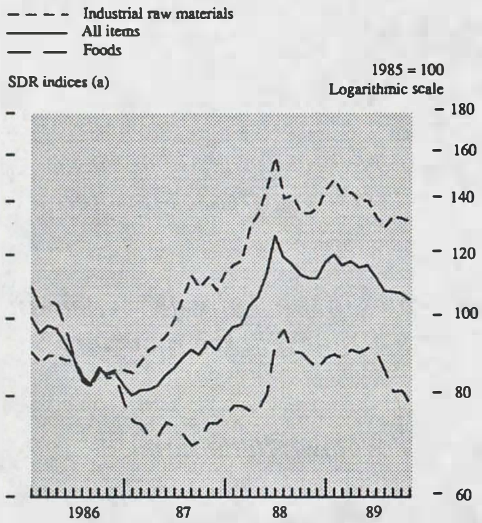
The resilience of the dollar in recent months has been a major feature of international economic developments. It has helped to contain inflation in the United States, while the worries expressed in the August *Bulletin* over the effects of dollar appreciation on inflation in Germany and Japan have not yet crystallised with the rise in inflation in the major economies having halted, partly owing to an easing back in non-oil commodity prices. Even so, it is still far too early to say whether inflation is firmly established on a downward path. A non-recessionary slowdown in US activity seems more likely than had been thought in the early summer, while underlying growth in Japan and continental Europe remains strong. External imbalances continue to narrow, although temporary effects associated with the rise of the dollar have exaggerated the underlying correction.

The dollar still shows signs of resilience despite doubts about its sustainability. The Group of Seven meeting in September reiterated that a rise in the dollar above current levels could adversely affect prospects for the world economy and was inconsistent with longer-run economic fundamentals. The meeting was followed by co-ordinated central bank intervention which succeeded in pushing the dollar back. Subsequently the dollar remained firm although it started to fall back in mid-October. The dollar's strength over the summer persisted in spite of a narrowing of interest differentials between the United States and elsewhere (see the chart opposite). This reflected a neutral monetary policy stance in the United States over the summer (although more recently signs of an easing have been evident) and an emphasis toward tightening in Europe and Japan. In early October the Bundesbank raised its discount and Lombard rates by 1 percentage point to 6% and 8% respectively, a move aimed at countering inflation and strengthening the deutschemark. The United Kingdom and a number of other European countries raised their key rates at the same time. Against a background of continuing concern about inflationary pressures in the economy, the Bank of Japan's official discount rate was raised by ½% to 3¾% a few days later.

Inflation *has stopped rising*

Inflation in the major economies as a whole has stopped rising although it is still too early to say that it is definitely set on a downward track. The easing of pressure from commodity prices has been helpful in its containment. Non-oil commodity prices have weakened in the past few months; the Economist index fell by 6% in the third quarter in SDR terms. The weakest component was food prices, which fell by 9%, largely because of a collapse in coffee and an easing in grain prices. Despite some supply disruptions, metals prices overall fell by 7% over the quarter. The price of oil has held up more than had been expected recently, largely owing to higher than expected demand. Nevertheless, it remains vulnerable to overproduction and disagreement over quotas.

Non-oil commodity prices have weakened

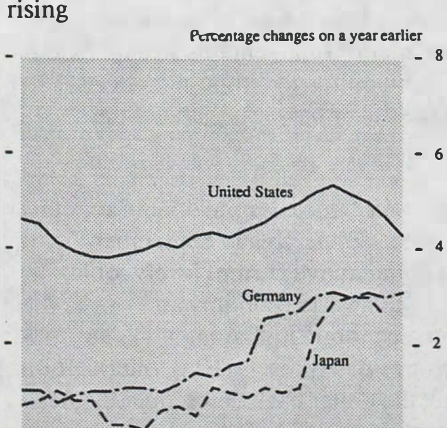


(a) 'Economist' index of non-oil commodity prices.

The easing of producer prices in the United States over the summer has also been reflected in the profile for consumer price inflation. It started to rise in the middle of last year but had edged up by only about 1½ percentage points before its peak in May, underlining the view that along with the receding threat from food and energy prices the dollar may have played some part in containing inflation in the United States. However, expectations for a significant improvement may be premature; producer prices rose by 0.9% in September following three consecutive monthly falls but there is no sign as yet of this having fed through to consumer prices.

The easing of non-oil commodity prices has helped those countries, such as Japan and Germany, which earlier in the year faced rising import prices, caused by the weakness of their currencies and the earlier strength of commodity prices. In both of these countries there has, in recent months, been a levelling off in consumer price inflation, though rates are still high by their own historical standards, partly reflecting the introduction of sales taxes in both countries earlier this year. In Japan, wholesale prices were broadly stable from June to August, and the twelve-month rate of increase started to fall, though it picked up slightly in September. Wage pressures seem to be easing back a little, having intensified earlier in the year, although the labour market is still very tight. In Germany, the twelve-month rates of producer and consumer price inflation have both so far remained stubbornly at around 3%. It seems likely that, given the high level of demand and capacity utilisation, German producers may be increasing their margins as well as passing on the effects of rising import prices seen earlier in the year. Average hourly earnings are rising on a twelve-month basis, but some of this is due to an increase in overtime earnings; unit labour costs are steady.

Consumer price inflation has stopped rising



Activity *is slowing in* **the United States . . .**

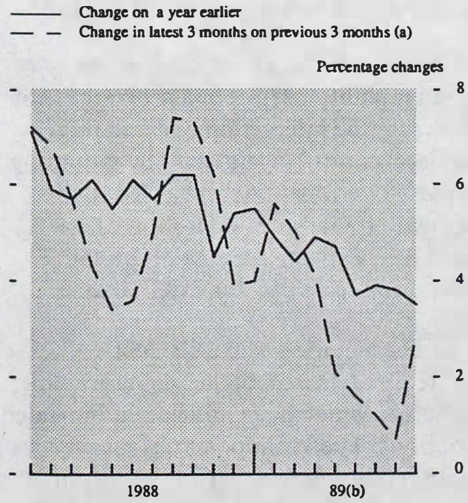
The US economy grew by 0.6% in the third quarter, the same rate as in the second. Consumer spending grew strongly; monthly retail sales data for the third quarter had already shown that this was partly due to automobile sales, which have been buoyed up by special incentives. Capital expenditure once again owed its strength to non-residential investment. Net exports made a large negative contribution to growth, an unwelcome feature from the perspective of the correction of external imbalances. Recent monthly data, however, point to a further slowing in activity. The growth in industrial production has moderated, and employment growth has slowed markedly in recent months from a monthly average of 300,000 earlier in the year.

