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PRIME MINISTER

BRG 1/11

TREASURY ECONOMIC FORECAST

I attach: at **Flag A** the internal Treasury October forecast
at **Flag B** the Industry Act forecast to be published in the Autumn Statement next Tuesday.

The internal forecast makes depressing reading. It is broadly based on the assumption of the policy stance staying as now, both on the monetary and fiscal side. Even so, it points for example to:

- a current account deficit of £13.8 billion in 1988, £14 billion in 1989 and £12.9 billion in 1990; and that is even after assuming export volume growth greater than import volumes in both 1989 and 1900;

- the RPI at over 7 per cent in each of the first seven months of 1989, peaking at 7.3 per cent in July and dropping only to 6 per cent by December 1989. By the end of 1990 the RPI is still at 4.9 per cent.

The Industry Act forecast to be published on Tuesday has been adjusted. The figures the Chancellor quoted to you at your last bilateral were based on this massaged forecast, i.e. current account deficit falling to £11 billion in 1989 and the RPI to 5 per cent by the end of 1989.

We know of course just how fallible the forecasts are. But the clear moral to be drawn from the internal forecast is just how difficult it is going to be to get things back on an even keel. We may well have to contemplate a further interest rate increase in a few months' time if the indicators are not moving in the right direction.

B

Since you have Peter Middleton at Chequers tomorrow for the "City lunch" you may want to consider having a private word with him afterwards - along the lines you had with Terry Burns this morning - to stress your concerns.

PRCG.

(PAUL GRAY)
28 October 1988

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H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000

Direct Dialling 01-270 ....

Sir Peter Middleton KCB
Permanent Secretary

Paul Gray Esq
10 Downing Street
LONDON
SW1

28 October 1988

Dear ~~Paul~~

I enclose a copy of the October 1988 Treasury Economic Forecast.

I am also sending a copy to Brian Griffiths.

Yours,

Simon

S D H SARGENT
Private Secretary

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14 (A-E2)

TREASURY ECONOMIC FORECASTING EXERCISE

OCTOBER 1988

<u>Contents</u> <u>Page</u>

B

TREASURY ECONOMIC FORECASTING EXERCISE

The forecast covers the period to 1990 (1990-91 for public finances). It embraces two of the three years for which the Autumn Statement will include revised public expenditure plans. Table 1 summarises the results and compares them with earlier forecasts and the current average of City forecasts.

(i) In 1988 growth of **real GDP** is likely to be just over 4 per cent (nearly 5 per cent excluding oil) and growth of **money GDP** to be about 11 per cent. Both are growing much more rapidly than expected at budget time. Official statistics probably underestimate growth.

(ii) **Domestic demand** growth is estimated to be 6 per cent in 1988. Domestic demand decelerates sharply from 1989 as the investment boom eases off, and as sustained high short term interest rates exert a sharp squeeze on personal sector finances. With growth of domestic demand slowing down, **GDP growth** falls to a little below potential during 1989 and 1990, even though the contribution of net trade to growth is once again positive.

(iii) **The current account deficit** for 1988 is likely to be about £14bn. The current account may not change significantly in 1989 because slower domestic demand growth is likely to be partly offset by a slowdown in the world economy. It should, however, fall in 1990.

(iv) **RPI** inflation, boosted by recent mortgage rate increase, reaches 6¼ per cent in 1988Q4, peaks at 7¼ per cent in the middle of 1989, and falls back thereafter. Less distorted measures of inflation - such as producer prices and the RPI less mortgage interest payments - are forecast to be over 5 per cent in 1989 and to fall slowly thereafter. **The GDP deflator** is likely to grow by just under 7 per cent in 1988-89 as a result of fast rising investment prices, high public sector earnings growth, and an improvement in the terms of trade. It is forecast to grow by 6 per cent in 1989-90.

(v) **The PSDR** (public sector debt repayment) is forecast to be £11¾bn. in 1988-89, almost 2½ per cent of GDP. On the working assumption that the PSDR excluding privatisation proceeds stays at its projected 1988-89 level, there is scope for modest cuts in personal taxes in the 1989 and 1990 budgets.

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TABLE 1 : SUMMARY OF FORECAST

	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
A THE WORLD ECONOMY				
1. GNP (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1987	2.8	2.9	**3.2**	
1988	2.5	4.0	**4.1**	
1989	2.1	2.8	**3.0**	
1990	2.7	2.7	**2.3**	
2. DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK) (per cent change on a year earlier)				
1987	3.1	3.1	**3.6**	
1988	2.5	4.0	**4.2**	
1989	2.1	2.7	**3.1**	
1990	2.8	2.6	**2.4**	
3. WORLD TRADE IN MANUFACTURES (per cent change on a year earlier)				
1987	5.5	6.0	**5.4**	
1988	4.9	10.0	**8.7**	
1989	4.3	5.0	**7.3**	
1990	6.6	5.2	**4.9**	
B UK ACTIVITY AND DEMAND				
4. GDP VOLUME (non-North Sea in brackets) (per cent change on a year earlier)				
1987	4.3(4.7)	4.3(4.7)	**4.2(4.6)**	
1988	3.2(4.3)	3.9(4.3)	**4.2(4.8)**	3.6
1989	2.6(3.0)	2.9(3.2)	**2.7(3.0)**	2.1
1990	2.5(3.0)	2.0(2.3)	**2.3(2.6)**	
5. VOLUME OF DOMESTIC DEMAND (per cent change on a year earlier)				
1987	4.2	4.1	**4.3**	
1988	4.2	5.8	**6.0**	
1989	3.3	3.1	**2.6**	
1990	3.1	1.6	**1.6**	
6. UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)				
1987 Q4	2.66	2.64	**2.66**	
1988 Q4	2.41	2.32	**2.10**	2.19
1989 Q4	2.41	2.24	**1.88**	2.19
1990Q4	2.45	2.32	**1.85**	

C

C INFLATION AND MONEY GDP

	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
7. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)				
1987-88	9¾	9.8	10.0	
1988-89	7½	10.0	11.1	
1989-90	6½	7.9	8.7	
1990-91	6	6.1	7.3	
8. RPI (excluding mortgage interest payments in brackets) (per cent change on a year earlier)				
1987 Q4	4.1(4.0)	4.1(4.0)	4.1(4.0)	
1988 Q4	4.0(3.9)	5.0(4.5)	6.2(5.0)	5.9
1989 Q4	3.0(2.7)	5.6(4.5)	5.9(5.5)	4.5
1990 Q4	3.4(3.5)	4.1(3.6)	4.9(4.8)	
9. GDP market price deflator (per cent change on a year earlier)				
1987-88	5	5.1	5.3	
1988-89	4½	5.7	6.8	
1989-90	4	5.2	6.0	
1990-91	3½	4.0	5.1	

D PUBLIC FINANCES

	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
10. PSBR - £ billion				
1987-88	-3.1	-3.5	-3.5	
1988-89	-3.2	-7.3	-11.8	-8.1
1989-90	0	-7.3	-11.3	-8.1
1990-91	0	-7.4	-12.2	
11. PSBR - % OF GDP				
1987-88	-¾	-¾	-¾	
1988-89	-¾	-1½	-2½	
1989-90	0	-1½	-2¼	
1990-91	0	-1½	-2¼	
12. ANNUAL FISCAL ADJUSTMENT - £ billion				
1988-89				
1989-90	3¾	2¾	2	
1990-91	¾	¾	1¼	-

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	FSBR 1988	JUNE 1988	OCTOBER 1988	AVERAGE OF CITY FORECASTS
E MONETARY CONDITIONS				
13. SHORT TERM INTEREST RATES (per cent))				
1987 Q4	9.2	9.2	**9.2**	
1988 Q4	9.0	9.5	**12.0**	11.5
1989 Q4	8.8	10.5	**12.0**	9.5
1990 Q4	8.4	10.5	**11.0**	
14. MO (per cent change on a year earlier)				
1987-88	5	4.9	**4.9**	
1988-89	1-5	5.1	**7.1**	
1989-90	1-5	1.9	**2.8**	
1990-91	0-4	0.9	**3.4**	
15. STERLING INDEX (1975=100)				
1987 Q4	74.9	74.9	**74.9**	
1988 Q4	75.5	76.7	**75.0**	75.3
1989 Q4	74.4	74.3	**73.2**	73.7
1990 Q4	74.1	72.9	**71.0**	
16. £/DM EXCHANGE RATE				
1987 Q4	2.94	2.94	**2.94**	
1988 Q4	3.00	3.08	**3.10**	
1989 Q4	2.97	2.96	**3.03**	
1990 Q4	2.91	2.84	**2.90**	
17. RELATIVE UNIT LABOUR COSTS (1980=100)				
1987	76.5	76.7	**75.5**	
1988	79.5	82.1	**79.1**	
1989	80.4	80.8	**79.2**	
1990	80.7	80.1	**77.9**	
F TRADE AND CURRENT ACCOUNT				
18. VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES (per cent change on a year earlier)				
1987	6.8	6.7	**6.5**	
1988	4.2	2.8	**2.9**	
1989	3.6	6.5	**6.6**	
1990	5.4	5.0	**4.6**	
19. VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES (per cent change on a year earlier)				
1987	8.5	8.4	**8.1**	
1988	6.4	9.5	**12.7**	
1989	4.4	6.1	**4.4**	
1990	4.9	3.2	**1.9**	
20. CURRENT BALANCE £ billion				
1987	-1.7	-1.6	**-2.5**	
1988	-3.9	-9.3	**-13.8**	-12.5
1989	-4.6	-10.1	**-14.0**	-11.8
1990	-4.3	-9.0	**-12.9**	

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(1) MAIN ISSUES

The world economy

3. **GNP** in the major industrialised countries and **world trade in manufactures** have grown strongly over the past year. The growth rate of real GNP in the major seven may now be moderating and is forecast to be in line with potential in 1989. Average consumer price inflation in the major seven has so far remained around 3 per cent, but a slight pick up in 1989 is forecast as a result of demand pressures, particularly in the US. The Fed is assumed to respond by some further tightening of monetary policy in 1989. Forecast growth of world trade in manufactures is still relatively high at 7¼ per cent in 1989 and 5 per cent in 1990. This favourable world background assumes that the further modest reductions in the external imbalances of the three large economies occur without major implications for exchange rates or interest rates.

UK demand and output

4. Interpretation of recent developments and assessment of prospects are hampered by huge discrepancies in the national and sectoral accounts, which are in a greater state of disarray than previously experienced. Growth of the expenditure measure of GDP is almost certainly under-recorded over the past three years, particularly in the first half of 1988. (The "compromise adjustment" accounts for 1¾ per cent of GDP growth in 1988, more than the overshoot of the FSBR forecast.) It is impossible to assess the financial position of the personal or corporate sectors with precision.

5. The **personal sector** has become a net payer of interest in 1988. With its very high gross debt/income ratio and record level of income gearing, it is now much more vulnerable to rises in short term interest rates than in the past. Sharp rises in the value of equities (until 1987) and housing wealth have allowed the personal sector to continue borrowing while maintaining a strong financial position. Consumers' expenditure has risen rapidly and the savings ratio has fallen. But following the recent rise in base rates personal sector net interest payments will rise sharply. In addition the forecast marked deceleration in house prices in 1989 will act as a brake on personal sector wealth and therefore consumption. In this less favourable financial climate the need to save will be greater. The saving ratio should therefore, after a short lag, rise a little from its current low level. This will involve a sharp deceleration in consumers' expenditure, though forecast growth in 1989 is - at 3 per cent - respectable by any standards except those of the last three years.

6. There is an enormous balancing item in the personal sector accounts - equal to about 8 per cent of personal disposable income. (The likelihood is that both personal income and expenditure are under-recorded, though the former by more than the latter.) This suggests that the savings ratio could be higher than the official figures suggest. If this were the case the deceleration in consumers' expenditure could be less marked than forecast. But even allowing for some under-recording of income, the savings ratio has fallen to historically low levels, and some rise is very likely.

7. The strong rise in **fixed investment** during 1988 should moderate in 1989. The effects on investment in 1989 of higher than expected growth in 1988 and the recent rise in base rates will probably more or less offset each other.

8. The slowdown in both consumption and investment during 1989 should ensure that year on year **GDP growth** falls back close to the growth of potential. But with so many difficulties in assessing what has happened so far this year, the timing of the moderation of growth is extremely difficult to predict. It is conceivable that there may not be firm evidence of the deceleration of consumers' expenditure until well into the first half of 1989, and later still for fixed investment.

The balance of payments

9. The recorded deterioration in the current account has occurred despite fast growth of world trade and of UK exports of manufactures. The rapid growth of domestic demand has led to a historically very high growth in the volume of imports of goods and services.

10. The loss of labour cost competitiveness in 1987 and capacity constraints in certain industries have probably contributed to the deterioration in the current account. The problem may, however, be worse than survey evidence suggests. With highly competitive and - in the EC - closely integrated and geographically close markets for manufactures it may well be more difficult directly to observe capacity constraints than in the past. Shortages of materials and parts or production bottlenecks may not be as visible because it is easier than in the 1960s or early 1970s to obtain supplies from abroad at short notice. The continuation of the rise in profit margins on manufactured exports during 1988, in spite of a worsening of measured competitiveness, is further evidence of capacity constraints that have almost certainly contributed to the sharp acceleration in imports. Capacity constraints may also have held down export growth as exporters have switched production to satisfy buoyant

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domestic demand. One of the principal difficulties in the forecast is to assess the extent and speed with which adverse capacity effects on the current account will be reversed. The forecasts for exports and imports do assume some reversal of such effects during 1989 and 1990.

11. Progress in reducing the current account deficit could be slow at first. Growth of visible exports, which has to be 2½ per cent more than import growth for the visible balance not to deteriorate, is likely to moderate as world growth eases. Domestic industry may continue working at high capacity utilisation rates for the next few quarters. Thereafter, with domestic demand decelerating, the current account deficit should begin to fall.

Inflation and money GDP

12. Short term movements in RPI inflation will be dominated by movements in the mortgage rate. If base and mortgage rates stay at current levels during 1989 the peak monthly inflation rate is forecast to be at 7¼ per cent in July 1989.

13. It is more difficult to assess the behaviour and prospects for underlying inflation. Both producer prices and the RPI excluding mortgage interest payments have been slowly accelerating through 1987 and 1988, with inflation rates at 5 per cent by the second half of 1988. This primarily reflects a continuation of the strong build up in profit margins over the past six years. The forecast is for a further rise in underlying inflation in the first half of 1989 to 5½ per cent. Thereafter inflation falls slowly as margins level off and earnings growth moderates.

14. Boosted by overtime payments, growth of private sector **average earnings** has risen slightly over the last year. Indeed the low level and very modest acceleration of wage settlements during two years of boom and gradually rising price inflation have been surprising features of recent economic performance. Because earnings and settlements have not been very sensitive to changes in activity recently, the forecast has a mild deceleration over the next two years.

15. Growth of the **GDP deflator** in 1988-89 is forecast to be above the conventional measures of underlying inflation. This is the result of fast rises in the prices of investment goods and in public sector consumption (the latter mainly reflecting growth of earnings) and an improvement in the terms of trade. **Money GDP** in 1988-89 rises at 11 per cent, compared with 10 per cent in the previous year. Growth of money GDP falls in both 1989-90 and 1990-91.

Financial conditions

16. The forecast has money GDP growth and underlying inflation above the 1988 MTFS paths. MO, however, comes back within its target range during 1989-90. The sterling index and important bilateral exchange rates fall a little from their present level during the forecast period. To achieve this degree of monetary tightness **short term interest rates** stay at 12 per cent until the end of 1989 and fall little thereafter.

17. There are great uncertainties attaching to any judgement on the appropriate level of short term interest rates necessary to achieve a particular degree of monetary tightness. The main risk in the short run is that short term interest rates may need to be higher than in the forecast to exert the necessary downward pressure on money GDP and inflation. In the absence of evidence of decelerating demand the exchange rate could come under significant pressure at a time when the current account is persistently in large deficit and UK inflation is above the G7 average - and indeed in 1989 above forecast inflation in every other G7 country.

Public finances

18. Public finances have continued to perform more strongly than expected, mainly as a result of higher activity and inflation. The buoyancy of the economy has probably contributed to the expected shortfall of public expenditure on plans in 1988-89, as well as boosted revenue. It could well be, however, that 1988-89 turns out to be the year in which the conjunctural position has been most beneficial for public finances. With slower growth it is much less likely that performance on public finances will continuously be better than expected as in the last two years.

19. There have been particular difficulties in producing the forecast for public expenditure. Inflation, as measured by the GDP deflator, is now estimated to have been a little higher in 1987-88 than assumed in the last PEWP and is forecast in 1988-89 to be over 2 percentage points higher than assumed in the PEWP. While this unanticipated inflation has been accompanied by some agreed rises in cash limits this year, spending has been squeezed in real terms. Inflation is forecast to be higher than currently assumed in the last PEWP and MTFS in each of the next two financial years. A key issue in the forecast is the extent to which there will be a further real squeeze on spending next year from unanticipated inflation and to what extent there will be overspending or future uplifting of cash plans. The forecast assumes that while the real terms squeezes of the past two years will intensify bids for more expenditure from 1989-90

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onwards this will not be sufficient to offset fully the higher forecast inflation. The level of public expenditure in real terms in future years is lower than in recent forecasts.

20. The (pre-fiscal adjustment) forecast for taxes for 1989-90 benefits from a further large increase in onshore corporation tax following the large expected rise in profits for 1988. Nevertheless total taxes and NICs (before fiscal adjustment) are forecast to rise only slightly as a percentage of GDP in 1989-90. With the working assumption of a constant PSDR ratio (excluding privatisation proceeds) there is scope only for very modest cuts in personal tax cuts in the 1989 or 1990 budgets, which is more the result of a forecast fall in the GGE ratio than the small rise in the tax ratio.

21. The UK is now running a larger budget surplus - as measured by the general government financial balance - than any other G7 economy, including Japan, and is assumed to continue to do so.

TABLE 2 : GENERAL GOVERNMENT FINANCIAL DEFICITS (per cent of GDP)

	1986	1987	1988	1989	1990
UK*	2½	¾	-1	-1	-1
G7 (less UK)	3	2½	2¼	2¼	2

*Financial years.

(2) THE WORLD ECONOMY

22. There was a spurt in the growth of **world trade** and **output** in the second half of 1987 and in the first half of 1988. Real GNP in the major seven industrialised countries was 4¼ per cent higher in 1988Q2 than a year earlier. Over the same period total world trade and world trade in manufactures may both have risen by almost 10 per cent, reflecting the continued buoyancy of G7 imports and an acceleration in the imports of many developing countries. If achieved, G7 real GNP growth of 4 per cent in 1988 will only have been exceeded once in the last ten years (in 1984).

TABLE 3 : G7 (EXCLUDING UK) GROWTH AND INFLATION

Percentage changes on a year earlier	1987	1988	1989	1990
Real GNP	3.2	4.1(4.1)	3.0(3.0)	2.3
Domestic demand	3.6	4.2(4.2)	3.1(3.2)	2.4
Industrial production	3.1	5.6	4.4	2.3
Consumer prices	2.5	2.8(3.2)	3.6(3.5)	3.9

Note: Figures in brackets are IMF forecasts for G7 <u>including</u> UK.

23. G7 GNP and world trade are expected to grow slightly more slowly in the second half of 1988, and then to grow in line with potential in 1989. If real growth in 1989 is 3 per cent as forecast, the major seven will have experienced seven years of growth at an average rate of 3½ per cent.

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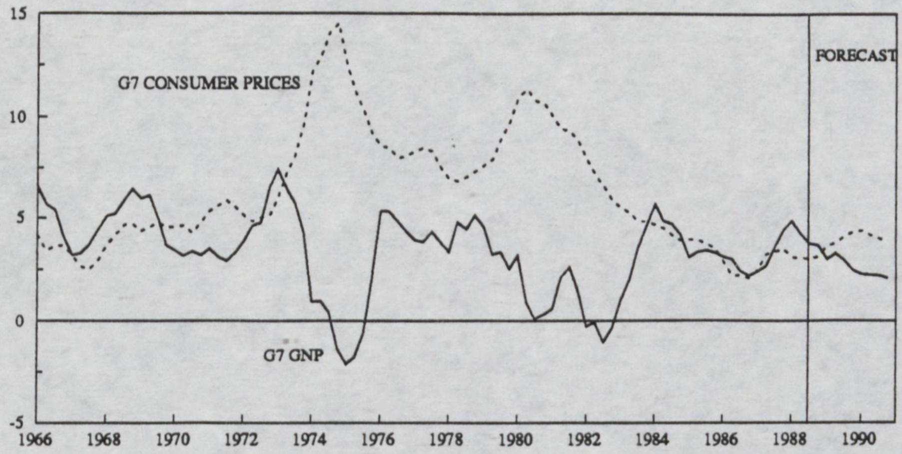
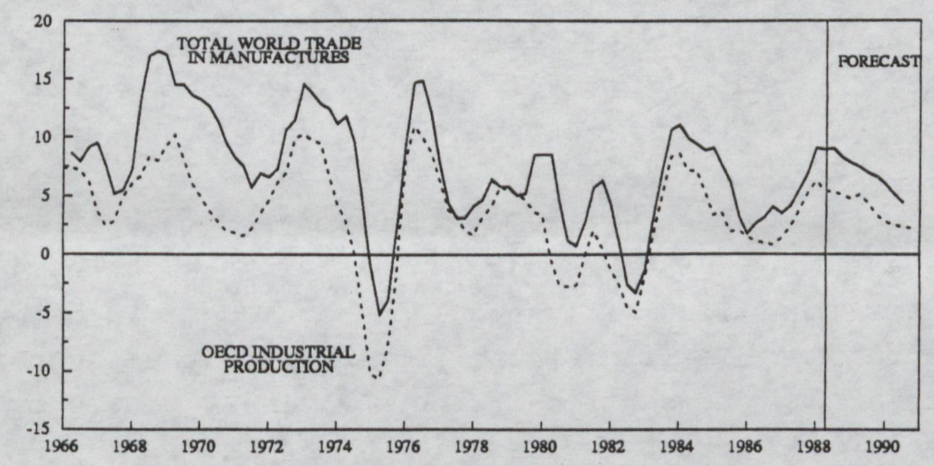
CHART A : G7 GNP AND CONSUMER PRICES
(Percentage Change Over Year Earlier)



OECD INDUSTRIAL PRODUCTION AND WORLD TRADE
(Percentage Change Over Year Earlier)



24. Growth of world trade has been strong because not only the G7 but other countries have increased their imports rapidly. The four Asian NIEs have experienced particularly rapid import growth. But many other developing countries are now increasing their imports, in part because rises in commodity prices have improved their external position. Some slow down in the growth rate of world trade seems probable in 1989 as the spurt in demand and activity in the major countries starts to fade, though world trade in manufactures may still grow strongly at about 7 per cent. Other factors contributing to slower import growth are weak oil prices, which may cause OPEC and other oil producers to adjust more rapidly than the beneficiaries of lower prices, and higher interest rates, which will limit the capacity of heavily-indebted countries to increase imports.

TABLE 4 : THE VOLUME OF WORLD TRADE IN GOODS

Percentage changes on a year earlier	(Share of 1986 imports)	1987	1988	1989	1990
World trade (imports)	(100)	5	8¾	6½	4¾
of which:					
- Major seven	(54)	6	9¾	6½	4½
- Other developed	(26)	6¼	7	6½	5
- OPEC	(5)	-11	1¾	-4¾	-4½
- NICs	(5)	20¾	17	13¾	12
- Other developing	(10)	-1	7	6½	5
World trade in manufactures		5½	8¼	7¼	5

25. **Non-oil commodity prices** rose very rapidly during 1987 and the first half of 1988. Real industrial materials prices in 1988Q2 were some 20 per cent higher than a year earlier. Spot prices have since fallen back a little, but have maintained most of the earlier rise. Over the forecast period real commodity prices are expected to remain steady.

26. **Oil prices** have been very weak recently in spite of strong world activity because many OPEC members have expanded their output. The forecast assumes that OPEC will have limited success in reimposing quotas. Only a modest recovery in prices is expected, and the average North Sea price is projected to rise from its current level to $14 by the middle of 1989, and remain constant thereafter.

27. **Consumer price inflation** in the major industrial countries has been around 3 per cent for some time. There are some signs of inflationary pressures in countries where capacity utilisation is approaching previous peaks - especially the United States - and indirect tax increases are expected in Japan and Germany. Recent rises in interest rates in G7 countries should help limit the rise in inflation, but G7 inflation is forecast to rise to 4 per cent next year.

(3) INTEREST RATES, THE EXCHANGE RATE, AND COMPETITIVENESS

28. The forecast has a path for short term interest rates that, in the light of the rest of the forecast, is judged to be consistent with a gentle decline in the exchange rate. It does not bring the growth of money GDP close to the path in the 1988 MTFS, though MO does come within its target

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range. The path for the exchange rate, together with forecasts of unit labour costs at home and abroad, imply little change from now on in the level of labour cost competitiveness.

TABLE 5 : EXCHANGE RATES AND COMPETITIVENESS

	Base rates	Sterling Index	$/£	Dm/£	Labour cost competitiveness*
1985	12.3	78.2	1.30	3.79	85.0
1986	10.9	72.8	1.47	3.19	77.4
1987	9.7	72.6	1.64	2.94	75.5
1988 Q1	8.8	75.1	1.79	3.01	77.5
Q2	8.2	77.8	1.85	3.14	80.4
Q3	10.8	75.9	1.70	3.16	79.2
(Oct 11)	12	76.4	1.72	3.18	
1988 Q4	12	75.0	1.68	3.10	79.1
1989 Q4	12	74.1	1.67	2.98	79.3
1990 Q4	11	71.0	1.65	2.85	77.9

* UK unit labour costs relative to those of trading partners. A fall implies an improvement in competitiveness.

29. It has been particularly difficult to form a judgement on the path of interest rates consistent with the exchange rate projection. The differential between UK short rates and eurodollar rates was around 3½ percentage points on average during 1985 to 1987. With UK base rates at 12 percent until the first quarter of 1990 the current differential of about 2½ percentage points with Eurodollar rates is maintained. Thereafter there is a small fall as UK rates fall by more than Eurodollar rates.

30. Interest rates have to stay at current levels for some time to slow down domestic demand and to attract the inflows necessary to finance the current account deficits expected over the next few years. Market analysts now expect large trade deficits to persist for a number of years and this does not seem to have had an adverse effect on confidence. It therefore seems likely that the predicted path of interest rates should be sufficient to attract the required foreign capital.

31. Table 6 shows the financing of the current account deficit. A large part of the finance comes from the balancing item. This item could, of course, reflect unrecorded earnings, implying that the current account is actually much smaller than the number published by the CSO. Irrespective of whether the balancing item reflects errors on the current or capital account, the forecast suggests that identified foreign capital inflows of between £4 and £5 billion will be needed each year from 1988 to 1990. The UK generally spends more on direct investment overseas than foreigners spend in the UK. This is likely to continue unless there is a big rush of

inward investment from outside the EC in the run-up to 1992. It has been assumed that the level of the net direct outflow continues at much the same rate as in the first half of 1988. The implication is that sterling inflows to banks - which are perhaps the most volatile form of finance - will need to average £10 billion per year between 1988 and 1990. There is a risk that foreigners' confidence could be upset by various factors such as temporary increases in the UK inflation rate. This would make it more difficult to achieve these inflows at the assumed level of interest rates.

