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29 June 1989

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~~Dear Paul,~~ RA

TREASURY ECONOMIC FORECAST

I enclose three copies of the forecast - one for the Prime Minister, one for Sir Alan Walters and one for Brian Griffiths.

As usual, these copies are provided on a personal basis for the Prime Minister, Sir Alan Walters, Brian Griffiths, Andrew Turnbull and yourself only.

in attached folder
Yours ever,
Simon

S D H SARGENT
Private Secretary

TREASURY ECONOMIC FORECAST

JUNE 1989

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TREASURY ECONOMIC FORECAST

SUMMARY

The forecast covers the period to 1991 (1991-92 for public finances). Table 1.1 summarises the results.

- Activity in the world economy has remained high in 1989; G7 GNP growth is forecast at over 3 per cent, and world trade in manufactures at 8½ per cent. The forecast has a slowdown in world trade growth in 1990 and 1991. Tight monetary policy halts the rise in G7 consumer price inflation, and leads to a gradual fall during 1990.
- Growth in UK GDP slowed at the end of 1988, though non-oil GDP in 1989Q1 was still 4 per cent higher than a year earlier, only a little above the FSBR estimate. It is forecast to grow by 3 per cent in 1989 and a little less thereafter. Total GDP growth, which is affected by North Sea accidents, is forecast at just over 2 per cent in 1989 and around 2½ per cent in the two subsequent years. Unemployment changes little from the end of 1989.
- Tight monetary policy has curbed the growth of consumers' expenditure, and is likely to continue to restrain it. But investment is likely to grow more rapidly in 1989 than envisaged in the FSBR, though less than in 1988, keeping domestic demand growth up to 3 per cent. Private sector investment is expected to be flat in 1990, with a modest fall thereafter. But, even with real interest rates at record levels, the downturn in investment is less than in previous cycles. Total domestic demand is forecast to grow by 1½ to 2 per cent in 1990 and 1991, a little below growth of GDP.
- Inflation is higher than in the FSBR throughout the forecast period. RPI inflation is expected to decline slowly from its peak of just under 8½ per cent in the middle of 1989 to 6½ per cent in 1989Q4 and 5½ per cent in 1990Q4. Forecast growth of money GDP overshoots the 1989 MTPS path in all years (when adjusted for distortions caused by the introduction of the community charge), mainly as a result of higher inflation.

- The current account deficit for 1989 is forecast to be £16½ bn., a little more than in 1988, and to fall gradually in 1990 and 1991.

- The PSDR is forecast to be £12 bn. in 1989-90, below the FSBR forecast mainly because of less buoyant NIC receipts following high take up of personal pensions. Thereafter the forecast is for both public expenditure and revenues to be higher than in the FSBR in cash terms, but lower or little different as a share of GDP. After small assumed fiscal adjustments in 1990 and 1991 the forecast path for the PSDR declines at a similar rate as in the FSBR.

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TABLE 1.1 : SUMMARY OF FORECAST

	<u>JANUARY†</u> <u>1989 (internal)</u>	<u>FSBR</u> <u>1989</u>	<u>JUNE</u> <u>1989</u>
A	<u>THE WORLD ECONOMY</u>		
1.	<u>GNP (MAJOR 7 EXCLUDING UK)</u> (per cent change on a year earlier)		
1988	4.1	4.1	4.2
1989	3.1	3.1	3.2
1990	2.6	2.6	2.9
1991	2.7	2.9	2.9
2.	<u>DOMESTIC DEMAND (MAJOR 7 EXCLUDING UK)</u> (per cent change on a year earlier)		
1988	4.2	4.2	4.3
1989	3.3	3.3	3.2
1990	2.7	2.7	3.0
1991	2.7	2.9	3.0
3.	<u>WORLD TRADE IN MANUFACTURES</u> (per cent change on a year earlier)		
1988	10.1	10.0	10.5
1989	7.9	7.9	8.5
1990	6.0	6.0	6.6
1991	5.5	5.5	5.5
B	<u>UK ACTIVITY AND DEMAND</u>		
4.	<u>GDP VOLUME</u> (per cent change on a year earlier)		
1988	4.4	4.3	4.4
1989	2.0	2.3	2.2
1990	1.5	2.1	2.5
1991	1.7	2.6	2.7
5.	<u>NON-NORTH SEA GDP VOLUME</u> (per cent change on a year earlier)		
1988	5.1	5.1	5.2
1989	2.7	2.8	3.1
1990	1.4	1.9	2.3
1991	1.8	2.7	2.7
6.	<u>VOLUME OF DOMESTIC DEMAND</u> (per cent change on a year earlier)		
1988	7.1	6.5	6.5
1989	2.6	2.5	3.0
1990	1.1	1.3	1.6
1991	1.2	1.8	2.2
7.	<u>UNEMPLOYMENT (UK S.A. EXCLUDING SCHOOL LEAVERS million)</u>		
1988 Q4	2.11	2.10	2.10
1989 Q4	2.00	1.92	1.81
1990Q4	2.07	2.15	1.88
1991Q4	2.27	2.15	1.86

†The January forecast used adjusted national and sectoral accounts.

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	JANUARY 1989 (internal)	FSBR 1989	JUNE 1989
C INFLATION AND MONEY GDP			
8. MONEY GDP (MARKET PRICES) (per cent change on a year earlier)			
1988-89	11.1	11.0	11.1
1989-90	7.2	7.8	9.8*
1990-91	6.3	5.9	7.7
1991-92	5.5	5.9	7.3
9. RPI (per cent change on a year earlier)			
1988 Q4	6.6	6.6	6.6
1989 Q4	5.5	5.6	6.7
1990 Q4	4.1	3.3	5.1
1991 Q4	3.1	2.8	4.6
10. RPI excluding mortgage interest payments (per cent change on a year earlier)			
1988Q4	5.2	5.2	5.2
1989Q4	5.1	5.1	5.6
1990Q4	4.0	3.7	5.1
1991Q4	3.2	3.1	4.6
11. GDP market price deflator (per cent change on a year earlier)			
1988-89	7.0	7.2	7.3
1989-90	5.8	5.4	7.2*
1990-91	4.5	3.9	5.2
1991-92	3.8	3.0	4.6
D PUBLIC FINANCES			
12. PSBR - £ bn.			
1988-89	-12.9	-13.9	-14.4
1989-90	-11.2	-13.8	-12.1
1990-91	-9.5	-10.0	-9.3
1992-92	-6.6	-6.0	-6.2
13. PSBR - % OF GDP			
1988-89	-2½	-3	-3
1989-90	-2½	-2½	-2½
1990-91	-1½	-2	-1½
1991-92	-1½	-1	-1
14. ANNUAL FISCAL ADJUSTMENT - £ bn.			
1989-90	1.5	0.0	0.0
1990-91	0.0	1.0	1.0
1991-92	0.0	2.0	1.0

* adjusted to remove the effects of the community charge which reduces growth by ½ per cent in 1989-90 and 2 per cent in 1990-91.

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E <u>MONETARY CONDITIONS</u>	JANUARY	FSBR	JUNE
	1989 (internal)	1989	1989
15. <u>SHORT TERM INTEREST RATES</u> (per cent))			
1988 Q4	12.5	12.5	12.5
1989 Q4	12.0	12.0	14.0
1990 Q4	11.0	10.0	13.5
1991 Q4	10.0	8.5	12.5
16. <u>MO</u> (per cent change on a year earlier)			
1988-89	7.3	7.2	7.1
1989-90	3.7	3.6	4.5
1990-91	3.5	2.7	3.2
1991-92	3.5	2.4	4.0
17. <u>STERLING INDEX (1975=100)</u>			
1988 Q4	96.7	96.7	96.7
Q4	96.0	95.3	90.0
1990 Q4	92.9	93.8	90.0
1991 Q4	89.7	92.9	90.0
18. <u>£/DM EXCHANGE RATE</u>			
1988 Q4	3.19	3.19	3.19
1989 Q4	3.09	3.16	3.04
1990 Q4	2.95	3.04	3.00
1991 Q4	2.82	2.97	2.97
19. <u>RELATIVE UNIT LABOUR COSTS (1980=100)</u>			
1988	93.9	96.5	97.2
1989	97.0	98.9	96.4
1990	96.2	98.5	94.8
1991	95.2	97.6	95.6
<u>F TRADE AND CURRENT ACCOUNT</u>			
20. <u>VOLUME OF NON-OIL EXPORTS OF GOODS AND SERVICES</u> (per cent change on a year earlier)			
1988	4.2	1.3	1.3
1989	6.1	6.1	8.0
1990	4.4	5.0	6.1
1991	4.3	6.5	4.4
21. <u>VOLUME OF NON-OIL IMPORTS OF GOODS AND SERVICES</u> (per cent change on a year earlier)			
1988	12.9	13.3	13.4
1989	6.2	3.9	7.2
1990	2.5	2.5	2.6
1991	1.9	2.5	2.4
22. <u>CURRENT BALANCE</u> £ bn.			
1988	-10.4	-14.7	-14.9
1989	-11.4	-14.5	-16.3
1990	-10.0	-12.1	-13.6
1991	-7.2	-8.6	-10.4

(1) MAIN ISSUES

The world economy

2. The forecast is for sustained growth of G7 GNP at about the rate of growth of productive potential. Inflation gradually declines as the effects of tighter monetary policy feed through. Real commodity prices are broadly constant over the next two and half years. Following the rise in the dollar in the first part of this year, the US and Japanese current balances are expected to fall somewhat, but to widen again in 1990 and 1991 (assuming unchanged real exchange rates).

3. Real interest rates in the G7 rise by just under 1 percentage point compared with 1988. If activity and inflationary pressure remain stronger than expected, particularly in Japan and Germany, it might be necessary for monetary policy in the affected countries to be tightened by more than the small further increases in short term interest rates that have been assumed. Stronger activity over the near future would put upward pressure on output and commodity prices, and might be followed by a period of lower growth.

Monetary conditions

4. The forecast deceleration in GDP and domestic demand occurs with very high short term interest rates, which stay at 14 per cent until mid-1990 and decline gradually thereafter. Real short term interest rates, which were on average already high by past standards during 1987 and 1988, are assumed to remain at even higher levels. The strong growth in the economy in recent years, together with supply side policies and liberalisation that contributed to it, appear to have produced much greater confidence among persons and companies. As a result they are saving less and planning to spend more than might have been expected. The forecast of continued buoyant expenditure contributes to further overshoots in money GDP growth with inflationary pressures abating slowly. If persons or companies adjust their spending by more than forecast, perhaps because of emerging financial constraints, there would be less need to keep interest rates high for so long. In these circumstances, however, a period of very low output growth in the short term - a hard landing - could occur, but inflation would probably fall more rapidly.

5. The forecast assumes that high short term interest rates will be necessary to keep the exchange rate close to its current level (90 for the sterling index). There are major uncertainties about the path for the

exchange rate with important implications for, inter alia, the path of inflation.

The national and sectoral accounts

6. There are still major inconsistencies for recent quarters in the latest national accounts (published on June 20). Sectoral balancing items remain very large. With more time to assess these data the forecast would have been based on adjusted national and sectoral accounts as in the January forecast (see Annex B). The inconsistencies make it more difficult to assess the precise extent to which the growth of output and domestic demand have fallen following the tightening of monetary policy. Nevertheless it is clear that growth of GDP and personal sector demand have fallen from the high rates in the first half of 1988. There are, however, major problems in assessing company sector spending. The poor state of the sectoral accounts makes it difficult to construct convincing interpretations of personal and company sector behaviour.

The personal sector

7. High short term interest rates have had a marked dampening effect on the growth of personal sector expenditure, particularly on housing. Nevertheless consumers' expenditure, while moderating, has continued to rise, and is likely to be 3½ per cent higher in 1989 than in 1988. But recent trends in retail sales and consumer intentions suggest that growth in the year to 1989Q4 could fall to 2 per cent, compared to 5½ per cent in the year to 1988Q4. While high short term interest rates have depressed the price of certain assets, especially house prices, they have not stopped persons increasing their gross borrowing more rapidly than their income. They now face very high levels of income gearing and debt service ratios.

8. Despite sustained high interest rates consumers' expenditure is expected to rise at 2 to 2½ per cent beyond 1989, though investment in new houses falls sharply. The personal sector savings ratio is likely to rise only slowly from its current low level. If high short term interest rates have a more powerful effect, the personal sector may adjust more than assumed in the forecast. In the forecast house prices stabilise from early 1990 and then grow very slowly: if they actually fell, there could be a sharper rise in personal sector savings.

The company sector

9. It is even more difficult to monitor recent behaviour of industrial and commercial companies than that of the personal sector. There are few signs that the company sector has yet been seriously affected by high short term interest rates; indeed the indications are that little change in spending behaviour or plans has occurred.

10. The recent and forecast strength of company sector spending is at first sight odd. Industrial and commercial companies (ICCs) are probably already in financial deficit on much the same scale as in 1974-75 and 1979-80, and their net liquidity is at a historically low level. (The balancing item in ICCs' accounts is consistent with an even larger deficit than recorded in recent years.) Both large deficits and falling liquidity persist throughout the forecast period, with investment at high levels.

11. Similar financial prospects have in the past been associated with recessions. They have led to sharp adjustment by companies to improve their financial position, which in turn has been a major factor behind low (or negative) GDP growth and rising unemployment. The difference between present conditions and earlier episodes is the very high profitability of companies. Despite the slowdown in the economy the return on investment remains very high relative to the 1970s and early 1980s. With profitability so high the financial and overseas sectors are assumed to be willing to finance the deficits implied by ICCs' high investment plans. The key issues are first whether the willingness to finance investment on this scale will persist if short term interest rates stay very high, and second how money GDP growth can be kept close to the MTFs path if companies carry on spending at a high rate.

Inflation and money GDP

12. Measures of "core" inflation - such as the RPI less MIPs or producer output prices - have risen gradually over the past two years to levels even further above the average for the G7. The forecast is that core inflation will stabilise at its mid-1989 level and then fall as slowly as it rose in recent years. In the second half of 1989 companies' profit margins should stop rising - they could fall a little - for the first time for 6 years, though the recent fall in the exchange rate will help companies. Pressure on margins will itself help to bring down inflation both directly and by strengthening companies' resolve to control the growth of earnings. Unless the company sector is under some financial pressure this disinflationary process cannot operate.

13. Some measures of inflation are likely to be higher than core inflation. The high assumed level of base and mortgage rates will keep up total RPI inflation in 1989 and early 1990. Further large increases in real nationalised industries prices, together with large increases in local authority rents and the forecast high initial level of the community charge - 17 per cent higher than domestic rates per head in 1989-90 - will also boost recorded RPI inflation until 1990.

14. Investment prices are likely to rise strongly in 1989 and 1990, particularly as construction industry output remains close to capacity. The pressure on construction capacity is likely to be maintained as public sector investment rises rapidly, just as the growth of private sector investment is forecast to slacken.

15. Earnings growth has risen gradually since the beginning of 1987, though less than might have been expected with such strong output growth. The forecast is for a gradual deceleration in private sector earnings from the end of 1989. Central government and local authority earnings are forecast to grow a little more than in the private sector.

16. In 1989-90 and 1990-91 the replacement of domestic rates by the community charge will produce a major discontinuity in the published numbers for money GDP at market prices (though not at factor cost) and the associated GDP deflator. Domestic rates are classified in the national accounts as a tax on expenditure, while the community charge will not be. For this reason the switch to the community charge reduces the growth of money GDP at market prices and the deflator of GDP at market prices by 0.2 per cent in 1989-90 and by 1.9 per cent in 1990-91.

TABLE 1.2 : THE EFFECT OF THE SWITCH TO THE COMMUNITY CHARGE
ON MONEY GDP AT MARKET PRICES

	Money GDP at market prices		Distortion caused by introduction of the community charge	The deflator for GDP at market prices	
	Recorded basis	Adjusted		Recorded basis	Adjusted
1989-90	9.6	9.8	0.2	7.1	7.2
1990-91	5.8	7.7	1.9	3.3	5.2

17. Money GDP at market prices is used in the MTF5 and to calculate the ratios of general government expenditure and taxes to GDP. In the rest of this report all these measures are adjusted to remove distortions.