. . . but remains strong in **Japan and Germany**

Despite the slowing of activity in Japan in the second quarter and beyond, underlying growth is still quite robust. Although GNP fell in the second quarter, it was nearly 5% up on a year earlier, about the same growth as for the year to the first quarter. Second quarter figures show that consumers' expenditure fell following a strong first quarter when spending surged ahead of the introduction of the consumption tax in April. Nevertheless, retail sales are recovering and have now returned to the rates of increase seen at the beginning of this year. The external sector made a large negative contribution to growth, reflecting the narrowing of the trade surplus. Meanwhile, the growth of industrial production has declined steadily relative to the rates seen a year ago.

Output in West Germany continues to exceed earlier expectations but the pattern of growth remains unhelpful in terms of the correction of external imbalances. Although GNP fell in the second quarter, this was again mainly a reaction from the large rise recorded in the first; output was still 5% higher than a year earlier. Private consumption remained weak and monthly retail sales data show that this has continued into the third quarter. There has been a slowing in both domestic and export orders, but only to the rates seen at the end of last year, prior to the exceptionally strong first quarter. Orders for investment goods both from within Germany and from abroad remain at a high level and, unhelpfully from the point of view of prospects for external imbalances in the European Community (which accounts for well over half of Germany's merchandise exports), the demand for consumer goods from abroad is also very strong. The buoyancy of orders over the past twelve months or so has helped to maintain an annual rate of growth of industrial production of about 5%, compared with an average of 2% in the previous twelve months. Increasing tightness in labour markets is evident from further sharp falls in unemployment, a very high level of vacancies and increased overtime working, though the recent increase in immigration from Eastern Europe will have the effect of easing labour shortages to some extent.

The twelve-month growth in major seven industrial production has fallen



(a) Seasonally adjusted at annual rates.
(b) Figures for July and August are partly estimated.

External adjustment *continues but the degree of progress has been exaggerated by exchange rate developments . . .*

A further reduction in trade imbalances was apparent in the first half of the year, with most of the underlying improvement coming from the United States and Japan. Improvements in the direction and magnitude of trade volumes for both countries contributed to the adjustment process. Even so the degree of correction (when measured in value terms) has been exaggerated by terms of trade movements associated with the strength of the dollar. An improvement in the US trade balance in the second

German visible exports
DM billions, *seasonally adjusted*

	1986	1987	1988	1988 H1	1989 H1
Total	**446**	**451**	**487**	**231**	**272**
of which:					
EC	269	278	307	146	174
Other industrial countries	177	173	180	85	98
of which, United States	56	50	46	21	23

Volume of German exports: by category of goods
DM billions, *seasonally adjusted*, 1980 prices

	1986	1987	1988	1988 H1	1989 H1
Basic and producer goods	122	127	136	66	72
Capital goods	233	235	252	120	138
Consumer goods	56	58	62	30	34

quarter was outweighed by a deficit in invisible trade, leading to a slight widening in the current account deficit, while the merchandise trade deficit has since widened with August's unexpectedly poor trade figures. The increase in the German trade surplus in the first quarter of this year seems to have been achieved, as in the recent past, at the expense of its partners in the European Community, and imbalances within Europe remain a source of some concern. Although the German trade and current account surpluses fell in the second quarter, this partly reflected the short-term effects of the deutschemark's weakness. The prospects for a significant reduction in these surpluses in the foreseeable future are slim.

. . . *while the* external environment for non-oil developing countries *is deteriorating*

A combination of a slowdown in the rate of growth of export markets and declining terms of trade has contributed to a deterioration in the external environment for non-oil developing countries as a whole. In China, a loss of competitiveness and supply constraints in export sectors (against a background of domestic political upheaval) have reinforced the negative effect of stronger domestic demand on the current account balance. Likewise, in Argentina and Brazil strengthening domestic demand has led to a worsening of trade performance. For the developing countries as a group, the downward movement overall in US interest rates over the first three quarters of 1989 was not sufficient to counteract the deterioration of export performance (in volume and value terms) and the ratio of interest payments to exports has if anything increased.

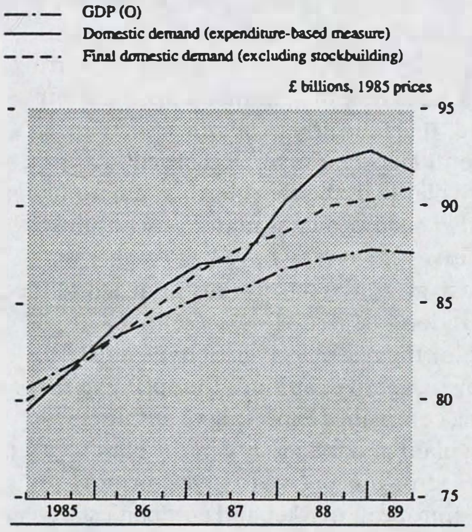
Inflationary problems persist in a large number of developing countries, often reflecting an inability to sustain a programme of economic adjustment. In Brazil, the interaction of escalating inflation and problems of fiscal control (aggravated by mounting interest payments on internal government debt) has led to the demise of the IMF adjustment programme and a shortfall in external funding. The result has been a tightening of capital controls and a partial moratorium on servicing external debt.

The details of a package for restructuring Mexico's debt, involving new money and reductions in debt and debt servicing, have been put to creditor banks, which have not, as yet, indicated their choices among the options. The Philippines has reached preliminary agreement with its commercial bank creditors on a package involving new money and debt buybacks at a discount to face value. Several other indebted developing countries have begun negotiations with commercial bank creditors on debt reduction agreements.

Output *and* domestic demand *in the United Kingdom both fell slightly in the second quarter . . .*

The preliminary estimate of GDP in the second quarter indicated that economic activity was still slowing. Between the first and second quarters the output measure of GDP fell by 0.2% (the first quarterly fall in output since 1985) to a level 2.2% higher than a year earlier. A further sharp reduction in energy output was a significant factor behind the fall; non-oil output rose by 0.2% in the quarter. This picture of a slowdown in the economy is also apparent in the other measures of GDP, which fell by broadly the

Final expenditure has grown more slowly than domestic demand in the past year



same amount. The convergence of the growth rates of the three estimates of GDP in the second quarter reflects the decision by the CSO to introduce adjustments to the expenditure and income measures in order to bring them more closely into line with the output measure—generally regarded as the most reliable in the short term. The adjustment to the expenditure measure has been made largely to the stockbuilding component while, in the case of the income measure, gross trading profits of companies have been adjusted. One consequence of this is that the expenditure-based measure of domestic demand, which showed a fall of 0.7% in the second quarter (to a level 5.2% higher than a year earlier) corresponds closely to a measure derived from output and trade statistics. However, the resulting picture of the composition of domestic demand (and, in particular, the large negative contribution to growth from stockbuilding) may not be wholly accurate.