TABLE 6 : FINANCING THE CURRENT ACCOUNT DEFICIT (£ BILLION)

	1988	1989	1990
Current Account	-13.8	-14.0	-12.9
Balancing Item	9.7	9.0	8.5
Required Identified Capital Inflows	4.1	5.0	4.4
of which:			
Net direct investment	-7.5	-7.2	-6.8
Net non-bank non-govt portfolio	-6.9	-3.4	-4.3
Net Banks £	12.6	8.8	8.8
FC	3.2	3.2	3.2
Net general government*	0.0	1.7	1.5
Other	2.7	2.0	2.0

* includes reserves

(4) TRADE AND THE BALANCE OF PAYMENTS

32. The latest estimates of the **current account** show a cumulative deficit of £9¼ billion for the first eight months of the year. This compares with a deficit of £2½ billion for the whole of 1987. The main contribution to this deterioration has come from the visible balance where the average monthly deficit in 1988 so far has been £¾ billion higher than in 1987. But there has also been a marked deterioration in the invisibles balance with the average monthly surplus being about £¼ billion lower than in 1987.

33. Chart B shows the underlying trends in **import and export volumes**. The recent deterioration in trade performance owes more to exceptional import growth than to poor export performance. This conclusion is strengthened by the suspicion that the 1988Q1 export figures in particular might still be subject to some under-recording as a result of the change in Customs procedures. While the published figures already incorporate some allowance for this, independent evidence on engineering export sales suggests that recorded exports might still be too low in 1988Q1. On the other hand, the latest survey by Customs and Excise for March of this year did not suggest

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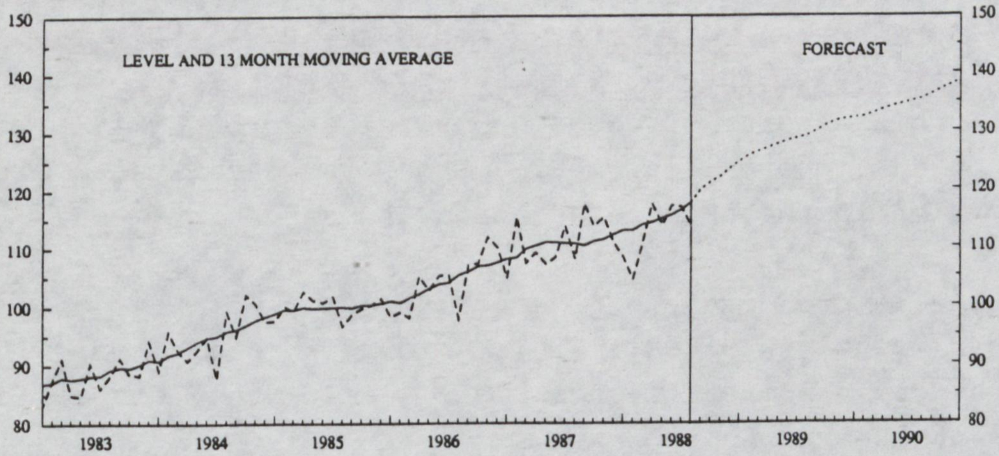
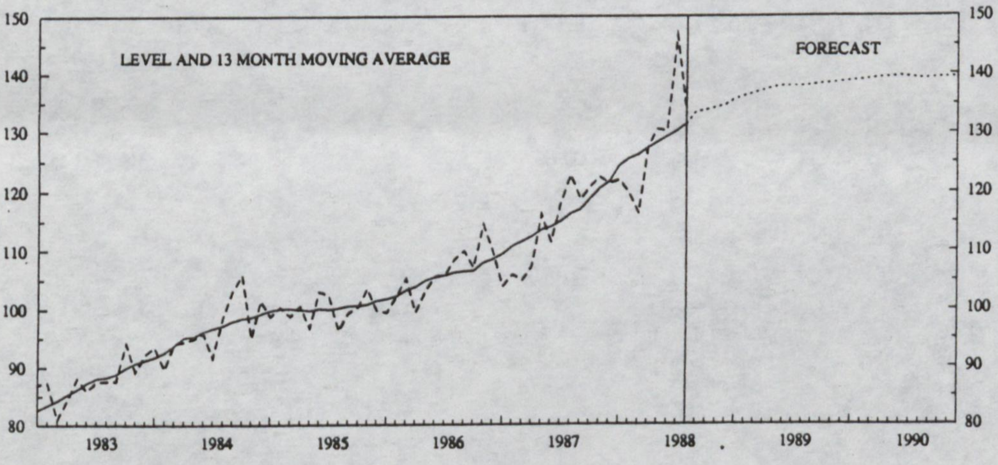
significant under-recording, and the data for manufacturing output and the CBI survey are consistent with some pause in export growth in 1988Q1.

CHART B: NON-OIL IMPORT AND EXPORT VOLUMES

NON-OIL EXPORT VOLUMES



NON-OIL IMPORT VOLUMES



34. In more recent months, the upward trend in non-oil exports has been resumed. Declining competitiveness and possibly also the effects of capacity constraints at home may have been restraining the growth of exports. In contrast, recent data on non-oil imports show a continuation of the strong upward trend.

35. Against a background of rapid UK domestic demand growth and the worsening in competitiveness since last year, a further deterioration in the **non-oil visible balance** is forecast through the rest of 1988. The oil surplus will be lower in the second half of the year than it was in the first, due to the combined effects of Piper Alpha and a lower sterling oil price. With the invisibles surplus also projected to decline, the current account deficit for 1988 is forecast to be £13.8 billion, 3 percent of GDP.

36. In 1989 the current account deficit is forecast to be virtually unchanged at £14.0bn. (nearly 3 per cent of GDP) despite the rapid slowdown in the growth of domestic demand. Three factors help to explain the delay in the turnaround of the current account:

(a) Imports of goods and services are now much higher than exports which implies that exports would have to grow significantly faster than imports in 1989, just to keep the deficit constant. So although the forecast shows exports of goods and services growing 1 percentage point faster than imports in 1989, this is consistent with a small deterioration in the balance on goods and services.

(b) World trade is projected to grow a little more slowly, following a rise of 8¾ per cent in 1988. This slowdown, combined with a slight deterioration in competitiveness, will limit the scope for a rapid improvement in exports.

(c) The surplus on trade in oil is likely to continue on its downward trend. The repercussions of Piper Alpha will be felt throughout the forecast period.

37. After 1989 the current account deficit falls as domestic demand slows significantly.

TABLE 7 : UK CURRENT ACCOUNT (£ billion)

	Visible Trade			Total	Invisibles	Current
	Manufactures	Oil	Other	Visibles		Balance
1986	-5.7	4.1	-7.1	-8.7	8.8	0.1
1987	-7.5	4.2	-6.9	-10.2	7.7	-2.5
1987 Q1	-0.9	1.2	-1.6	-1.3	2.1	0.8
Q2	-1.8	1.0	-1.6	-2.4	2.0	-0.4
Q3	-2.3	0.9	-1.9	-3.2	2.1	-1.1
Q4	-2.5	1.1	-1.8	-3.3	1.4	-1.9
1988 Q1	2.9	0.9	-2.0	-4.0	1.1	-2.8
Q2	-3.3	0.7	-1.8	-4.4	1.5	-2.9
Forecast						
1988	-14.2	2.3	-7.5	-19.4	5.6	-13.8
1989	-14.7	2.0	-7.4	-20.0	6.0	-14.0
1990	-14.0	1.8	-7.4	-19.6	6.7	-12.9

Non-oil visible trade

38. The volume of **manufactured exports** rose by 7½ percent in 1987 as the lagged benefits of improved competitiveness in 1986 helped UK manufacturers gain an increased share of world trade. However, exports of manufactures have failed to keep pace with world trade so far this year. While data for recent months show a strong recovery in exports of manufactures from the

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poor performance in the first quarter, the growth rate for the year is forecast to be 5 per cent compared with world trade growth of 8¾ percent. Over the rest of the forecast the UK's share of world trade is expected to be little different from its average between 1984 and 1986, though to be a little lower than in 1987.

CHART C: THE UK'S SHARE OF WORLD TRADE IN MANUFACTURES

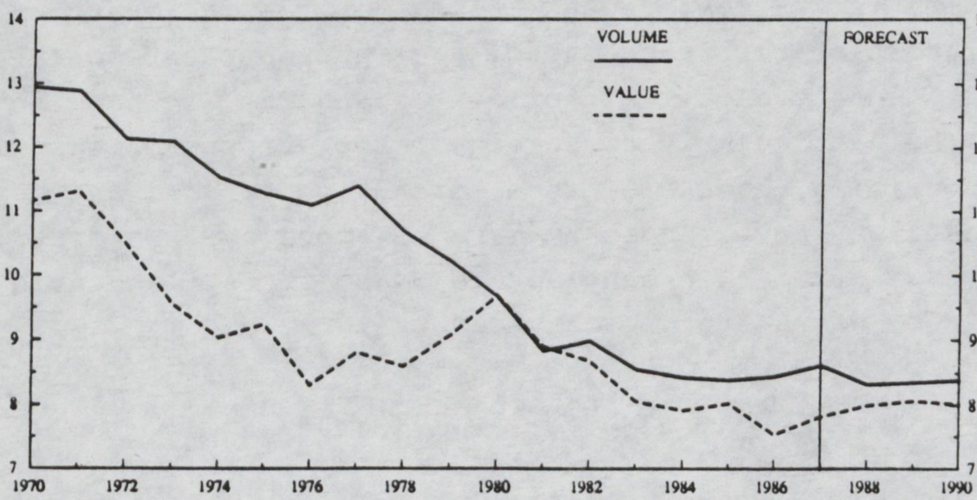


TABLE 8 : WORLD TRADE AND DOMESTIC DEMAND FOR MANUFACTURES AND COMPETITIVENESS

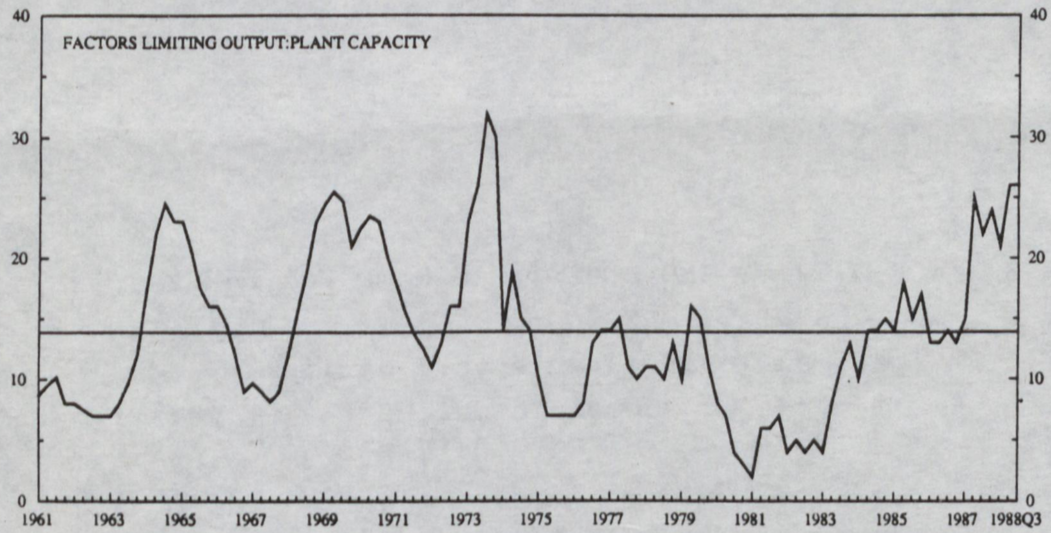
(per cent changes on a year earlier)

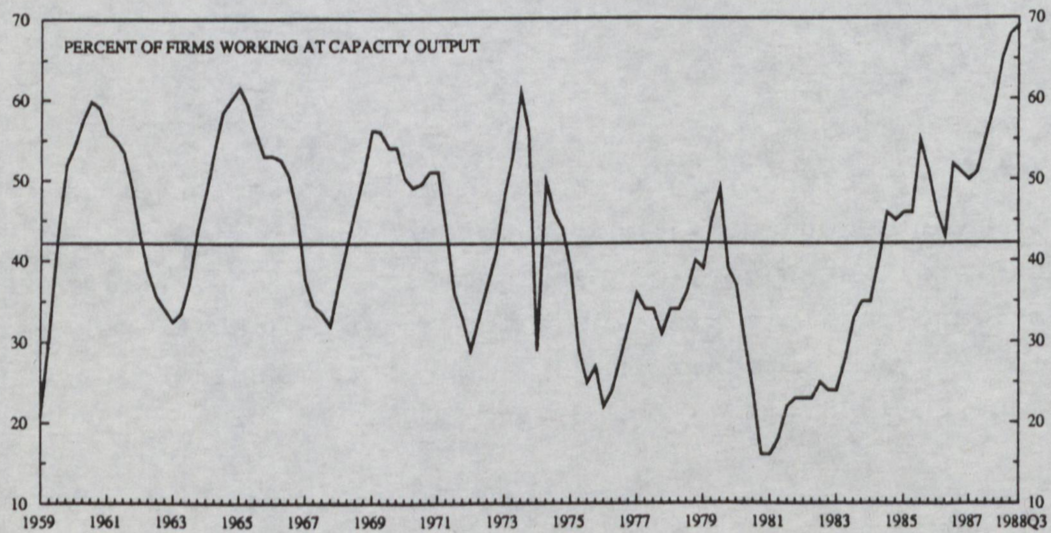
	World trade	**Domestic demand for manufactures**	**Relative unit labour costs**
1986	2.6	2.2	-9.0
1987	5.4	5.6	-2.3
1988	8.7	7.5	4.7
1989	7.3	3.6	0.2
1990	4.9	2.0	-1.7

39. The volume of **imports of manufactures** rose strongly in 1987 (particularly in the second half) and has grown even more strongly so far in 1988. This reflects very buoyant domestic demand, the worsening in competitiveness, and possibly also the effects of capacity shortages in some industries. The forecast is for imports of manufactures to grow by nearly 17 percent in 1988.

40. The performance of both imports and exports of manufactures in 1988 so far has been worse than expected. Part of the explanation is likely to be that capacity shortages in some industries are currently having an adverse effect. On the exports side, producers may have been diverting exports to the domestic market in response to capacity constraints; higher profit margins on domestic sales than on exports provides some supporting evidence for this hypothesis. There is growing evidence of capacity shortages in certain industries. The proportion of manufacturing firms reporting output below capacity in the most recent CBI survey has fallen to an all time low, and the proportion reporting capacity as an important constraint on output is at a very high level by historical standards. The industries which appear to be particularly constrained at present are metal manufacturing, chemicals, building materials, food, drink and tobacco and motor vehicles. These industries have tended to make an above average contribution to the worsening trade deficit in manufactures, and it is reasonable to attribute part of this to worsening capacity constraints.

CHART D: CBI INDICATORS OF CAPACITY UTILISATION IN MANUFACTURING





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41. Some reversal of the adverse capacity effects of 1988 is likely in the later years of the forecast as constraints are eased by the slowdown in the growth of domestic demand and the increase in capacity following strong investment in 1988 and 1989. The forecast makes an allowance for this effect by projecting slightly more favourable rates of growth of imports and exports of manufactures than suggested by the paths of world trade, domestic demand and competitiveness.

TABLE 9 : TRADE IN MANUFACTURES

(per cent change on previous year)

	Volume		**Value**	
	Exports	**Imports**	**Exports**	**Imports**
1986	3.3	5.9	4.2	8.6
1987	7.6	9.6	11.4	13.3
1988	4.9	16.9	8.1	17.0
1989	7.7	6.1	12.7	11.1
1990	5.3	2.6	9.4	7.1

42. The terms of trade have improved in 1988 so far, helped by sterling's appreciation, and the latest monthly data suggests a further gain in the third quarter. The forecast assumes little further change from the 1988 level; export and import price inflation is predicted to remain close to 4 per cent.

43. The manufactures trade deficit is expected to widen to £14¼ billion in 1988 compared with £7½ billion in 1987 as the rapid growth of import volumes relative to export volumes more than offsets the improvement in the terms of trade. But with import growth slowing down substantially in later years and slowing well below the growth of exports, the manufactures deficit begins to fall in the second half of 1989.

44. 1988 is turning out to be a poor year for (non-oil) **non-manufacturing visible trade**. (Non-manufacturing exports account for about 12 per cent of total exports of goods.) Exports are expected to be unchanged on last year's level. Over the next few years non-manufactured exports should behave more like manufactured exports, so volume growth may be substantial next year. Imports of non-manufactures consist of food, drink and tobacco and basic materials. The former category has shown little growth during 1988 and imports from this sector are likely to fall in line with the slower growth rate of consumer spending. Basic materials imports have also increased surprisingly slowly. (It is worth noting that construction materials, like bricks, concrete and cement are classified as manufactured imports.)

Oil Trade

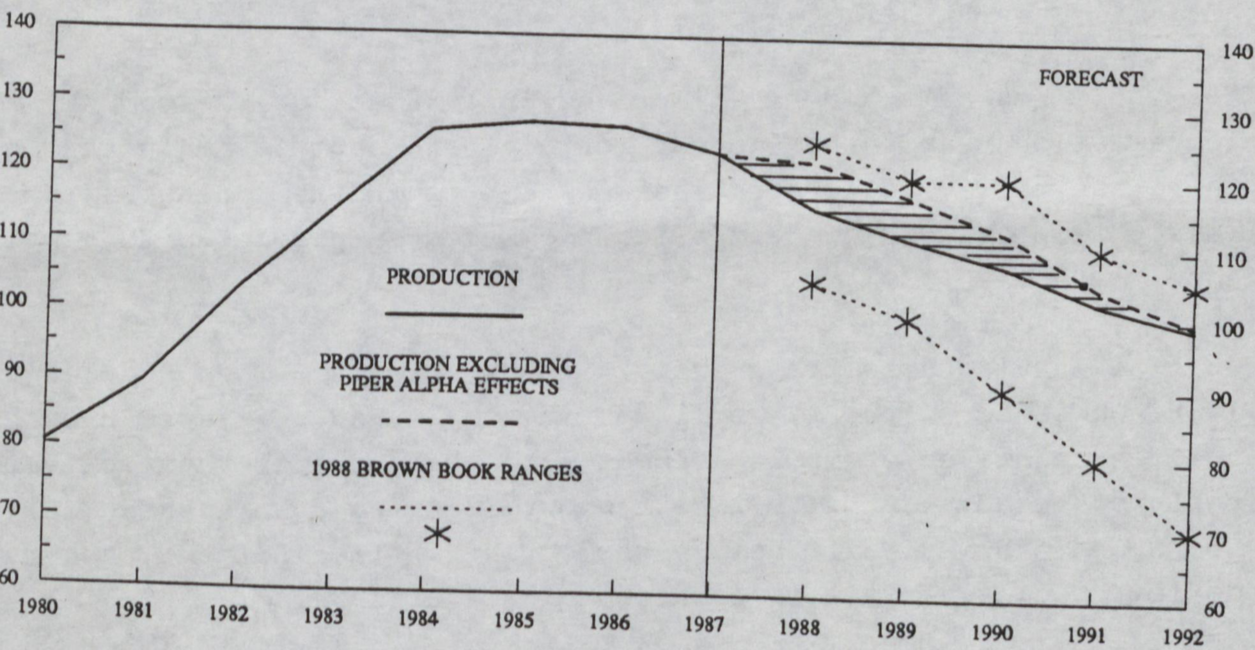
45. The oil trade surplus is expected to fall by almost £2 billion in 198{
for three reasons:

(i) a substantial fall in the sterling oil price;

(ii) a decline in production, mainly caused by the Piper Alpha disaster;

(iii) a recovery in UK demand for oil reflecting the strong growth in domestic demand.

CHART E: NORTH SEA OIL PRODUCTION
(MILLIONS TONNES)



The surplus is expected to fall further in 1989 and 1990 as the downward trend in production continues and domestic demand for oil remains quite buoyant. (Even after Piper Alpha, however, production is expected to remain above the centre of the 1988 Brown Book range.)

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TABLE 10 : NORTH SEA OIL

	Average North Sea oil price $/barrel	£/barrel	N Sea output m tonnes (oil + NGLS)	Oil trade balance - £ billion -	N Sea* taxes
1986	14.2	9.7	127	4.1	4.8
1987	17.9	10.9	123	4.2	4.7
1988	14.7	8.4	116	2.3	3.4
1989	13.6	8.1	111	2.0	2.6
1990	14.0	8.4	108	1.8	2.3

* Financial years.

46. The detailed effects of the Piper Alpha disaster are explained in a separate note. The disaster is expected to increase the current account deficit by around £0.3 billion in 1988 and £0.4 billion in 1989. The loss of production is estimated to be worth around £0.4 billion in 1988 and £1¼ billion over the whole forecast period. There will also be substantial losses of tax revenue, but in 1988 this will probably be more than offset by payment of the tax due on insurance payments received by the affected companies.

Invisibles

47. Figures for the first half of 1988 show a very marked deterioration in the invisibles balance from 1987, which is almost entirely due to a decline in the balance on services.

- There has been a deficit on travel of £1 billion in the first half of the year, equal to the whole of last year's deficit. UK residents have been travelling more outside Western Europe, in particular to North America, and have been spending considerably more while abroad.

- The financial services surplus grew dramatically in the 1980s but has fallen back this year. The main cause has been a sharp drop in Lloyds net premiums, which for the year as a whole could be around £½ billion down on the 1987 level. The turnaround in Lloyd's position is attributable to a number of factors: the decline in the dollar since 1987Q3 (over two-thirds of Lloyds business is denominated in dollars); the downturn in the insurance cycle, which is thought to have peaked in the middle of 1987; the catch-up of claims with higher premiums which were introduced to protect Lloyds against large awards in the US courts in compensation cases.

48. The **services** balance is expected to be £2 billion lower in 1988 than in 1987. Thereafter the surplus is forecast to rise slowly as the small exchange rates depreciation improves UK competitiveness.

TABLE 11 : INVISIBLES
£ billion

	Services	Oil IPD	Non-oil IPD	EC transfers	Other transfers	Total invisibles	Estimated net overseas assets (end-year)
1986	5.6	-1.3	6.3	-0.7	-1.5	8.8	114
1987	5.6	0.3	5.2	-1.8	-1.7	7.7	90
1988	3.6	1.2	4.3	-1.3	-2.2	5.6	98
1989	4.0	1.9	4.4	-2.1	-2.2	6.0	100
1990	4.3	2.1	4.6	-2.1	-2.2	6.7	106

49. **Net IPD earnings** in the first half of 1988 were close to their average level in 1987, although this hides an improvement in the oil balance, offset by a reduction in the non-oil surplus. Net oil IPD earnings should continue to rise as the declining level of production reduces payments abroad by North Sea companies. However the non-oil IPD surplus is expected to fall by almost £1 billion in 1988, due in part to the very low UK portfolio earnings and the subsequent repatriation by UK companies of part of their overseas assets after the October crash. Over the rest of the forecast the non-oil IPD surplus is flat. High bilateral aid led to the **transfers** deficit being erratically large in 1988H1. Over the forecast, the deficit on net transfers is expected to be a little higher than of late, as transfers to the EC increase.

50. The invisibles surplus for 1988 as a whole is likely to be around £2 billion lower than in 1987. As a percentage of money GDP this represents a decline from 2¼ per cent in 1986 to 1¼ per cent in 1988 at which level it is expected to remain over the forecast.

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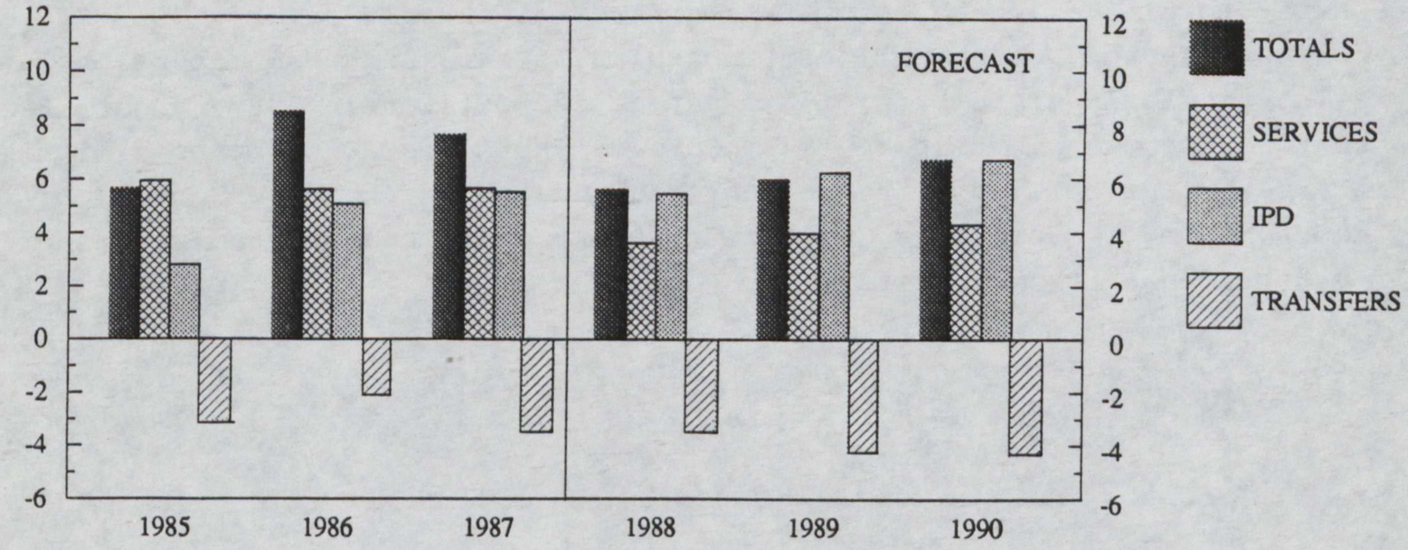
CHART F: INVISIBLE BALANCES
LEVELS (£,BILLIONS)



51. Large current account deficits are usually associated with a decline in a country's net asset position. However, the large deficits are expected to be accompanied by unusually high balancing items. The required net identified capital inflows are therefore quite small. For the purpose of forecasting invisibles and net foreign assets the forecast assumes that the balancing item reflects errors of equal magnitude in the capital and current accounts. The effect of sustained recorded current account deficits on forecast net foreign assets is offset by assumed unidentified current account credits (half the forecast balancing item) and by the positive revaluations of foreign assets (in sterling) as the exchange rate declines. As a consequence the published, identified, net overseas asset position is expected to remain at around £100 billion up to end-1990.