18. Adjusting for distortions, growth in the GDP deflator and money GDP are above the paths in the 1989 MTFS in every year. Strong growth of investment prices and the price of general government consumption (mainly pay) are the main factors behind the high growth in money GDP: forecast real growth is only a little above the path underlying the 1989 MTFS.

Balance of payments

19. The forecast is for a slow fall in the current account deficit from the very high levels - over 4 per cent of GDP - at the end of 1988 and in early 1989. Exports are responding favourably to the combination of slowing domestic demand, which helps to ease capacity constraints, and to strong growth in world trade. Imports remain at high levels, although there are signs that the growth rate of import volumes is slowing down. The visible deficit is expected to peak in 1989 and 1990 at around £22 bn., but thereafter to decline gradually. It would require much lower growth of domestic demand than forecast, or a faster increase in capacity, for the deficit to fall more quickly. Only about half of the excess of GDP growth over productive potential in the last four years is reversed over the three years to 1991.

20. The oil surplus has been adversely affected by a spate of accidents in the North Sea. Output was reduced by 6 per cent in 1988 and probably will be 12 per cent below potential in 1989.

21. The invisibles balance is unlikely to improve in 1989, but in time the slower growth of domestic demand should reduce the demand for imports of services, particularly travel. There may also be an improvement in the financial services balance with the spread of financial liberalisation in the EC and as memories of the stock market crash begin to fade. There is also likely to be an improvement in net earnings from interest, profits, and dividends on the UK's net overseas asset holdings, due in part to the decline in sterling. But estimates of IPD flows are subject to wide margins of error as knowledge about the true level of net external assets is limited. The overseas sector balancing item has amounted to £40 bn. over the last three years, a large part of which probably reflects unidentified capital inflows. Given errors of this magnitude it is unwise to place much faith in precise estimates of IPD flows and the level of the UK's net overseas assets.

Public finances

22. The relentless improvement over the past two and a half years in the prospects for public finances may well have come to an end. The forecast

PSDR for 1989-90 is over £1½ bn. less than the FSBR forecast.

23. There are a number of obvious upward pressures on public expenditure that contribute to forecast growth of general government expenditure (excluding privatisation proceeds) of 2½ per cent in 1990-91 and 3 per cent in 1991-92, following the more modest growth in recent years. Public sector pay is forecast to rise rapidly than in the private sector. Local authorities are forecast to increase their current expenditure at a rapid rate from 1990-91 and to set a high starting level for the community charge.

24. The prospect is for the volume of public sector investment to rise at a very rapid rate by historical standards. The forecast allows for the current level of provision for public sector investment and for some sizeable addition for roads, prisons, health, education, nationalised transport industries and water (this will score as private investment after privatisation). Apart from water, the additions are, however, well below departmental aspirations and make no allowance for mega-transport projects (most of which would not involve investment on a sizeable scale during the forecast period). Indeed the increase in the volume of projects, many of which will increase pressures on the construction industry, is so great that the forecast assumes that much of the volume growth - though not necessarily the cash expenditure - will slip into later years, as in previous public sector investment booms.

25. Fast growth of public expenditure on pay and investment is likely to be offset by lower than expected growth of more demand sensitive components, such as social security payments, which could continue to benefit from the high level of activity.

26. The forecast for receipts in 1989-90 has been reduced by over £2 bn. since the FSBR. Higher than assumed take-up of personal pensions has reduced national insurance contributions through higher rebates and incentive payments, more than offsetting the boost to receipts from faster growth of money GDP. In subsequent years higher money GDP produces more receipts than in the FSBR.

27. The non-oil tax burden is forecast to fall by ¼ to ½ percentage point in 1989-90, compared with no change in the FSBR, because of faster forecast growth of money GDP. Thereafter, it is forecast to fall marginally before fiscal adjustment, with the lagged effects of the 1988 and 1989 Budgets, and lower growth of corporation tax, more than offsetting real fiscal drag. The forecast assumes two small fiscal adjustments of £1 bn. in 1990-91 and 1991-92, that are by convention allocated to personal income tax.

28. Table 1.3 shows that the ex post fiscal stance in the UK is forecast to remain tighter than the average for the G7 - as given by the general government financial deficit, the only comparable measure for G7 economies. But the general government financial surplus in the UK falls over the forecast period as public sector investment accelerates.

TABLE 1.3 : GENERAL GOVERNMENT FISCAL DEFICITS
(per cent of GDP)

	1988	1989	1990	1991
UK*	-1	- $\frac{1}{2}$	- $\frac{1}{2}$	0
G7 (less UK)	2	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$
(Japan)	- $1\frac{1}{2}$	- $1\frac{1}{2}$	-2	- $2\frac{1}{2}$

*financial years

(2) THE WORLD ECONOMY

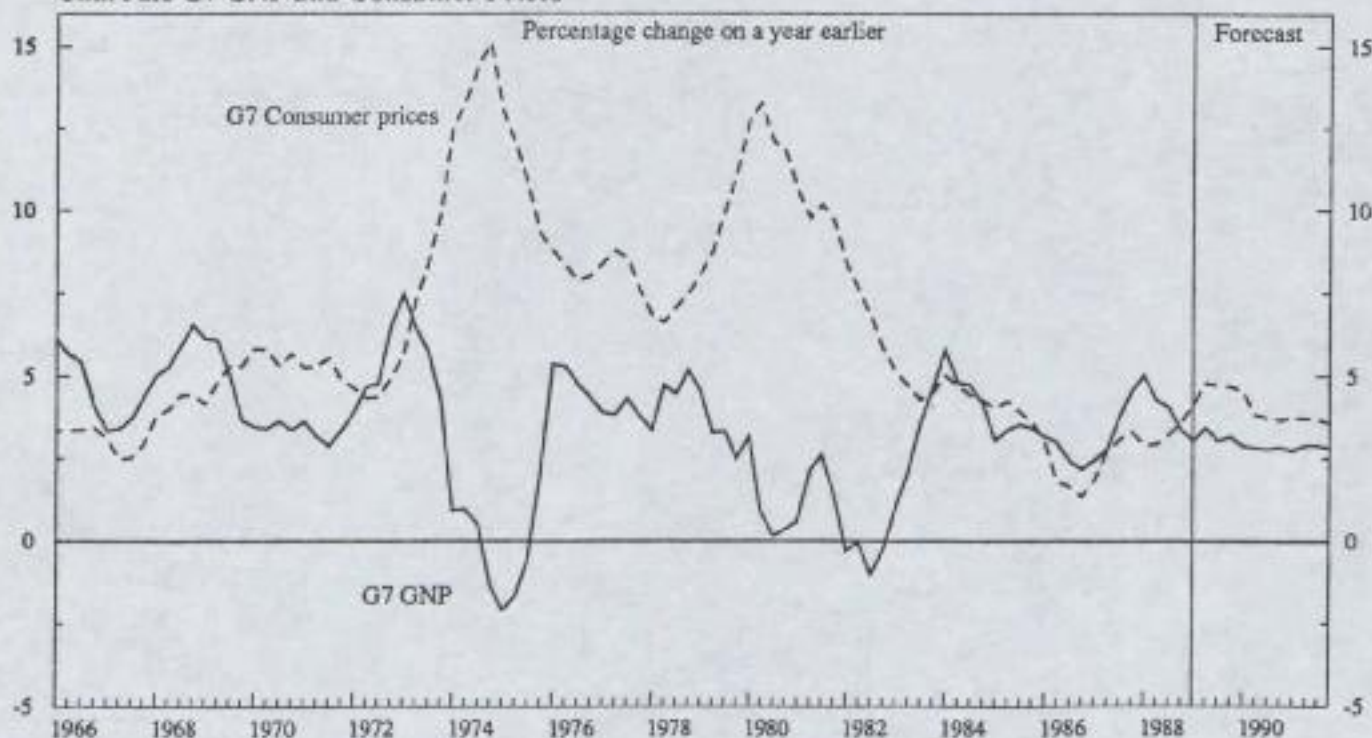
29. The available indicators suggest that activity in the G7 countries so far in 1989 has remained strong. In the US, Canada and the UK, there are significant signs that activity is slowing. Elsewhere there are some indications that by the beginning of this year growth had slowed compared with the very fast rates experienced at the start of last year. But data for industrial production and, where available, provisional first quarter national accounts, suggest that little further deceleration has taken place: growth in Japan and Germany seems particularly buoyant.

TABLE 2.1: G7 GROWTH AND INFLATION

	1988	1989	1990	1991
Real GNP	4.2	3.2	2.8	2.8
Domestic Demand	4.4	3.2	2.8	2.9
Industrial Production	6.0	4.3	2.8	2.9
Consumer Prices	3.1	4.5	3.9	3.7

30. The prospects for output growth, coupled with higher than expected inflation so far this year suggest that the peak in nominal interest rates may not yet have been reached. The forecast assumes that there will be further rises in interest rates in the second half of this year in Continental Europe and Japan, taking nominal short rates to the highest levels since 1985. However real interest rates in the G7 peak at a level only a little higher than the average of 1984 to 1988. Once it is apparent that inflation is no longer rising nominal interest rates outside the US are slowly reduced through 1990 and 1991. This easing back is similar to the pattern already observed in the US.

Chart 2.1 G7 GNP and Consumer Prices



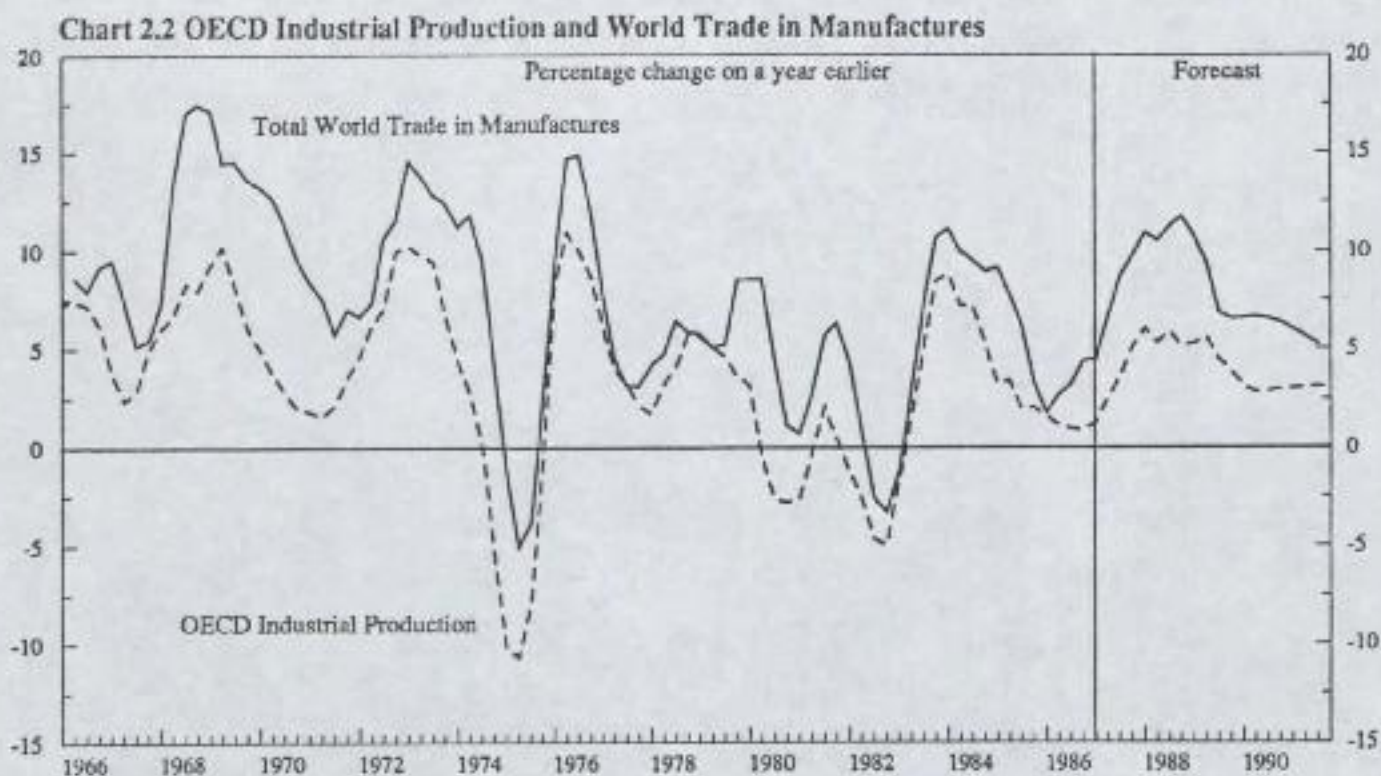
31. The recent strength of the dollar is assumed to be only partly reversed: by the end of 1989 it is still above its end 1988 level. Thereafter constant real exchange rates are assumed.

32. The forecast for G7 GNP for 1989 is of growth of 3½ per cent, following 4½ per cent in 1988. Growth in the US slows to about 2½ per cent: but in Japan and Germany it continues at or above 3 per cent. In 1990 and 1991, as the effects of the assumed monetary tightening outside the US come through, G7 GNP growth is forecast to fall below 3 per cent for the first time since 1986. G7 consumers expenditure is expected to grow steadily at about 2½ per cent with little change in the savings ratio. Growth of business investment slows down to about 4 per cent from the exceptionally fast rate of 1988.

33. In 1989 the growth of world trade in manufactures continues to be quite rapid, 8½ per cent up on a year following 10½ per cent in 1988. In 1990 and 1991 the pace slows to 6½ and 5½ per cent respectively. If growth is as forecast, 1986 to 1991 would represent the strongest and most sustained period of growth since the 1960s.

TABLE 2.2 : WORLD TRADE
(Per cent change on previous year)

	average 1980-88	1988	1989	1990	1991
Total World Trade	4.2	9.6	7.4	5.4	4.9
World Trade in manufactures	5.6	10.5	8.5	6.6	5.5
G7 Imports	5.1	10	7.0	5.0	4.8



34. Non-oil commodity prices have fallen back slightly since the beginning of the year, repeating less sharply the pattern of last summer. The forecast is for real commodity prices to remain at current levels through the forecast at a level close to the average for 1988.

35. Oil prices have remained firm, with an average world price so far this year of \$17pb, about \$2½ pb below the April peak. The forecast assumes some weakening in 1989H2 and again at the beginning of 1990.

36. Consumer price inflation in G7 countries has risen since the beginning of the year by more than was earlier expected. Special factors - expenditure taxes in Japan and Germany, higher oil prices, and the effect of the strong dollar on import prices in Japan and Europe - have all contributed. Consumer price inflation is currently running at about 4½ per cent in G7 countries. The forecast is for this

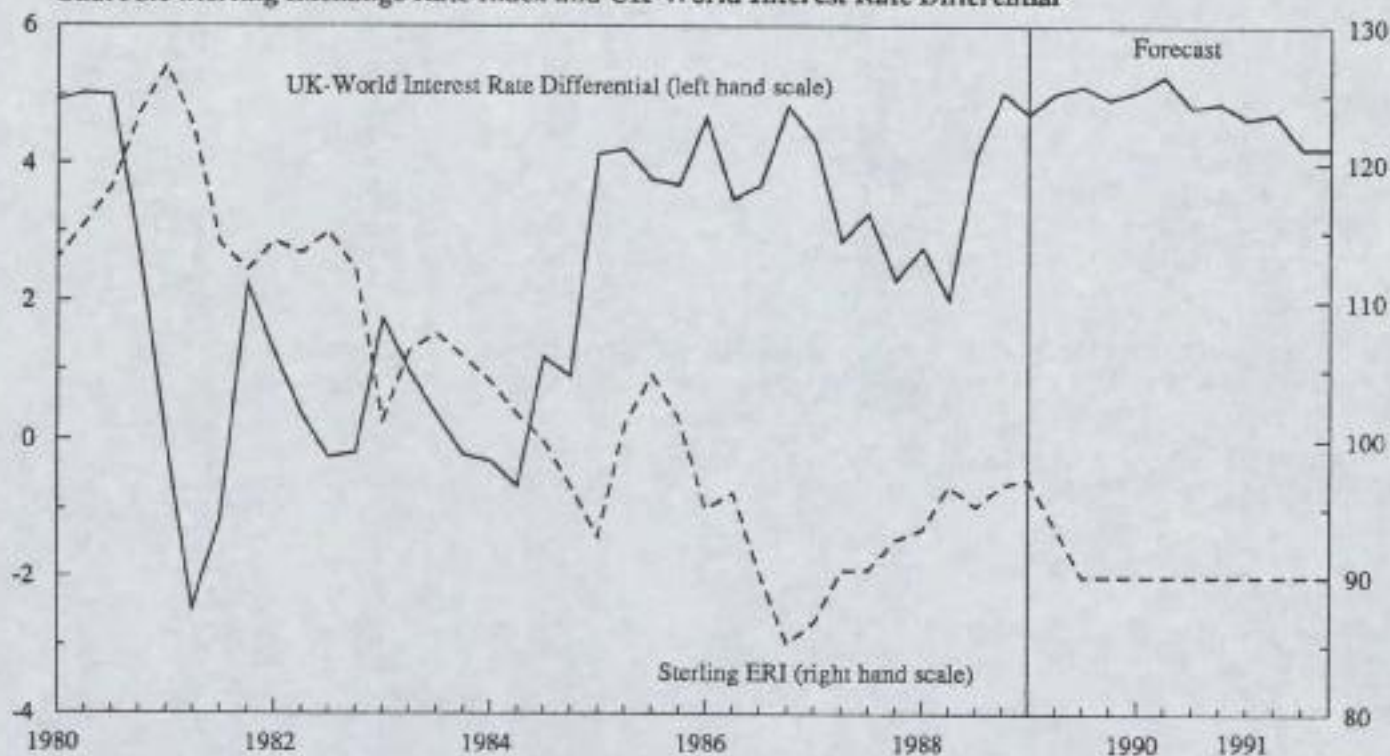
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to reach a peak of between 4½ and 4¾ per cent in the second half of the year with a gradual fall to about 3¾ per cent by the middle of 1990, and little change thereafter. The US inflation rate, currently above the G7 average, is expected to fall to about the average by the end of 1991, reflecting relatively weak growth.