Substantial revisions have also been made to the historical data on GDP. These indicate that the economy was growing much more rapidly in 1988 than previous estimates indicated. On the average measure, growth has been revised up from 3.7% to 4.4% in the year as a whole, while domestic demand (on the expenditure-based measure) is now estimated to have grown by 7.3%—again closely in line with estimates based on output and trade data.

Industrial production fell by 1% in the second quarter of 1989, reflecting developments in the energy sector, where oil production continued to be seriously affected by supply disruptions. Energy production recovered somewhat over the summer months, presaging a stronger rise in the second half of the year as oil production recovers from the series of strikes and accidents which occurred in the second half of last year and the first half of this. Manufacturing output was broadly flat in the second quarter, and despite rises in July and August, the outlook for manufacturing is for little growth in the coming months. The latest CBI survey shows a continued weakening of demand, with a balance of 13% of firms indicating that order books were below normal, in contrast to balances recording above-normal orders through most of the previous two years. The survey also shows a substantial drop in the balance of firms expecting to increase output in the coming months. It seems clear that manufacturing output growth has fallen back significantly from the rapid rate seen last year. There is no indication, however, that manufacturing is experiencing a recession; profitability remains high by historical standards and manufacturers in aggregate are still operating at a high level of capacity utilisation.

The picture for the third quarter is, as yet, incomplete, though some increase in output in the economy as a whole seems likely as oil production recovered. The fact that the current account deficit widened suggests, however, that domestic demand may also have picked up, though its composition is not yet known.

. . . and **investment** *is recorded as having slowed*

Industrial investment seems to have been flat in the second quarter (though detailed figures have not been released). This will have depressed the twelve-month growth rate, which in the first quarter had been almost 16%. The aggregate picture conceals differing sectoral movements. Manufacturing investment rose by a record 14% in the second quarter, although erratic seasonal movements mean that the second quarter's figure should probably be considered alongside that for the first (when investment was recorded as being weak). Even on this basis, however, the rise over the second half of last year was still 7%.

Non-manufacturing investment, in contrast, fell by 3½% in the second quarter. This may be associated with the deterioration in companies' financial positions, though this is far from certain. Alternatively, the high level of interest rates may also be exerting some influence, as may a reduction in confidence arising from the prospects for demand. It is too early to advance such explanations with any confidence, however. Recorded investment is extremely volatile in the short term and not only is it difficult to know whether a slowdown is under way but the possibility remains that investment may have been higher than recorded in the recent past, given the uncertainty attached to the figures for expenditure. It does, nevertheless, seem that a slowdown is in prospect for the reasons given above—the CBI survey, for example, shows a sharp drop since the spring in the balance of manufacturing companies expecting to authorise increases in spending on plant and machinery in the coming year. However, there remains a strong incentive to invest prior to completion of the single European market and companies are still able to borrow relatively easily to finance investment expenditure. Non-manufacturing investment is also underpinned by a number of large infrastructure projects such as the Channel Tunnel and developments in London Docklands. These factors suggest that, provided corporate profitability can be maintained, the cyclical downturn in investment may be modest in comparison with the retrenchment seen in other periods when the company sector has found itself in financial deficit.

The behaviour of recorded stockbuilding in recent quarters has been dominated by the substantial upward adjustment made to the expenditure measure of GDP to bring it more closely in line with the output measure. This adjustment has been attributed to stockbuilding since this is perceived by the CSO to be the component for which accurate measurement is most difficult. On the adjusted basis, stockbuilding in the year to the second quarter totalled over £7 billion, though a fall in the second quarter itself—to £0.8 billion from £2.5 billion in the first—was largely responsible for the fall in recorded domestic demand. The revised figures suggest that stock/output ratios have risen since the middle of last year, reversing the trend decline seen since 1984. The statistical adjustment is not allocated by sector, however, and it is therefore not clear whether, to the extent that it has occurred, any such build-up is associated with the production or distribution sectors. Recent CBI surveys have indicated that manufacturers' stocks have been rising and indeed have been above desired levels, and to the extent that any build-up of stocks has been involuntary—reflecting an unanticipated slowdown in demand—the unwinding of positions could have significant implications for output and trade.

Consumer spending *picked up in the second quarter but was flat in the third*

Consumers' expenditure grew by 1½% in the second quarter of 1989 following only a marginal rise in the first. The pattern of growth, however, was significantly different from that seen for much of last year. Expenditure on durables, which grew on average by 2½% in real terms in each quarter of 1988, remained flat in the second quarter. This was as expected since much of this component of spending is housing-related; spending on furniture and floor coverings has been flat since the middle of last year and fell by over 9% in the second quarter. Spending on other categories of durable goods, however, was more buoyant. Much of the rise in consumption was accounted for by services, though, as in previous quarters, this rests uneasily alongside the figures for output of services, which showed only a marginal rise (notwithstanding some differences in coverage).

Total personal incomes rose by 1% in the second quarter (rather less than in the first); wages and salaries increased by 2% but 'other income' (rent, dividends and net interest) fell by 2½%, mainly as a result of a drop in dividend receipts. Total personal disposable income rose by less than the consumers' expenditure deflator, leading to a fall in RPDI of around ½%. Given the rise in consumers' expenditure, the saving ratio fell in the second quarter to 3.2% from 5.2%. It seems unlikely, however, that this represents anything more than an erratic drop in the ratio; its level in the first half of the year—at 4½%—was comparable to the average in 1988.

Preliminary figures for the third quarter indicate that consumer spending was flat across the board. Spending on household goods fell back further, while demand for vehicles was flat despite earlier reports that car registrations had been high in August. Spending on services was also virtually static compared to the second quarter. This, together with the uncertainty attached to spending on services in the first half of the year, reinforces the view that higher interest rates are having a significant depressing effect on consumption.

There are few firm signs as yet of any easing of the **labour market . . .**

Unemployment in the United Kingdom (seasonally adjusted) fell to 1.7 million, 6% of the workforce, in September. It has now fallen in every month since July 1986 (a cumulative fall of over 1.4 million). The rate of decline may be moderating but only very slowly; the average monthly fall over the last three months has been around 38,000, little changed from the previous six but 6,000 less than the monthly average for 1988. There is some evidence of a slowdown in employment growth but overall this remains strong. The workforce in employment is now estimated to have increased by a little under 500,000 (about 2%) in the year to June, compared with nearly 800,000 in the corresponding period a year earlier. Service sector employment grew by over 250,000, while manufacturing employment fell by 25,000 over the same period, offsetting part of the gain seen in the previous eighteen months.