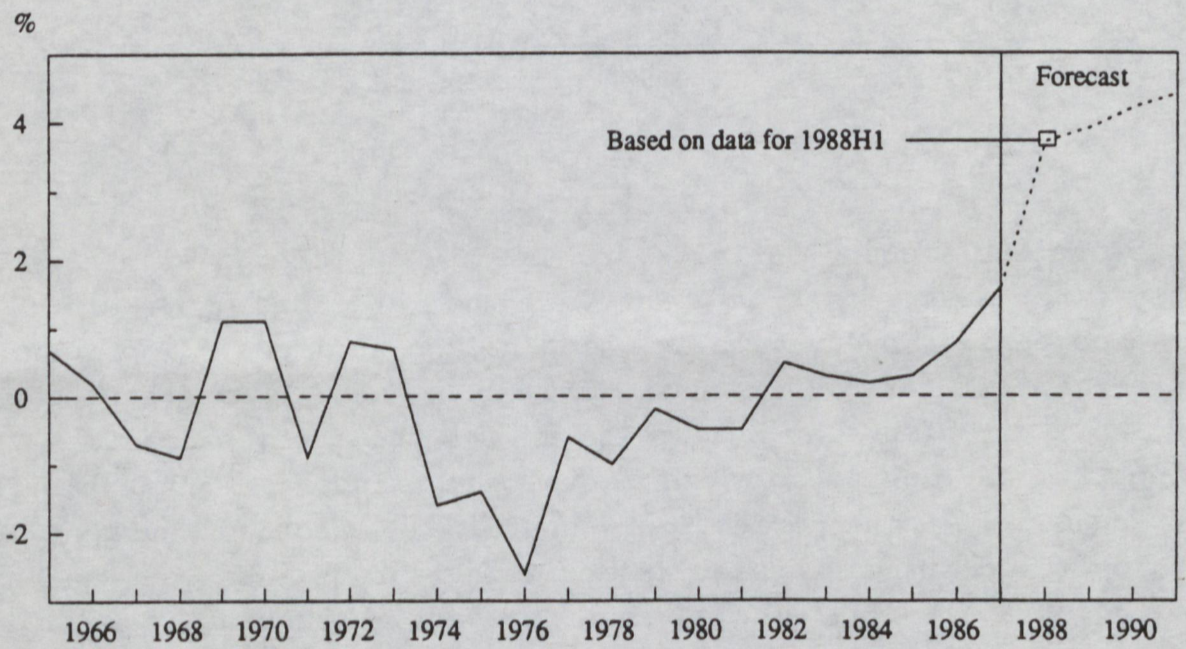
(5) **THE NATIONAL AND SECTORAL ACCOUNTS**

52. Serious inconsistencies in the national accounts continue to hamper interpretation of recent developments and assessment of prospects. Data revisions in the 1988 Blue Book led to some improvements to the annual data to 1987. The **residual error** (the difference between the current price income and expenditure measures of GDP) was reduced over 1985-87. But it was still 1½ per cent of GDP in 1987, and there remains a marked upward

trend over the past decade (Chart G). There were analogous improvements to annual estimates of the **compromise adjustment** (the difference between the average measure of real GDP and the expenditure measure of real GDP). But again there is an upward trend in the data. Despite these improvements, the **sectoral balancing items** deteriorated sharply over 1985-87. The personal sector balancing item (including life assurance and pension funds) is particularly disturbing; it is put at £22 billion in 1987, about 8 per cent of personal disposable income. There is a strong suspicion (now shared by the CSO) that the nominal and constant prices estimates of the expenditure measure of GDP have systematically understated actual growth over the past three years.

CHART G: RESIDUAL ERROR

(Proportion of GDP(E))



53. The problem has intensified with initial estimates of GDP in the first half of 1988. The residual error was an unprecedented 3½ per cent of nominal GDP(E) in 1988H1. GDP(E) rose much more slowly than the other measures, and the compromise adjustment was equivalent to 2½ per cent of real GDP(E). Most of the sectoral balancing items have also deteriorated further though there is a slight improvement in the personal sector).

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CHART H: GROWTH IN DIFFERENT GDP MEASURES

(Percentage change on year earlier)

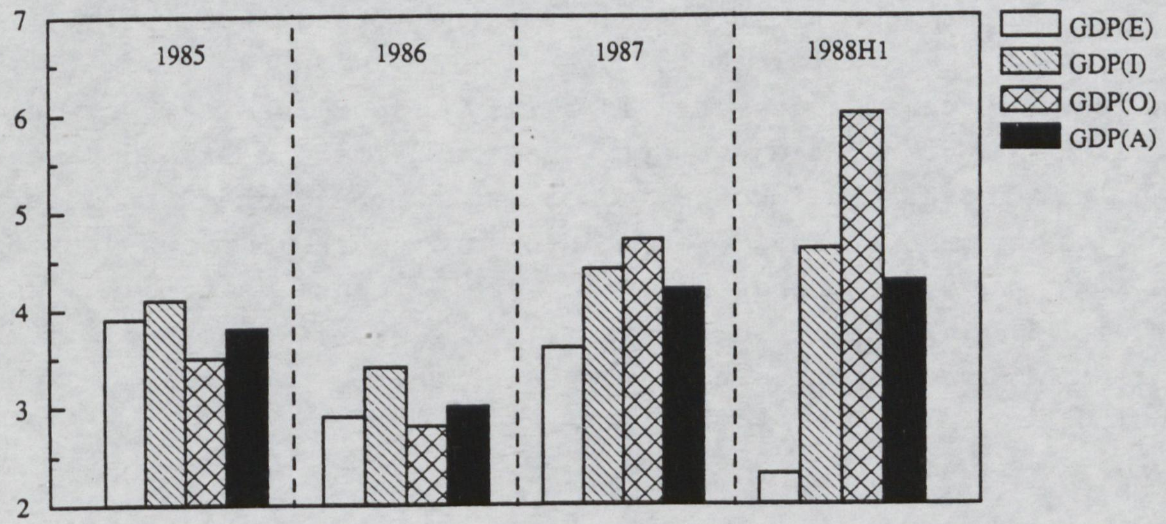
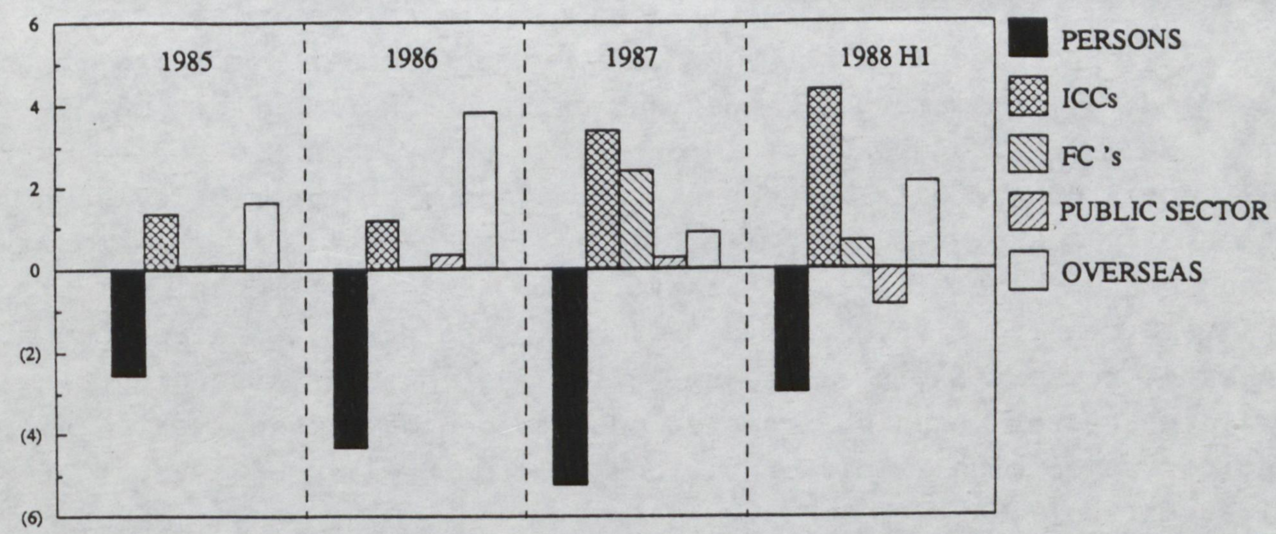


CHART I: SECTORAL UNIDENTIFIED TRANSACTIONS

(Per cent of money GDP)



54. The size of both the residual error and compromise adjustment present forecasting problems. The current forecast maintains the judgements made in June.

(i) The residual error rises over the future, broadly in line with its trend over the decade to 1987, but from the high 1988H1 level.

(ii) The compromise adjustment also rises in line with its long run again trend from the high 1988H1 level. This adds about ¼ per annum to growth in GDP(A) over the forecast period.

55. Neither of these judgements is firmly based. Ideally, we would allocate the past compromise adjustments to the different expenditure components (including exports and imports) according to the degree of uncertainty in their measurement. This would involve creating our own "shadow" measure for GDP(E) and its components. This could cause serious presentational difficulties in published forecasts. Moreover, we just do not know where the greatest uncertainties now are, nor where to allocate the missing expenditure.

(6) THE PERSONAL AND COMPANY SECTORS

Recent developments

56. **Personal sector spending** has continued to grow strongly 1988, though first estimates of total consumption indicate only marginal growth between the first and second quarters of 1988. The forecast discounts this feature of the data (the same phenomenon was apparent in first estimates in 1986 and 1987). The growth of imports, MO, and VAT in the second quarter are all consistent with faster consumption growth, and upward revisions to the consumers' expenditure data are likely as later information is incorporated. **Retail sales** data for July and August reveal a strong pick up relative to 1988Q2, and **new car registrations** also rose strongly. Together these point to a sharp rise in consumer spending in 1988Q3. **Private sector housing completions** throughout this year confirm other indicators of high levels of **personal sector dwellings investment** in the first half of 1988.

TABLE 12: RECENT PERSONAL SECTOR DEMAND INDICATORS
(Seasonally adjusted)

		Consumers' Expenditure (Percentage change on year earlier)	Retail Sales volume (Percentage change on year earlier)	New car Registrations (Percentage change on year earlier)	Private Housing completions (Thousands per month)
1987	1	4.5	5.1	5.3	14.2
	2	4.2	5.8	3.1	14.3
	3	5.4	6.6	10.1	14.4
	4	6.4	5.6	20.1	14.1
1988	1	6.9	7.8	10.7	16.4
	2	5.4	6.3	8.5	15.3
April			5.0	12.9	15.8
May			8.3	12.9	15.5
June			5.8	4.8	14.6
July			6.9	9.3	20.2
August			6.1	17.0	19.0

57. The 1988 **business investment** boom predicted by the last two DTI Investment Intentions Surveys (December 1987 and June 1988) and recent CBI Trends Enquiries is confirmed by latest data.

TABLE 13 : INVESTMENT GROWTH
(per cent growth on year earlier)

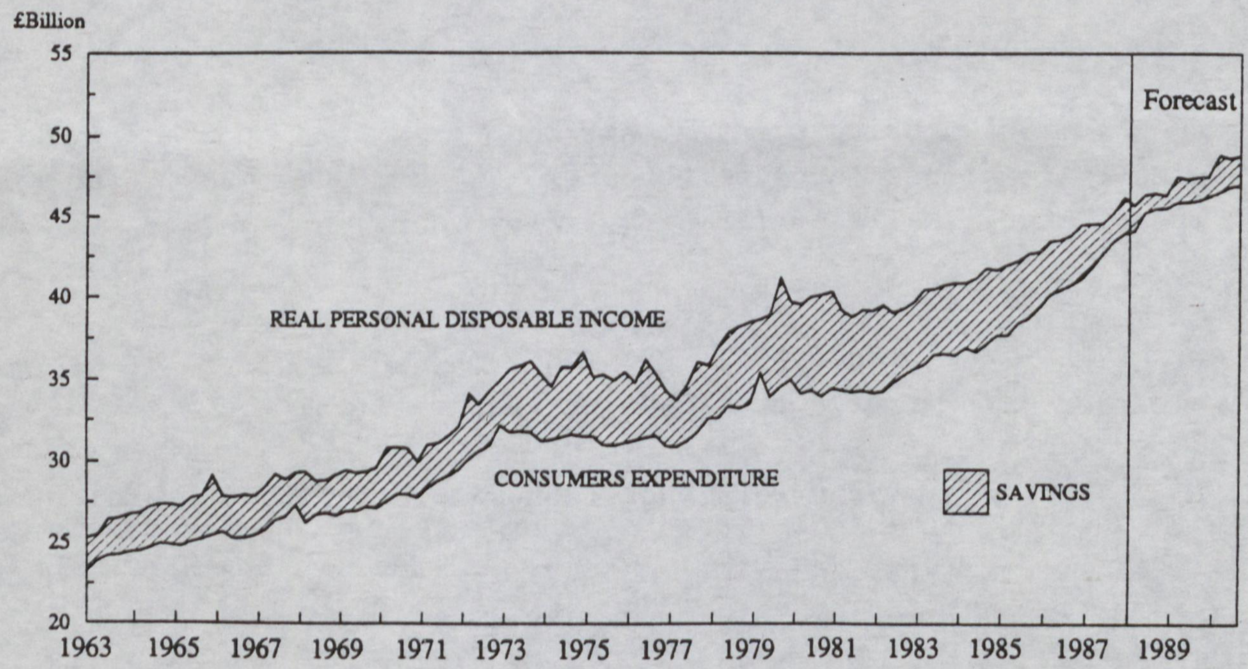
		Manufacturing incl leased assets	Non-manufacturing excl leased assets	Total Business Investment
1987	1	- 12.3*	9.3	- 1.0
	2	12.2	17.9	8.2
	3	9.0	13.1	6.1
	4	13.9	22.7	13.5
1988	1	13.7	15.3	10.4
	2	14.3	9.5	9.0

* This figure reflects a very high figure for 1986Q1, which was itself the result of changes to Corporation Tax in the 1984 Budget.

Personal Income and Expenditure : the forecast

58. **Consumer spending** has grown faster than expected over the last three years and the **saving ratio** has fallen to 4.2 per cent in 1988H1. The most likely explanation is that lower inflation expectations, increased wealth (especially increased housing wealth) and greater consumer confidence, have all reduced the perceived need for saving relative to income. Wealth increases have boosted personal borrowing capacity, and there has been increased demand for (and supply of) credit following financial deregulation and increased competition among financial companies. Overall, consumer spending is expected to rise by nearly 6 per cent in calendar 1988, with the savings ratio falling further (to 2¾ per cent) in 1988H2.

CHART J: PERSONAL SECTOR REAL DISPOSABLE INCOME AND SPENDING



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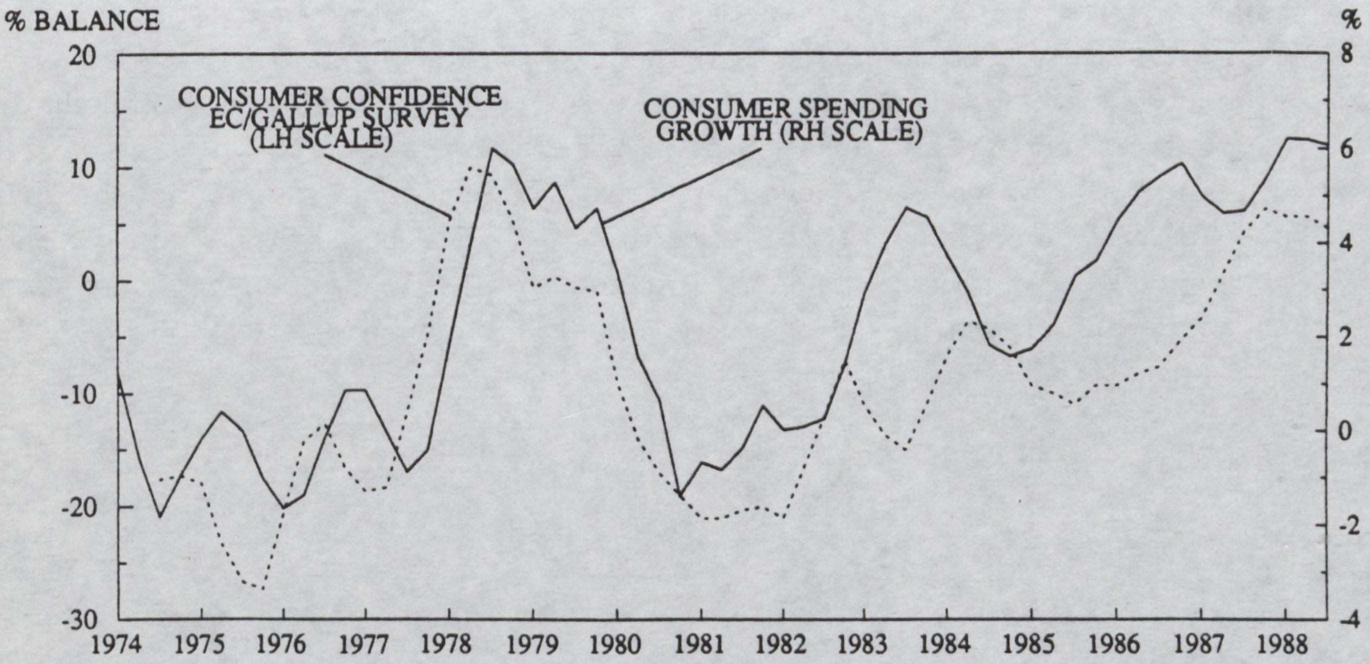
59. There is as yet little or no evidence of a slowdown in consumer spending. Nonetheless, it should decelerate sharply in 1989. The rise in interest rates since the low point of May 1988 should discourage further strong growth in borrowing, and encourage greater saving. Moreover, the sharp rise in consumer debt over the last three years means that persons have become net payers of interest, reversing a long tradition of being net recipients of interest. Any increase in interest rates, therefore, now <u>reduces</u> personal sector disposable income rather than increasing it. (This is set out in more detail in the paper on the effects of interest rates in the forecast being circulated separately.) In addition to these influences, the rise in house prices and housing wealth is expected to abate sharply through 1989. Finally, the EC's UK consumer confidence index fell from a perecentage balance of +9 in June to -2 in September. This comes hard on the heels of recent interest rate increases, and there was a particularly sharp dip in the balance expecting to purchase major consumer durables.

CHART K: CONSUMER CONFIDENCE AND CONSUMER SPENDING

(3 quarter moving average)



60. Against this background, consumer spending is expected to rise by 3 per cent in 1989 and by about 2 per cent in 1990. The saving

ratio should gradually recover throughout 1989 and 1990, though only slowly. However, there may be a risk that consumer spending will rise more slowly than we foresee given what looks like a severe tightening of the personal sector financial position discussed in para 66 et seq.

TABLE 14: PERSONAL INCOME, EXPENDITURE AND SAVING

	Real personal disposable income	Real consumer' expenditure	Personal savings ratio
1985	2.3	3.5	9.5
1986	2.9	5.4	7.3
1987	3.0	5.1	5.4
1988	3.6	5.8	3.5
1989	2.7	3.0	3.2
1990	2.7	1.9	3.9

61. How secure is this judgement in the light of the recent enormous personal sector balancing items, which suggest that personal sector income and saving may have been much higher than recorded? By way of illustration, the forecasters have looked at the implications of assuming that 50 per cent of the personal sector balancing item represents unrecorded income. (The personal sector balancing item has always been the same sign, consistent with under-recording of income.) Even on this assumption, it remains true that consumer spending has risen faster than income over the past three years and that the "adjusted" saving ratio has fallen to historically low levels. Even if income growth has been faster than recorded, consumption growth should still moderate relative to income, and the saving ratio should recover slowly over the next two years. (See Chart L). Nonetheless, the <u>extent</u> and timing of these movements could be different.

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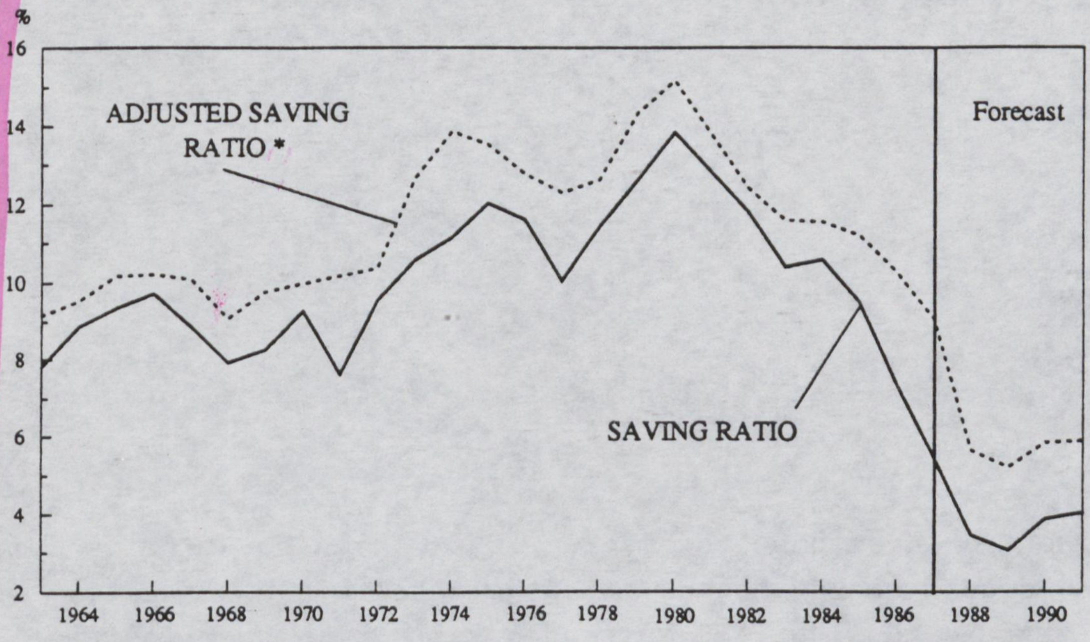
CHART L: SAVING RATIO

(Savings as per cent of personal disposable income)



* Assuming HALF the personal sector balancing item reflects unrecorded personal income

The Housing Market

62. The housing market has been particularly buoyant over the past year with **private sector investment in dwellings and improvements** expected to increase by 16 per cent in 1988, and mortgage lending projected to rise by about 20 per cent. But this exceptional growth seems to be tailing off. **Building society mortgage commitments** have been around 32 per cent lower in the two months August-September compared with July. The July figure was itself probably boosted by the ending of double MIRAS relief. Nonetheless, some of the fall in the last two months (and September was lower than August) probably does reflect a response to higher mortgage rates. Personal housing investment is forecast to slow markedly in 1989, to under 3 per cent, and to remain flat in 1990.

TABLE 15 : HOUSING FINANCE

(Percent change on a year earlier unless otherwise stated)

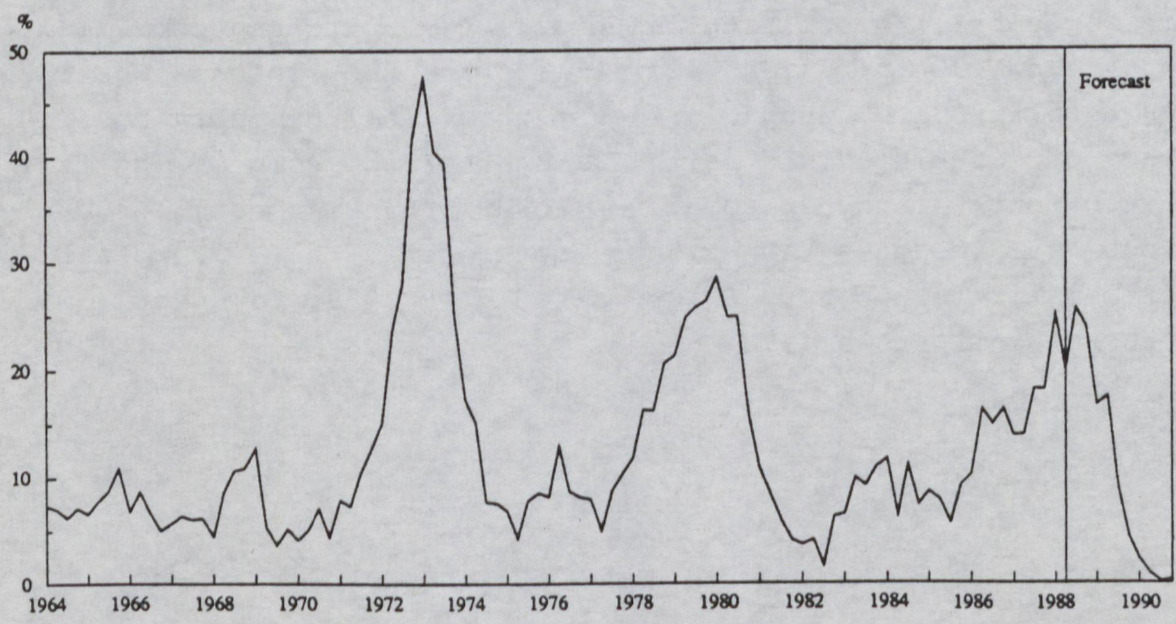
	New House Prices	Mortgage Borrowing from all sources		Estimated Mortgage Equity Withdrawal		Mortgage Rate
		%	£bn	%(1)	£bn	%
1985 Q4	9.2	17.7	19.1	5.3	6.7	13.2
1986 Q4	16.4	20.9	26.6	7.7	11.9	11.8
1987 Q4	18.2	19.3	29.7	6.9	12.6	11.5
1988 Q4	23.9	21.5	39.5	8.8	19.6	11.0
1989 Q4	4.6	15.2	33.9	4.3	11.1	12.8
1990 Q4	0.5	13.5	34.6	4.4	11.3	12.1

(1) As a percentage of outstanding stock of mortgage borrowing

63. The forecast has a dramatic reduction in house price inflation, as income growth slows, higher mortgage rates begin to bite, and new houses started during the current construction boom increase supply. Nevertheless, mortgage borrowing continues to grow fairly rapidly, the growth rate falling only to around 14 percent per annum. In part this represents financing of purchases of new houses and of home improvements.

CHART M: CHANGE IN NEW HOUSE PRICES

(Percentage change on year earlier)



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Personal Sector Financial Position

64. The forecast projects a considerable tightening of the personal sector financial position. The forecasts of real consumer spending and housing investment already take account of this tightening through higher interest rates and their impact on income, lower net financial wealth and lower house price increases. Nonetheless, an emerging and significantly new feature of the forecast is that some part of the projected increase in mortgage (and other) borrowing is to sustain consumption and/or service debt. This imparts considerable uncertainty to the outlook for real personal spending.

65. Charts N and O summarise the personal sector's overall financial position. The two measures of net financial wealth shown in Chart N tell very different stories. If individuals disregard their pension fund surpluses when assessing their financial position, the measure excluding LAPFs (life assurance and pension funds) is relevant and this shows a deterioration in the personal sector's position to historically low levels. A similar, but less dramatic, picture emerges from Chart O which includes the value of housing in the measure of personal wealth.