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

37. The forecast has the sterling index remaining at 90. Short-term interest rates stay at 14 per cent until mid-1990, then gradually fall. The projected path for interest rates implies a sustained very high interest differential against overseas short rates in comparison with the rest of the 1980s. The consequences for sterling are very difficult to predict. It could be that the perceived tightness of the monetary stance and the very favourable yield on sterling assets results in periodic strong upward pressure on sterling. Alternatively, the forecast of persistent large current account deficits together with growth of money GDP and inflation above the MTF5 profiles may give rise to further sterling weakness.

Chart 3.1 Sterling Exchange Rate Index and UK-World Interest Rate Differential*



* UK 3 month interbank rate less weighted average of G7 (excluding UK) 3 month interest rates

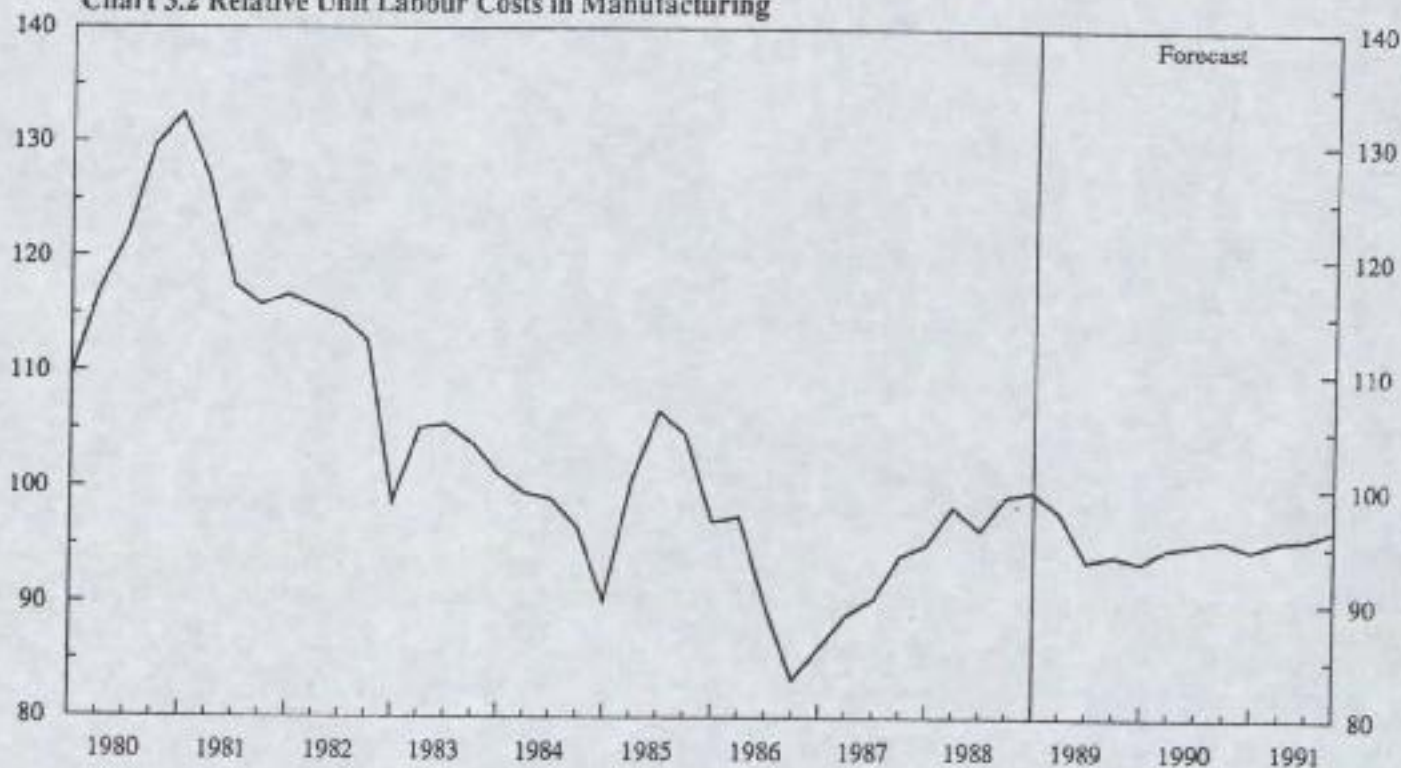
38. The path for the exchange rate, together with forecasts of unit labour costs at home and abroad, imply that the 8 per cent loss in competitiveness between 1987 and 1988 is not regained over the forecast period. Labour cost competitiveness is forecast to fall by a further 5½ per cent through 1989, but to recover slightly, so that by the end of 1990 it is slightly above its average level of 1988.

Table 3.1 : EXCHANGE RATES AND COMPETITIVENESS

	Base rates	Sterling Index (1985=100)	\$/£	Dm/£	Labour cost competitiveness* (1985=100)
1985	12.3	100.0	1.30	3.78	100.0
1986	10.9	91.6	1.48	3.19	91.0
1987	9.7	90.1	1.65	2.94	89.4
1988	10.1	95.5	1.80	3.13	96.6
1988 Q1	8.8	93.5	1.81	3.01	94.5
Q2	8.2	96.6	1.86	3.14	97.7
Q3	11.1	95.2	1.71	3.16	95.8
Q4	12.4	96.7	1.81	3.19	98.7
1989 Q1	13.0	97.1	1.77	3.27	99.0
June 21	14.0	90.6	1.55	3.05	-
1989 Q2	13.4	93.6	1.64	3.18	97.3
Q3	14	90.0	1.60	3.05	93.1
Q4	14	90.0	1.62	3.04	93.6
1990 Q1	14	90.0	1.63	3.03	93.1
Q2	14	90.0	1.63	3.02	94.3
Q3	13.5	90.0	1.64	3.01	94.6
Q4	13.5	90.0	1.64	3.00	94.9
1991 Q1	13	90.0	1.65	2.99	94.2
Q2	13	90.0	1.65	2.98	94.9
Q3	12.5	90.0	1.66	2.97	95.1
Q4	12.5	90.0	1.66	2.97	95.8

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

Chart 3.2 Relative Unit Labour Costs in Manufacturing



39. The differential between UK short rates and eurodollar rates averaged about 3½ points from 1985 to the end of 1988, while against world rates the

average differential over the same period was about 3½ points. Differentials are currently 4½ and 5½ points, respectively, which is around their highest levels throughout the 1980s. They are forecast to remain fairly close to these levels as the gradual easing of UK rates is accompanied by an easing of rates abroad. These interest differentials should be sufficient to attract the inflows to finance the current account deficits expected over the next two years, without requiring a lower exchange rate. The forecast assumes no further intervention.

40. Table 3.2 summarises the financing of the current account deficit. The consistently large balancing item and known statistical discrepancies in the capital account increase uncertainty, but it is clear that substantial net capital inflows, especially into UK banks, will be required over the next two years.

TABLE 3.2 : FINANCING THE CURRENT ACCOUNT DEFICIT (£ bn.)

	1988	1989	1990
Current Account	-14.9	-16.3	-13.6
Balancing Item	13.9	13.5	13.0
Required Identified Capital Inflows	1.0	2.8	0.6
of which:			
Net direct investment	-7.3	-5.2	-4.5
Net non-bank non-govt portfolio	-5.1	-14.4	-11.8
Net Banks £	9.0	13.7	12.5
FC	3.9	4.6	3.2
Net general government*	0.5	4.1	1.2

* includes reserves

41. The forecast envisages net outflows on direct investment, at a slightly lower level than in 1988. Such net outflows - due in part to the retention of earnings by UK subsidiaries abroad - have been a feature of the UK economy for some years. Both inward and outward cross-border investment flows are expected to remain high in anticipation of more open EC markets in 1992, but the UK is not expected to benefit especially in terms of net inflows from the gradual removal of capital restrictions across the EC.

42. There are also large net outflows on non-bank portfolio investment, which in part reflects institutional requirements to place investment funds against the background of a contracting gilts market. Institutional investment abroad has already begun to recover sharply following their substantial disinvestment overseas after the stock market crash in October 1987. Overseas disposals of gilts will reduce the inward portfolio figure slightly.

(4) TRADE AND THE BALANCE OF PAYMENTS

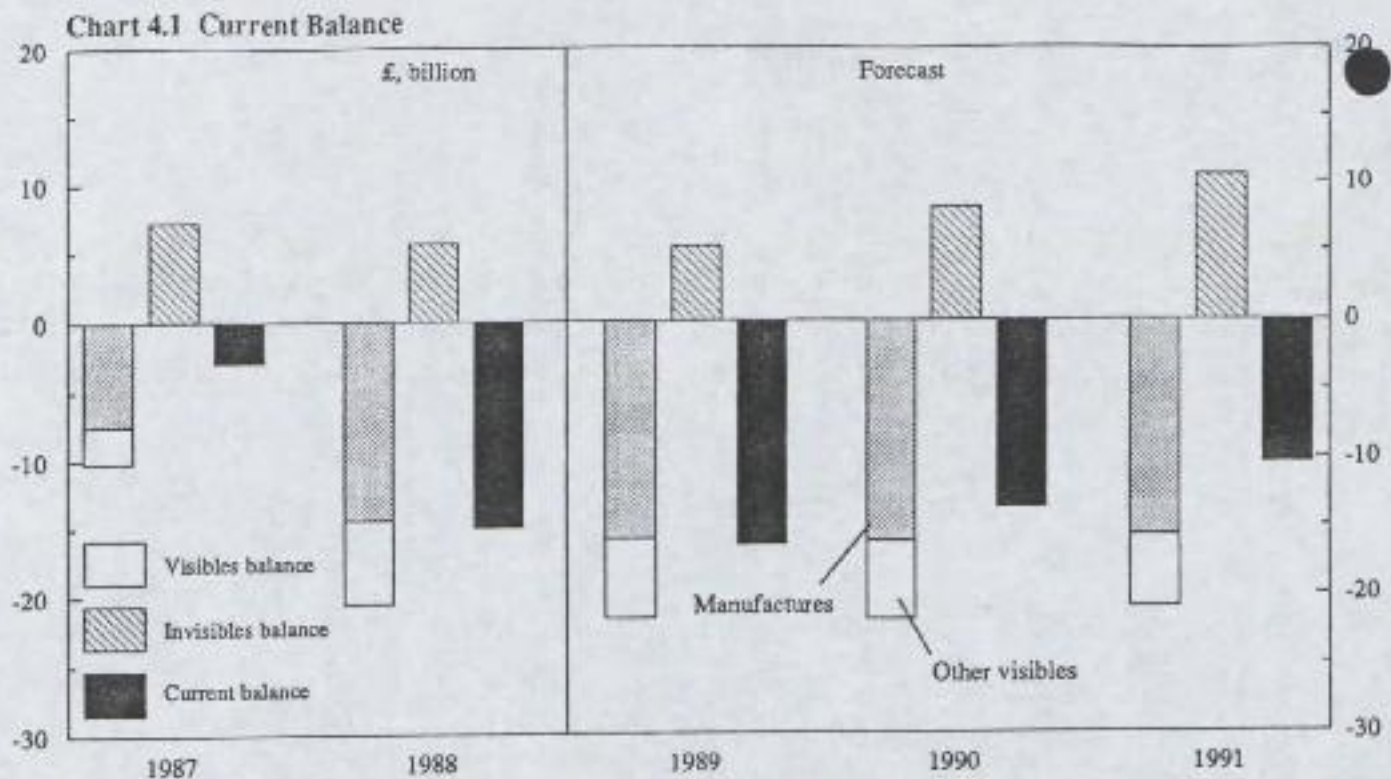
Summary

43. The forecast is for a current account deficit of £16½ bn in 1989, £1½ bn higher than last year's deficit and £1½ bn. higher than the FSBR forecast for this year. Given a cumulative deficit for the first four months of the year of £6½ bn., this implies an average monthly deficit for the rest of the year of £1½ bn.

TABLE 4.1: CURRENT BALANCE (£ bn)

	Visible trade			Total visibles	Invisibles	Current balance
	Manufactures	Oil	Other			
1987	-7.5	4.2	-6.8	-10.2	7.3	-2.9
1988	-14.4	2.3	-8.5	-20.6	5.6	-14.9
1988 Q1	-2.7	0.7	-2.0	-4.0	1.0	-3.0
Q2	-3.4	0.8	-2.0	-4.5	1.7	-2.9
Q3	-3.9	0.5	-2.2	-5.7	2.2	-3.5
Q4	-4.4	0.3	-2.2	-6.3	0.7	-5.6
1989 Q1	-4.2	0.2	-1.9	-5.9	1.0	-4.8
<u>Forecast</u>						
1989	-15.9	1.6	-7.4	-21.7	5.3	-16.3
1990	-16.1	1.7	-7.4	-21.8	8.2	-13.6
1991	-15.7	1.9	-7.1	-20.9	10.6	-10.4

44. Since reaching a peak in the fourth quarter of 1988, the deficit is estimated to have fallen somewhat in the first quarter, and this trend is expected to continue through the year. While the improvement through 1989 is not sufficient to prevent a deterioration in the current balance for the year as a whole, a steady reduction in the deficit is forecast in subsequent years.



45. The £1½ bn. deterioration in the current account forecast for 1989 is made up of a deterioration in the visibles deficit of just over £1 bn. and a deterioration in the invisibles surplus of slightly over £½ bn. The worse outcome for visibles occurs despite favourable movements in domestic demand growth and competitiveness (although world trade growth is forecast to slow down a little), and reflects two factors.

- (a) Mainly as a result of the recent spate of accidents in the North Sea, the oil balance is forecast to deteriorate by £½ bn.
- (b) The difference between the levels of non-oil imports and exports in 1988 implies that exports would need to grow by around 3½ percentage points faster than imports just to keep the non-oil deficit constant. The forecast differential of only a little under 3 percentage points in 1989 implies a deterioration of nearly £½ bn. in the non-oil trade balance.

Non-oil visible trade

46. After failing to keep pace with world trade in 1988, the volume of exports of manufactures is forecast to regain some of the losses in 1989. Despite a significant deterioration in competitiveness last year (whose lagged effects on export growth this year are expected to outweigh the effect of the more recent gains in competitiveness), the volume of exports of manufactures is forecast to grow by 9 per cent this year. More than half of this growth has already occurred in the first four months of the year;

over this period exports of manufactures were 5½ per cent higher, on average, than in 1988.