Changes in employment in the United Kingdom

Thousands

	June 1984– June 1985	June 1985– June 1986	June 1986– June 1987	June 1987– June 1988	June 1988– June 1989
Manufacturing	-47	-135	-75	63	-25
Services	272	191	298	578	269
Self employment	114	17	233	126	124
Other(b)	-38	-47	55	33	125
Workforce in employment	**301**	**26**	**512**	**799**	**493**

Source: *Employment Gazette.*

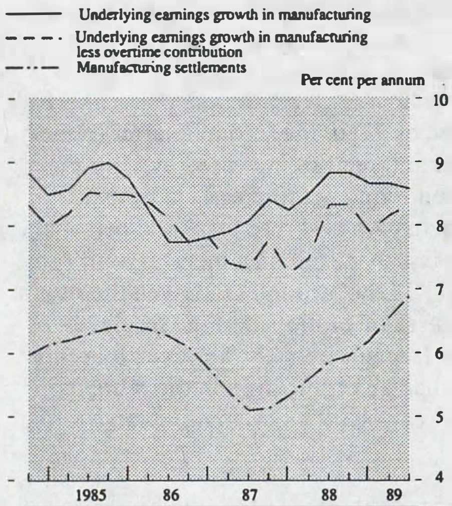
(a) HM Forces, work-related government training and other employees.

The latest employment figures have been revised downwards as a result of the 1987 *Census of Employment* (this follows earlier, upward revisions following the 1988 *Labour Force Survey*). These revisions have affected both the level and the rate of growth of employment. Employment growth between 1984 and 1987 has, for example, been revised down from 1.3 million to just under 1 million. The picture of employment growth in 1988 has been revised down only slightly—by around 70,000. The revisions are due entirely to a lower estimate of employees in employment, particularly in the service sector.

. . . **wage settlements** *continue to edge up . . .*

Notwithstanding any indications of an incipient easing of labour market conditions, wage settlements have continued to increase. In manufacturing (where settlements should, in principle, be most influenced by international competitive pressure) settlements averaged just over 7.5% in the second quarter, slightly up on the first quarter figure and 1.5 percentage points higher than in the second quarter of last year according to CBI estimates. The evidence from recent settlements suggests that the figure for the third quarter may have been over 8%. The figures for underlying earnings growth have been reweighted and rebased and for manufacturing show a rate of increase of 8½%–8¾% in the first eight months of this year—somewhat lower than on the old basis but still showing no clear trend. It still appears that earnings drift in manufacturing has narrowed considerably, with the main factor insulating earnings growth from the rise in settlements having been the fall in overtime working that has occurred over the past year. Overtime payments contributed only ¼ of a percentage point to manufacturing earnings growth in the second quarter compared with almost one percentage point at the end of last year.

Earnings drift in manufacturing has fallen



Settlements and earnings in the private service sector have also been rising. The CBI estimates that private service settlements averaged 8.5% in the first half of this year, up more than one percentage point on the second half of last year. As in manufacturing, a further rise is likely to have occurred in the third quarter. A number of disputes involving a large number of workers in the public sector were also resolved over the summer months with settlements well above the rate of inflation (typically 8¾%). The figures for the underlying increase in earnings in the services sector as a whole have been revised more extensively than those in manufacturing and, somewhat surprisingly, show a fall to around 8¼% in the third quarter from 9¼% in the first (also on the new basis). If taken at face value, this suggests a substantial narrowing in earnings drift in the service sector also, even though earnings growth in services is generally thought to be less cyclical than in manufacturing.

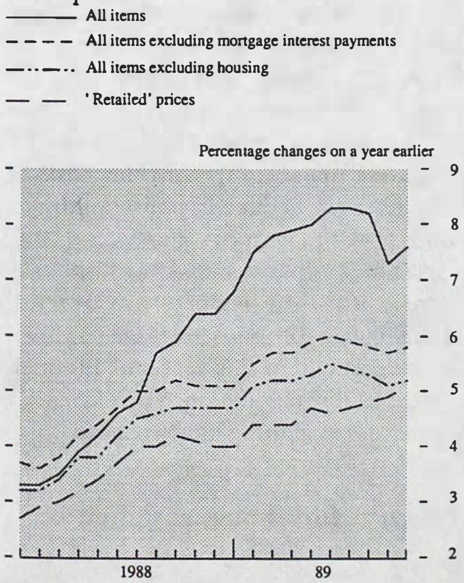
. ... *and* **unit wage costs** *have risen further*

Manufacturing output per head in the three months to August was 4¼% higher than a year earlier. Productivity growth on this measure has slowed over much of this year (the comparable increase in the year to the first quarter was over 6%)—the counterpart to the slower growth of manufacturing production. With manufacturing earnings growth broadly constant, this has fed through into higher unit wage costs which, in the three months to August, were over 4½% higher than a year earlier (the increase in the twelve months to the first quarter was below 2½%).

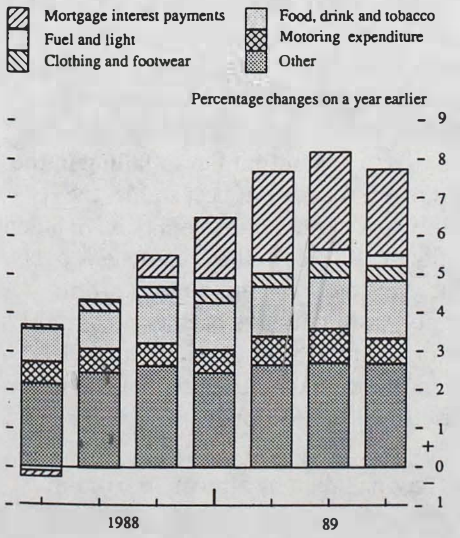
There have been significant upward revisions to figures for productivity growth in the economy as a whole back to 1984 following the incorporation of the new employment figures. Productivity growth in 1988, for example, is now estimated to have been 1¾%, almost ½ a percentage point higher than earlier estimates. The latest estimates show that whole economy productivity grew by $\frac{3}{4}$% in the year to the second quarter. This figure, however, is depressed by up to one percentage point by the effects of lost oil production. Allowing for this, unit wage costs in the economy as a whole increased by around $7\frac{1}{4}$% in the year to the first quarter—over one percentage point faster than a year earlier.

It is clear that a continued rise in settlements, combined with a fall in productivity growth, has potentially serious implications for unit costs and hence for competitiveness and output. To the extent that settlements come to be based on a going rate, rather than moving in line with labour market conditions, the adjustment to lower demand growth could be protracted and involve significant shedding of labour, particularly as the authorities have made clear their determination—as demonstrated by the increase in base rates to 15% in October—not to accommodate excessive wage rises through an easing of policy.