CHART N : PERSONAL SECTOR WEALTH : RATIOS OF NET FINANCIAL WEALTH TO INCOME

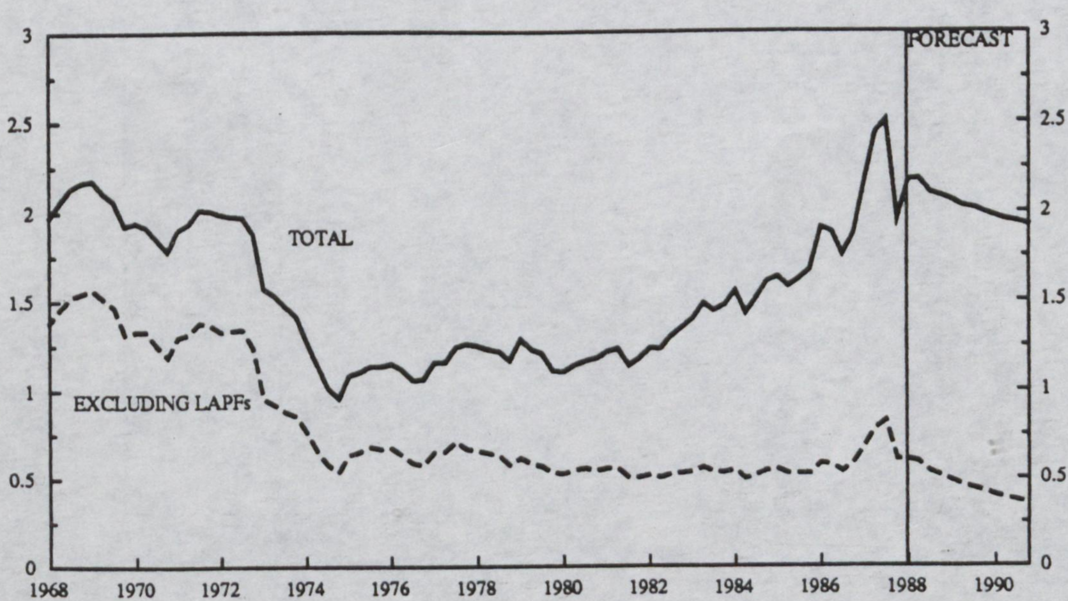
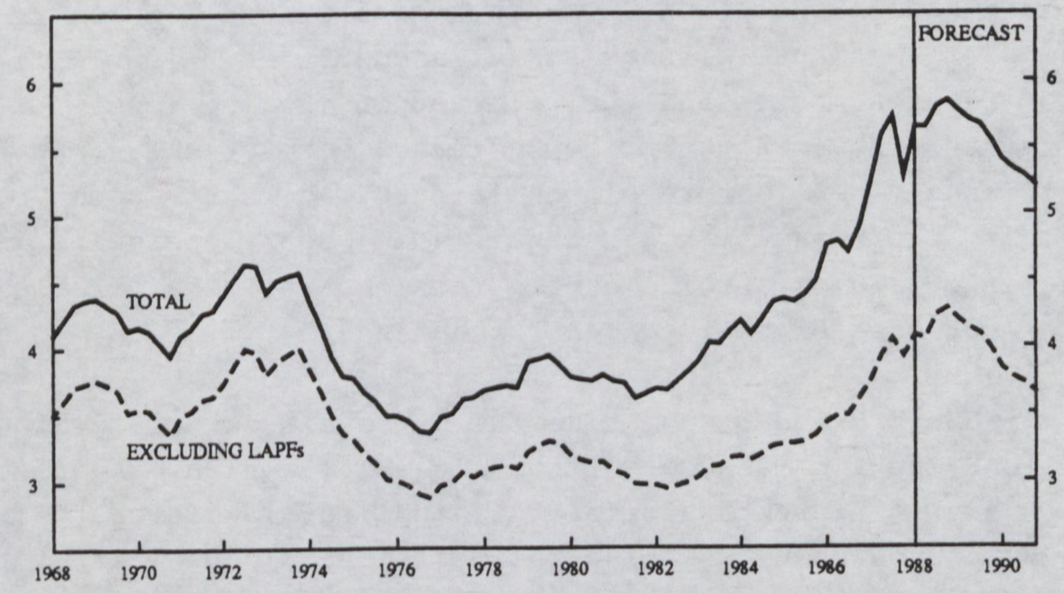
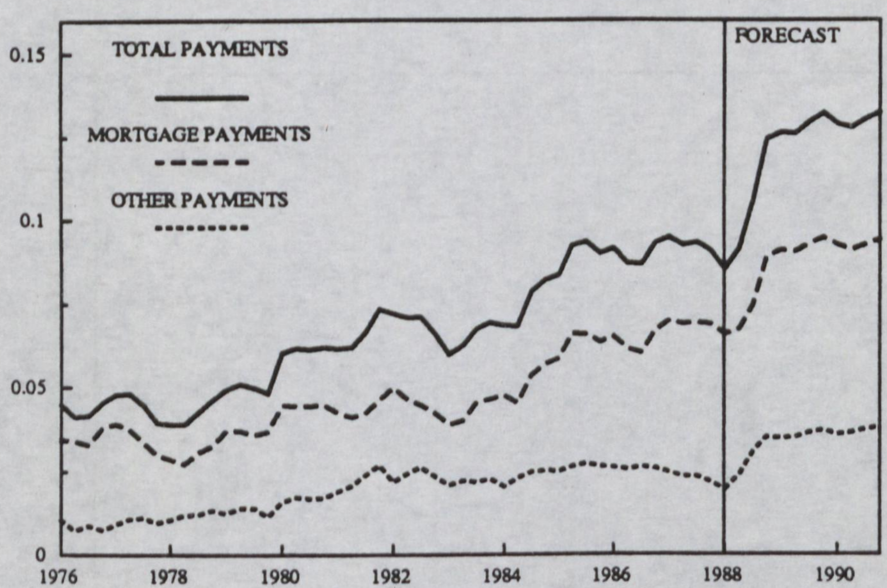


CHART O : PERSONAL SECTOR WEALTH : RATIOS OF TOTAL WEALTH (Including housing) TO INCOME



66. An additional indicator of the possible financial squeeze on the personal sector is gross income gearing. The increase in gross debt would raise personal sector income gearing to record levels. Total (gross) interest payments could account for about 14 percent of disposable income by the end of the forecast period.

CHART P : PERSONAL SECTOR INCOME GEARING
(ratio of personal sector gross interest payments to income)



67. The UK personal sector's gross debt-income ratio is currently at a similar level to that in many G7 countries. But the increase projected in the forecast would take the UK well above the average levels observed elsewhere, even the US.

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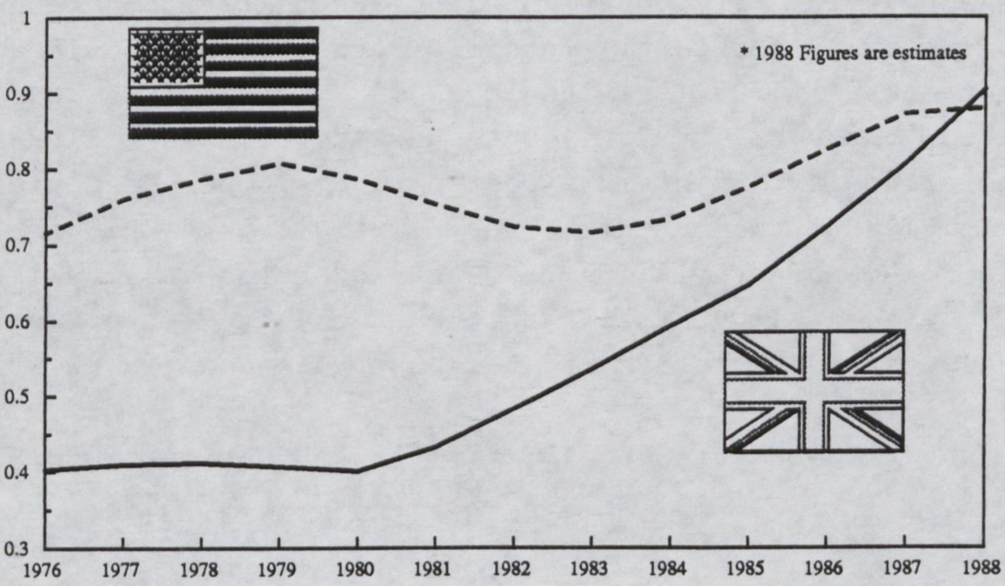
CHART Q : HOUSEHOLD DEBT : INCOME RATIO US V UK



68. High income gearing could involve substantial financial difficulties for a small minority who have over extended themselves to buy a house. They may try to postpone cuts in consumption by lengthening the repayment period of their mortgage. Mortgage arrears and possessions are expected to increase and there could be a rise in the number of personal bankruptcies. But any increases will be from a very low base and will not have any discernible direct macroeconomic impact, except, perhaps, in inducing greater caution in future borrowing.

69. The relatively tight financial position of the personal sector could result in a more serious break in consumer confidence so that persons may rein back their spending by more than assumed in the forecast. On the other hand, financial deregulation has given consumers the ability to borrow more than ever before. They may exploit this to postpone spending cuts, in the hope that rising incomes and a swift reduction in interest rates will solve their problems. It remains to be seen just how the personal sector reacts; but the tight financial position clearly imposes a major uncertainty.

Company Income and Expenditure

70. **Business investment** has already shown very strong growth in the first half of 1988, and this is expected to continue into the second half of the year. Overall, **manufacturing investment** is likely to increase by 18 per cent in 1988 and **private non-manufacturing investment** by 13 per cent. Interest rates may have only a small impact on investment in 1989, and the level of investment is expected to be sustained through 1989 at about the same rate as in 1988H2. Overall, manufacturing investment is expected to be 10 per cent higher in 1989 than in 1988 (though with very little growth through the year) and private non-manufacturing 5 per cent higher (again with little growth - perhaps even a slight fall - through the year). Investment is expected to be flat in 1990, reflecting the sharp slowdown in growth in 1989 and 1990.

TABLE 16: GROSS DOMESTIC FIXED CAPITAL FORMATION
(percentage changes on previous year)

	1986	1987	1988	1989	1990
Business	- 2.0	6.7	13.3	6.9	0.6
of which:					
North Sea	-12.0	-22.3	13.4	17.0	30.4
Manufacturing	- 6.6	5.0	18.0	10.0	- 4.0
Other business*	0.8	10.0	11.9	5.3	- 0.1
Private dwellings	6.4	7.1	12.9	1.5	- 0.5
General government	7.2	- 3.4	- 2.4	4.4	7.6
Total Investment	**0.9**	**5.5**	**12.0**	**5.2**	**1.1**

* Includes public corporations

71. Though **stockbuilding** was the same in 1988H1 as in 1987H2 the rapid growth in output over the same period implied a further fall in stock-output and stock-sales ratios, continuing the trend declines of recent years. These ratios continue to fall though at a slightly slower rate, and stockbuilding will remain low.

72. **Non-North Sea industrial and commercial companies's** profits net of stock appreciation showed further strong growth (about 20 per cent) in 1987. Since 1984 profits growth has averaged 25 per cent a year. With buoyant domestic demand and output growth in 1988 profits should rise further, by about 24 per cent. Profits may grow more slowly in 1989 and beyond as economic activity slows down and the rise in profit margins abates. Despite the rise in company sector spending, ICCs net acquisition of financial assets remain in surplus throughout the forecast. ICCs' net income, which approximates the Corporation Tax base, grows more slowly in 1989 and 1990 than in the previous two years.

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TABLE 17: COMPANIES' INCOME AND RATES OF RETURN

(a) Profit shares and rates of return

(per cent)	Total	Non-oil	Non-oil (excl privatised) companies	Net rate of return on assets, non-ICCs
1973-85 average	11.8	8.7	8.6	5.5
1986	15.4	12.8	11.7	8.9
1987	17.3	14.6	12.8	9.8
1988	18.3	16.3	14.4	11.7
1989	18.7	17.2	15.0	12.3
1990	19.0	17.5	14.8	12.2

(b) Growth of profits and net income (per cent change on a year earlier)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies
	Gross Trading Profits**	Net Income	Net Income
1986	21.3(21.3)	24.8	28.8
1987	19.5(15.4)	29.9	12.5
1988	23.7(23.7)	17.9	29.4
1989	14.7(13.3)	9.2	23.8
1990	9.3(6.9)	6.9	14.9

* Figures in brackets show growth of profits adjusted to exclude the effect of newly privatised companies being included in the sector.
** Net of stock appreciation.

Company Sector Financial Position

73. In some ways the industrial and commercial company sector is in a similar position to the personal sector. It has always been a net payer of interest. Its sensitivity to interest rate rises has increased recently because it switched heavily from equity to bank finance after the stock market crash. To finance their forecast expenditure, ICC's will need to continue increasing their borrowing, particularly from banks. Gross liquidity falls a little as a proportion of TFE and the net liquidity position worsens considerably. It is a moot point as to how willing ICCs will be to run with this outlook. There must be some risk that they will cut back on their real spending.

(7) DOMESTIC DEMAND AND ACTIVITY

74. Table 18 summarises latest estimates of **real GDP growth.** Once again, **GDP(E)** presents an implausibly low picture of recent growth. **GDP(O)** is still thought, even by CSO, to present the most reliable guide over the past year. It points to very rapid growth, even faster than the **income measure**, which tracked the output measure reasonably closely in 1987.

TABLE 18 : REAL GDP GROWTH

per cent change on a year earlier

	GDP(O)	GDP(I)	GDP(E)	Average measure of GDP(A)	Compromise adjustment (% of GDP(E)
1985	3.5	4.1	3.9	3.8	0.0
1986	2.8	3.4	2.9	3.0	0.2
1987	4.7	4.4	3.6	4.2	0.7
1988Q1	6.3	5.1	2.4	4.5	2.2
1988Q2	5.7	4.1	2.3	4.0	1.8

75. **Domestic demand** growth is likely to be substantially higher in 1988 than 1987. But GDP growth is expected to remain at just over 4 per cent in 1988 (nearly 5 per cent excluding oil) due to weaker net exports of goods and services. GDP growth is likely to fall to 2½ per cent (3 per cent excluding oil) in 1989, and slow further in 1990. Changes in the compromise adjustment contribute an uncomfortably large amount to recent year-to-year fluctuations in growth.

TABLE 19: EXPENDITURE AND OUTPUT

(percentage changes on previous year)

	1986	1987	1988	1989	1990
Domestic demand	3.8	4.3	6.0	2.6	1.6
Export of goods and services	3.7	5.5	1.1	5.2	3.7
Import of goods and services	6.5	7.3	11.7	4.4	2.1
Compromise adjustment (change as a per cent of GDP.)	0.2	0.7	1.8	0.2	0.3
GDP(A)	**3.0**	**4.2**	**4.2**	**2.7**	**2.3**
GDP Output measure:					
Non-oil GDP	3.0	5.2	6.2	3.2	2.9
Manufacturing	0.9	5.8	6.4	3.7	2.5

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(8) PRICES AND EARNINGS

Recent Inflation Trends

76. Inflation indicators have trended up so far through 1988. The **all items RPI** rose quite sharply in August, entirely due to increased mortgage interest rates. But, even excluding MIPS, there has been a pronounced increase in the RPI inflation rate in recent months. **Producer prices** (excluding food, drink, and tobacco industries) rose by 4.9 per cent in the year to 1988Q3, with continued strong growth in profit margins augmented by slowly rising unit labour costs.

TABLE 20: INFLATION INDICATORS
(per cent change on year earlier)

		Manufacturers output prices*	RPI All items	RPI Less MIPS	GDP (Market price) Deflator
1987	Q3	4.5	4.3	3.6	5.3
	Q4	4.8	4.1	4.0	5.7
1988	Jan	4.8	3.3	3.7	
	Feb	4.7	3.3	3.6	
	March	4.7	3.5	3.8	
	April	4.6	3.9	4.2	
	May	4.7	4.2	4.4	
	June	4.7	4.6	4.7	
	July	4.8	4.8	5.0	
	August	4.9	5.7	5.0	
	Sept	5.0			

* excl food, drink and tobacco.

Producer Prices

77. Producer price inflation is likely to continue rising over the rest of this year. Domestic demand remains strong, so that margins continue to rise through 1988, by a little more than in 1987. Producer price inflation is expected to be around 5 per cent by end-1988. Thereafter, unit labour costs are expected to increase as recent exceptional productivity growth slows down. The forecast thus sees little prospect of any significant drop in producer price inflation through 1989, though it is expected to fall through 1990.

TABLE 21: COSTS AND PRICES IN MANUFACTURING

(percentage changes on previous year)

	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices*
1986 Q4	- 0.7	- 5.0	1.5	3.7
1987 Q4	1.4	5.1	1.3	4.8
1988 Q4	1.8	2.8	2.5	5.0
1989 Q4	4.9	5.1	4.8	5.0
1990 Q4	3.5	2.5	3.9	4.0

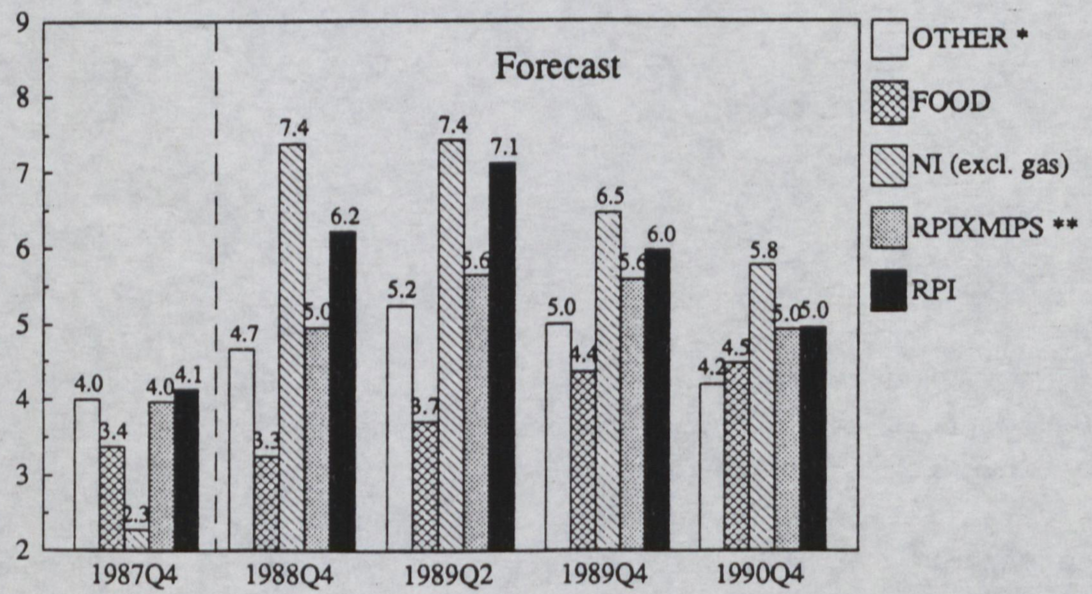
* Excluding food, drink and tobacco.

Retail Prices

78. **RPI inflation** will be over 6 per cent by end-1988, mainly as a result of higher mortgage rates, but also due to particularly sharp increases in nationalised industry prices (Chart R and Table 20.) It should rise further to around 7¼ per cent by mid-1989, with mortgage interest rates again the main impetus, though private sector prices generally are forecast to rise faster than last year. Local authority rent and rate increases also contribute to the rise.

CHART R: GROWTH IN MAIN RPI COMPONENTS

(Percentage change on year earlier)



* Private sector prices excluding food, housing and petrol.

** RPI excluding mortgage interest payments

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79. RPI inflation should fall to around 6 per cent by 1989Q4 as the effects of mortgage interest rate increases through 1988H2 drop out. (The Annex presents a more detailed assessment of prospects for nationalised industry prices.)

TABLE 22: COMPONENTS OF THE RETAIL PRICE INDEX

	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4
Food prices	3.2	3.4	3.2	4.4	4.5
NI prices	3.6	2.3	7.4	6.5	5.7
Housing costs	7.1	7.0	15.9	10.7	7.1
Other prices					
- petrol	-12.6	1.3	- 0.4	5.2	4.6
- other items	3.9	4.0	4.7	4.9	4.2
Total RPI	3.4	4.1	6.2	5.9	4.9
RPI excluding Mortgage Interest payments	3.4	4.0	5.0	5.5	4.8

80. Table 23 sets out the monthly RPI inflation path until the end of 1989 together with the path consistent with the FSBR forecast. Mortgage interest rate increases dominate the outlook. The profile assumes that interest rates rise in October 1988. Thereafter, mortgage interest rates are flat. The **all items RPI** is expected to peak at 7.3 per cent in July 1989. It then falls as the mortgage interest rate increases which took effect from mid-1988 drop out. It falls further in October 1989 as the October 1988 mortgage increase falls out. The **RPI excluding MIPS** peaks at 5.7 per cent in April 1989 and stabilises at 5.6 per cent thereafter.

TABLE 23: MONTHLY PATH OF RPI INFLATION
(percent changes on a year earlier)

	All items RPI		RPI excluding mortgage interest payments	
	FSBR	Autumn	FSBR	Autumn
1988 Aug	4.3	5.7	4.2	5.0
Sep	4.2	5.9	4.2	5.4
Oct	4.0	6.2	3.9	5.1
Nov	3.8	6.1	3.7	5.0
Dec	4.2	6.5	3.8	5.0
1989 Jan	4.5	7.1	4.1	5.3
Feb	4.5	7.1	4.2	5.5
Mar	4.4	7.1	4.1	5.4
April	4.3	7.0	4.0	5.7
May	4.1	7.1	3.8	5.6
June	3.9	7.2	3.6	5.6
July		7.3		5.6
August		6.4		5.6
Sept		6.5		5.6
Oct		6.0		5.6
Nov		5.9		5.5
Dec		6.0		5.6

The GDP deflator

81. The **market price GDP deflator** rose 5.3 per cent in 1987-88, compared with 3.4 per cent in 1986-87. (The low figure for 1986-87 was mainly accounted for by the collapse in oil prices during 1986.) The CSO's latest estimates are for a rise of 5.9 per cent in the year to 1988Q2. In the light of the poor short-term inflation prospects, it now looks as if the FSBR projections for GDP deflator inflation in 1988-89 were much too low. The outturn could be fully two points higher at about 6¾ per cent (7 per cent non-oil), compared with 4½ per cent in the FSBR (5 per cent non-oil). The GDP deflator is likely to rise by about 6 per cent in 1989-90.

TABLE 24: GDP DEFLATOR AT MARKET PRICES
(percentage change on previous year)

	1986-87	1987-88	1988-89	1989-90	1990-91
MTFS					
Total	3.2	4.9	4.5	3.9	3·5
non-oil	6.0	4.3	4.9	3.6	
October forecast					
Total	3.4	5.3	6.8	6.0	5.1
non-oil	6.0	4.8	7.0	5.9	5.0

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82. The main influences underlying the bigger increase in the GDP deflator than expected in the FSBR (apart from the general faster rise in prices) are particularly sharp increases in the public authorities consumption deflator, dominated by public sector earnings growth. (Central government earnings are expected to rise by 9¼ per cent in 1988-89 and 7¾ per cent in 1989-90. Corresponding local authority earnings figures are 8¼ per cent and 9½ per cent respectively.) The improvement in the terms of trade in 1988-89 - to a considerable extent already recorded - also boosts growth of the GDP deflator in 1988-89, as it did in 1987-88

TABLE 25: COMPONENTS OF GDP DEFLATOR

(a) Component deflators (Percentage increase on previous year)

	Consumers' expenditure	Investment	Stocks	General Government current expenditure on goods & services	Export	Imports	Total
1987-88	3.7	6.4	5.6	6.5	3.7	2.1	5.3
1988-89	5.4	6.3	5.1	7.8	2.3	1.3	6.8
1989-90	5.6	6.1	4.9	7.7	4.1	4.6	6.0
1990-91	5.0	3.8	4.3	7.1	4.3	4.3	5.1

(b) Contribution of components to total percentage increase in deflator

	Consumers' expenditure	Investment	Stocks	General Government current expenditure on goods & services	Export	Imports	Total
1987-88	3.6	1.6	0.2	0.9	0.9	- 2.0	5.3
1988-89	4.7	2.9	0.1	0.9	0.6	- 2.6	6.8
1989-90	3.6	1.3	-0.1	1.0	1.5	- 1.4	6.0
1990-91	3.2	0.3	0.0	1.3	1.5	- 1.2	5.1

Earnings

83. **Private sector settlements** have continued to edge up; they are now about ¾ per cent higher in manufacturing and ½ per cent higher in the private sector as a whole than a year ago. Non-manufacturing settlements have been running at a slightly higher rate than manufacturing (6 per cent rather than 5½ per cent).

84. Immediate prospects are finely balanced. Over the rest of this year and early next year (and the first half of the year is the key

period for settlements), many factors point to further increases in settlements. Tighter labour market conditions (firms are increasingly citing the need to recruit and retain labour as a factor in settlements) and buoyant company profits both point to such an outcome. Moreover, RPI inflation will be picking up strongly; the forecast is for RPI inflation to average over 7 per cent in the first half of 1989. Cost of living increases may, therefore, impart a sharp upward twist to pay claims.

85. Against that, however, the forecast has a pronounced slow down in growth in the first half of 1989, and recorded productivity growth should also slow down sharply. Employers may be well placed, therefore, to resist higher settlements. The forecast has **private sector settlements** rising by a further 1 per cent to 6¾ per cent in the 1988-89 pay round, before falling back thereafter.

86. Overtime in manufacturing increased steadily through 1987 and has been sustained at near record levels throughout 1988. Overtime has contributed some ¼ per cent to the 8½ per cent growth in **private sector earnings** over the year to 1988Q3. Other bonus payments and drift contributed to an increase of 9¼ per cent in **manufacturing earnings** in the year to August 1988. Earnings growth should slow down towards the end of 1988 as output growth itself moderates. For 1989, the continued slow down in activity should lead to lower settlements and earnings increases.

TABLE 26: PRIVATE SECTOR SETTLEMENTS AND EARNINGS
(Contributions to changes on a year earlier)

	1987Q3	1988Q3	1989Q3
Settlements	5¼	5¾	6¾
Drift	2¼	2½	2½
Overtime	½	¼	- ¼
Increase in average earnings	8	8½	9

87. In the year to August 1987 **local authority earnings** grew more rapidly than in the private sector. Over the year to August 1988 they rose more slowly. Teachers were paid 7½ per cent from October, as the second step of their 1987 settlement, and received another 1 per cent in April from restructuring. They received an increase of 4¼ per cent in April. Local authority manuals settled on a 10½ per cent increase.