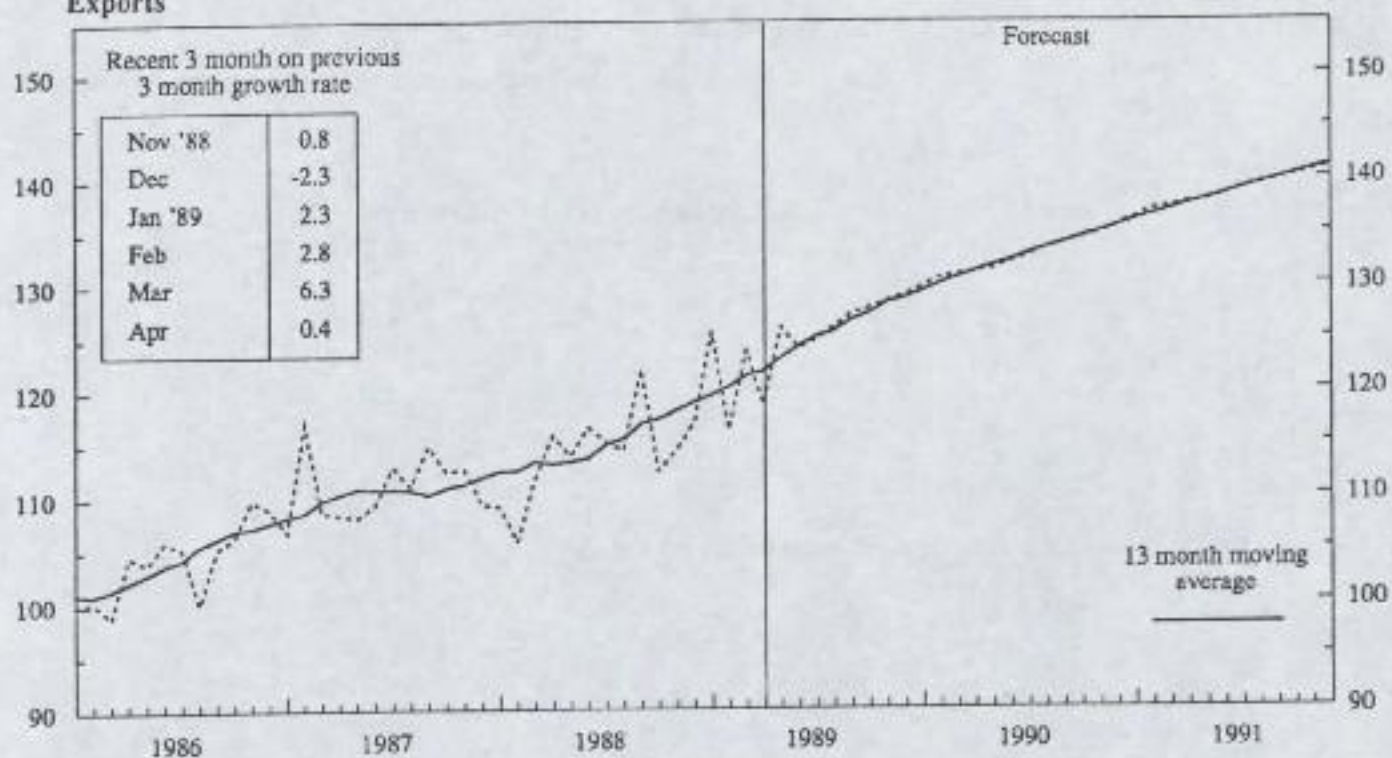
Table 4.2: EXPORTS OF MANUFACTURES AND MAIN DETERMINANTS

(per cent change on previous year)

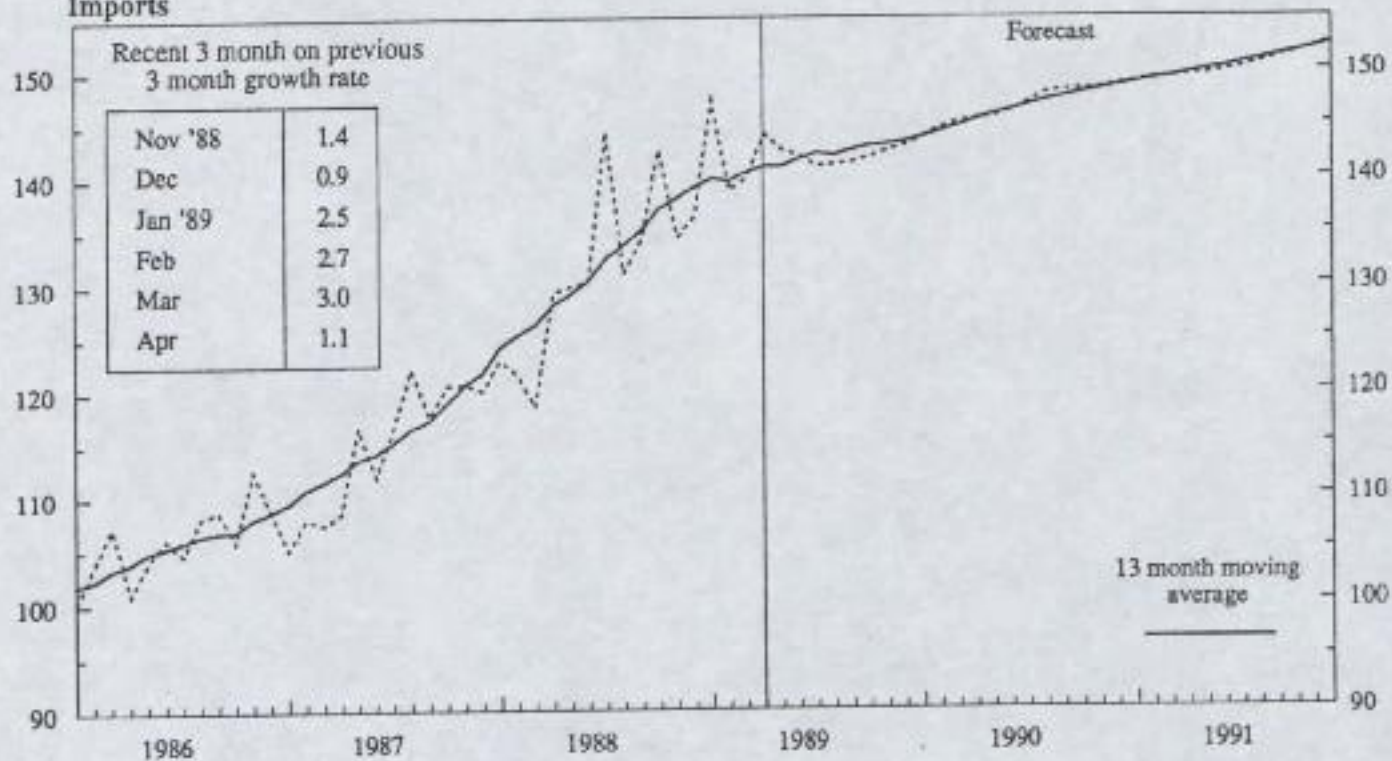
	World trade	Relative unit labour costs*	Volume of exports of manufactures
1986	2.6	-8.9	3.3
1987	8.0	-1.9	7.7
1988	10.5	8.2	4.3
1989	8.5	-0.9	9.1
1990	6.6	-1.6	6.8
1991	5.5	0.8	4.9

* fall implies improves competitiveness

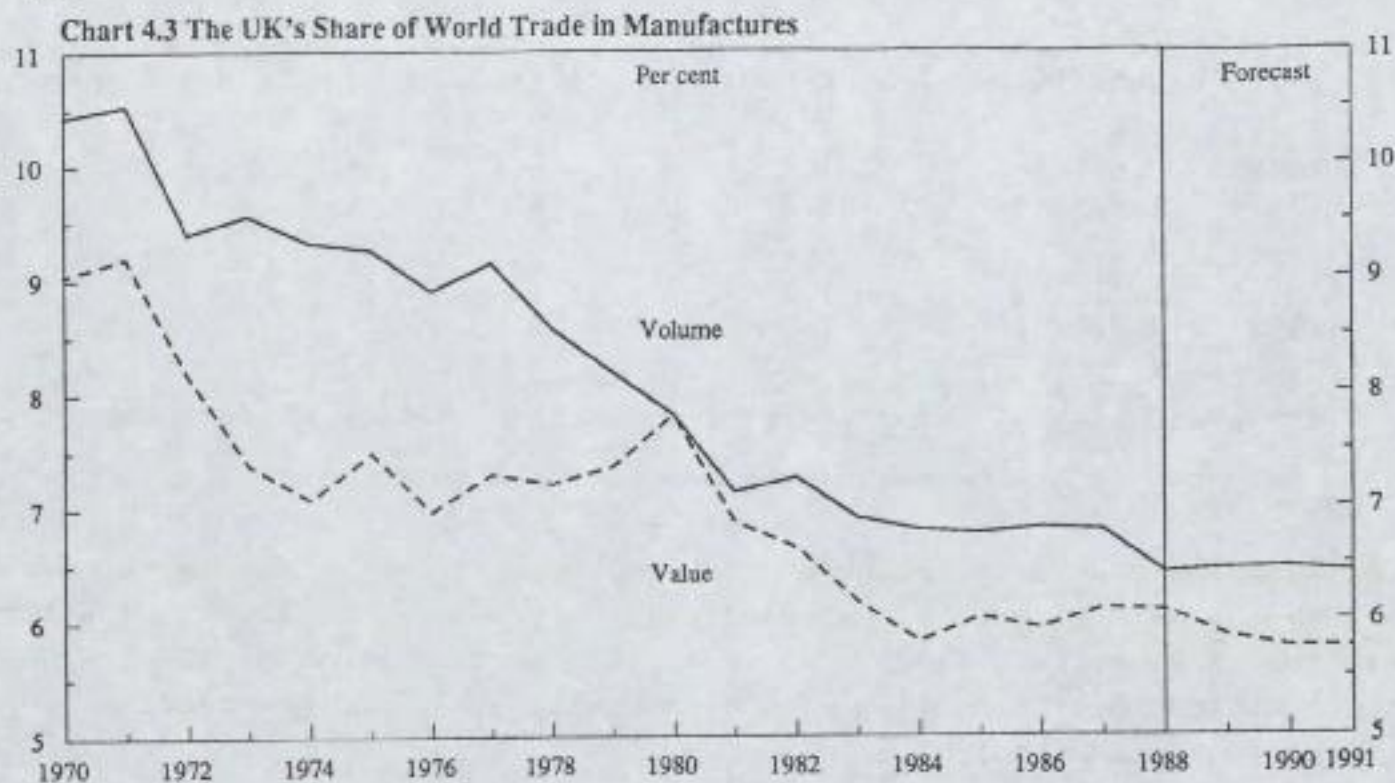
Chart 4.2 Non-Oil trade volumes
Exports



Imports



47. In subsequent years, exports of manufactures are forecast to grow broadly in line with world trade.



48. The volume of imports of manufactures is forecast to grow by just over 11 per cent in 1989. This implies that there will be little further growth on average this year beyond that which has already taken place in the first four months. This forecast flattening of imports of manufactures over the rest of the year is attributable to

- (i) the slowdown in the demand (which is rather more marked for the manufacturing-intensive components of TFE than for TFE itself),
- and (ii) the associated reduction in capacity utilisation whose effects only start to feed into import volumes in the second quarter.

The pattern of deficits in 1989 will probably be affected by the threatened dock strike. Imports and exports may have been boosted by similar percentages in the second quarter in anticipation of a strike and may be correspondingly reduced in the third quarter whether a strike occurs or not.

SECRET

TABLE 4.3: IMPORTS OF MANUFACTURES AND MAIN DETERMINANTS
(per cent change on previous year)

	Total final expenditure	Relative unit labour costs*	Capacity utilisation**	Volume of imports of manufactures
1986	4.1(3.3) ¹	6.3	48	5.9
1987	5.0(6.0)	1.8	54	9.7
1988	4.8(9.4)	-8.2	68	17.1
1989	3.3(5.1)	-0.5	62	11.1
1990	2.7(3.5)	1.2	54	4.1
1991	2.5(2.6)	-1.3	51	3.0

* rise implies improved competitiveness

** percentage of firms (level) reporting operation at full capacity

¹Figures in brackets show the demand for manufactures

49. A sharp slowdown in the growth of imports of manufactures is forecast in 1990 as the main effects of slower demand growth and lower capacity utilisation are felt. Also, the fall in competitiveness in 1988, whose effects on trade tend to be felt with a lag, will no longer be exerting any significant adverse effect by 1990.

50. The effects of changes in capacity utilisation have again played an important part in the forecast. Changes in capacity utilisation in 1989 and 1990 reduce imports of manufactures by around 2 per cent (nearly £2 bn.) in each year. A small allowance for capacity effects, worth about £½ bn. in both 1989 and 1990, is built into the forecast for exports.

51. Some support for the link between capacity utilisation and trade volumes is provided by commodity-level data which shows some correlation between improved trade performance and the extent to which capacity constraints have eased.

TABLE 4.4 : CAPACITY* AND TRADE BALANCE (£bn) BY COMMODITY GROUP

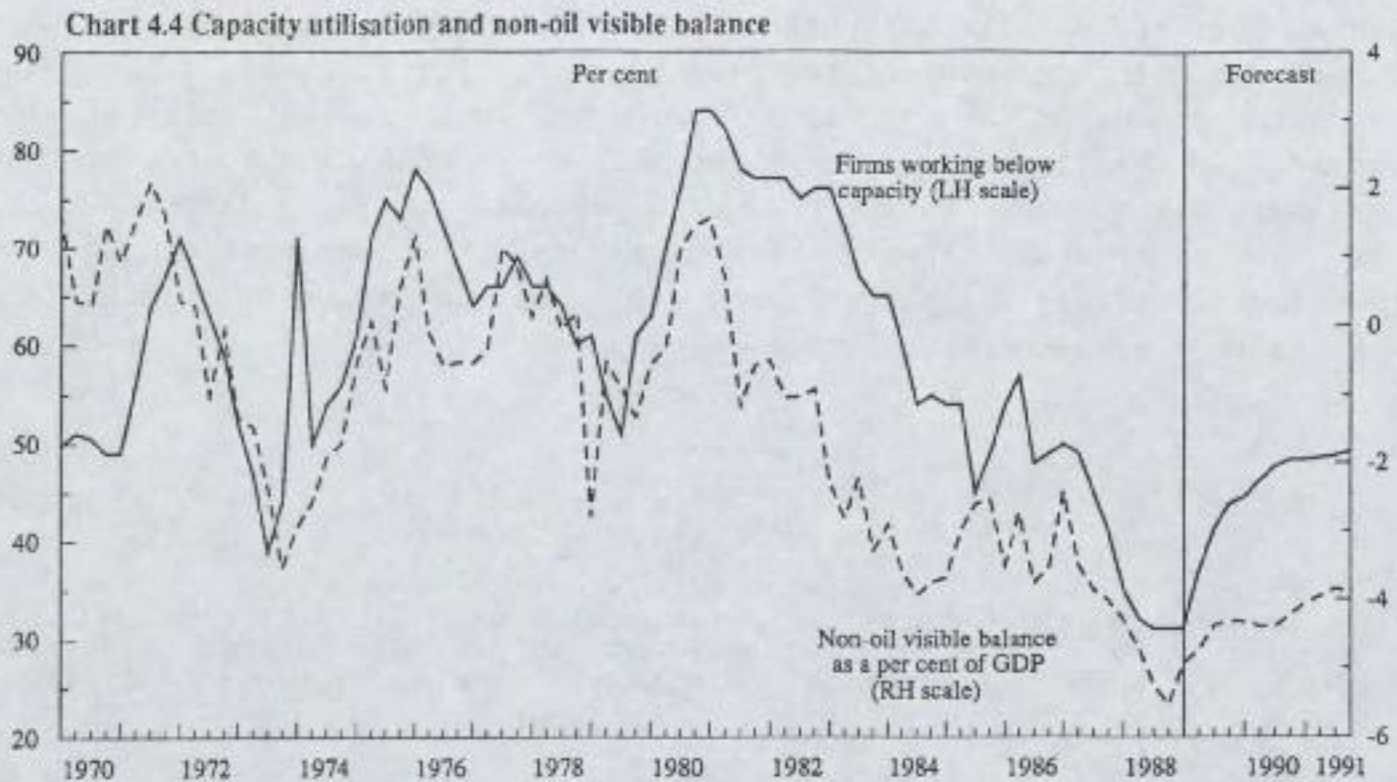
	Consumer goods		Capital goods		Intermediate goods	
	Trade balance	Capacity	Trade balance	Capacity	Trade balance	Capacity
1988 Q4	-4.3	74	-0.3	65	-2.9	68
1989 Q1	-3.7	69	-0.4	70	-2.9	68
1989 Q2**	-3.8	58	-0.6	66	-3.2	64

* CBI measures of percentage of firms operating at full capacity

** April figure at quarterly rate

52. The consumer goods industries have reported the most pronounced reduction in capacity shortages this year, and this has been accompanied by

a significant improvement in the trade balance. But in the capital goods industries - where capacity constraints have, if anything, worsened in 1988 - the trade balance has deteriorated. Chart 4.4 summarises the relationship at the aggregate level.