Inflation, on the RPI measure, eased in the third quarter



Mortgage interest payments have been a significant factor in the rise in the RPI



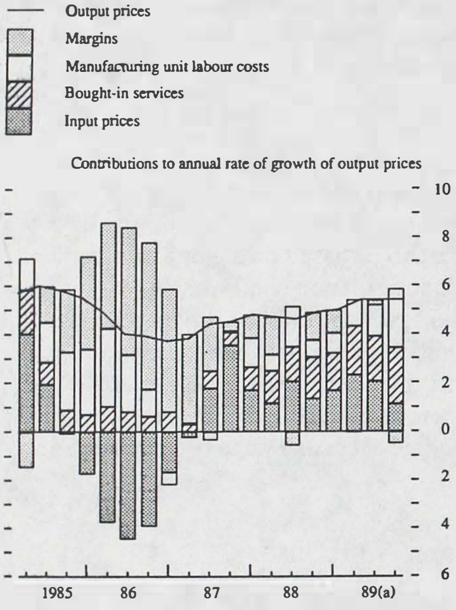
Inflation *has fallen in recent months*

Inflation, as measured by the all-items retail price index, rose slightly to 7.6% in September but remains well below the 8.3% recorded in May and June. A sharp fall in this measure of inflation between July and August was largely the result of August 1988's steep rise in mortgage interest rates dropping out of the twelve-month comparison. This led to a narrowing of the gap between inflation on this measure and that excluding mortgage interest payments, which fell back from the 6% recorded in May to 5.8% in September.

The twelve-month inflation rate is likely to show some variation in the final months of the year. The dropping-out of rises in mortgage interest rates in October 1988 and January and February 1989 from the twelve-month comparison will, in itself, exert a downward influence on inflation on the all-items measure. Some offsetting increase in the twelve-month rate is likely in November, however, as building society mortgage rates are increased in that month in response to the latest rise in base rates. Inflation will not fall smoothly in the coming months, therefore, though the trend remains downwards.

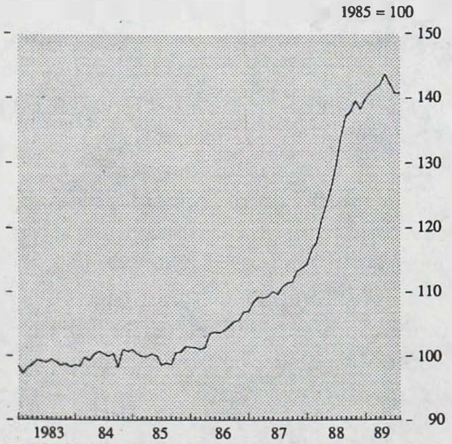
As in other industrial countries, raw materials prices have had a restraining effect on inflation. Despite picking up in September, the rise in manufacturers' input prices in the year to the third quarter was just over 4%, compared with over 6% in each of the first two quarters. Weak import prices have played an important part in this—imports comprise around 50% of the index—with subdued commodity prices more than offsetting the effects of a 2% depreciation of sterling (in effective terms) between the second and third quarters. The twelve-month rate of increase of manufacturers' output prices, meanwhile, remained extremely stable at around 5% in the second and third quarters. Given these developments and the fact that the increase in unit wage costs in manufacturing has so far remained fairly modest, manufacturers are likely to have been under less pressure to reduce their margins than might have been expected with the slowdown in demand. Given the pressure from the labour market, however, the likelihood of any further widening of margins is small. Indeed, latest CBI survey shows a considerably smaller balance of firms expecting to increase prices in the coming months than

Contributions to the annual growth in manufacturers' output prices



(a) Estimated.

The ratio of house prices to earnings has fallen



that expecting an increase in their costs, suggesting that some narrowing is in prospect.

Recent movements in the annual increase in national house prices indicate that the housing market continues to respond to the past year's mortgage rate increases. According to the Halifax Building Society, the twelve-month increase in house prices fell to 14% in the third quarter, while on a seasonally adjusted basis, September saw the fourth consecutive monthly fall. With the lower rate of house price increase and the continued rise in earnings there was a modest reduction in the ratio of house prices to earnings in the third quarter. In recent months, faster growth in prices in the North and North West has gone some way towards reducing the wide dispersion in the levels of house prices in the regions. There are now signs though that the slowdown is beginning to spread to some Northern regions. For example, the twelve-month rate of house price increases peaked in the second quarter in Yorkshire and Humberside (at around 50%) before falling to below 40% in the third quarter.

House prices have been weaker for new dwellings than for existing ones (once allowance is made for property characteristics and location), according to the building societies. Although there has been a reduction in the supply of new dwellings, reflecting the decline in private sector housing starts and completions, this is from the high levels recorded in 1988, and the relative weakness of new house prices may reflect builders' efforts to sell the stock of houses accumulated then rather than bear the carrying costs of keeping them on their books. Both the decline in housebuilding and a fall in the ratio of house prices to earnings (likely to continue well into next year) should prove a stabilising influence on the housing market. There is little firm sign of any recovery in housing market activity in the figures for total mortgage lending. This remained fairly flat in the first half of this year and although building society lending increased through the third quarter, much of this reflected their success in gaining market share.

The **company sector** *remained in* **financial deficit** *in the second quarter . . .*

The indications are that company profitability fell in the second quarter, although it remains high by historical standards. As usual, however, the interpretation of the company sector's accounts is subject to the need to make allowance for statistical discrepancies. In the second quarter, errors and omissions in the sector's accounts amounted to 40% of industrial and commercial companies' gross trading profits and would be consistent with a higher level of spending by companies than is apparent from the recorded figures. With manufacturing output flat to falling in the second quarter of 1989 and profit margins at best stable, the implication is that profitability in manufacturing may have fallen slightly. Gross trading profits of all ICCs' fell by nearly 2½% over the quarter (although in the year to the second quarter profits rose by 17%). The fall was not, as might have been expected, the result of output problems for North Sea companies; North Sea profits in fact rose by 12% in the second quarter, with a rise in oil prices in sterling terms offsetting lower output.

Dividends are recorded as having fallen by almost 30% in the second quarter and, in consequence, undistributed income of

ICCs rose, although only marginally, because of the offsetting effect of a fall in profits as well as strong rises in interest and tax payments. The reasons for the large fall in dividends are far from clear; in particular, it is not possible to say whether it is a response by companies to their deteriorating financial position and lower profitability. The fall in the second quarter followed sharp rises in the preceding two quarters and, despite their erratic quarterly path, the underlying strength of dividends can be gauged from the fact that in the second quarter they were still 16% higher than a year earlier.

Interest payments rose by 14% in the second quarter, reflecting a further increase in bank borrowing and the rise in interest rates. With a small recorded rise in undistributed income and a substantial fall in stockbuilding, there was a fall in ICCs' financial deficit from £5.5 billion to £3.6 billion. The size of the company sector financial deficit in the coming year will be closely dependent upon movements in capital expenditure. Recorded investment was weak in the second quarter but it is not yet clear that this represents the beginning of a sustained downturn; if investment by ICCs remains buoyant for the remainder of the year, a sustained deficit may be in prospect.