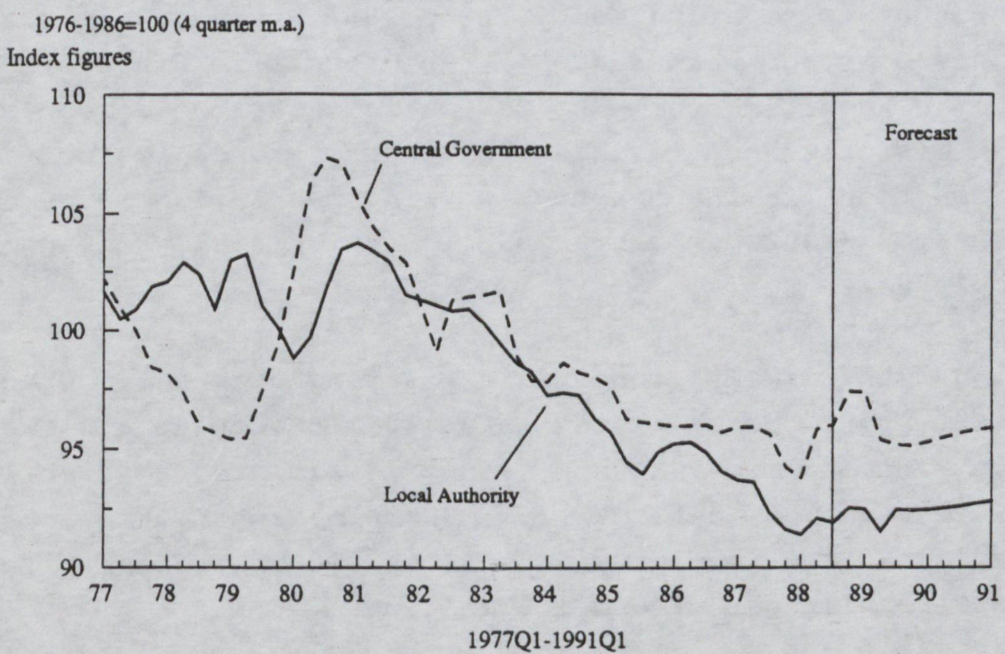
88. Overall, **underlying local authority earnings** are likely to rise by 7½ per cent in the 1987-88 pay round (compared to about 8½ per cent in the private sector), and 8 per cent in the following round. They rise slightly faster than private sector settlements thereafter. **Actual local authority average earnings** increase by 8.1 per cent and 9.0 percent respectively in the 1987-88 and 1988-89 rounds. The difference between underlying and actual earnings is due to the timing of back pay.

89. **Central government earnings** grew more slowly (7¼ per cent) than the private sector in the 1986-87 pay round, though nurses and some other health workers fared notably better. For central government earnings as a whole, the forecast has increases of 9 per cent for the 1987-88 and 8 per cent 1988-89 pay rounds.

TABLE 27 : PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(percentage changes over years to August)

Pay rounds	Central Government	Local authorities	Private sector
1986-87	7¼	10¼	8
1987-88	9	7½	8½
1988-89	8	8	9
1989-90	9	9	8½

CHART S: RATIO OF LOCAL AUTHORITY AND CENTRAL GOVERNMENT EARNINGS TO PRIVATE SECTOR EARNINGS



Labour Costs

90. Manufacturers' unit labour costs are likely to rise more quickly over the next two years than in 1987 and early 1988, mainly because productivity growth falls back to more normal rates as output growth moderates.

TABLE 28: LABOUR COSTS INCREASES IN MANUFACTURING
(percentage increases on previous year)

	UK	Major 7 (less UK)
1986	4.9	2.5
1987	0.3	0.5
1988	1.4	0.7
1989	3.8	1.6
1990	3.9	2.3

(9) EMPLOYMENT, UNEMPLOYMENT AND PRODUCTIVITY

91. The **employed labour force** rose by 450,000 in the year to 1988Q2, (a reflection of strong output growth) bringing the total rise over the past five years to 1.8 million. **Unemployment** fell by 550,000 in the year to 1988Q2, and by a further 100,000 between June and August. (Unemployment figures for September became available after the forecast was completed. They show **no fall**. But this should be discounted - the numbers are thought to be affected by the postal dispute.) The fall in unemployment has been somewhat faster than the rise in employment. This probably results from the so-called Layard effect, where administrative measures have reduced the tendency to claim benefits and led to a reduction in the measured working population relative to a more comprehensive measure of labour supply (which would include non-claimant unemployed).

92. With growth likely to be fairly strong over the rest of this year, employment should go on rising into 1989, though at a slower rate than recently. Beyond mid-1989 employment is expected to stabilise as output slows down. The outlook for unemployment (UK seasonally adjusted) reflects the employment prospect; it continues to fall to mid-1989 before settling at around 1.9 million.

93. Much of the recent exceptional increases in **productivity** (especially in the manufacturing sector) are cyclical, reflecting very

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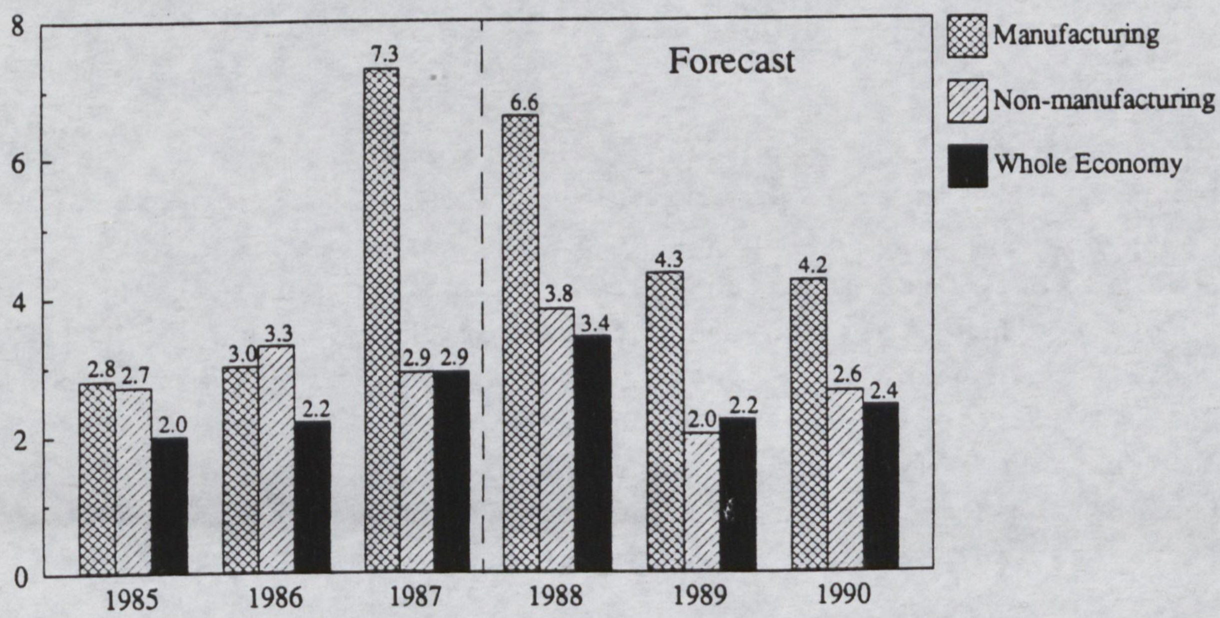
strong output growth. Productivity growth is thus likely to slow down in 1989 and 1990 as output growth itself moderates. Even so, we expect employers to maintain pressure for better productivity performance and to lay-off labour in manufacturing and curtail recruitment in the non-manufacturing sectors more quickly, relative to output, than in previous slowdowns in the 1960s and 1970s.

CHART T: LABOUR PRODUCTIVITY
(Percentage change on year earlier)



(10) FINANCIAL CONDITIONS

Yield curve and Funding

94. In the first half of 1988 the **yield curve** sloped upwards, a rare occurrence in the UK during the last three years. Short rates are currently well above long rates and this pattern is predicted to continue throughout the forecast period.

TABLE 29 : UK SHORT AND LONG INTEREST RATES

	3 month interbank (1)	20 year gilts (2)	Yield gap (2)-(1)
1985	12.2	10.6	-1.6
1986	11.0	9.9	-1.1
1987	9.7	9.5	-0.2
1988 Q1	9.0	9.4	0.4
Q2	8.2	9.2	1.0
Q3	11.0	9.5	-1.5
Oct 11	11.8	9.2	-2.6
1988	10.1	9.5	-0.6
1989	12.0	9.8	-2.3
1990	11.0	9.8	-1.3

95. A major factor holding down gilt yields is their scarcity. The combination of large PSDRs and the requirement not to overfund means that the Bank will have to buy in a significant portion of the outstanding stock of gilts. Life assurance and pension funds are particularly attracted to gilts as they help to match the profiles of their assets and liabilities. Companies may take the opportunity of the negatively sloped curve to substitute long term bonds for bank lending as a source of finance. This would enable LAPFs to invest the funds previously earmarked for gilts into a sterling asset of similar nature, but probably shorter maturity (although higher risk), rather than in domestic equities or overseas assets.

TABLE 30 : PSBR AND FUNDING (£ BILLION)

	PSBR	Net Gilt Sales to nbnbsps*	Nat Savings	Other Debt Sales to nbnbsps	Reserves	Other overseas finances†	Over funding+	Gross gilt sales to all sectors
1985-86	5.7	3.5	2.1	-1.4	-2.4	4.3	0.4	12.4
1986-87	3.4	3.8	3.4	-1.7	-3.8	5.3	3.5	16.6
1987-88	-3.5	4.1	2.1	-0.4	-11.1	2.8	1.3	13.9
1988-89	-11.8	-12.5	2.0	-2.1	0.2	1.0	0.4	-5.4
1989-90	-11.4	-13.4	1.0	-0.7	2.2	-0.5	0	-5.6
1990-91	-12.2	-14.5	1.0	-0.4	2.5	-0.8	0	-9.1

* non-bank non-building society private sector
† includes foreign currency finance
\+ overfunding on M4 definition

96. Table 30 shows the **financing of the PSBR**. National Savings are assumed to bring in £2 billion in 1988-89 and £1 billion each financial year thereafter. Gross gilt sales are negative every year from 1988-89. The combined effect of the PSDR forecast and the other funding assumptions is

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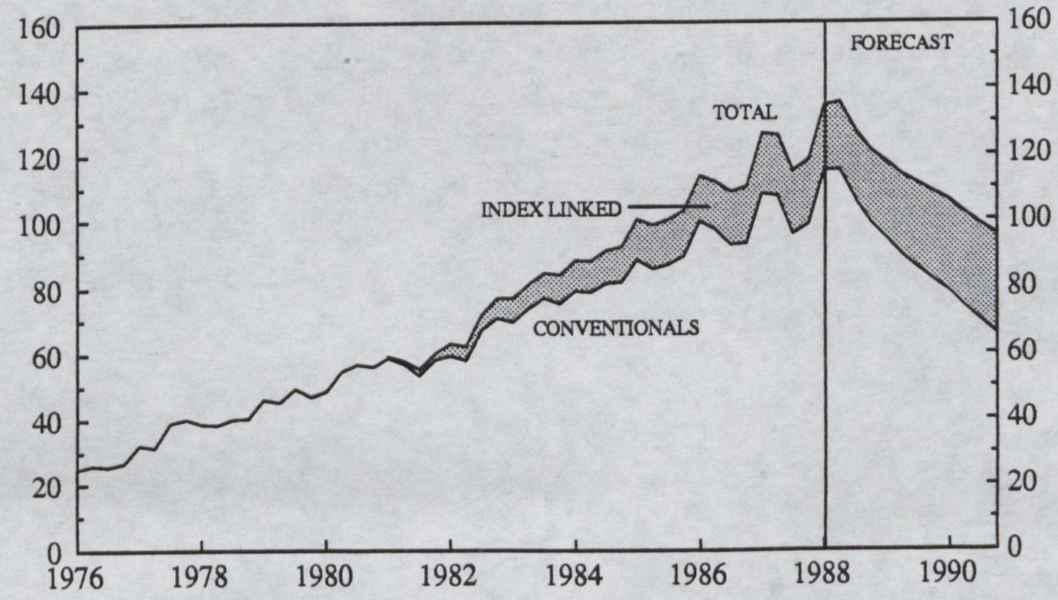
that the stock of outstanding gilts declines substantially. There may also be a sharp decline in the bill mountain, particularly if the buying in is concentrated on short gilts which are held mainly by banks and building societies. Buying in short gilts alters the redemption profile. This effect has been incorporated in the final column of Table 30.

CHART U : OUTSTANDING STOCK OF GILTS
(market value £bn)



Monetary aggregates and credit

97. **M0** has been growing at a rate well in excess of its current target. The increases in interest rates that have already taken place should soon start to slow down its growth rate. Indeed in the forecast M0's growth on a year earlier peaks in the current quarter at 8¼ percent and then falls back to around 3 per cent on average in 1989-90.

98. MO has grown on average by around 4 per cent less than money GDP since the mid 1970s, although there have been considerable short run fluctuations in velocity. Over the forecast period MO growth falls before money GDP growth following the recent increases in interest rates. By the end of the forecast the gap between the growth rates of MO and money GDP returns to its long run average level of 4 per cent.

TABLE 31 : MONETARY AGGREGATES AND CREDIT

(percent change on a year earlier)

	Money GDP	M0	M4
1985-86	9.3	4.0	13.5
1986-87	6.8	4.4	15.6
1987-88	10.0	5.1	15.6
1988-89	11.1	7.1	14.8
1989-90	8.7	2.3	11.9
1990-91	7.3	3.7	11.4

99. The growth rate of **M4** is expected to come down much more gently. This is largely because interest rates have an increasingly ambiguous effect on M4. Higher interest rates make bank and building society borrowing more expensive, but the household sector could well maintain its borrowing to avoid an unpleasantly sharp decline in spending and to help pay the interest on the current level of borrowing. The latter - a kind of household sector rescheduling - may make the banks and building societies a little nervous, and they will probably try to persuade clients in this position to cut their spending even further.

A2

(11) PUBLIC FINANCES

100. Table 32 compares the forecast with the FSBR and internal June forecast.

TABLE 32 : PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING (£ billion)

	1988-89			1989-90			1990-91		
	FSBR	June Fore-cast	Oct Fore-cast	FSBR	June Fore-cast	Oct Fore-cast	FSBR	June Fore-cast	Oct Fore-cast
General Government Expenditure	183	181	181	193	194½	194	201½	205½	206
General Government receipts	185	187½	190½	195	204	206½	205	216	221½
Assumed cuts in personal taxes (cumulative)				3½	2½	2	4½	3½	3½
GGBR	-2	-6	-9½	1	-7	-10½	1	-7½	-12
Public corporations' overseas and market borrowing	-1	-1	-2	-1	-½	-1	-1	0	-½
PSBR	-3	-7½	-12	-0	-7½	-11½	0	-7½	-12
(per cent of GDP)	(-¾)	(-1½)	(-2½)	(0)	(-1½)	(-2¼)	(0)	(-1½)	(-2¼)

PSBR

101. There has been a further large upward revision to the forecast of the PSDR in 1988-89, to £12 billion or 2½ per cent of money GDP. This compares with a forecast of £7½ billion in June and £3 billion in the FSBR. Much of the further revision is the result of higher than expected economic activity. Table 33 summarises the main changes to the forecast since the Budget and June. The forecast makes the working assumption that the PSDR excluding privatisation proceeds will be the same, as a percentage of GDP, in 1989-90 and 1990-91, as forecast for 1988-89.

102. If the forecast is correct the budget surplus for 1988-89 will exceed the surplus of 1¼ per cent of GDP achieved in 1969-70 and be the largest recorded in the period since records of the PSBR began in 1952. Excluding privatisation proceeds however the 1988-89 surplus will be the same as that in 1969-70.

TABLE 33 : MAIN CHANGES TO THE PSBR FORECAST FOR 1988-89

	£ billion	
	Changes since	
Higher General Government Receipts	FSBR	June
- higher PAYE and NICs reflecting higher wages and salaries, which are not yet fully reflected in the national accounts data;	2.0	2.0
- North Sea revenues lower than in June due to Piper Alpha and lower prices, but still a little up on FSBR;	0.1	-0.2
- stamp duty up on FSBR, reflecting higher house prices and stock market turnover, but down a little on June;	0.5	-0.1
- higher VAT and specific duties mainly reflecting higher consumer spending;	1.9	0.9
- higher interest receipts (largely reflecting removal of presentational adjustments in Budget forecast);	0.7	-
- higher ECGD trading deficit than in the FSBR on the assumption of no refinancing of loans but not as high as in June;	-0.4	0.2
- higher other receipts	0.6	0.2
TOTAL RECEIPTS	5.5	3.0
Lower General Government Expenditure		
- lower programme spending, mainly on social security and local authority capital	-1.9	-1.7
- higher privatisation proceeds	-1.0	-0.1
- changes to other adjustments largely reflecting switch of PC borrowing from market to central government	0.8	1.3
TOTAL GGE	-2.1	-0.4
Lower Public Corporations' market borrowing	-1.0	-1.0
TOTAL CHANGE IN PSBR FORECAST	-8.6	-4.4

Public Expenditure

103. **The planning total excluding privatisation proceeds** could fall in real terms in 1988-89, following zero growth in 1987-88. This reflects a number of factors including a deceleration in the growth of social security spending, a (temporary) fall in net EC contributions, improved nationalised industry performance, high local authority capital receipts and a squeeze on cash limited expenditure from higher than expected inflation. Some of these forces could be less strong from now on.

B2

However, with inflation assumptions for the Survey below those now forecast, it is possible that 1989-90 will see a further real squeeze on cash limited spending.

104. Table 34 compares the forecast of the planning total in cash terms with the PEWP and Survey Baseline. The main changes from the June forecast are lower social security expenditure and higher local authority capital receipts in the next two years. Local authority current spending is still seen as the largest potential claim on the Reserve. Taking defence and health together, about three-quarters of the forecast overspend in cash terms in 1989-90 and 1990-91 on existing plans is attributable to pay. Forecast overspending on other central government programmes is consistent with some future increase in provision for investment in roads, prisons etc.

TABLE 34 : PLANNING TOTAL EXCLUDING PRIVATISATION PROCEEDS

	1988-89	1989-90	1990-91
<u>£ billion current prices</u>			
1988 FSBR	161.8	172.1	181.1
Forecast	159.9	173.8	187.6
<u>Real growth %</u>			
1988 FSBR	2½	2¼	1¾
Forecast	-¾	2½	2¾

<u>Local authorities</u>

105. With the ending of grant penalties **local authority current spending** may rise relatively quickly in 1989-90 - the forecast has an underlying increase of 4 per cent in real terms. Some of this may represent spending brought forward from later years, and a smaller real increase of about 1 per cent is forecast for 1990-91. This summer's grant settlement for 1989-90 was for a 4¼ per cent increase in total cash grant. This is likely to be well below the general rate of inflation and the rate of increase of LA current spending. But if authorities run down balances to finance spending, average rate poundage increases of around 7½ per cent are in prospect, much the same increase as in 1988-89. For 1990-91, the first year of the Community Charge in England, it is assumed that the growth of grant and non-domestic rates together, will be such as to leave the Community Charge per head unchanged in real terms from LA domestic rates per head in the previous year. The forecast is that this will involve a real increase in grant of 3-4 per cent.

106. The forecast assumes that local authority capital receipts will be maintained as best at the level expected for 1988-89. On this basis the

LABR as a percentage of GDP may on average be a little lower over the period 1988-89 to 1990-91 than in the three previous years.

Public corporations

107. Against a background of falling nationalised industry prices in real terms, slower growth of economic activity, heavy capital investment programmes, less scope for productivity gains than in the past 10 years, and large restructuring costs for the coal industry, nationalised industries remaining in the public sector are not likely to achieve the reductions in external finance which have been a feature of recent years. In addition, by comparison with the PEWP and Survey baseline, public expenditure will be increased by the loss of the negative EFLs of those industries due to be privatised. But this "EFL offset" is partially offset on the receipts side of the public finances by government dividend and interest receipts from residual equity and debt holdings respectively in the newly privatised companies. By 1990-91 these might amount to only £¾bn, but they could be approaching £1 billion in the year after that.

C2

TABLE 35 : FORECAST ADDITIONS TO EXPENDITURE PLANS

£ billion

	1988-89		1989-90		1990-91	
	PEWP 1988	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve	Survey Baseline	Forecast Claims on Reserve
Allocated to programmes						
1. Social Security (including HB)	46.9	-0.6	49.5	-0.1	52.0	1.7
2. Defence	19.2	0.2	20.0	0.7	20.6	1.5
3. Health	21.8	1.1	22.9	2.0	24.0	3.2
4. Net EC	0.8	0.2	1.5	0.6	1.3	0.6
5. Other CG	29.3	0.2	31.1	1.4	32.0	3.3
6. LA current (excluding HB)	34.9	1.4	35.2	4.1	36.2	5.6
7. LA capital	4.0	-0.6	3.9	-0.5	3.8	-0.4
8. Nationalised industries	0.7	-0.3	-	0.5	-0.4	1.4
9. Other PCs	0.8	-	1.0	-	1.2	-
10. Total programme	158.3	1.6	165.1	8.7	170.7	16.9
11. Privatisation proceeds	-5.0	-1.0	-5.0	0.0	-5.0	0.0
12. **Expenditure met from existing reserve**						
(i) allocated to programme baseline	0.0	0.6	0.0	7.0	0.0	10.5
(ii) unallocated	3.5	0.0	7.0	0.0	10.5	0.0
13. **Underspend (-) Required Addition to Reserve (+)**	0.0	-2.9	0.0	1.7	0.0	6.4
PLANNING TOTAL	156.8	153.9	167.1	168.8	176.2	182.6*

* Forecast of the planning total outcome

108. General government **gross debt interest payments** are forecast to be a little higher in 1988-89 than in 1987-88 because the need to finance the rise in the foreign exchange reserves has continued to push up the gross stock of debt outstanding. After 1988-89, with large repayments of debt by general government and a partial unwinding of the rise in the reserves assumed, gross interest payments fall sharply, particularly in 1990-91.

109. The ratio of GGE (excluding privatisation proceeds) to money GDP is forecast to fall by about two percentage points in 1988-89. It is forecast to fall further, by just over one percentage point, over the next two years.

TABLE 36 : RATIO OF GGE EXCLUDING PRIVATISATION PROCEEDS TO MONEY GDP (per cent)

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
1988 FSBR	44½	43¾	41¾	41¾	40¾	40
October forecast	44½	43¾	41¾	39½	38¾	38½

110. Table 37 compares the forecast of GGE excluding privatisation proceeds with earlier internal forecasts, successive PEWPs and the 1988 FSBR. The October forecast is little different from the June forecast in current prices, but somewhat lower in real terms.

TABLE 37 : PAST AND CURRENT FORECASTS OF GGE EXCLUDING PRIVATISATION PROCEEDS (£ billion)

Forecast	1987-88 Current Prices	1987-88 Real Terms*	1988-89 Current Prices	1988-89 Real Terms*	1989-90 Current Prices	1989-90 Real Terms*	1990-91 Current Prices	1990-91 Real Terms*
PEWP 1986	174	168	179	168	-	-		
Oct 1986	178	171	188	172	-	-		
PEWP 1987	179	172	185	172	193	174		
Oct 1987	178	170	190	172	203	175		
PEWP 1988	178	170	188	173	198	176		
Jan 1988	177	169	188	171	200	173		
FSBR 1988	177	169	188	171	198	174	207	175
June 1988	177	169	187	168	200	171	210	173
Oct 1988	177	168	187	166	199	167	211	169

* 1986-87 prices

(c) Receipts

111. General government receipts are forecast to rise by 9½ per cent in 1988-89, about a percentage point and a half less than the growth of money GDP. Without the budget tax reductions receipts would probably have grown at a similar rate to GDP. Non-North Sea taxes and NICs are forecast to grow faster than total receipts - non-North Sea corporation tax (up 22 per cent), capital taxes (up 30 per cent) and VAT (up 14 per cent) are forecast to grow particularly fast. But with the peak month's for corporation tax receipts being October and January (accounting for more than 50 per cent of the annual total), the corporation tax forecast is still very uncertain. The total tax burden may fall by around ½ percentage point in 1988-89, but,

D2

with a sharp fall in North Sea revenues, the fall in the non-oil tax burden will be less.

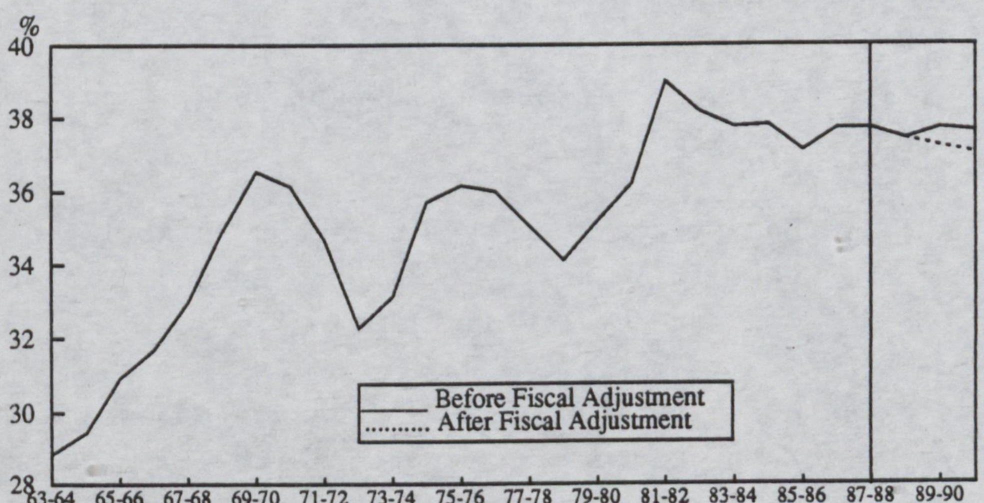
112. The growth of general government receipts (before fiscal adjustment) is forecast to be lower in 1989-90 and 1990-91, around 8½ per cent and 7 per cent respectively. The deceleration in 1989-90 mainly reflects lower growth of expenditure and incomes, and occurs despite a further rise of around 25 per cent in non-North Sea corporation tax - the delayed effect of buoyant 1987 and 1988 profit growth. A further fall in North Sea revenues is forecast and the rapid growth of capital taxes is expected to end. The ratio of total taxes and NICs (before fiscal adjustment) to money GDP is forecast to change very little in 1989-90 and 1990-91 from the level forecast for 1988-89. After fiscal adjustment the total and non-North Sea tax burdens may edge down a little, by about ½ percentage point over two years.

TABLE 38 : NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP

	1986-87	1987-88	1988-89	1989-90	1990-91
MTFS					
(a) pre-fiscal adjustment	37.5	37.7	37.7	37.7	
(b) post-fiscal adjustment	37.5	37.7	37.7	36.9	36.6
October Forecast					
(a) pre-fiscal adjustment	37.7	37.7	37.4	37.7	37.6
(b) post-fiscal adjustment	37.7	37.7	37.4	37.2	37.0

CHART V : NON-NORTH SEA TAXES & NICS

(As a Percentage of non North Sea GDP)



ANNEX A: RPI OUTLOOK

1.1 Table 1 sets out the detailed changes in nationalised industry prices assumed for domestic consumers over the years to 1988Q4, 1989Q4 and 1990Q4, and Table 2 gives real price increase over a run of financial years.