53. The recent upward movement in the terms of trade in manufactures has continued in the first quarter of 1989 with a 1 per cent rise on the previous quarter. However the fall in the exchange rate is expected to halt this upward movement. Nevertheless the terms of trade are still forecast to be higher in 1989 than in 1988. The forecast assumes no change in the terms of trade from the fourth quarter of 1989.

TABLE 4.5: TERMS OF TRADE IN MANUFACTURES
(per cent change on year earlier)

	Price of Imports (AVI)	Price of Exports (AVI)	Terms of trade
1987	3.4	3.5	0.1
1988	-0.8	2.3	3.0
1989	1.3	3.7	2.4
1990	5.0	4.0	-1.0
1991	4.3	4.3	0

54. While the forecast for trade in manufactures contributes £1½ bn. to the deterioration in the current balance in 1989, the balance on non-manufactures is forecast to improve by £1 bn. The relatively slow growth of imports of non-manufactures is not surprising since these goods tend to have a lower income-elasticity than manufactured goods. But the strength of exports of non-manufactures forecast for 1989 is rather surprising. Around two-thirds of the forecast 12 per cent growth in 1989 has already occurred in the first quarter and represents a combination of higher than normal exports of grain to the USSR as a result of poor harvests last year, and increased exports of eggs and dairy produce to the EC. With these factors likely to prove temporary, non-manufactured exports are expected to grow substantially more slowly over the rest of the forecast.

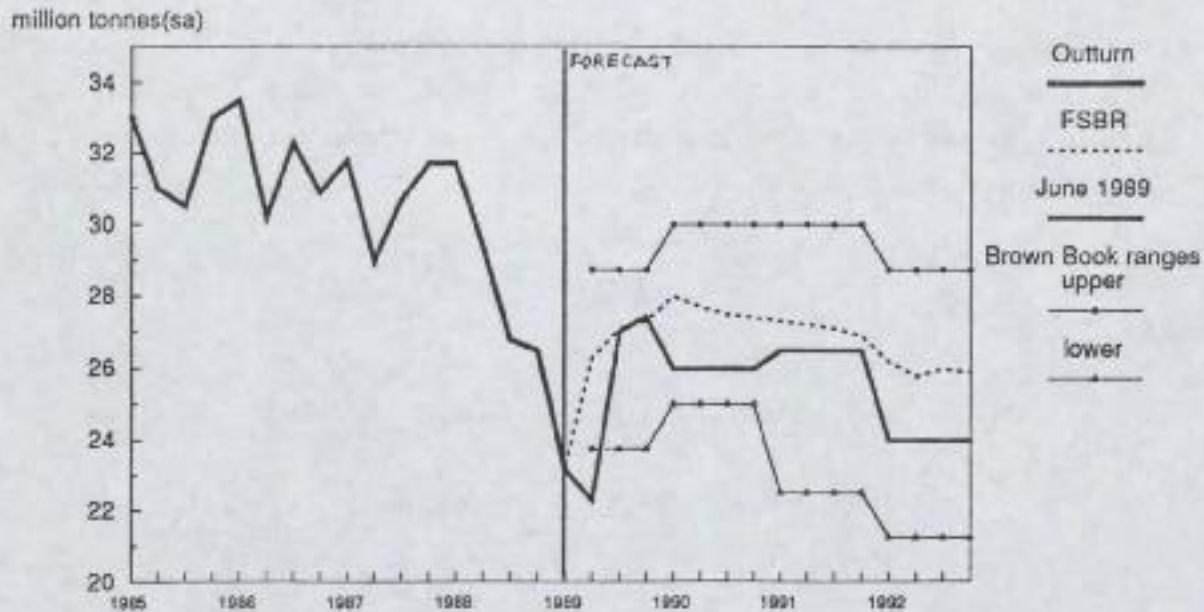
North Sea oil

TABLE 4.6 : NORTH SEA OIL FORECAST

	Average North Sea price		Output (oil+ NGLs) (m.tonnes)	Estimated accidents loss (m.t)	Growth in UK demand (% p.a)	Oil Trade balance (£bn)	North Sea Revenue (£bn)
	\$p.b	fp.b					
1987	18.0	10.9	123.2	-	-3.4	4.2	4.5
1988	15.1	8.4	114.4	7.0	6.0	2.3	3.6
1989	17.6	10.7	99.9	13.7	3.5	1.6	3.0
1990	16.4	10.0	104.0	7.9	2.0	1.7	2.6
1991	17.3	10.4	106.0	3.5	1.5	1.9	2.6

55. The underlying path of a gentle decline in North Sea production since its peak in 1985 has been severely disrupted by a series of accidents. Most of the implications of the accidents were incorporated in the PSBR forecast, but the subsequent Cormorant Alpha incident and revisions to expected restart dates in other fields have reduced the 1989 output forecast by a further 4 million tonnes (mt) to 100mt. The latest estimate is that output has been reduced by 7mt in 1988 and 13.7mt in 1989 on account of accidents - roughly 6 per cent and 12 per cent of potential.

Chart 4.5: Quarterly path of North Sea production
FSBR & June forecast



56. Over the forecast production recovers as fields come back on stream, but is lower than in the FSBR. Postponement of new field starts and downward revisions to some existing fields are partly responsible, but the main factor is a 5 per cent allowance for further accidents in the older fields which has been incorporated in this forecast. Set against this, the Piper reservoir is now expected to produce more than it otherwise would have done in years beyond 1993. Annual production is still expected to fall within the announced (Brown Book) ranges.

57. Oil prices turned out somewhat higher in Q1 than was assumed in the FSBR and the forecast has been revised upwards in the light of market developments. The premium which Brent oil attracts over higher sulphur Middle Eastern crudes has recently been as high as \$2.50 with the shortage of supply, but is not expected to fall back further than \$2 by the end of 1989 and through 1990 because of the shift in demand towards unleaded petrol which is more easily manufactured from light crudes. Prices have fallen recently following the OPEC agreement to increase supply.

58. The oil trade balance is now believed to be more adversely affected by the accidents than was anticipated in the FSBR. The effects are still concentrated in the first half of 1989 - net exports in 1989H1 are now likely to be only one third of the 1988H1 value. Overall, the loss to visible trade in 1989 due to North Sea accidents could be as much as £1 bn. at current and forecast prices and exchange rates. The oil trade surplus is

forecast to be around £1½ bn. in 1989 and then to rise gradually to just under £2 bn. in 1991.

59. On invisibles, however, the contribution of oil improves as North Sea production declines, with as a result lower profits due abroad, and UK companies invest relatively more abroad. Net credits from oil interest profit and dividends should reach £2 bn. in 1990, exceeding the surplus from oil trade.

Invisibles

TABLE 4.7 : SUMMARY OF INVISIBLES BALANCES

	Services	IPD	Transfers	Total Invisibles
1987	5.3	5.4	-3.5	7.3
1988	3.4	5.8	-3.6	5.6
1989	4.2	5.1	-4.0	5.3
1990	6.0	6.9	-4.7	8.2
1991	6.9	8.5	-4.8	10.6

60. The invisibles balance for 1988 is currently estimated at £5.6 bn., a sharp fall over the 1987 level. Data revisions are common in this area. Interest profit and dividends (IPD) improved marginally, but have essentially been flat for 3 years, and net outflows of transfers were unaltered in 1988. Earnings from trade in services fell back to their lowest level for five years.

Services

61. Two principal factors lie behind this fall in the surplus on services:

- The deficits on travel and on civil aviation have increased sharply as UK residents have been travelling and spending more outside Western Europe (particularly N America), reflecting favourable movements in the exchange rate during 1988 and strong growth in consumer demand. Foreign tourists spent 3 per cent less in the UK in the year to 1988, whereas UK residents spent 12 per cent more abroad over the same period.
- Earnings from exports of financial services grew dramatically in the early 1980s, but have now levelled off at a surplus of around £9 bn.

This is mainly attributable to a turnaround in Lloyds net premiums reflecting the decline in the dollar, a downturn in the insurance cycle after mid 1987, and a catch-up of claims with the higher premiums introduced to protect against high awards in the US courts.

62. Data on services for the first quarter of 1989 are encouraging on the exports side, but do not yet show a reversal of the trend in imports. The forecast for import volumes has been revised up from the FSBR. Nevertheless import volume growth is forecast to fall in 1989 and 1990 as domestic demand slackens. Travel debits in particular are expected to fall from recent high levels in response to the tightening of monetary policy. Export volume growth is a little higher than in the FSBR reflecting strong growth in world demand. In addition export prices are expected to rise faster than import prices in 1989, hence the services surplus is forecast to recover in 1989 and improve further in 1990 and 1991.

TABLE 4.8 : TRADE IN SERVICES

	Volumes		Values (f bn.)		
	Exports (Percentage change over previous year)	Imports	Exports	Imports	Balance
1988	-2.3	8.6	27.5	24.1	3.4
1989	4.3	2.9	30.9	26.7	4.2
1990	5.3	0.4	33.9	28.0	6.0
1991	3.4	1.7	36.4	29.6	6.9

IPD

63. The IPD balance improved slightly in 1988, with the largest increase coming from the oil sector where declining production and accidents reduced payments abroad by North Sea companies. Portfolio earnings declined despite a gradual recovery in the share of portfolios allocated to overseas equities and bonds after the repatriation of assets following the October 1987 crash.

TABLE 4.9 : SUMMARY OF IPD BALANCES

	Banks' lending Foreign currency	sterling	Direct Investment Non-oil	Oil	Portfolio	Other	Total	Change in net assets
1877	0.7	-0.9	4.3	0.2	1.9	-0.8	5.4	-11.0
1988	0.9	-1.2	4.3	1.1	1.4	-0.7	5.8	16.1
1989	0.8	-3.2	5.7	1.2	1.6	-1.0	5.1	35.3
1990	1.2	-4.9	6.6	2.1	3.0	-1.0	6.9	11.8
1991	1.3	-6.0	6.9	3.1	4.3	-1.1	8.5	15.8

64. The IPD surplus falls in 1989, but recovers in 1990 and 1991. The UK's net identified stock of net overseas assets should rise considerably in 1989 on account of the strength of the dollar, but this is not forecast to be sufficient to offset an increase in interest payments abroad on banks' sterling lending. This interest element of IPD is adversely affected by higher levels of UK interest rates, because the stocks of liabilities are so much higher than of assets in respect of banks' sterling lending. Net IPD credits improve beyond 1989 as the spreads between rates of return on debits and credits narrow back to long run levels.

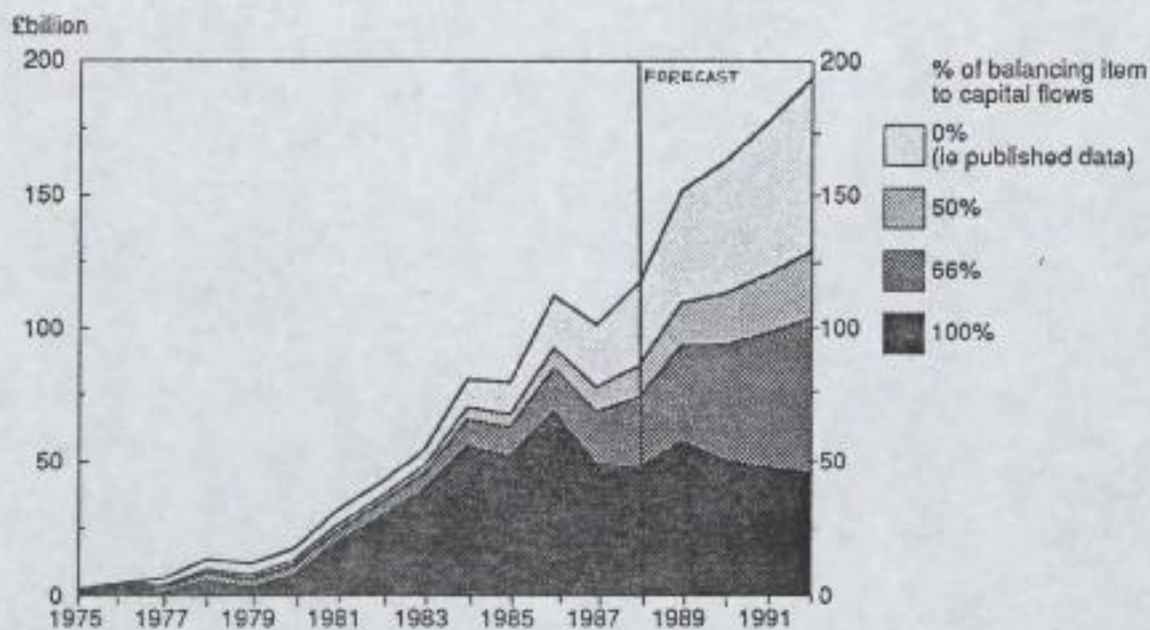
65. The invisibles surplus as a whole is expected to rise over the forecast - net debits on transfers increase, but the surpluses on services and IPD increase by more. The improvement in the balance after 1989 is not especially dramatic in relation to GDP - the invisibles surplus was 1.8 per cent of money GDP in 1987, and is forecast to fall to 1.1 per cent in 1989 and recover to 1.8 per cent by 1991.

The UK's net overseas assets

66. The continuation of large current account deficits might initially be expected to result in a reduction in the net overseas asset stock. But revaluations, caused by sterling's decline and the relatively slower growth of UK equity prices, raise the sterling value of the UK's net asset position. In addition the net capital inflow required to finance the deficit equals the current account deficit less the balancing item. Since large balancing items on the overseas sector are expected to continue, the identified stock of net external assets is not reduced very much by the large deficits. The combined effect of the revaluations and the assumption about the balancing items results in a projected increase in the net identified overseas asset stock to nearly

£180 bn. by the end of 1991. However this overstates the true level of the UK's net assets. Chart 4.6 shows the level of net overseas assets using various assumptions about the proportion of the balancing item that represents unidentified capital inflows.

Chart 4.6: STOCK OF NET OVERSEAS ASSETS, 1975-92



Top line is IDENTIFIED net stock overseas assets using CSO's methods

Other lines show net stock of overseas assets implied if various proportions of the balancing item are allocated to capital (in)flows

Recent developments

67. Consumer spending has slowed sharply since the summer of last year. Retail sales have decelerated since July, though they have recently been subject to erratic monthly movements (Chart 5.1). For example there was a strong pick up in May, following a sharp fall in April. The pick up in May was briefly foreshadowed by a recovery in the EC/Gallup Survey of consumer confidence, which till then had been on steep downward trend from June of last year (Chart 5.2). The EC Consumer Confidence indicator fell back in June, following the increase in interest rates in late May. The attitude to major purchases from the same survey has been flat since late 1988 following a steep fall from mid-year (Chart 5.3). The CBI/FT survey also reported a recovery in retail sales in May. Despite the recovery in May, retail sales growth in the latest three months (March-May) on the same period a year earlier was 3.8 per cent, the lowest annual growth since early 1986. John Lewis sales figures for the first two weeks of June suggest slower growth than in May.