. . . *and* merger and acquisition activity *was relatively subdued—though probably only temporarily*

Expenditure by ICCs on domestic acquisitions and mergers is estimated to have been £2.8 billion in the second quarter, down from £3.6 billion in the first. However, there were few very large transactions in the first two quarters of 1989, by comparison with some of those completed in the third quarter, so a significant recovery is expected. Expenditure on overseas acquisitions and mergers by UK companies also fell in the second quarter to £4.2 billion (from £5.9 billion in the first), although it still remains at a historically high level. The main part of this fall was associated with lower expenditure in the United States, although takeover activity in Europe also faltered. Europe still remains the destination of only 13% of total overseas merger and acquisition expenditure, while the United States accounts for over 80%.

ICCs' bank borrowing and domestic capital issues
£ millions

		Bank borrowing	Ordinary shares	Preference shares	Loans: Convertible	Loans: Other
1987		12,316	12,711	694	128	-427
1988		30,974	4,355	464	469	174
1988	Q1	8,251	323	127	-8	5
	Q2	8,010	871	-142	59	-123
	Q3	7,938	1,396	346	156	83
	Q4	7,477	1,765	133	242	209
1989	Q1	7,324	-1,603	99	-4	692
	Q2	8,490	1,333	105	804	-229

ICCs' eurobond issues
£ millions

		Sterling	Other currencies
1987		2678	933
1988		2429	2195
1988	Q1	889	901
	Q2	840	300
	Q3	375	570
	Q4	325	423
1989	Q1	1288	944
	Q2	539	392

Bank borrowing by ICCs increased to £8.5 billion in the second quarter and rose further in the third but it is not clear for what purpose the funds were borrowed. One possible explanation is that companies may have been building up cash holdings in the second quarter in preparation for an upturn in (predominantly cash financed) acquisition activity in the third, though it is also possible that borrowing by companies has reflected a build-up of stocks. There was a strong recovery in net issues of ordinary shares in the second quarter even once allowance is made for a repurchase of shares by BP in the first quarter and a call on BP shares in the second. The recovery may, in part, have been the result of a rally in the stock market in the second quarter which made equity a more attractive source of finance.

The current account deficit *widened in the third quarter*

The current account deficit in the second quarter of this year was £4.9 billion—slightly larger than both the first quarter deficit and the provisional estimate. The deterioration occurred in spite of improvements in visible trade and trade in services, and mainly reflects a fall in net IPD receipts from £1.1 billion in the first quarter to £0.5 billion in the second. The visible trade deficit narrowed slightly, with a modest increase in the oil surplus and a fall in the non-oil deficit. Invisible earnings, at £1 billion, were less than in the first quarter, and substantially less than last year's £1.5 billion quarterly average. This was despite an increase in the surplus on services of £0.5 billion reflecting a fall in the deficit on travel and civil aviation (as consumer spending slowed) and an increase in financial service earnings due to a rise in insurance earnings.

In spite of the weakness of sterling over the second quarter, net IPD receipts fell to £0.5 billion, the lowest quarterly level since 1985. With the exception of direct investment earnings, all major categories of credits continued to rise, but were outweighed by sharp rises in monetary sector debits. Banks' net interest receipts became more negative as spread earnings (from traditional banking intermediation) fell and the cost of servicing net liabilities rose, owing in part to sterling's weakness.

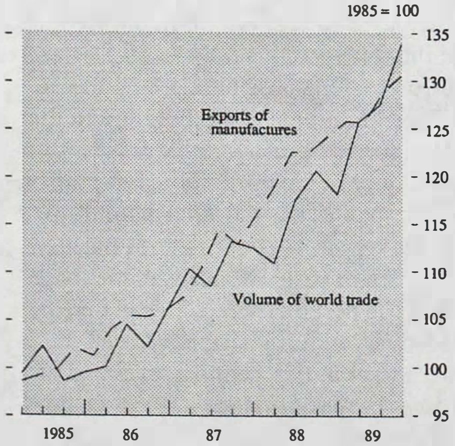
Contributions to change in the visible balance[a]

£ billions

	1988 compared with 1987	1989Q3 compared with 1988Q3	1989Q3 compared with 1989Q2
Total change	**-10.4**	**-1.1**	**-0.9**
of which:			
Oil	1.4	-0.5	-0.1
Non-manufactures	-1.4	—	-0.2
Manufactures	-7.1	-0.6	-0.6
of which:			
Erratics	*-1.0*	*0.6*	*0.1*
Semi-manufactures	*-1.7*	*-0.2*	*-0.1*
Cars	*-1.6*	*-0.2*	*-0.4*
Other consumer goods	*-1.1*	*-0.3*	*-0.1*
Intermediate goods	*-1.7*	*-0.3*	*-0.1*
Capital goods	—	*-0.3*	*0.1*

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

UK exports of manufactures have grown faster than world trade [a]

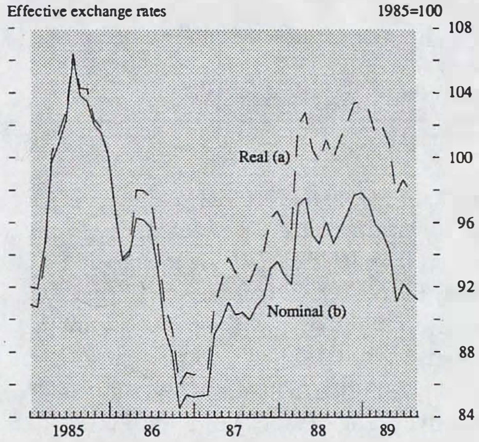


(a) World import volumes weighted by UK trade. Latest figures include Bank projections.

The visible trade deficit in the third quarter was £6.8 billion. The oil surplus was £0.2 billion—around half the already depressed second quarter figure, though the recovery in oil production already evident in the third quarter suggests that this sector should make a stronger contribution to trade through the rest of the year. The non-oil visible trade deficit was £4.7 billion—£0.7 billion larger than in the second quarter. A comparison of the visible balance in the third quarter with the previous quarter (shown in the table), indicates that almost half of the deterioration was due to a worsening of the balance on passenger cars. The remainder was broadly-based, with small deteriorations elsewhere in manufactures and in non-manufactures. The official dock strike may have boosted imports relative to exports in the third quarter, although this effect is difficult to quantify and anticipation of the strike may also have affected the figures in the second quarter. It is possible that the worsening of the balance on cars in the third quarter may be reversed to some extent in the fourth. Imports of cars (which rose by 23% in volume terms in the third quarter) may have been boosted by an over-optimistic view of potential car sales. Preliminary consumer spending figures indicate that car sales were subdued in the third quarter and the September CBI/FT *Distributive Trades Survey* indicates little rise in the fourth. Imports of cars may therefore be reduced (and exports boosted) if the recent increase has resulted in unanticipated stockbuilding. A comparison of the visible balance in the third quarter with the same period of last year indicates that the overall deterioration of £1.1 billion was evenly divided between the manufactures and oil balances with a modest worsening of the balance for each category of manufactures, other than the erratics.