TABLE 1: NOMINAL NATIONALISED INDUSTRY PRICE INCREASES FOR CONSUMERS

(per cent)	Year to 1987 Q4	Year to 1988 Q4	Year to 1989 Q4	Year to 1990 Q4
Post	3.0	6.1	0.0	6.9
Rail	5.7	6.6	9.7	7.8
Electricity	- 0.5	8.6	6.0	5.4
Coal and coke	0.5	2.4	1.3	1.2
Bus	6.7	6.9	8.1	6.7
Water	6.9	8.1	9.0	6.0

TABLE 2: REAL NATIONALISED INDUSTRY PRICE INCREASES

(percent changes on previous financial year; weighted average for consumers and industry)

	Average 1983-84 - 1985-6	1986-87	1987-88	1988-89	1989-90	1990-91
British Coal	0.8	- 3.5	- 3.4	- 4.0	- 4.5	- 3.3
Electricity	- 3.0	- 2.0	- 3.8	0.7	- 0.4	0.6
BSC	- 1.4	- 2.0	- 2.9	- 3.4	- 4.5	- 2.4
Post Office	- 3.0	- 2.1	- 0.3	- 1.9	- 3.7	- 0.5
Water	1.9	4.5	2.3	2.0	2.5	1.0
LRT	- 6.1	2.2	2.1	4.6	5.2	5.3
British Rail	- 3.1	2.7	1.5	0.8	0.2	1.2

1.2 Increased nationalised industry prices will, by themselves, raise RPI inflation in 1988Q4 by ¼ per cent compared with inflation in 1987Q4. Other influences underlying the RPI inflation outlook to 1988Q4 are:

(i) **Mortgage interest payments** add 1¼ per cent to inflation in 1988Q4.

(ii) **Gas prices** rose by 6 per cent in April after a 4½ per cent fall in 1987. (The difference is worth about ¼ per cent on total RPI inflation).

(iii) An 8½ per cent rise in average **domestic local authority rate poundage** compared with 7¾ per cent last year (the difference is worth less than 0.1 per cent on inflation).

E2

1.3 All the above factors put upward pressure on inflation in the year to 1988Q4. Moreover, they are augmented by a steady rise in inflation in **other private sector prices**, which are projected to rise by 4¾ per cent in the year to 1988Q4, compared to 4¼ per cent in the year to 1987Q4. There was a step increase in the inflation rate in 1988Q2, mainly due to Budget measures. Other private sector price inflation rises further to 5.0 per cent by end-1989, largely because of rising costs and import prices. Only food and petrol prices rise more slowly to 1988Q4 than they did in the year to 1987Q4.

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B

CONFIDENTIAL

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000

Direct Dialling 01-270 ....

Sir Peter Middleton KCB
Permanent Secretary

Paul Gray Esq
10 Downing Street
LONDON
SW1

28 October 1988

Dear Paul,

INDUSTRY ACT FORECAST

I attach a copy of the near-final version of the Industry Act Forecast, which is to be issued as a press notice on Tuesday.

I am also sending a copy to Brian Griffiths.

Yours,
Simon

S D H SARGENT
Private Secretary

DRAFT

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-270 5238
Facsimile: 270 5244
Telex: 9413704

1 NOVEMBER 1988

ECONOMIC PROSPECTS FOR 1988

The Industry Act (1975) requires the Government to publish economic forecasts twice a year. This forecast reviews economic developments so far this year and outlines the prospects for 1989. The main details of the forecast were given to the House of Commons this afternoon by the Chancellor of the Exchequer.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-270 5238

ECONOMIC PROSPECTS FOR 1989

Summary

GDP is forecast to grow by 3 per cent in 1989, following growth of 4½ per cent this year. Inflation is expected to peak in mid-1989, and fall back by the end of the year.

Assumptions

2. The forecast assumes that fiscal and monetary policies are operated within the framework of the Medium Term Financial Strategy (MTFS). It assumes that both North Sea oil prices and sterling remain close to their recent levels. The Public Sector Debt Repayment (PSDR) is expected to be about £10 billion in the current financial year, equivalent to 2¼ per cent of GDP. The forecast assumes a similar PSDR in 1989-90 as in 1988-89; the actual PSDR for that year will, as usual, be set in the Budget.

World economy

3. GNP in the major industrialised countries has grown faster than expected and is forecast to rise by 4 per cent in 1988; growth is forecast to slowdown slightly, to 3 per cent, in 1989. World trade in manufactures has also picked up strongly and should grow by 8½ per cent in 1988. Inflation in the major industrialised countries is expected to remain low.

Demand and activity

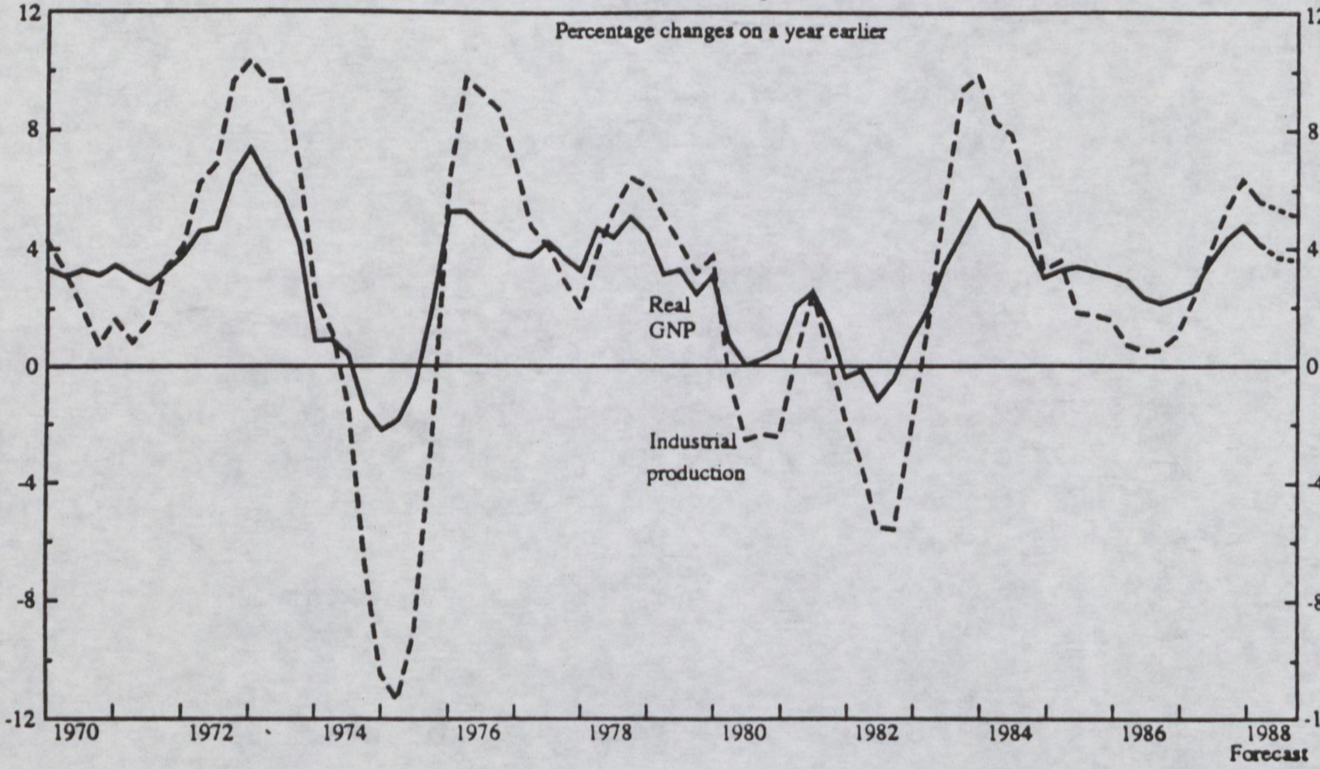
4. The economy has grown strongly over the past year, though major inconsistencies in the official statistics (discussed in the Annex) make it difficult to assess the precise extent of growth. The average measure of GDP is likely to grow by about 4½ per cent in 1988, with manufacturing output rising by 7 per cent. Non-oil export volumes have recovered strongly after falling in early 1988. Domestic demand growth, which has risen sharply over the past year as investment has boomed and consumers' expenditure has continued to grow rapidly, is expected to moderate in 1989.

UK trade and current account	5. The UK current account is forecast to be in deficit by £13 billion in 1988. This is considerably larger than forecast at Budget time, due mainly to stronger growth in both investment and consumption. The current account deficit should show some reduction during 1989.
Inflation	6. Retail price inflation is expected to be 6¼ per cent in the fourth quarter of 1988. It is likely to rise further in the first half of 1989 before falling to 5 per cent in the fourth quarter of 1989. Unit labour costs have risen slowly over the past year, since productivity has continued to grow at a very fast rate, especially in manufacturing. Wage settlements need to moderate to keep growth of unit labour costs in check as output growth slows down.
Labour market	7. Employment has increased rapidly over the past year. Unemployment fell by 500,000 in the year to September. Unemployment should continue to fall over the next year, though probably at a slower rate than recently.

World economy

Recent developments	8. Since the recession in 1982 the major seven OECD countries have experienced six years of steady growth, with real GNP growing at an average rate of 3½ per cent a year and the unemployment rate falling by 2½ percent.
	9. Growth in these countries is estimated to have increased to over 4 per cent over the past year. Exports have grown strongly, especially to those developing countries which benefitted from the rise in real commodity prices in 1987 and the first half of 1988. Greater exchange rate stability following the Louvre Accord and rising capacity utilisation have strengthened business confidence and contributed to a resurgence of investment.

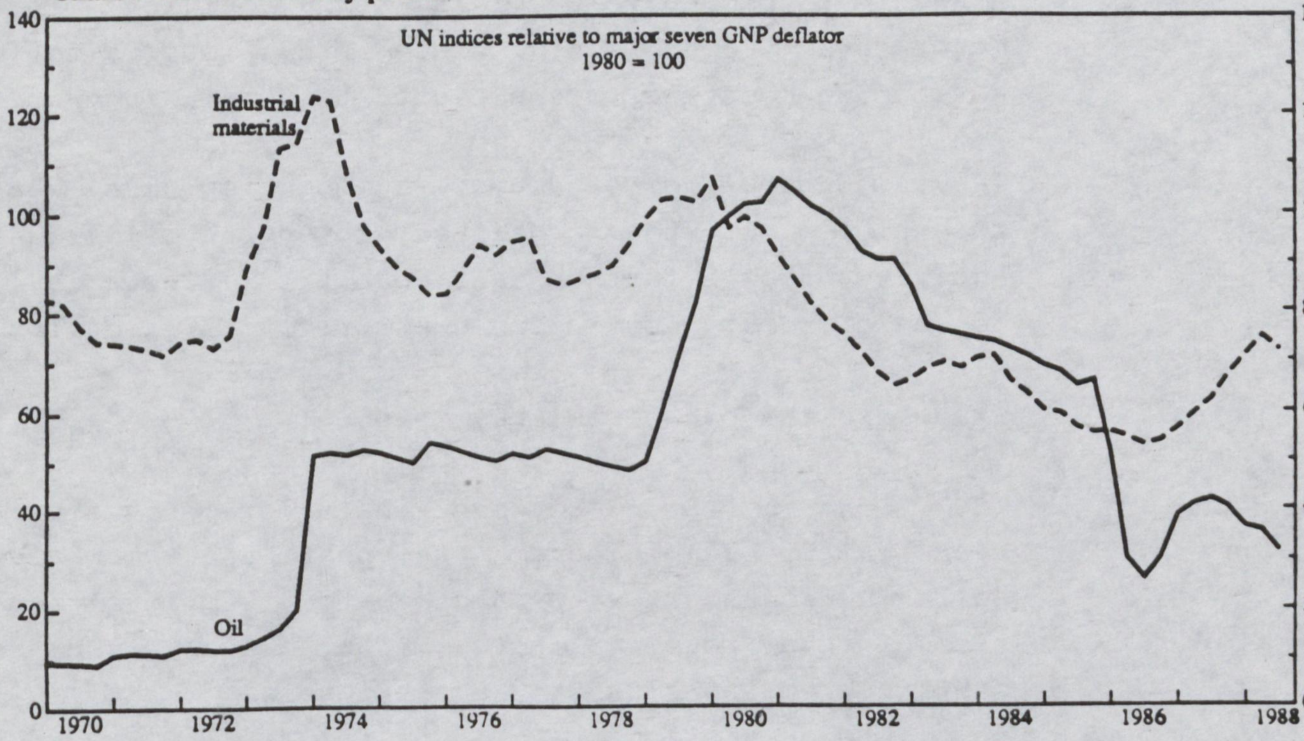
Chart 1 Major seven economies' real GNP and industrial production



10. In contrast to 1984, when the strength of activity in the major seven mainly reflected developments in the United States, the latest spurt in activity has been worldwide. This is reflected in the pick up in total trade and in world trade in manufactures, both of which are rising at around 9 per cent a year. All the major seven countries are currently experiencing an investment boom.

11. Although non-oil commodity prices rose by around 20 per cent in real terms over the last year, oil prices fell by rather more. The net effect on aggregate costs in industrial countries is likely to be small. Consumer price inflation in the major seven countries has remained around 3 per cent.

Chart 2 Real commodity prices



Forecast

12. Table 1 shows the forecasts for world trade and activity and inflation in the major seven countries. Real GNP in the major seven countries is expected to grow a little less strongly in 1989 than in 1988, with some slow-down in consumer spending.

Table 1 World economy

	Percentage changes on a year earlier		
		Forecasts	
	1987	1988	1989
Major seven countries[1]:			
Real GNP	3½	4	3
Real domestic demand	3½	4	3
Industrial production	3½	5½	4½
Consumer prices	3½	3	4
World trade, at constant prices			
Total imports	5	9	6½
Trade in manufactures	5½	8½	7½

[1]US, Japan, Germany, France, UK, Italy and Canada

13. Growth in world trade may also slow a little in 1989, but probably by less than activity in the major seven countries, since the imports of some developing countries are expected to remain buoyant.

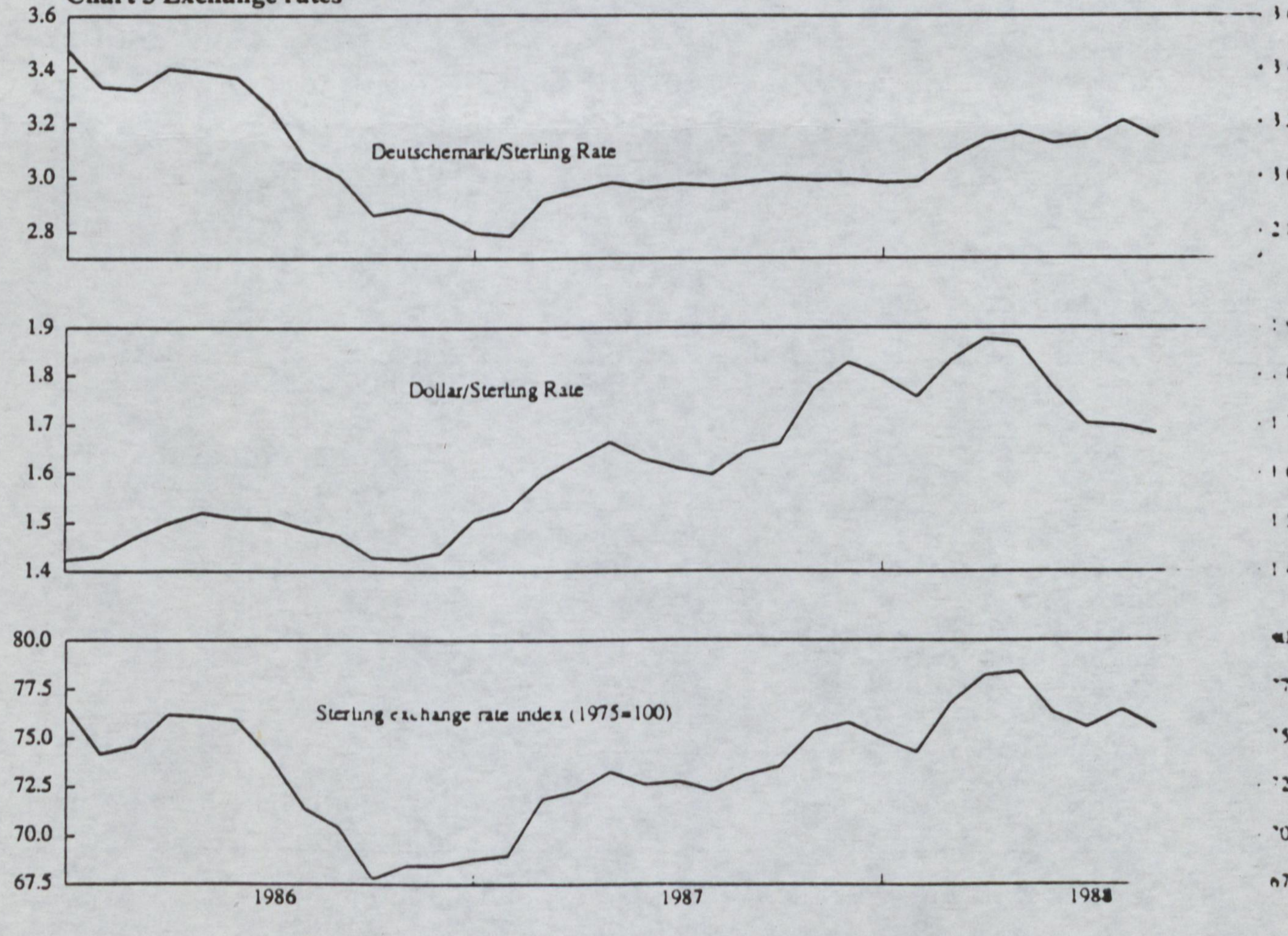
14. Spot prices of non-oil commodities have weakened recently, but the continued strength of industrial activity makes a further fall doubtful. There is likely to be a modest rise in consumer price inflation in 1989.

Trade and the balance of payments

Exchange Rates

15. Exchange rates between the major currencies have been fairly stable over the past eight months. The dollar/Deutschemark rate is close to its level at the time of the Louvre Accord. The forecast assumes that sterling remains close to recent levels.

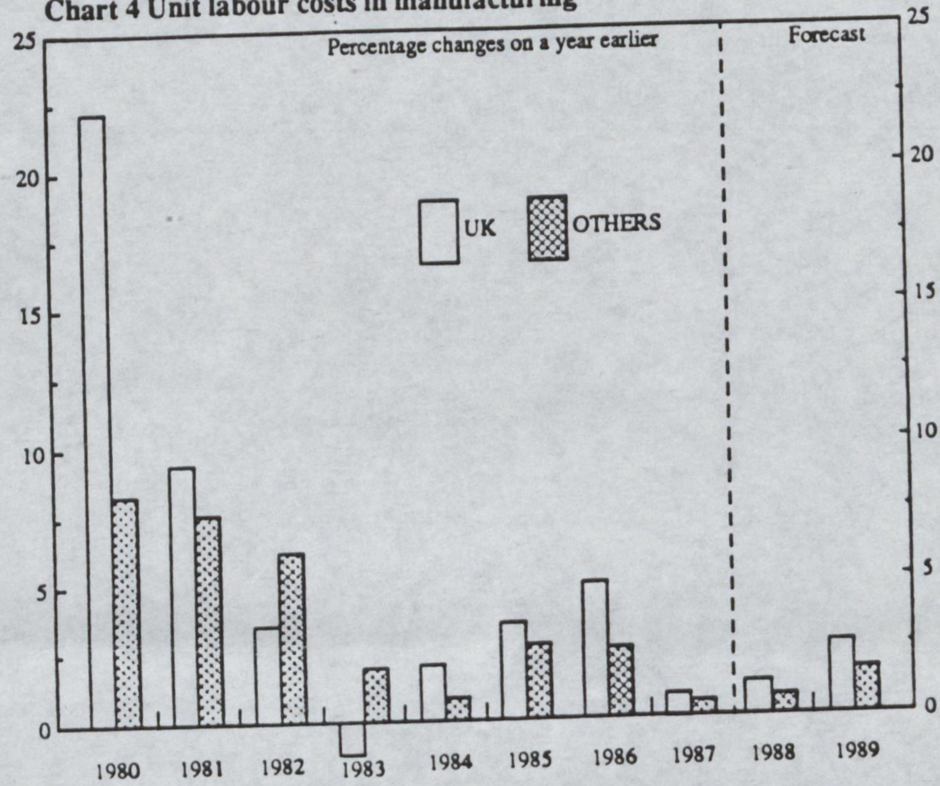
Chart 3 Exchange rates



Relative costs and prices

16. Manufacturing unit labour costs in the UK have risen only slightly over the past year, but still marginally faster than the average of other major industrial countries. Nonetheless, most of the large gains in labour cost competitiveness in 1986 has been maintained.

Chart 4 Unit labour costs in manufacturing

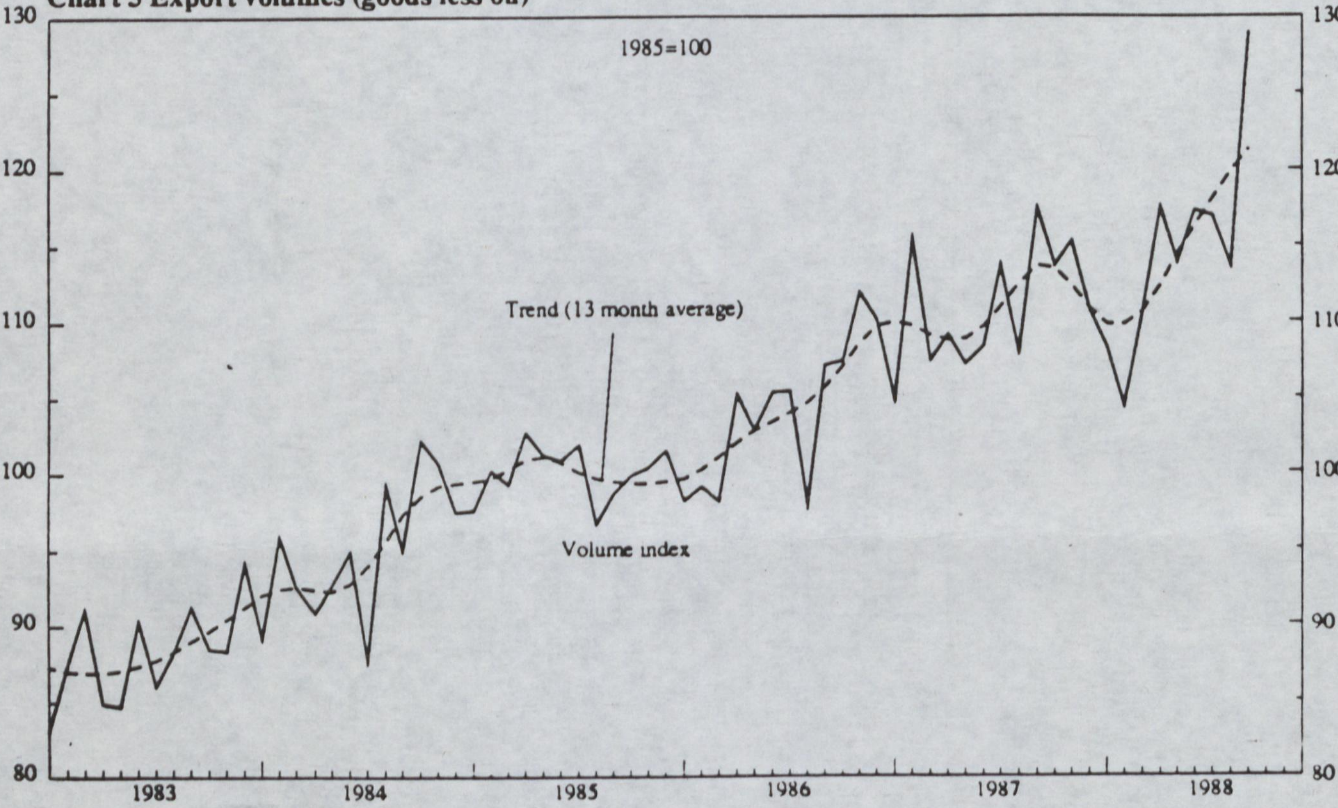


17. It is the rapid increase in domestic demand that explains most of the deterioration in the current account. Recent CBI Surveys suggest that some industries have been facing capacity constraints, so it is likely that part of the unexpected domestic demand has been satisfied by imports. Some potential exports may also have been diverted to the domestic market.

Trade volumes (goods other than oil)

18. After erratically low figures in early 1988, the volume of UK manufactured exports has since risen as world trade has continued to expand. In the third quarter of 1988 the volume of exports of manufactures was around 8½ per cent higher than a year earlier. Manufactured export volumes, are forecast to rise by nearly 9 per cent in 1989, in line with the projected growth of world trade.

Chart 5 Export volumes (goods less oil)



19. Chart 6 shows how after decades of decline, the UK's volume share of world trade in manufactures has changed little since 1981. Indeed, over the past two years, exports of manufactures have grown a little faster than world trade and the UK's share has risen slightly.