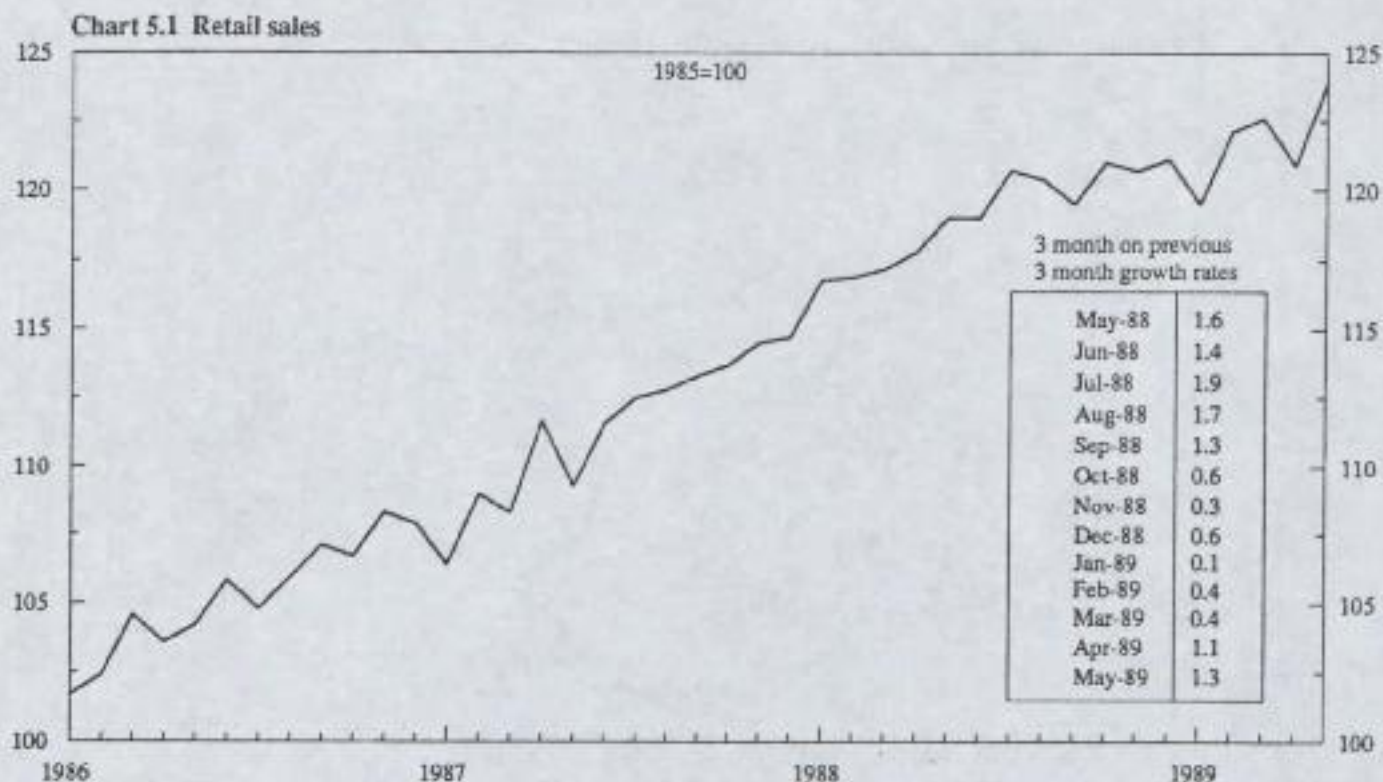


Chart 5.2 Consumer confidence and total consumer spending

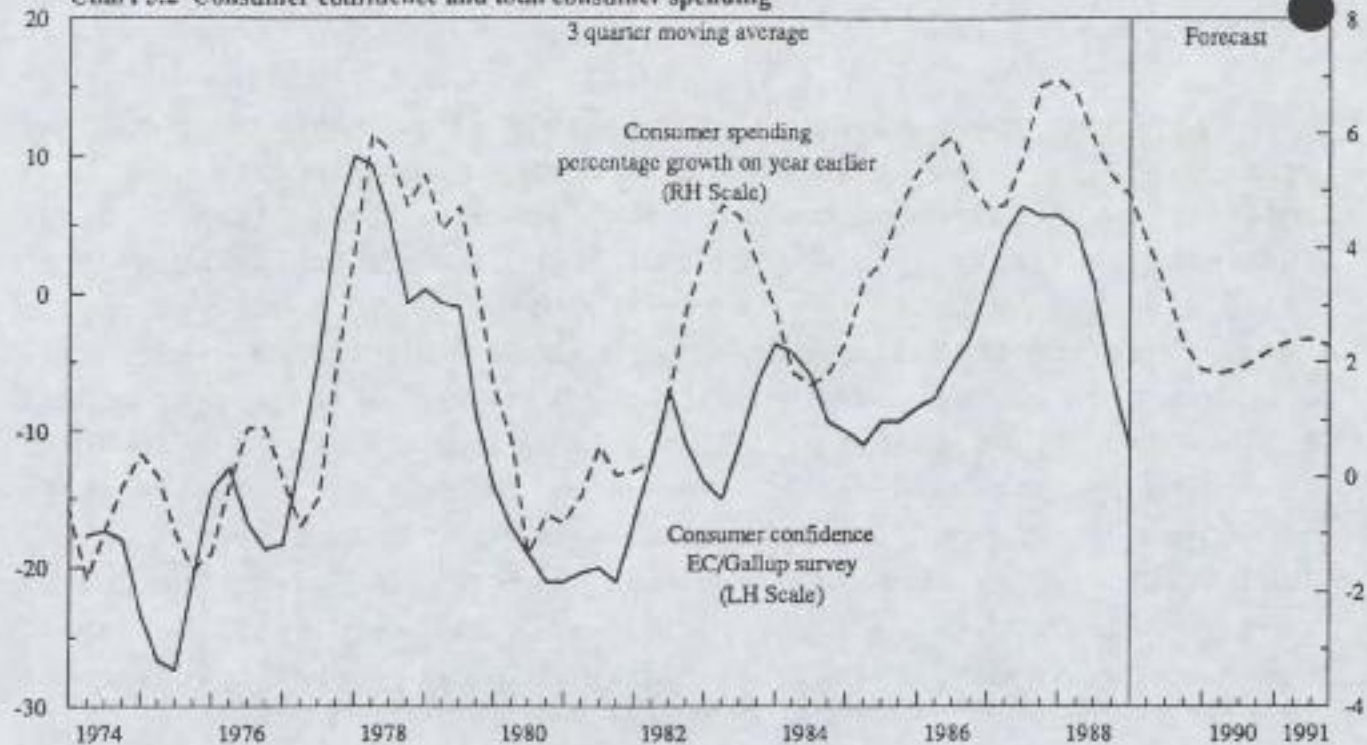


Chart 5.3 Attitude to major purchases and durables spending

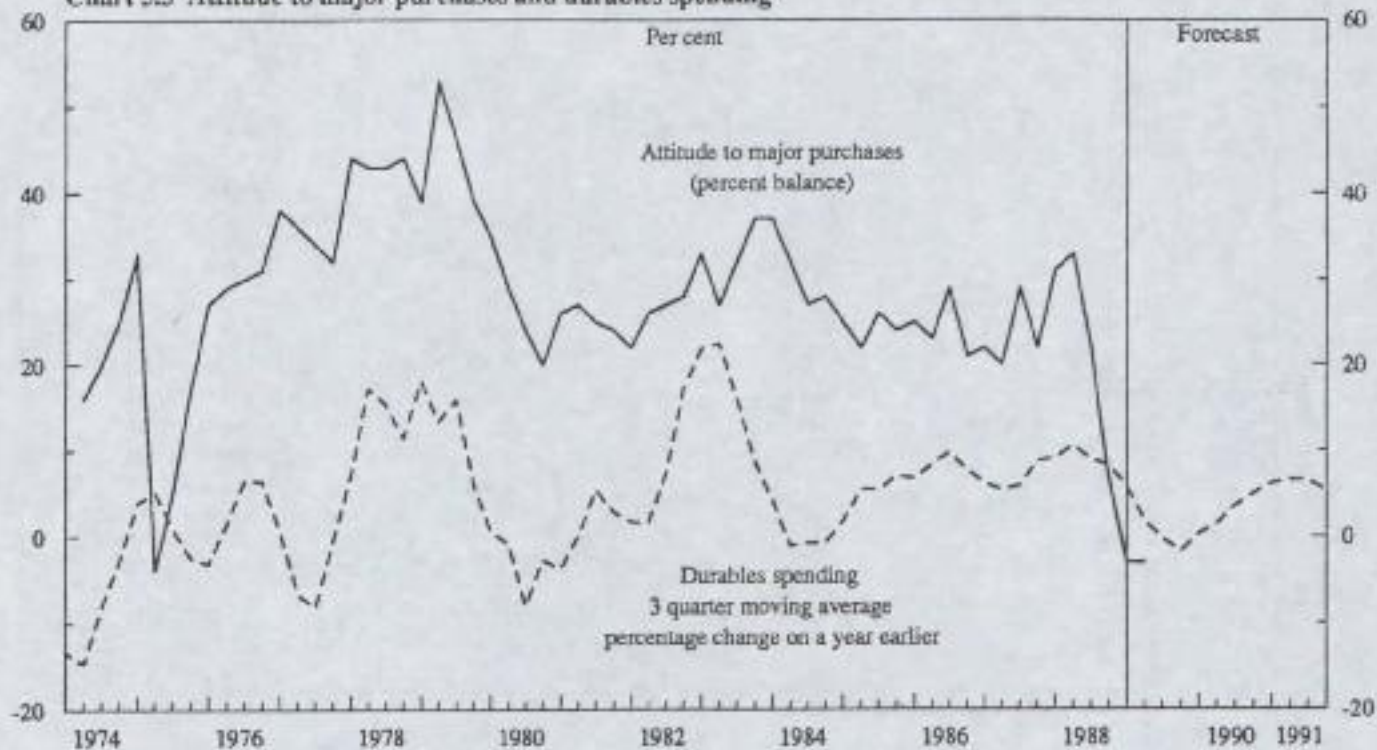


Chart 5.4 New car registrations by persons and companies

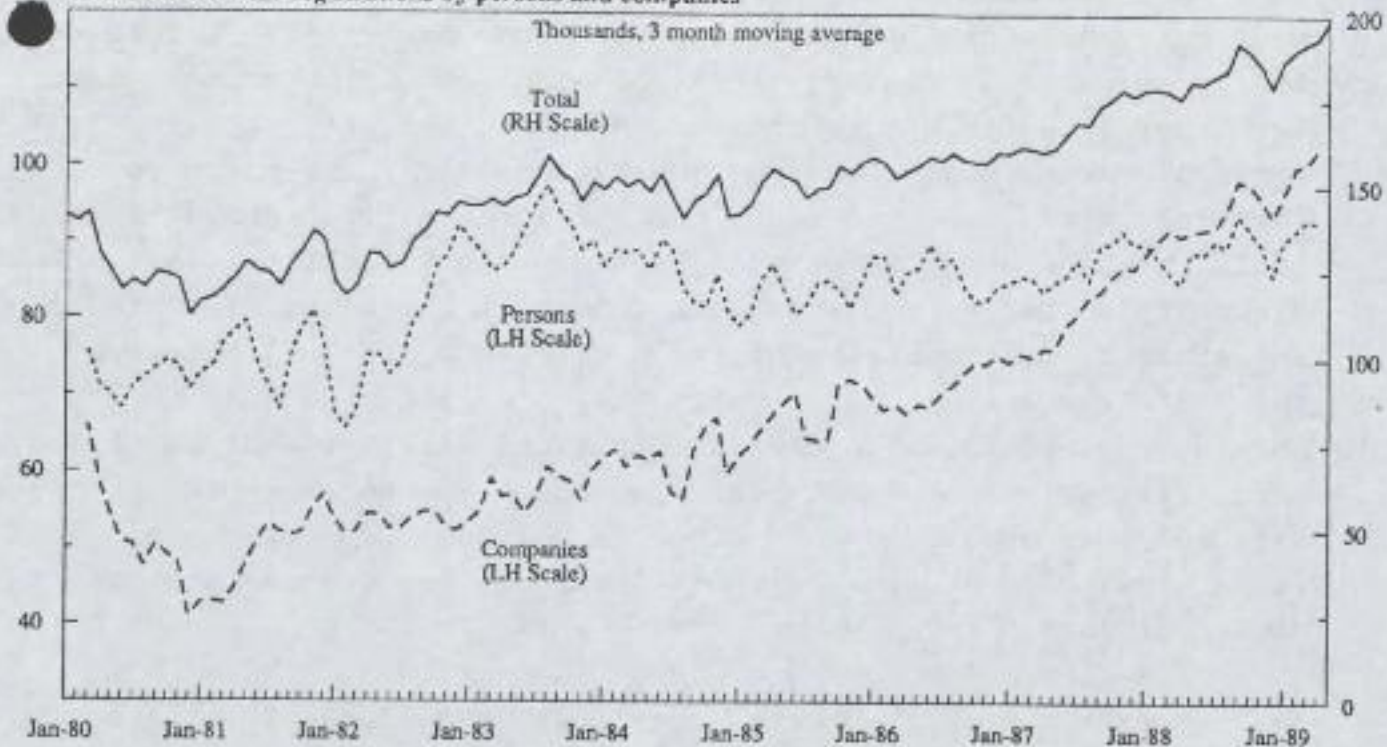
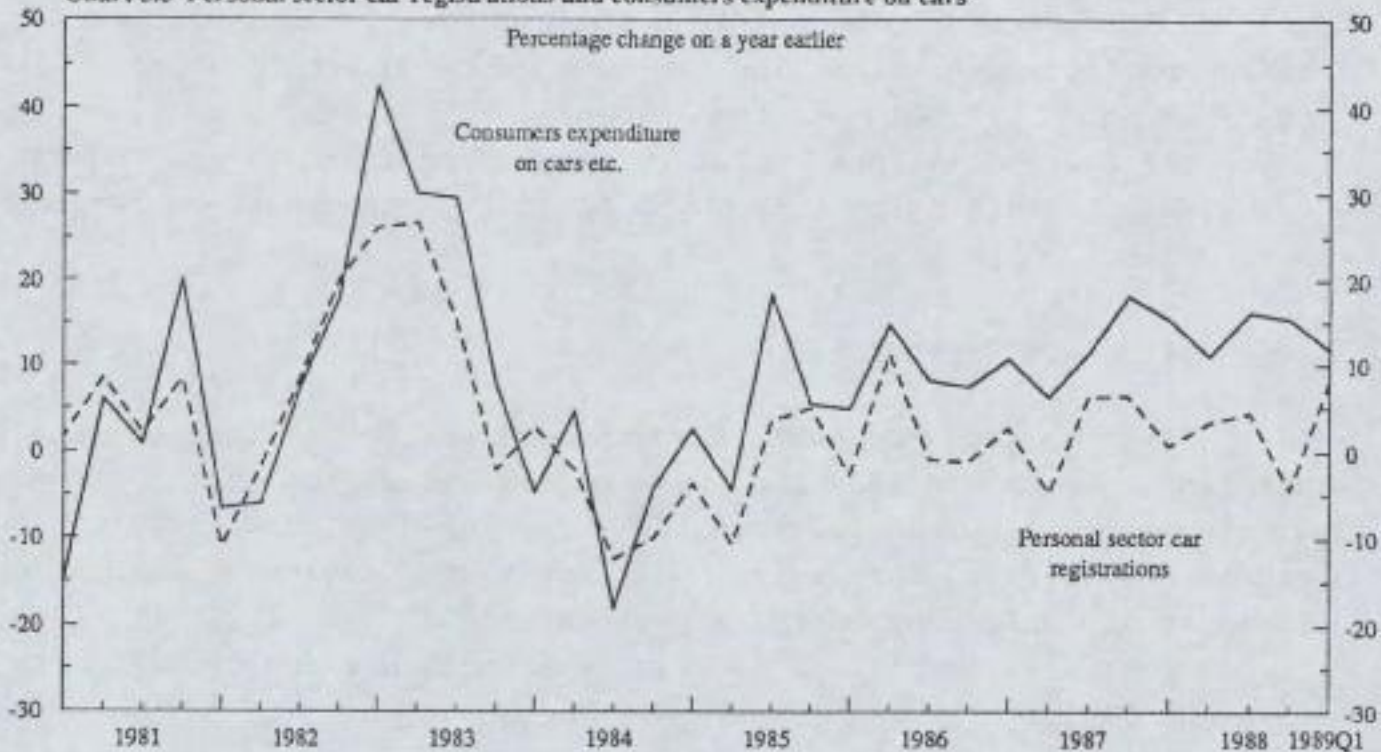


Chart 5.5 Personal sector car registrations and consumers expenditure on cars



68. New car registrations continue to grow quite strongly. But most of the sharp pick-up in growth since early 1987 is accounted for by company car registrations. The number of personal sector new car registrations has been rising slowly (Chart 5.4). Personal sector real spending on vehicles (including motor cycles, caravans etc), on the other hand, has risen at an annual rate of 10-15 per cent over the past eighteen months (Chart 5.5). The disparity between registrations and real expenditure is probably explained by the inclusion of car purchases by the self-employed in personal sector spending, while they are likely to be recorded as company registrations in the registrations data. The disparity may also reflect second-hand car purchases in the consumer spending data and, perhaps, a move to bigger or higher quality cars. But even growth in consumer spending on cars has come down since the middle of 1988.