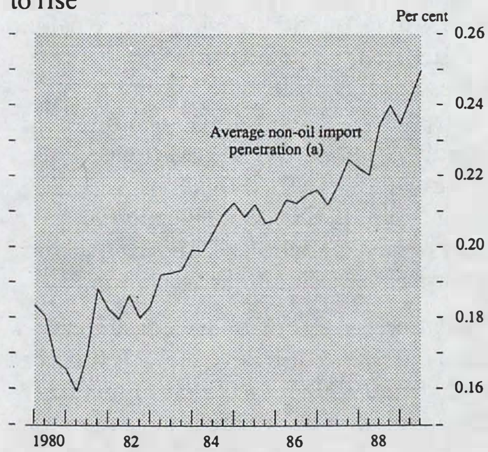
A slowdown in domestic demand growth might be expected to effect a reduction in the trade deficit by reducing the rate of growth of imports and by encouraging exporters to embark upon more aggressive export sales drives. There is evidence at the aggregate level that producers have switched to export production; the volume of non-oil exports increased at a considerably faster rate between the first halves of last year and this than did the United Kingdom's export markets, in spite of a deterioration in effective competitiveness over the same period. At the industry level also, increasing concentration on export

The exchange rate has fallen in real as well as nominal terms



(a) 'Major six' effective exchange rate adjusted for consumer prices. The retail price index excluding mortgage interest payments is used for the United Kingdom. Some bank projections are used for 'major six' prices.
(b) Nominal effective exchange rate against the 'major six' currencies.

Non-oil import penetration has continued to rise



(a) Non-oil imports as a proportion of domestic demand (output-based).

markets is evident. An examination by class of good shows that the proportion of output which is exported has been increasing rapidly across a range of industries, with car exports leading the way (up to the second quarter) and export shares in the output of the consumer, capital and intermediate goods industries also rising over the period. In the third quarter, non-oil export volume growth was again in excess of the provisional estimate of the growth of world trade. Non-oil export volumes rose by 8.6% year-on-year but the comparable rise in non-oil imports was 10%.

Competitiveness, as measured by relative unit labour costs (in common currency terms), improved during the second quarter, following a generally adverse movement during the previous year. It appears that there may have been a further improvement in competitiveness during the third quarter, as indicated by the real effective exchange rate measure based on relative consumer prices. Despite the improvement in competitiveness this year, levels of import penetration have yet to respond. Non-oil import penetration rose to 25% in the first half of this year, from 24% in the second half of last year and 23% in the first. Imports also continued to grow rapidly in the third quarter and, in consequence, import penetration is likely to have remained high.

The **public sector's surplus** *has been smaller so far this year than last*

The cumulative PSDR for the first six months of 1989/90 is estimated to have been £0.5 billion. This compares with £3.6 billion in the same period of 1988/89. Privatisation proceeds in the first half of the financial year were £2 billion lower than in the first half of last year, while supply expenditure was 6½% higher and revenue receipts 3% higher.

The slowing of consumer spending so far this year has been partly counterbalanced by the increase in inflation, so that customs and excise duties (which include VAT receipts) have grown at broadly the same rate as last year in nominal terms. Growth in Inland Revenue receipts has also continued at much the same rate as last year, mainly because growth in wages and salaries has not moderated. In addition, any reduction in the rate of growth of company profits will feed through with a lag to corporation tax payments.

World economic prospects—latest Bank forecasts[1]

Economic performance in the major overseas economies as a group has evolved broadly as expected in the spring forecast. Output has slowed from the heady levels recorded last year, in response to the significant tightening of monetary policy. The balance of growth has become more differentiated, with the most marked slowdown in the United States, while growth in Japan and continental Europe has continued quite strongly—indeed in Germany growth continues to outstrip expectations and appears to have accelerated this year despite the monetary and fiscal tightening to date. The pattern of world growth and the initial effects of the strength of the dollar have helped to promote further reductions in the US external deficit and Japanese surplus, which have improved by more than expected in the spring. Less helpfully, strong export performance has been a major factor in Germany, where the current account surplus has widened further. Potential inflationary threats remain a major source of concern among policymakers. Consumer price inflation overseas rose steadily from around 3½% at the end of 1988 to a peak of around 4½% in May, with a slight easing more recently. This was broadly as expected in the spring, although the unexpected strength of the dollar led to slightly weaker than expected inflation in the United States, and to stronger than expected pressures in Europe and Japan. Higher oil and non-oil commodity prices, together with expenditure tax increases in Germany and Japan, were the main factors pushing up inflation earlier in the year; wages overseas have picked up, but to date show no sign of marked acceleration despite the tightness of labour markets. Interest rates have risen through the year in most countries as monetary policy has been further tightened to combat the continued inflationary threat.

Given the tight policy stance and some easing of cyclical pressures on investment, as immediate capacity constraints are eased, GNP growth in the major overseas economies is expected to slow to 3½% this year, 1 percentage point lower than in 1988. A further slowdown is expected into 1990 and 1991, to some 2¾% and 2½% respectively (Table A). This forecast is broadly unchanged from that in the spring, with stronger growth in Japan and Germany counteracting a somewhat weaker performance in North America. There are few signs of tensions such as an overhang of stocks or a marked deterioration in business or consumer confidence which would cloud this relatively optimistic projection, while the policy stance is judged to be sufficiently tight to avoid the threat of a pick-up of inflation. Consumer spending is forecast to weaken to an average growth rate of about 2¾% over the forecast period, from an average of some 3½% in recent years. Business investment, the main engine behind growth in 1988, is expected to remain quite strong on average. Nevertheless, as the effects of tighter monetary policy continue to feed through, consumer spending weakens and immediate capacity pressures are eased, the rate of investment growth is expected to fall back. Following a zero contribution this year, net external demand is expected to have a slightly negative impact on growth of the major overseas economies as a group.