Chart 6 Share of UK exports in total world trade in manufactures

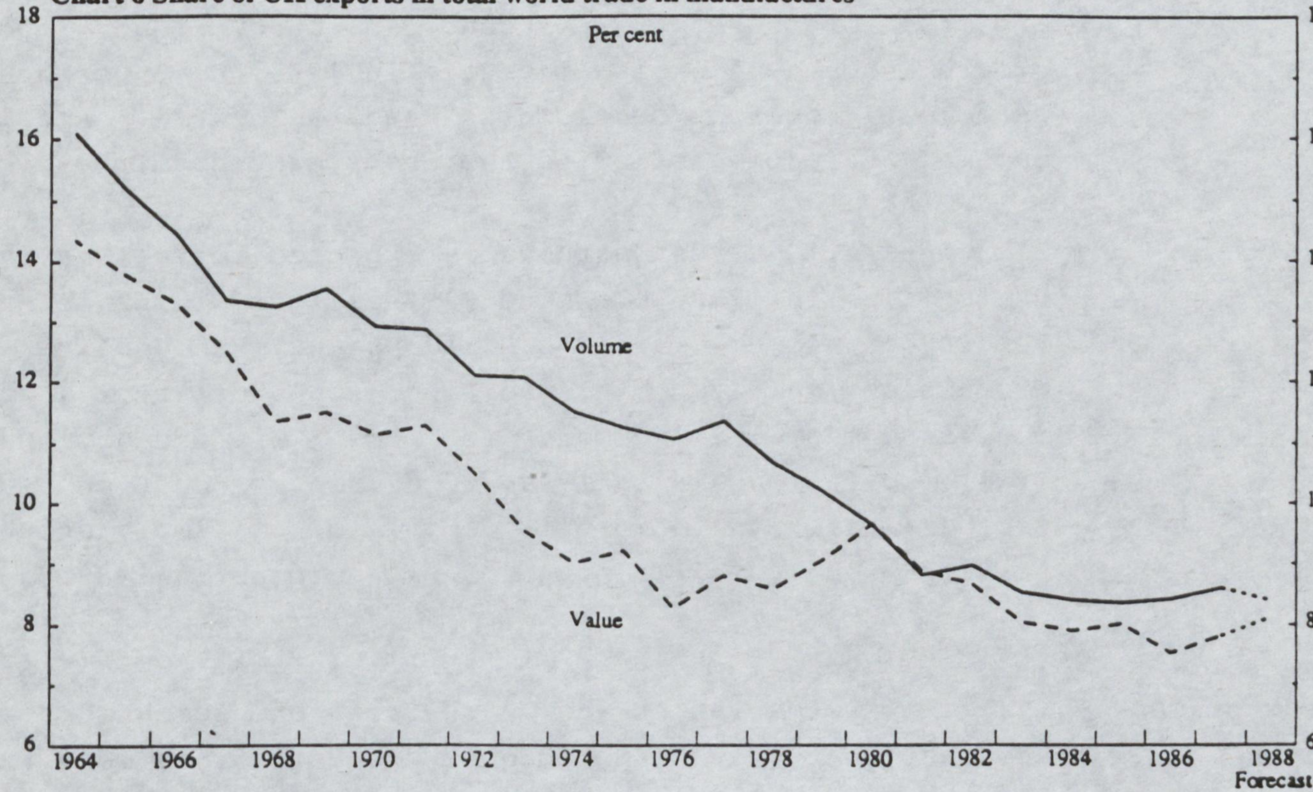
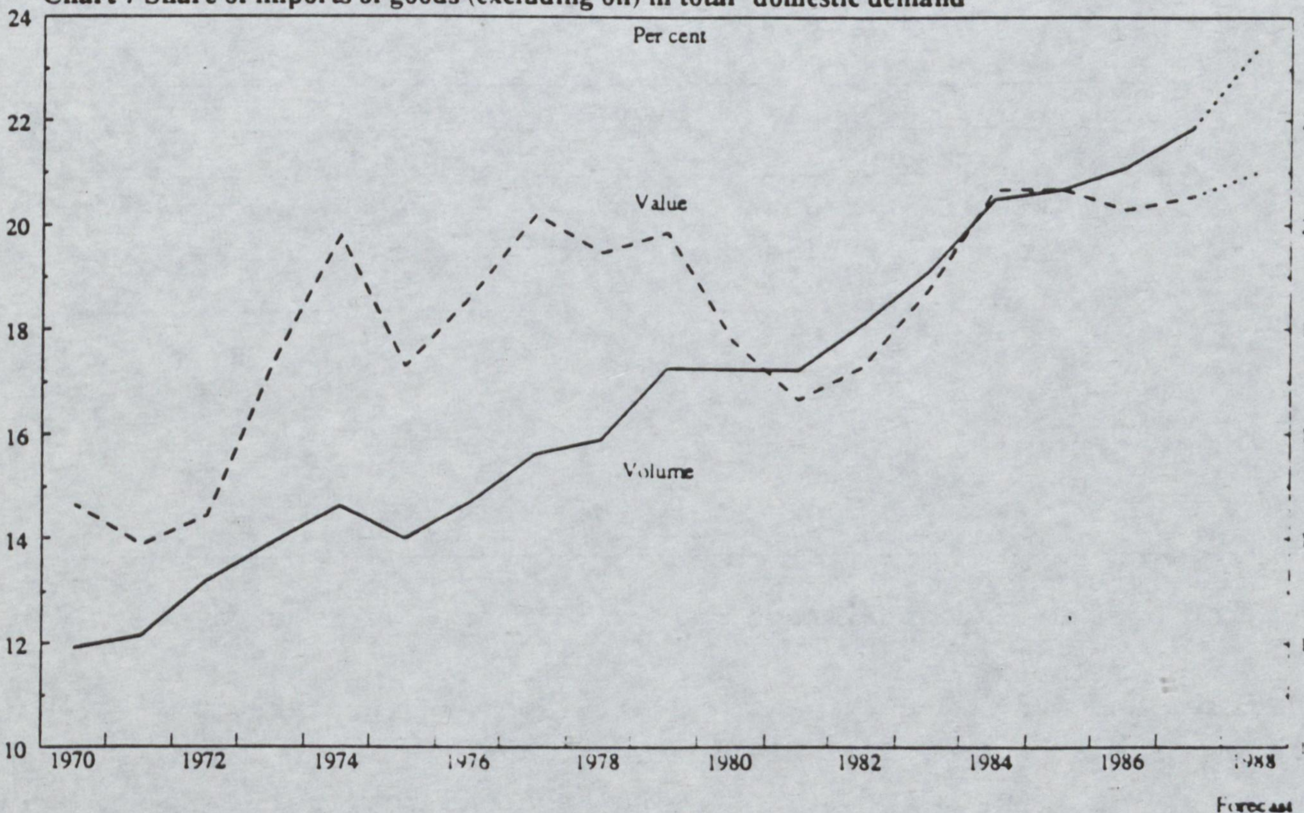


Chart 7 Share of imports of goods (excluding oil) in total domestic demand



20. Non-oil imports have risen very rapidly this year reflecting the strength of domestic demand and capacity shortages in some industries. Non-oil imports are expected to grow by 13½ per cent in 1988. But import growth should slow significantly in 1989, to 5 per cent, as domestic demand decelerates and as extra capacity becomes available following the investment boom.

Oil trade

21. The oil trade surplus is expected to fall by over £1½ billion in 1988 to around £2½ billion. This is the result of lower sterling oil prices, a decline in production (mainly due to the Piper Alpha disaster), and increased domestic demand for oil. Oil production is likely to fall again in 1989. Declining production and a further rise in domestic demand for oil imply another fall of about £½ billion in the oil surplus in 1989.

Trade prices and the terms of trade

22. The terms of trade have improved somewhat over the past year, with the higher exchange rate more than offsetting the effects of falling oil prices. The terms of trade are expected to remain unchanged between 1988 and 1989.

Table 2: Visible trade

	Percent changes on previous year					
	All goods			Goods less oil		
	Export volume	Import volume	Terms of trade[1]	Export volume	Import volume	Terms of trade[1]
1987	5	7	1	6½	8	1
1988 Partly forecast	2	12½	2	5	13½	2½
1989 Forecast	6½	5	1½	8½	5	½

[1] The ratio of UK export average values to import average values.

Invisibles and overseas assets

23. The surplus on invisibles for 1988 is likely to be around £2 billion lower than in 1987. This is largely due to a fall in the balance on services. UK tourists have been spending more abroad and the surplus on financial services has come down due to lower net premiums on insurance.

24. Net earnings from interest, profits and dividends are expected to be unchanged from last year. The deficit on transfers is also expected to be unchanged in 1988 with lower payments to the European Community offset by higher bilateral aid.

25. The invisibles surplus should rise in 1989 as the balance on services recovers and payments abroad by North Sea companies continue to fall. These improvements will be partially offset, however, by increased payments to the European Community.

26. In 1987 the value of the stock of UK net overseas assets fell by £24 billion to £90 billion by the end of the year, mainly due to revaluations following the fall in the US dollar.

Current account 27. The current account is estimated to have been in deficit by just under £10 billion in the first 9 months of 1988 (though the large overseas balancing item suggests that this may overstate the actual deficit). The forecast for the year as a whole is for a deficit of £13 billion (about 2¼ per cent of GDP).

28. The forecast for 1989 is for a slightly smaller current account deficit. The expected slowdown in domestic demand growth will help reduce the current account deficit, but this will be partially offset by the smaller oil surplus and the fact that world trade growth is projected to be somewhat slower.

Table 3: Current account

	£ billion				
	Manufactures	Other	Oil	Invisibles	Current balance
1987	- 7½	-7	4	7½	- 2½
1988 Partly forecast	-13½	-7½	2½	5½	-13
1989 Forecast	-12	-7	2	6	-11

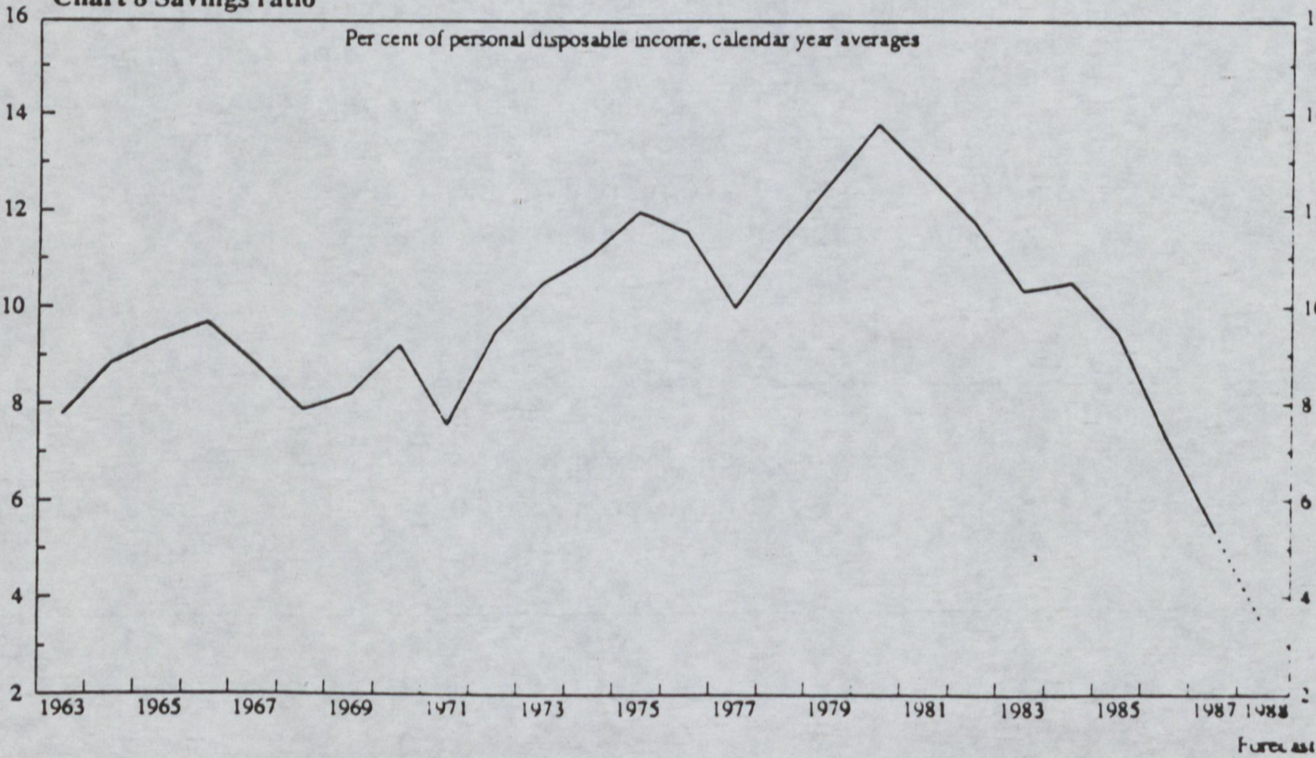
Demand and activity

Personal sector expenditure

29. Consumer spending is estimated to have risen by 5½ per cent in 1986 and by 5 per cent in 1987. This is considerably faster than real personal disposable income, and the recorded savings ratio fell from an estimated 9½ per cent in 1985 to 5½ per cent in 1987. In 1988 consumer spending is likely to increase by about 5½ per cent, a similar rate to that in 1986 and 1987. The savings ratio is likely to have fallen further, to about 3½ per cent.

30. Several factors may explain the substantial fall in the savings ratio since 1980. Most important has been greater confidence in the future, with people having lower inflation expectations and greater wealth, (especially following the large rise in house prices). In addition, employers' contributions to pension funds have been falling [relative to personal disposable income] in recent years as companies have reacted to the surpluses that many funds have been running; this scores in the official statistics as lower personal income and savings.

Chart 8 Savings ratio



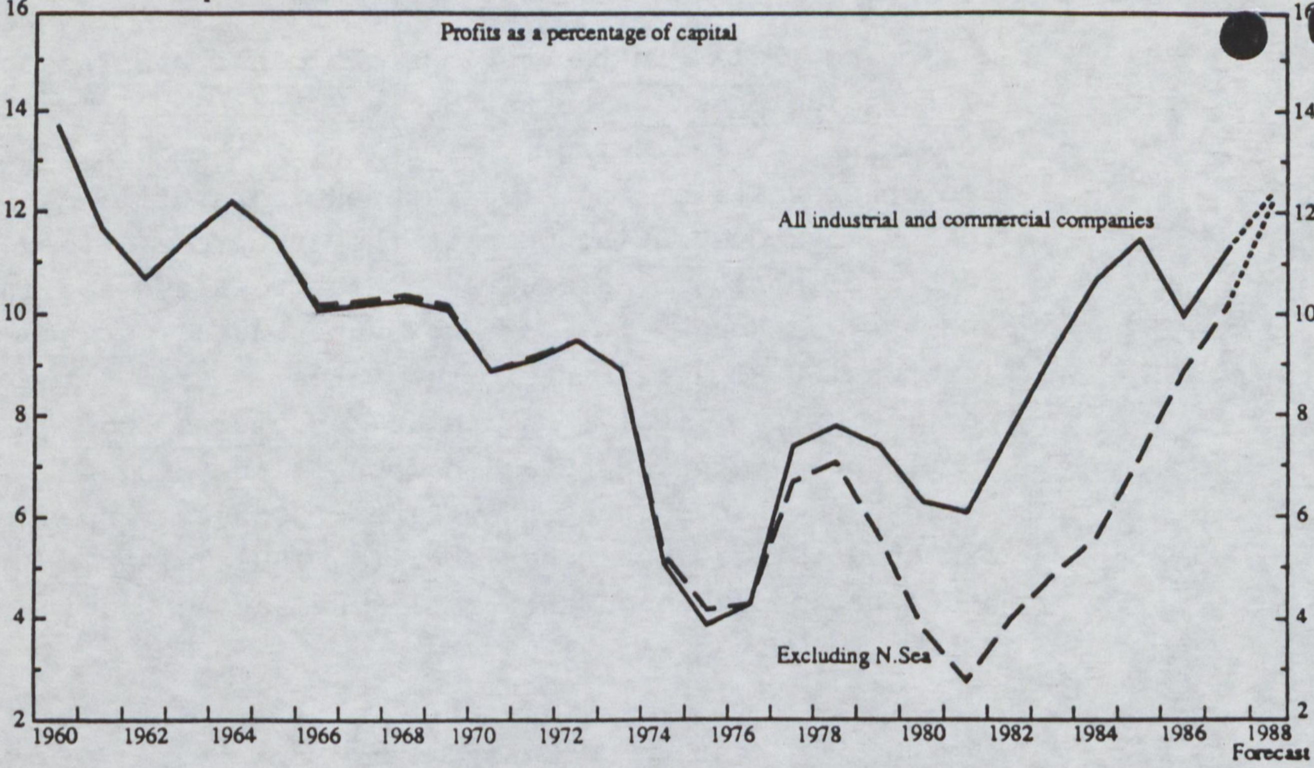
31. The fall in the savings ratio has been associated with an increase in borrowing - particularly mortgage borrowing - following the ending of mortgage rationing and other restrictions. But householders will not wish to go on accumulating debt at the same rate as recently. Levels of borrowing are already high relative to income. Moreover, households are now substantial net payers of interest. Higher interest rates are therefore particularly likely to reduce consumer spending. This should be reinforced by a slowdown in the growth of house prices and, hence, housing wealth. Consumer spending is expected to rise by 3½ per cent in 1989 with a marked deceleration through the year. The savings ratio should recover slowly during 1989.

32. The housing market has been particularly buoyant over the past year, though the fall in building society mortgage commitments in August and September suggests that the pressure of demand is easing. Nonetheless, for 1988 as a whole private sector investment in dwellings and improvements is likely to increase by 16 per cent compared to 5½ per cent in 1987. Housing investment is unlikely to rise significantly further in 1989.

Company incomes and expenditure

33. The net rate of return of non-North Sea industrial and commercial companies (ICCs) rose for the sixth successive year in 1987, back to levels not seen since the late 1960s. The net rate of return of manufacturing companies rose to just over 9 per cent in 1987, again the highest level since the late 1960s. With continued strong profit growth likely in 1988 net rates of return are expected to improve further.

Chart 9 Companies' net rates of return



34. Developments so far in 1988 confirm the investment boom predicted by recent CBI and DTI Investment Intentions Surveys. Manufacturing investment (including leased assets) rose 13 per cent higher in the year to the first half of 1988, while private non-manufacturing investment rose 15 per cent. Business investment is expected to rise a little faster in 1988 than the June DTI Intentions Survey suggested. Further growth in business investment is expected in 1989. Recorded stockbuilding is expected to continue on only a moderate scale in 1988 and 1989.

Table 4: Gross fixed domestic capital formation

	£billion at 1985 prices 1987	Percentage changes on previous year 1987	Forecast 1988	1988
Business[1]	41.1	6½	13½	7½
of which: non-oil business	39.2	8½	13½	6½
manufacturing	10.1	5	18	10
Private dwellings[2]	16.5	7	13	2
General government	6.7	-3½	- 1½	6½
Total fixed investment	**64.2**	**5½**	**12**	**5½**

1 Includes investment by public corporations.
2 Includes purchase less sales of land by persons, companies and and public corporations, other than purchases of council houses.

Prospects for demand and activity

35. Growth of the average measure of GDP is expected to be around 4½ per cent in 1988. It could turn out to be even higher if, as seems likely, the expenditure measure is subsequently revised up. The slowdown in domestic demand, GDP is expected to rise more slowly in 1989.

36. North Sea output fell by some 3 per cent between the first half of 1987 and the first half of 1988, and is expected to decline further in 1988. In 1989 declining output in the North Sea may reduce GDP growth by ½ percentage point. Manufacturing output is forecast to rise faster than total non-North Sea GDP in both 1988 and 1989.

Table 5: Domestic demand and GDP

Percentage changes on a year earlier

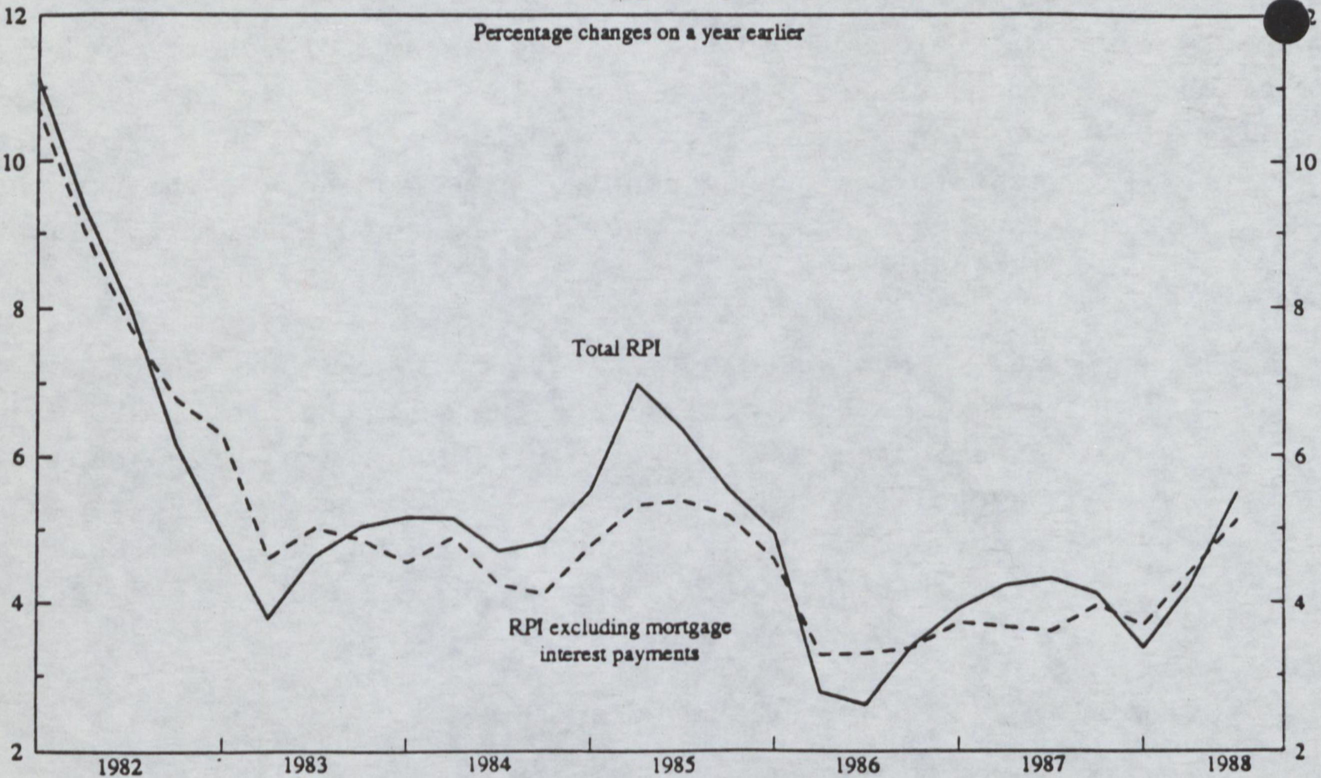
		Forecast	
	1987	**1988**	**1989**
Domestic demand	4½	6	3
Exports of goods and services[1]	5½(6½)	1½(3½)	5½(7)
Imports of goods and services[1]	7½(8)	12(13)	4½(4½)
Gross Domestic Product[1,2]	4 (4½)	4½(5)	3 (3½)
Manufacturing Output	6	7	4½

[1] Non-oil shown in brackets. [2] Average measure.

Inflation

37. The annual rate of RPI inflation has risen since early 1988, mainly as a result of the rise in mortgage interest rates. Chart 10 shows that, excluding mortgage interest payments (MIPs), the increase has been less pronounced, though it has risen from the low levels of 1986 and 1987 which were associated with the oil price fall.

Chart 10 RPI inflation: Total and total excluding mortgage interest payments



38. Total RPI inflation is likely to average 6¼ per cent in the fourth quarter of 1988; excluding mortgage interest payments (MIPs) the figure is expected to be 5 per cent. Producer price inflation has also edged up during 1988. Though higher than expected at Budget time, the underlying rate of increase in prices has been much lower than in periods of comparably fast demand and output growth in the 1970s.

39. The underlying increase in average earnings has risen from 7¾ per cent in August 1987 to 9¼ per cent in August 1988. The rise is mainly accounted for by higher settlements (especially in the public sector). But high overtime payments and performance related bonuses have also played an important part.

40. Despite high earnings increases, growth in manufacturing unit labour costs have been kept down by the rapid growth in productivity, and they are expected to rise by just over 1 per cent in 1988.

Prospects

41. The low growth in costs over the last two years has not been fully reflected in producer output prices. With fast growth demand, UK manufacturing industry has increased profit margins substantially. The projected slow down in demand and activity may mean that profit margins will show less growth in 1989. But slightly faster growth in unit labour costs (because of a likely cyclical slowdown in productivity growth) and increased costs of materials and fuels could, together, imply that producer output price inflation may rise by only a little less in 1989 than in 1988.

Table 6: Costs in manufacturing

	Percentage changes on previous year			
	Unit labour costs	Costs of[1] materials and fuel	Estimated total[2] unit costs	Output[1] prices
1986	5	-10½	2¼	4
1987	¼	5	1½	4½
1988 Partly forecast	¾	4	1¼	4¼
1989 Forecast	2½	1½	3¼	4¼

[1] Producer prices excluding food, drink and tobacco industries.
[2] Including costs of bought-in services.

42. Retail price inflation could rise further during the first half of 1989 before moderating to 5 per cent by the fourth quarter. The fluctuations in the RPI are chiefly the result of past changes in mortgage rates; excluding mortgage interest payments, the inflation path is likely to be much smoother.

Table 7: Retail prices index

		Percentage changes on a year earlier		
			Forecasts	
	Weight in 1988	1987 Q4	1988 Q4	1989 Q4
Food	16¼	3½	3¼	3¼
Nationalised industries	5½	2¼	7¼	6¼
Housing	15¼	7	16¼	7
Other	63	3¾	5¼	4¾
Total	100	4	6¼	5

43. The GDP deflator which measures the price of domestic value added (principally unit labour costs and profits per unit of output) is forecast to rise by 6¼ per cent in 1988-89 and by 5 per cent in 1988-89.

Productivity and the labour market

44. The workforce in employment in Great Britain has continued to rise strongly over the last year: in the twelve months to June 1988 it is estimated to have risen by 440,000 thousand. Since 1983, there has been an increase of over 1¼ million in the number of jobs.

Table 8: Changes in Employment

	Thousands, GB seasonally adjusted					
	Employees in employment		Self-employed	HM forces	Work related government training programmes	Workforce in employment
	Male	Female				
June 1985 to June 1986	-68	+152	+ 16	-4	+50	+145
June 1986 to June 1987	- 6	+242	+234	-3	+85	+552
June 1987 to June 1988	+60	+222	+124[1]	-3	+35	+438

[1] Figures for self-employment over the last year are a projection based on self-employment growth over the previous five years.

45. Productivity has been growing strongly, with manufacturing productivity now estimated to have risen by 4½ per cent a year on average since 1979. Underlying growth in labour productivity in manufacturing industry now appears to be higher than the rate experienced in the 1960s. Output per head in the non-manufacturing sector has risen by about 1¾ per cent a year since 1979, and by about 2½ per cent a year since 1983.

Table 9: Output per head of the employed labour force

(Annual average, percentage changes)

	1964-73	1973-79	1979-88[2]
Manufacturing	3¾	¾	4½
Non-manufacturing[1]	3	½	1¾
Whole economy	2¾	1	2¼
Non-North Sea economy	2¾	½	2

[1] Excludes public services and North Sea oil and gas extraction.

[2] Includes estimate for calendar year 1988

Unemployment

46. By September 1988, seasonally adjusted adult unemployment in the UK had fallen for 26 successive months, and by some 940,000 in total. The fall in unemployment over the past year is mainly attributable to the strong growth of output and employment. A further, though slower, fall in unemployment is likely over the year ahead.

Financial developments

47. Over the past year, with the exception of a short-lived upsurge in April and May, the sterling index has been in the range 73-79. In the year to September, the reserves have increased by an underlying $5billion, net of official borrowing.