69. Consumer credit growth continues significantly below the average in the first eight months of last year. Though building society mortgage lending and commitments picked up in April, the levels remain lower than in the first half of 1988. In any case, the recovery seems to be mainly accounted for by increased market share by building societies in the first quarter (expected to continue into 1989Q2) at the expense of banks. By itself, therefore, it does not point to renewed pressure in the housing market or to a significant increase in equity withdrawal to finance consumption.

Income and expenditure: the outlook

70. The forecast projects a sharp deceleration in real personal disposable income in 1989 and 1990, mainly because of much slower growth of employment relative to 1988 (caused by the slow-down in output growth), and increasing net interest payments. RPDI is forecast to rise by only 2 per cent in 1989 and 1990; it rises 2½ per cent in 1991. It is boosted by a small assumed tax cuts in 1990 and 1991.

71. The slowdown in real disposable income and house price inflation projected for 1989, along with an already high level of debt servicing and recent low levels of confidence, all point to a deceleration in consumer spending in 1989. It is likely to rise by 2 per cent in the year to 1989Q4, after growth of 5½ per cent in the year to 1988Q4. Consumer spending is likely to remain sluggish, rising by 2 to 2½ per cent through both 1990 and 1991.

Spending on durables is expected to fall slightly during 1989. The saving ratio is projected to fall further through 1989 and to recover slowly in 1990 and 1991.

Table 5.1: CONSUMER SPENDING, RPDI AND THE SAVING RATIO
(percent changes on a year earlier)

	<u>Total</u>	<u>Consumer spending</u>		<u>RPDI</u>	<u>Saving Ratio (%)</u>
		<u>Durables</u>	<u>Non-durables</u>		
1988	6.4	10.0	6.0	4.8	4.6
1989	3.5	1.1	3.8	2.1	3.3
1990	1.8	2.5	1.8	2.0	3.4
1991	2.4	6.6	1.9	2.7	3.7
1988Q4	5.6	8.1	5.3	5.6	5.0
1989Q4	2.0	-0.6	2.3	-0.2	2.9
1990Q4	2.0	5.7	1.6	2.4	3.3

72. The forecast slow-down in consumers' expenditure relative to income is similar to the last lull in personal spending between 1983Q3 and 1984Q4. The main difference is that it endures longer. However, it comes after the most sustained burst of strong consumer spending for the last twenty-five years (averaging almost 6 per cent a year between 1985 and 1988). Some retrenchment may, therefore, be expected, especially given a tightening personal sector financial position over the forecast period.

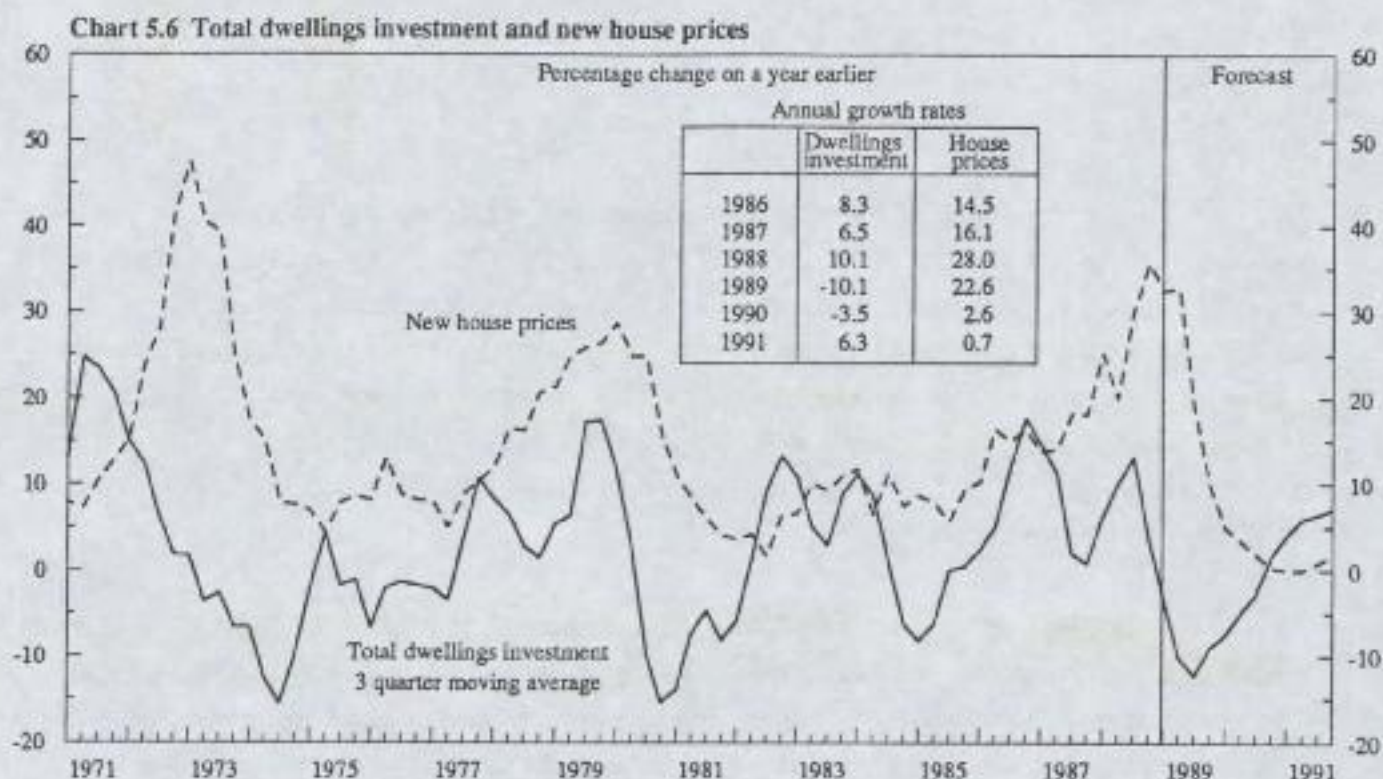
73. Nonetheless, there is still a major uncertainty. Persons may continue to borrow to finance rising consumption and interest payments. Their total wealth: income ratios, while falling over the forecast period, still remain at historically fairly high levels. So there may be considerable scope for further borrowing. In that event, consumer spending growth may be faster than predicted in 1989 at least and perhaps into 1990. But that would be storing up trouble for later years, when retrenchment would have to be correspondingly more severe.

The housing market

74. The housing market has eased substantially in recent months in response to high interest rates. House prices are decelerating, mortgage activity is sluggish, and new housing starts and completions have both fallen from their levels in early 1988. House price inflation is expected to abate to 10 per cent by the end of 1989. House prices

are forecast to be flat from 1990Q1 till the middle of 1991. A sharp fall in house price inflation is consistent with behaviour in the aftermath of past housing booms (Chart 5.6). What is unusual in the current forecast is a sustained period of stable house prices from the beginning of 1990. But real interest rates are maintained at an unprecedentedly high level for an unprecedentedly long time, at least in post war experience. It is possible that average UK new house prices may actually fall for a while against such a background.

75. Total housing investment (new housing and improvements) is expected to fall by 10 per cent in 1989 (investment in new houses actually falls 25 per cent, while investment in improvements rises hardly at all) and to fall further in 1990. It starts to recover thereafter (Chart 5.6).



76. In these circumstances, turnover in the housing market is expected to decline substantially, with a fall in the annual rate of growth of mortgage borrowing from current levels of over 20 per cent to around 14 per cent by end-1990. The scope for mortgage equity withdrawal declines markedly. This is another factor likely to depress consumers' expenditure.

TABLE 5.2: HOUSING FINANCE

(Percent changes on a year earlier unless otherwise stated)

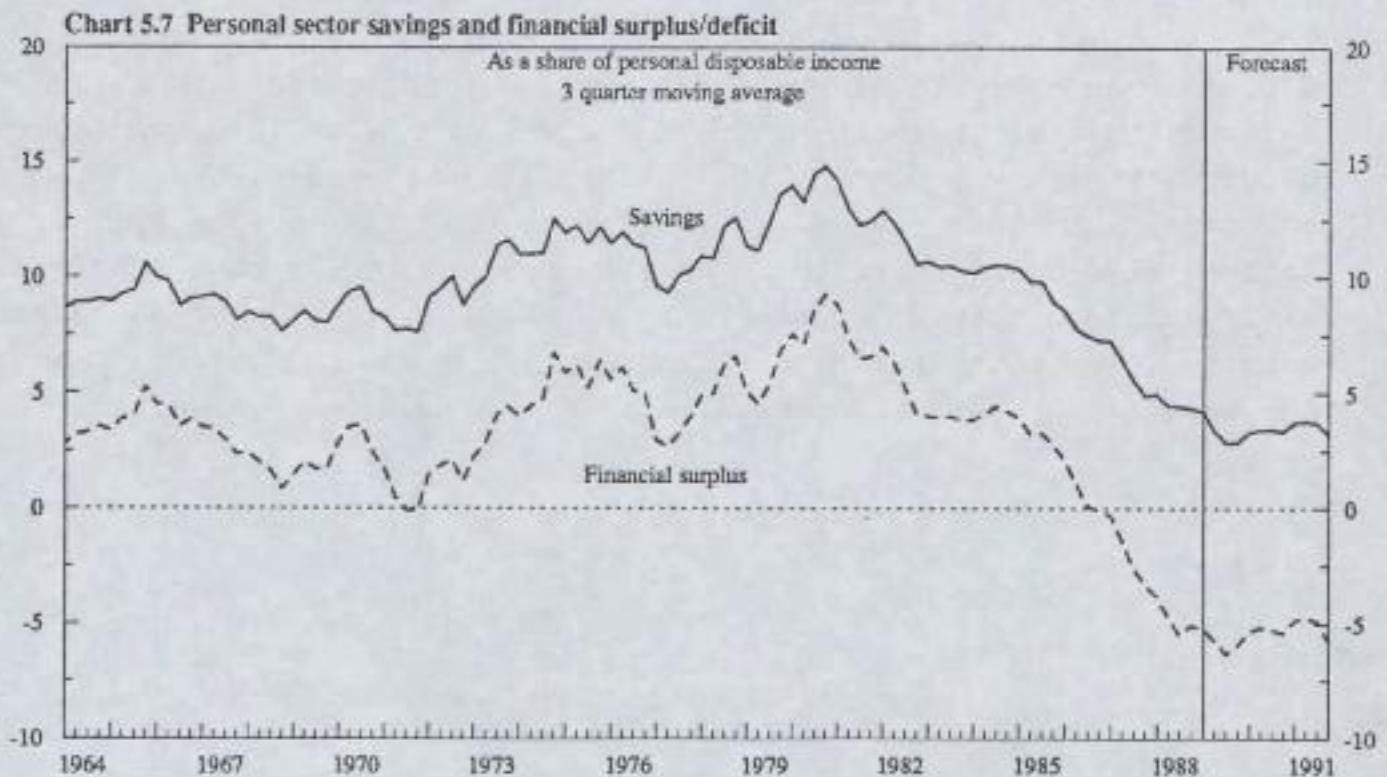
	New House Prices	Mortgage Borrowing from all sources			Estimated Mortgage Equity Withdrawal		Mortgage Rate Average over year
		%	fbn		% ⁽¹⁾	fbn	%
1985Q4	9.2	17.9	19.0	1985	6.3	7.4	13.2
1986Q4	16.4	21.6	27.0	1986	9.6	13.5	11.8
1987Q4	18.2	18.9	28.7	1987	7.5	12.7	11.5
1988Q4	35.7	22.2	40.2	1988	9.4	19.3	11.0
1989Q4	10.0	13.8	33.5	1989	3.7	8.8	13.5
1990Q4	0.4	14.0	37.7	1990	4.8	13.2	13.5
1991Q4	1.8	13.7	41.6	1991	5.2	16.1	13.3

(1) As a percent of outstanding stock of mortgage borrowing.

Personal sector financial position

77. Charts 5.7-5.11 summarise the personal sector's financial position. The personal sector went into financial deficit in 1987 and is forecast to remain in deficit over the next three years. The last time the personal sector ran a sustained (or even a single year) deficit was in the late 1940s and early 1950s, in the post-war recovery. Most measures of the personal sector's wealth-income ratios rose sharply through the 1980s. The forecast reveals a mixed picture.

78. The slight rise in the savings ratio and the fall in dwellings investment lead to a small reduction in the personal sector's financial deficit during 1990 (Chart 5.7).



79. The net financial wealth: income ratio (including life assurance and pension funds (LAPFs)) falls steadily over the forecast period, but remains historically high (Chart 5.8). Excluding LAPFs, however, the forecast projects a continued deterioration in the net financial wealth: income ratio to historically low levels. Arguably it is the latter which features most prominently in individuals' assessment of their financial position. A more sanguine picture emerges from total wealth: income ratios which include housing wealth (Chart 5.9). On this measure, the personal sector's position deteriorates over the next two years, but remains very strong by historic standards if LAPFs are included. Excluding LAPFs, the position is still comparatively comfortable.

80. Income gearing (the ratio of gross debt interest payments to personal income) reached record levels in 1988 and early 1989, and is expected to go on rising steeply (Chart 5.10). Total gross interest payments could account for about 13 to 15 per cent of disposable income throughout the forecast period. Any given level of gross interest payments now has a greater impact on net income because income tax rates have been reduced substantially and the proportion of mortgage payments that qualify for tax relief has been steadily declining.

81. Finally, the UK household sector's gross debt: income ratio, which until recently was at similar levels to other G7 countries, is projected to rise well above average levels elsewhere - even the US (Chart 5.11).

82. In summary, total wealth (including housing and LAPFs) of the personal sector remains fairly healthy. This could be exploited to secure further borrowing to sustain faster spending growth than forecast for 1989 and into 1990, though perhaps at the expense of a sharper slow-down thereafter. Another possibility is that individuals will maintain their consumption by running down their gross wealth holdings. Most other financial indicators, however, suggest that the personal sector needs to concentrate on moderating its spending.