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

	1988	Forecast 1989	1990	1991
Domestic demand	4.3	3.6	2.9	2.6
of which:				
Private consumption	3.4	2.7	2.8	2.7
Business fixed investment	10.2	9.2	4.1	2.1
Public expenditure	1.5	2.2	1.6	1.4
Stockbuilding(b)	0.2	—	—	—
Net external demand	0.2	—	-0.1	-0.2
GNP/GDP	**4.5**	**3.6**	**2.8**	**2.4**

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

Consumer price inflation (measured by the consumers' expenditure deflator) is expected to fall from 4¼% this year to 4% and 3½% in 1990 and 1991 respectively (Table B). External pressures on inflation are thought to have peaked earlier in the year. The oil price has been higher than expected in the spring, buoyed by stronger than expected oil demand and by a succession of disruptions to supply. Nevertheless, with signs of falling growth in demand and higher OPEC production, the average price is expected to weaken in coming months. Non-oil commodity prices have weakened a little more rapidly than expected through 1989 (although they were higher in the first half of the year than in the second half of 1988); and a further weakening of prices is expected. In contrast, domestic factors are pushing in the opposite direction.

Table B
Prices in the major overseas economies
Percentage changes

	1988	Forecast 1989	1990	1991
Import prices (a)	0.4	5.3	0.2	1.4
Whole-economy unit labour costs	2.2	3.7	4.2	3.8
Consumer prices (b)	3.0	4.2	3.9	3.6

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

(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.

Wage growth has picked up and is set to rise further next year, while productivity growth has eased from the exceptional rate of last year. Given the tight monetary stance, margins are likely to be squeezed, which will absorb some of the cost pressure. On balance the downward forces on inflation are judged to dominate, although inflation is likely to remain high by recent standards.

Economic performance in the United States has evolved broadly as expected last spring, with growth slowing from 4½% in 1988 to 3¼% (annual rate) in the first half of 1989. Much of this slowdown is accounted for by a weakening in consumption growth, despite quite strong employment and steady wage growth. The fundamental supports for spending—employment, wages and salaries and consumer confidence—remain buoyant and favour stronger spending in the second half of the year following the mid-year easing in monetary policy. Consumer spending is forecast to grow at around 2% per annum on average in 1990 and 1991, following an increase of 2½% in 1989, as real personal disposable income growth weakens. Business investment is expected to rise by 5½% this year but slows to 2¼% in 1990 as a result of declining profitability, slower demand growth and an easing of capacity pressures in strategic sectors. Domestic demand growth is expected to weaken through the forecast period, from around 2¾% this year to 2% and 1½% in 1990 and 1991 respectively. The external sector is forecast to make a small negative contribution to growth next year as the effects of the loss in competitiveness in 1989 impact on trade performance.

Although the Japanese economy has shown some signs of a slowdown from the exceptional pace of 1988, the underlying performance remains strong. Business investment continues to be the main source of strength, with an increase of 17% expected this year, following a 16% gain in 1988. Domestic demand may rise by nearly 6% this year, although with import volumes continuing to grow at a strong pace, the net external contribution will again be negative, albeit less so than in 1988. GNP growth is expected to be around 5¼% in 1989 before slowing to 4¾% in 1990 and further to 4% in 1991. Growth in consumer spending is expected to average around 4¼% over the next two years with around 3½% projected for 1989. While remaining quite strong, the rate of business investment growth is expected to slow substantially over the next two years as rising unit labour costs reduce profitability and immediate capacity pressures are alleviated.

Economic activity in continental Europe has turned out to be more robust than envisaged in the spring. In Germany activity has been mainly supported by strong gains in business investment, which is now expected to rise by over 10% this year, and net external demand, which to some extent reflects the strength of demand for investment goods overseas. Consumer spending has remained relatively weak so far this year, as real income growth has been significantly reduced by higher prices, and is expected to rise by only 1½%. Domestic demand is expected to grow by around 3% this year, while the external sector is projected to add over 1 percentage point to this figure, resulting in GNP growth in excess of 4%. Next year, domestic demand is projected to rise by around 4%, as income tax cuts and a recovery of real wage growth contribute to a significant pick-up in the pace of consumer spending, which more than offsets an easing in the pace of investment growth. A negative external contribution to growth is expected in 1990 as stronger consumer spending is accompanied by more rapid growth in import volumes. As a result, GNP is projected to rise by around 3¼% in 1990.

The French economy continues to expand at an impressive rate with business investment and net exports making the major contributions to overall growth. The especially strong business investment performance has been fed by strong corporate profitability and extremely high rates of capacity utilisation. Exports continue to respond to a favourable world environment and recent gains in competitiveness. Consumption growth remains relatively subdued, restrained by moderate growth in personal disposable income and increased social security contributions. In 1990–91, the growth of business investment may slow to around 3% per annum following a 10% increase in 1989. As consumer spending remains relatively weak, domestic demand growth is projected to slow from 4% this year to around 2½% in 1990 and 1991. The external sector is expected to make a positive contribution to growth this year and next as exporters continue to increase market share. As in Germany and France, the Italian economy has continued to grow strongly, albeit at a slower rate than in 1988, although in contrast to Germany and France, this reflects relatively strong consumer spending as well as buoyant investment. Domestic demand is expected to increase by some 4% this year before slowing to an average of 3¼% in 1990 and 1991, while GNP growth is expected to be somewhat lower as external performance continues to deteriorate.

World trade, as measured by import volumes, is projected to rise by about 7¾% this year, around ¼ of a percentage point higher than in 1988. As world activity slows in 1990-91, world trade is expected to rise at around 5¼% a year. Import volumes continue to grow at a buoyant pace in the industrial countries in 1990–91, with growth particularly strong in Japan and Germany, reflecting relative patterns of domestic demand growth, while imports volumes in the United States rebound from this year, as the recent loss in competitiveness begins to feed through. Imports are expected to continue rising rapidly in the Asian newly industrialising economies over the forecast period. However, as the pace of economic expansion in these economies slows, import growth moderates substantially, though to rates still in excess of 10%. Other non-OPEC developing countries are forecast to achieve import growth averaging over 6% per annum in 1989–91, although developments are projected to vary considerably within the group. Domestic growth is forecast to be strongest in Asia, where it is expected to be supported by both private direct investment and commercial finance, whereas it is expected to remain slow for many heavily indebted countries. These problems may be compounded by adverse movements in their terms of trade, particularly for the oil and tropical beverage exporters.

Following a decline of around ¼ of a percentage point of GNP this year, little further progress is expected in reducing the US current account deficit which is projected to stabilise at 2.4% of GNP in 1990 and 1991, compared with 2.6% in 1988. The Japanese surplus may fall to 2.3% of GNP this year, from 2.8% in 1988, but is then expected to widen slightly to average 2.4% in 1990–91. There is unlikely to be any significant progress in reducing the German current account surplus, which is still around 4¼% of GNP in 1991. Elsewhere, the current account surplus of the Asian NIEs is expected to fall by around $15 billion between 1988 and 1991.