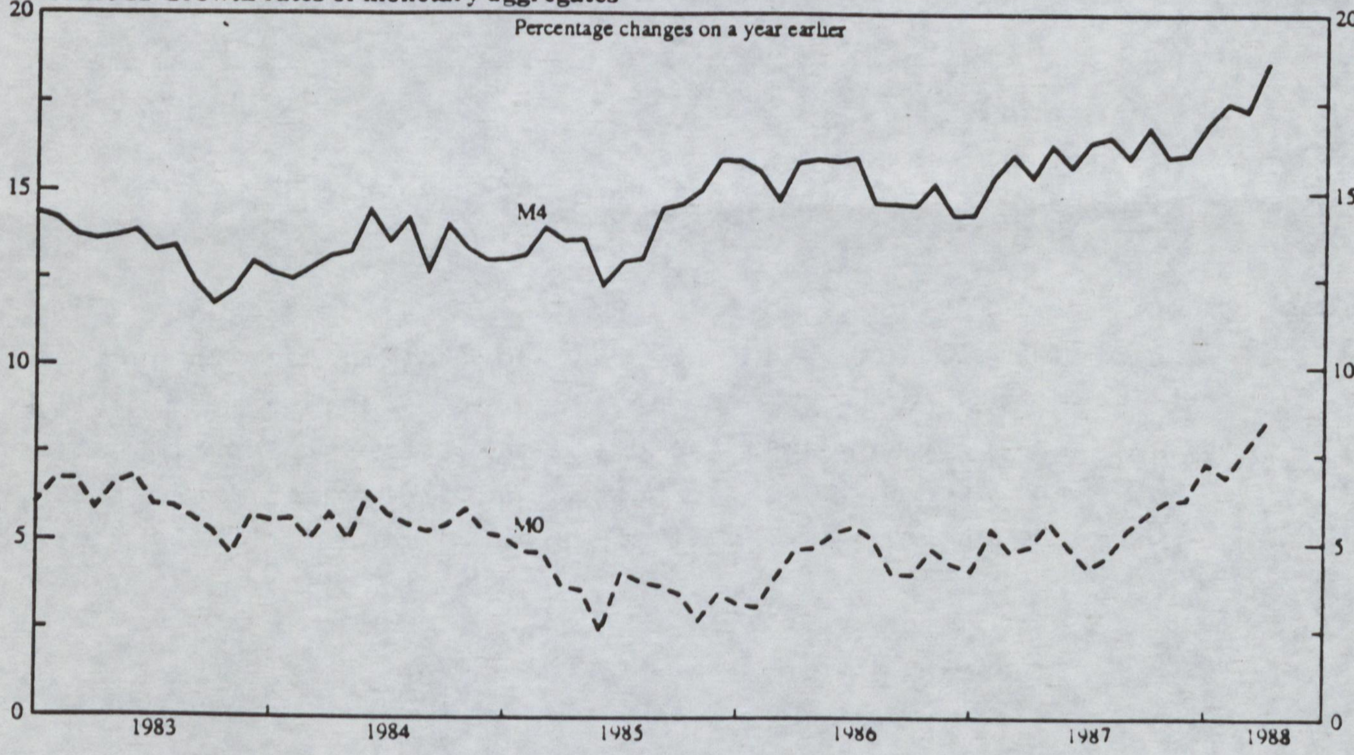
Narrow Money

48. The year on year growth of M0 has remained above the top of its 1-5 per cent target range. Increases in interest rates since the summer are expected to slow the growth of M0 considerably over the next six months, although it may not return within its target range by the end of the financial year.

Broad Money

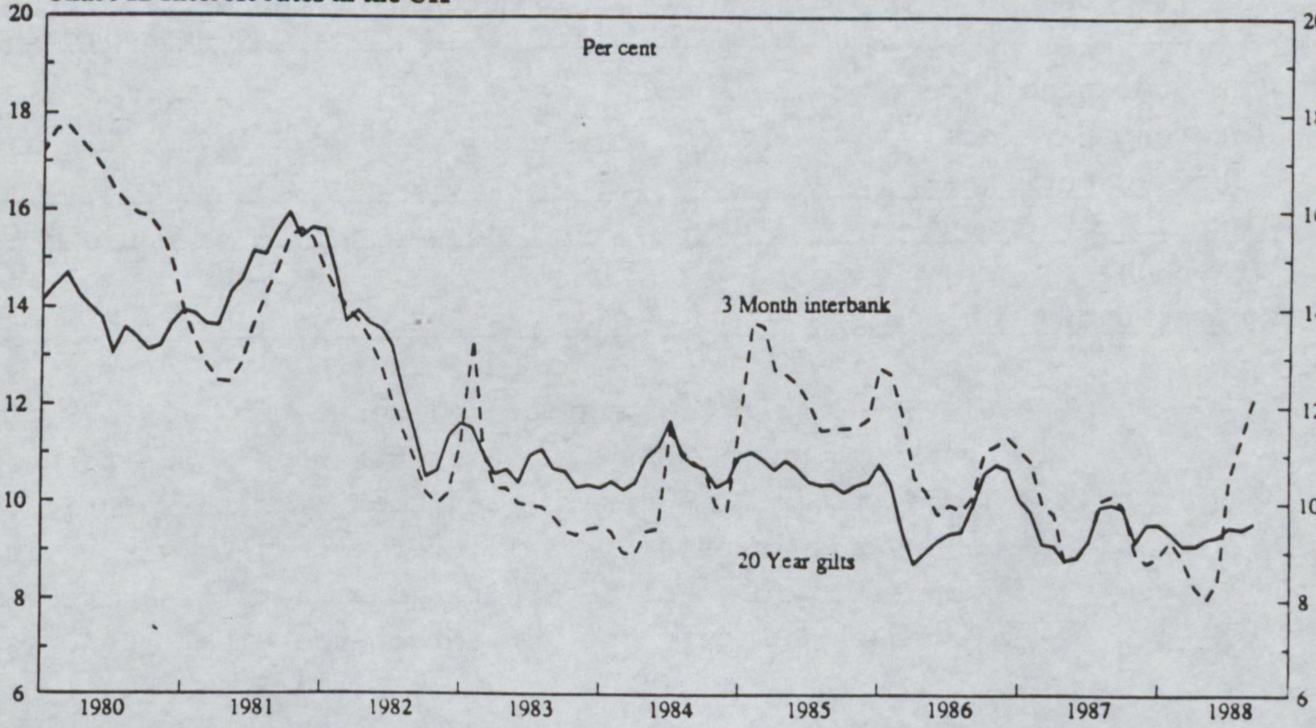
49. Broad money has continued to grow rapidly. There has been a marked increase in personal and financial sector deposits, as the stock market crash led to a move away from new investment in equities and unit trusts. Financial innovation and liberalisation continues to contribute to the growth of broad money. [Growth in liquidity from these sources does not of itself represent inflationary pressure.]

Chart 11 Growth rates of monetary aggregates



50. Chart 12 shows the recent path of interest rates. Monetary conditions have tightened considerably during this year.

Chart 12 Interest rates in the UK



Fiscal developments

51. Tables 10 to 12 show both the Budget projections and latest forecasts for general government expenditure and receipts and the public sector debt repayment (PSDR). The PSDR in 1987-88 was £3½ billion, slightly higher than estimated in the 1988 FSBR.

52. In the first half of 1988-89 there was debt repayment of just over £3½ billion, compared with public sector borrowing of about £2 billion in the first half of 1987-88. The revised forecast for 1988-89 as a whole is a PSDR of £10 billion, £7 billion higher than forecast in the FSBR. This is due in roughly equal amounts to higher than expected receipts and lower than expected expenditure. The revisions on the receipts side largely reflect the higher than expected growth of money GDP.

Table 10: General government expenditure

	£ billion		
	1987-88	1988-89	
	Outturn	Budget Forecast	Latest Forecast
Public expenditure planning total	145.7	156.8	153.6
Interest payments	17.5	17.5	17.7
Other adjustments	8.2	8.6	9.6
General government expenditure	**171.5**	**182.9**	**180.8**
of which			
Privatisation proceeds	- 5.2	- 5.0	- 6.0

53. Gross debt interest payments in 1988-89 are a little higher than in 1987-88, and than forecast at Budget time. The upward revision to the forecast of other adjustments largely reflects a change in the composition of public corporations' net financing which increases GGE but does not affect the PSDR.

54. The Budget forecast for general government receipts has been revised up by £4 billion, most of which is accounted for by higher taxes and national insurance contributions. Income tax and VAT are expected to be £1 billion and £1¼ billion higher respectively than in the Budget forecast. Other significant increases come from national insurance contributions (up £¾ billion), and stamp duty (up nearly £½ billion). The latter mainly reflects the buoyancy of the housing market earlier this year. Total taxes and national insurance contributions are expected to be somewhat lower in 1988-89 than in 1987-88 as a percentage of money GDP.

55. Total interest and dividend receipts are forecast to be £½ billion higher in 1988-89 than in 1987-88. Within this, dividends are about £¼ billion lower due to the sale of the government's remaining BP shares, and interest receipts £¾ billion higher. General government receipts in total are now forecast to increase by 9 per cent in 1988-89, much the same rate of increase as in 1987-88.

Table 11 General government receipts

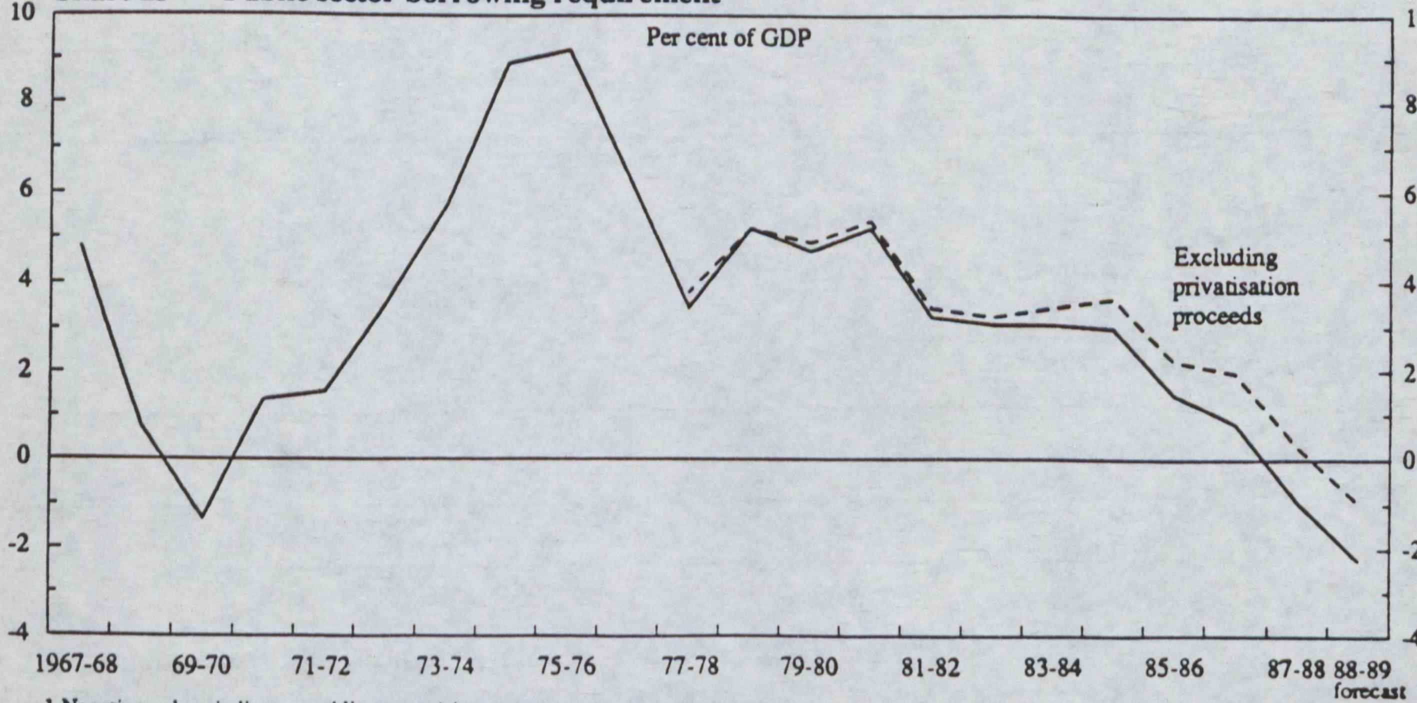
	£ billion		
	1987-88	1988-89	
	Outturn	Budget Forecast	Latest Forecast
Taxes on income, expenditure and capital	132.7	141.2	144.0
National insurance and other contributions	28.9	31.6	32.4
Interest and dividends	6.0	5.6	6.4
Other receipts	5.9	6.4	6.2
Total receipts	**173.6**	**184.9**	**189.3**
of which			
North Sea revenues	4.7	3.3	3.3

56. Table 12 shows the old and new forecasts for the PSDR. The forecast is still subject to a wide margin of error; the average error on PSDR forecasts for the current financial year made in the autumn is ½ per cent of GDP, or nearly £3 billion. On the basis of this forecast, the budget surplus in 1988-89 will be larger as a proportion of money GDP than in any year since the beginning of the 1950s, the earliest date for which figures on this basis are available.

Table 12: Public sector debt repayment

	£ billion		
	1987-88	1988-89	
	Outturn	Budget Forecast	Latest Forecast
General government expenditure	171.5	182.9	180.9
General government receipts	173.5	184.9	189.0
General government debt repayment	2.0	2.0	8.2
Public corporations' market and overseas debt repayment	1.6	1.2	2.0
PSDR	3.6	3.2	10.2
PSDR as per cent of GDP	¾	¾	2¼
PSDR excluding privatisation proceeds as per cent of GDP	- ¼	- ½	1

Chart 13 Public sector borrowing requirement[1]



1 Negative values indicate a public sector debt repayment

Table 13: Economic prospects: summary

Percent changes on a year earlier unless otherwise stated

	1987	Forecast 1988	Forecast 1989	Average errors from past forecasts[1]
GDP and domestic demand at constant prices				
Domestic demand	4½	6	3	1
of which:				
Consumers' expenditure	5	5½	3½	1¼
General government consumption	1	½	- ½	¾
Fixed investment	5½	12	5½	2¼
Change in stockbuilding (as a percentage of GDP)	0	0	0	¾
Exports of goods and services	5½	1½	5½	2¼
Imports of goods and services	7½	12	4½	2¾
Gross domestic product	4	4½	3	¾
Manufacturing output	6	7	4½	2
Balance of payments current account (£ billion)	- 2½	-13	-11	4¼
Inflation				
Retail price index (Q4 on Q4)	4	6¼	5	1¼
GDP deflator at market prices (financial year)	5¼	6¾	5	1¼
Money GDP at market prices (financial year)	10	11	8	1¼
£ billion	424	471	508	
PSDR (financial year) £ billion	3½	10		3
as a percent of GDP	¾	2¼		½

[1] The errors relate to the average differences (on either side of the central figure) between Autumn Industry Act forecasts and outturn over the last ten years and apply to the forecasts for 1989, except for the PSDR where they apply to the forecasts for 1988-89.

TABL[illegible]14 GROSS DOMESTIC PRODUCT AND ITS COMPONENTS

£billion at 1985 prices, seasonally adjusted

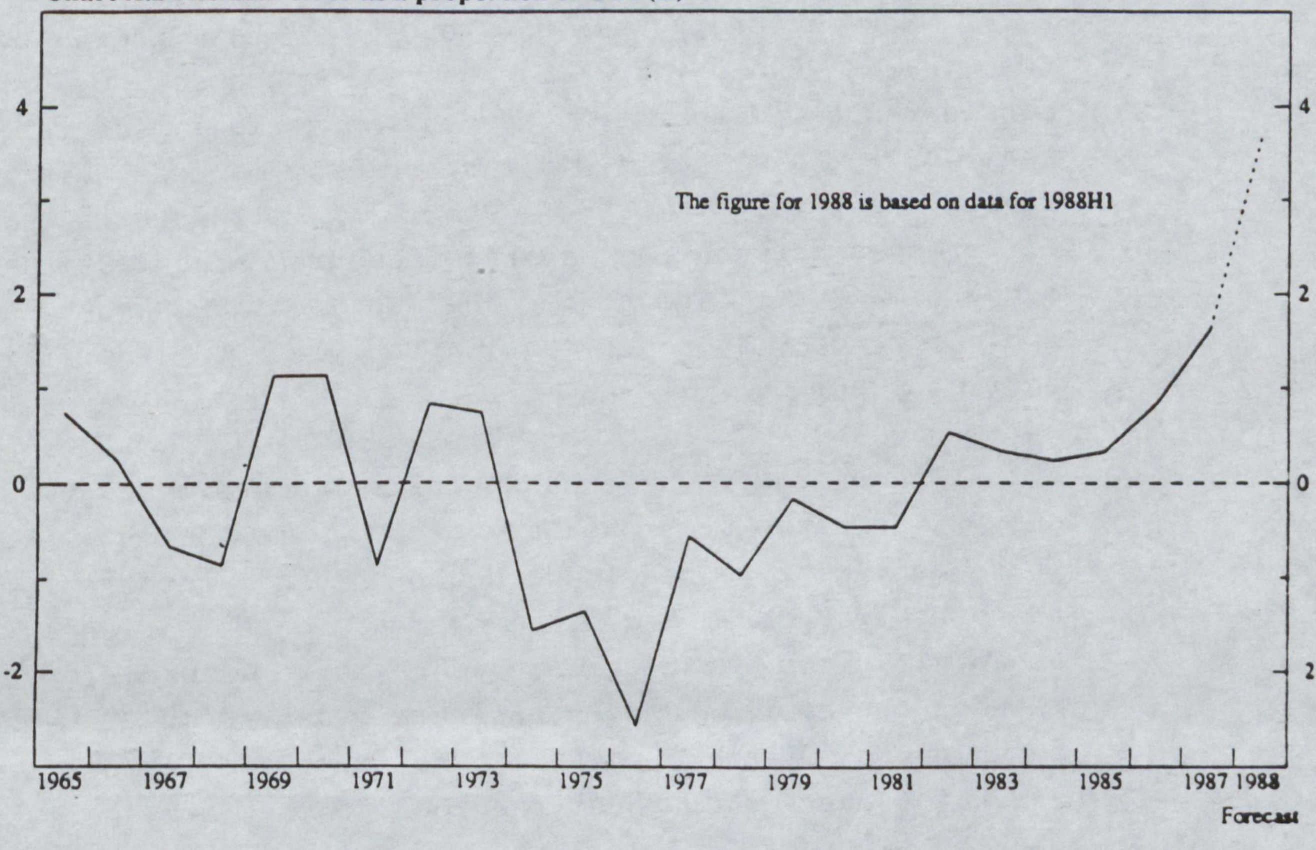
	Consumers' expenditure	General Government consumption	Total fixed investment	Exports of goods and services	Change in stocks	Total final expenditure	Less imports of goods and services	Less adjustment to factor cost	Plus statistical adjustment	GDP at factor cost[1] (average measure)	GDP index (average measure) 1985=100
1984	207.9	74.0	58.1	97.1	1.1	438.1	96.7	48.7	0.8	293.5	96.3
1985	215.3	74.0	60.3	102.8	0.6	452.9	99.2	49.5	0.5	304.7	100.0
1986	226.8	75.4	60.8	106.6	0.6	470.3	105.6	51.8	1.1	314.0	103.0
1987	238.5	76.0	64.2	112.5	0.6	491.8	113.3	54.5	3.1	327.1	107.4
1988	251.9	76.4	72.0	114.3	1.0	515.8	126.8	57.0	9.1	341.1	112.0
1989	261.1	75.9	76.0	120.7	0.6	534.4	132.5	59.4	9.7	352.2	115.6
1987H1	117.0	37.8	31.2	55.5	-0.2	241.4	53.9	26.7	0.9	161.6	106.1
H2	121.4	38.3	32.9	57.1	0.7	250.4	59.4	27.8	2.3	165.5	108.7
1988H1	124.2	38.0	34.2	56.0	0.5	253.0	60.9	27.8	4.1	168.5	110.6
H2	127.8	38.4	37.8	58.3	0.5	262.8	65.9	29.2	5.0	172.6	113.4
1989H1	129.8	37.9	37.9	59.8	0.3	265.7	65.6	29.5	4.7	175.4	115.0
H2	131.3	38.1	38.1	60.9	0.3	268.7	66.9	29.9	5.0	176.9	116.2
Per cent changes 2											
1986 to 1987	5	1	5½	5½	0	4½	7½	5	½	4	4
1987 to 1988	5½	½	12	1½	0	5	12	4½	2	4½	4½
1988 to 1989	3½	- ½	5½	5½	0	3½	4½	4	0	3	3

1 The GDP figures are averages of constant price output, expenditure and income estimates of GDP. Percentage changes are calculated from unrounded levels and then rounded to the nearest half per cent. Figures for 1988H2 and beyond are forecasts. In the year to 1988H1, the expenditure measure grew by 2½ per cent compared with 4½ per cent growth for the income measure and 6 per cent for the output measure. It is likely that the expenditure measure and, consequently, the average both understate recent growth.

2 Changes as a percentage of GDP for stockbuilding and statistical adjustment

A.3. There are analogous problems with the current price national accounts figures, reflected in a rising residual error (the difference between the current price income and expenditure measures of GDP), especially in the first half of 1988.

Chart A.2 Residual error as a proportion of GDP(E)



A.4. The large residual error is associated with large balancing items in the sectoral financial accounts. (The balancing item is the difference between net acquisitions of financial assets as measured from financial data and as measured from national income and expenditure data. The sum of the balancing items is equal to the residual error.)

ANNEX

UK national and sectoral accounts

A.1. How strongly the UK economy has grown over the past two years is unclear because of the considerable disparity between the various measures of real GDP. The disparity is particularly marked for the first half of 1988. Chart A1 illustrates the differences between the separate measures since 1985. The output measure, which is the most reliable short-term indicator, grew by 6 per cent in the year to the first half of 1988.

A.2. By contrast, the expenditure measure of GDP grew by only 2½ per cent over the same period. It seems likely that aggregate expenditure has been under-recorded over the past two years, and maybe over a longer period. As a result, the statistical adjustment - the difference between the average and expenditure measures of GDP - has contributed 2 per cent to the recorded 4½ per cent growth of average GDP over the year to the first half of 1988.

Chart A.1 Growth in different GDP measures

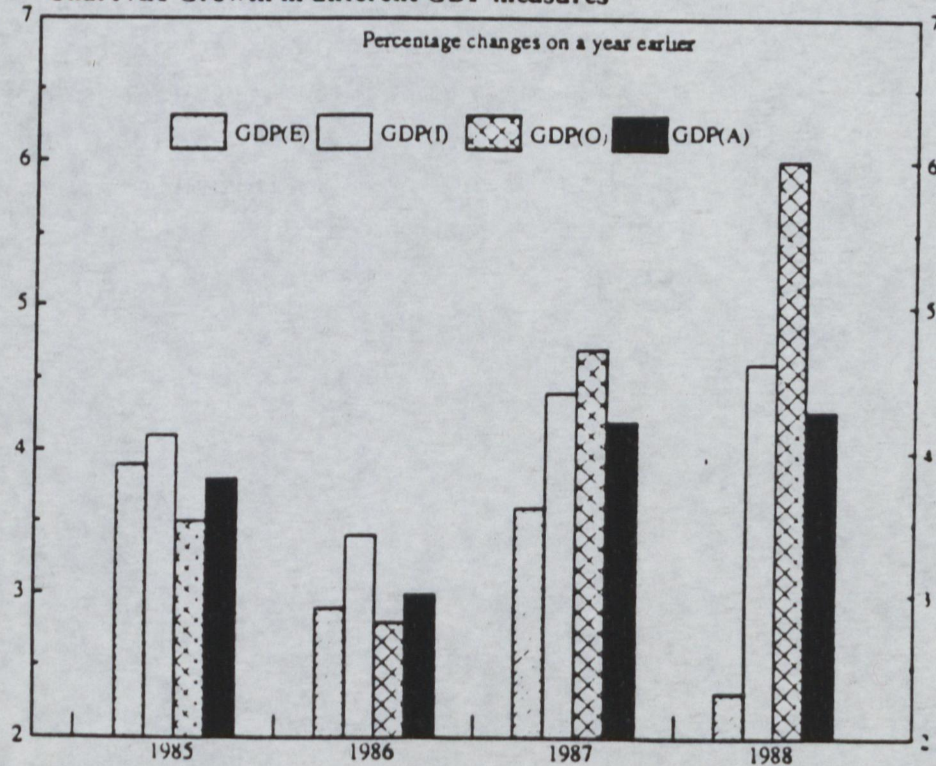
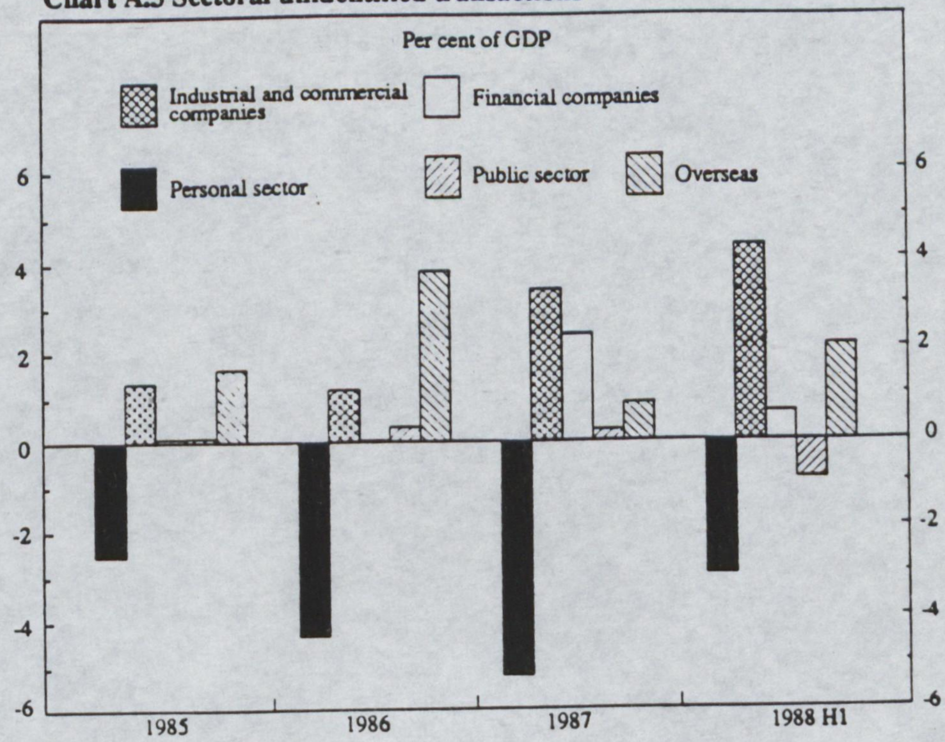


Chart A.3 Sectoral unidentified transactions



A.5. In 1987, the balancing item for the personal sector was about 8 per cent of personal disposable income. This suggests that the personal sector acquired far more financial assets than the national income and expenditure estimates imply. There may also have been some under-recording of personal sector income.

A.6. The large balancing item in the overseas sector in the first half of 1988 (about £7 billion) indicates that there were either unrecorded credits on the current account or unrecorded net capital inflows - or, most likely, both. To the extent that it reflects unrecorded net exports or interest, profits, and dividends, the true current account deficit was lower than the recorded figure. The balancing item in the industrial and commercial companies sector may imply some under-recording of real spending on investment and stocks or unrecorded trade credit extended to other sectors. If, as these balancing items suggest, the current account deficit was small and company sector spending was higher than the recorded figures indicate, that would go some way to explain the sluggish behaviour of the expenditure measure of GDP relative to the other measures.

A.7 The forecast for 1989 presented in table 13 of the main text makes some allowance for a further rise in the average estimate of GDP, relative to the expenditure measure, though much less than in 1988.