Chart 5.8 Ratio of personal sector net financial wealth to income

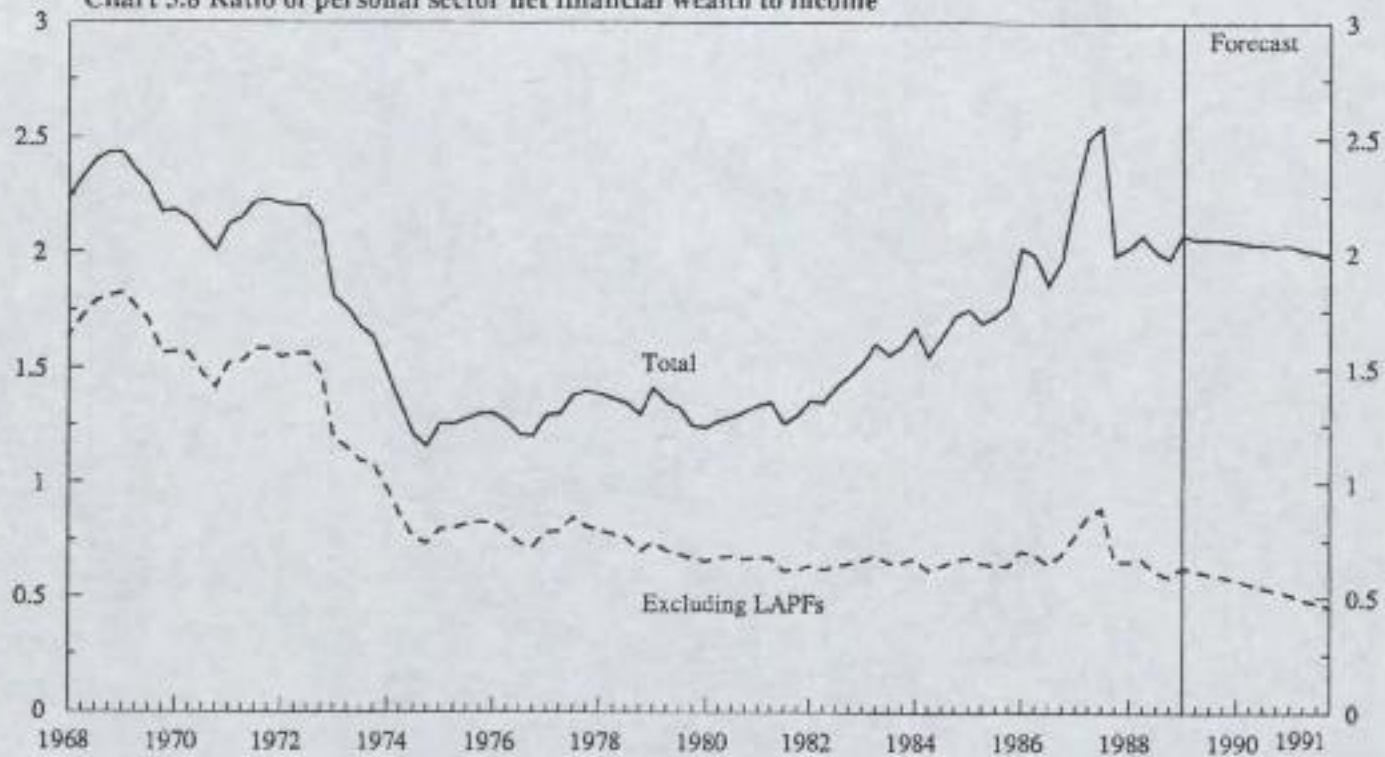


Chart 5.9 Ratio of personal sector total net wealth (including housing) to income

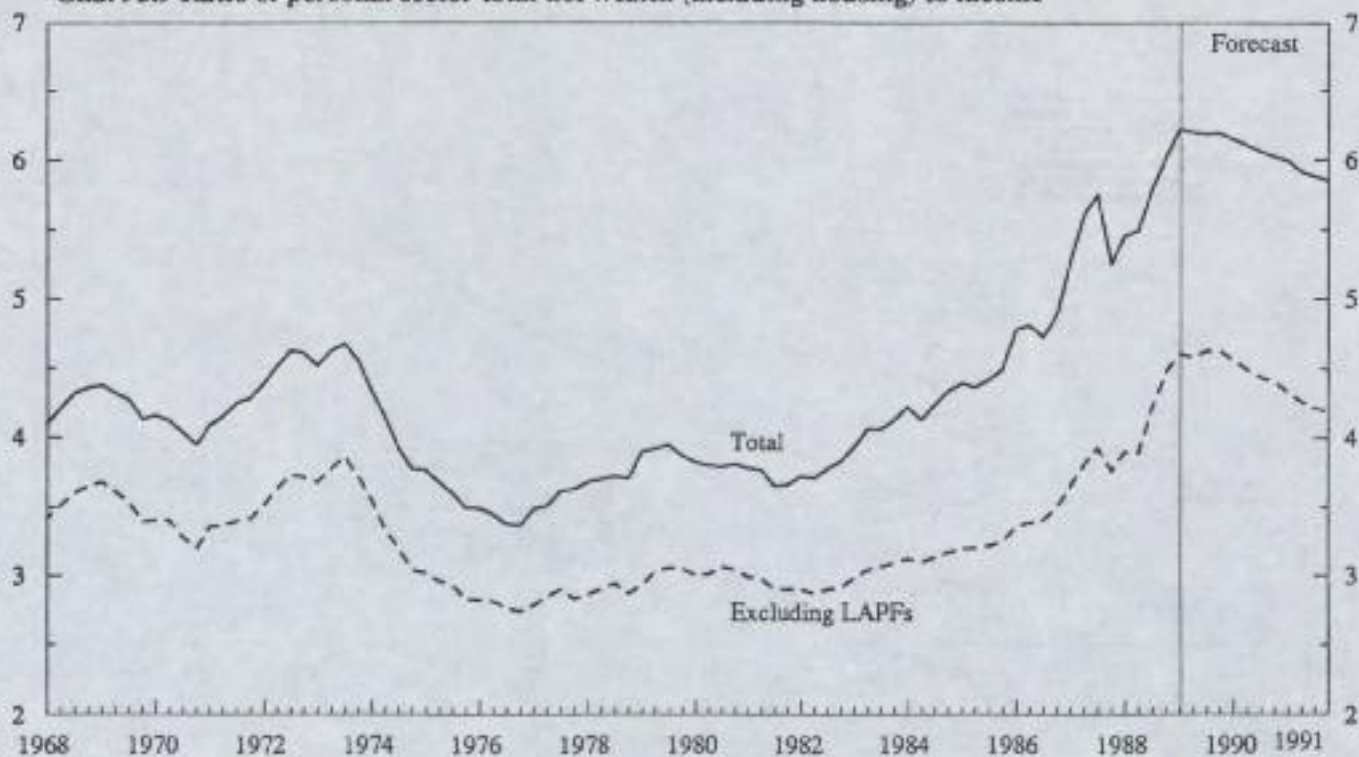


Chart 5.10 Personal Sector Income Gearing

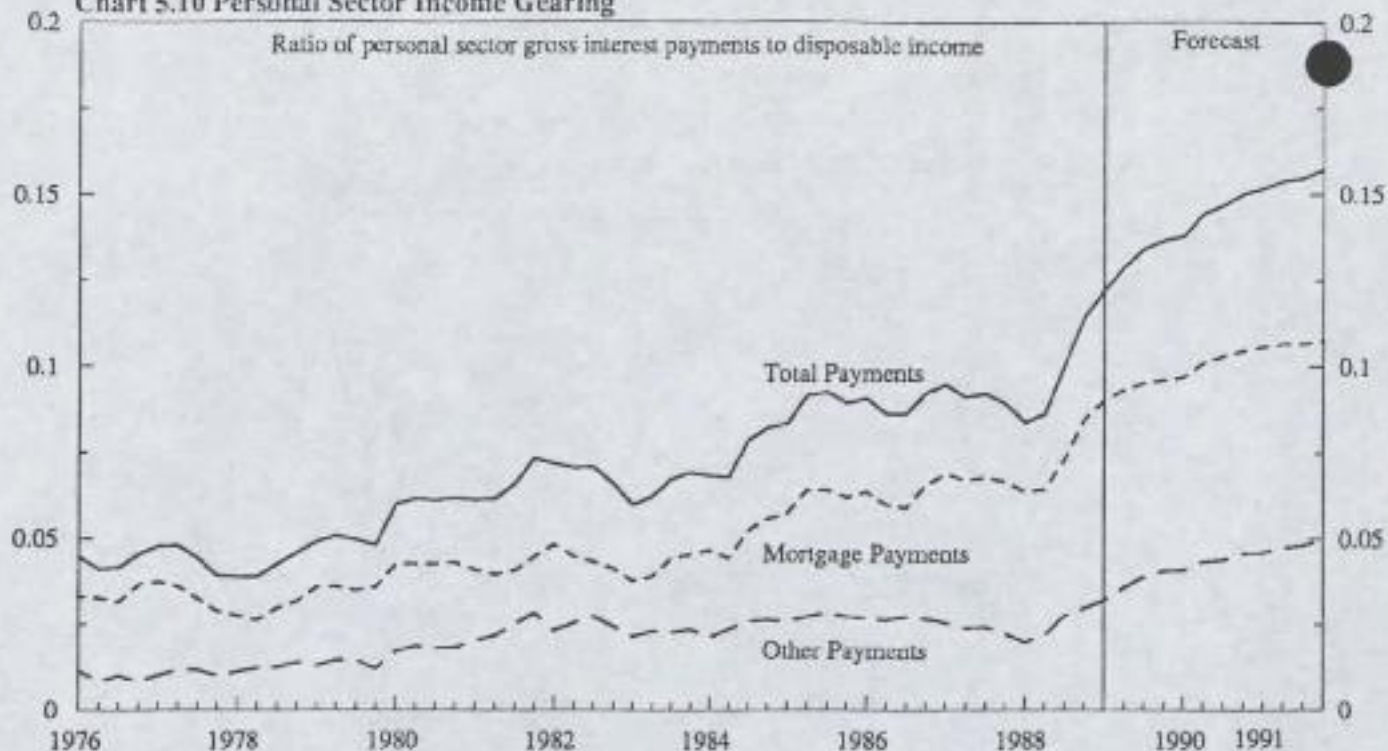
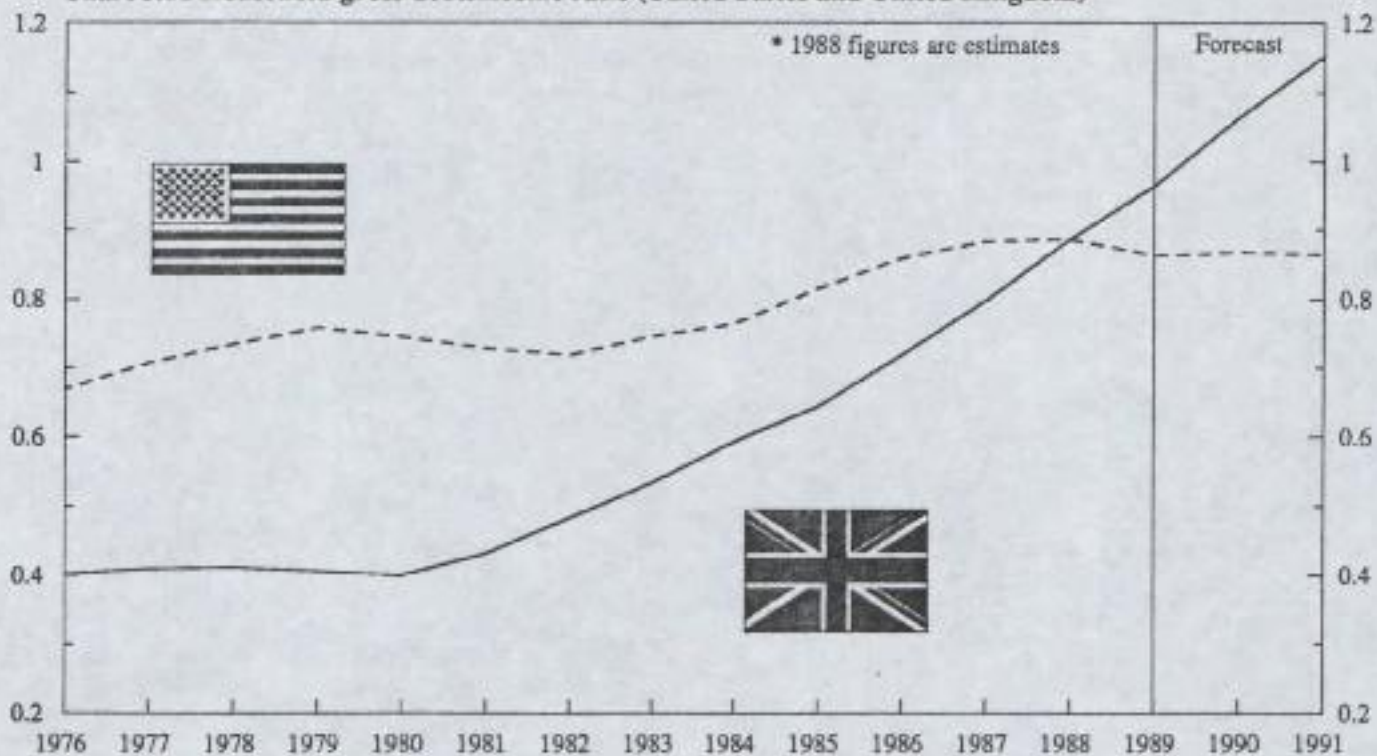


Chart 5.11 Household gross debt:income ratio (United States and United Kingdom)



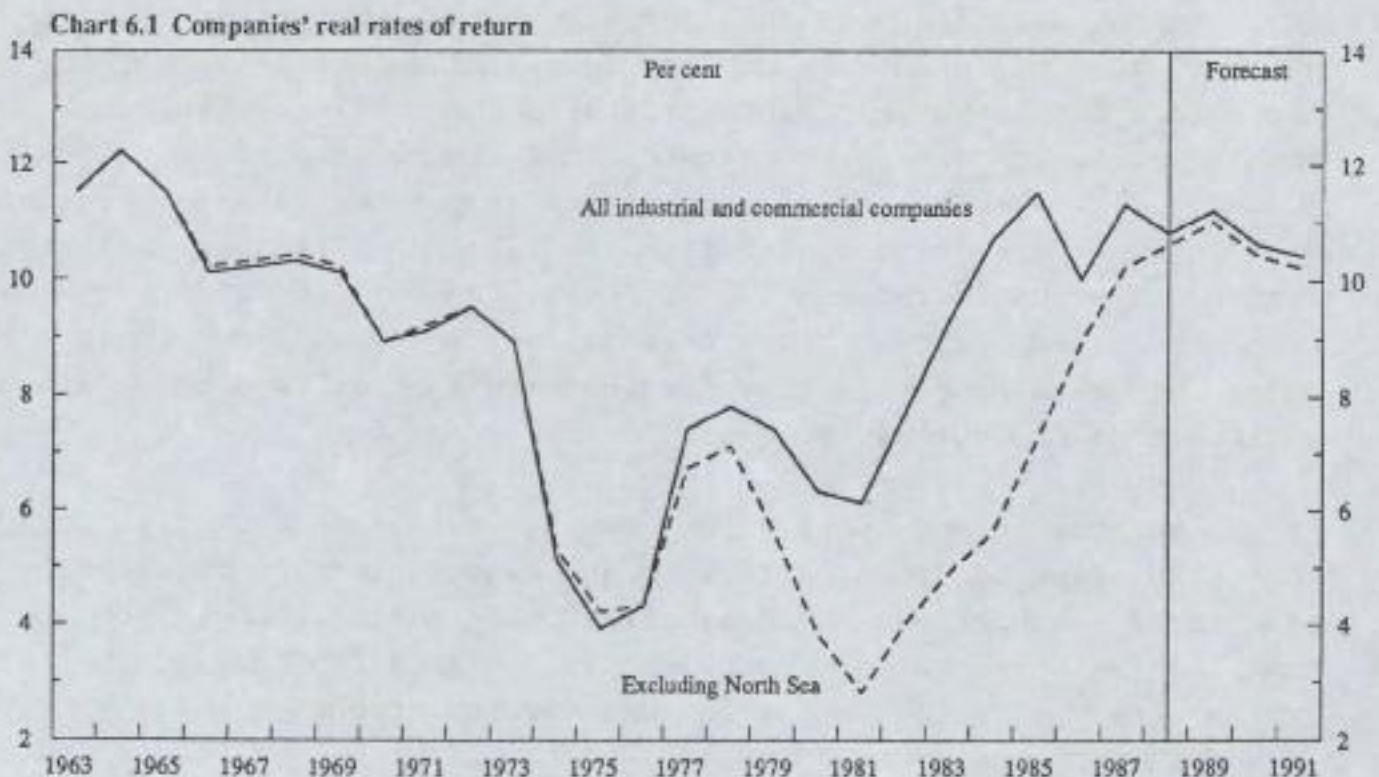
(6) COMPANY SECTOR

Recent developments

83. Business investment data are in a mess, with BSO and CSO publishing inconsistent estimates in two separate press notices in June. The data used in this report for 1988 and 1989Q1 are based mainly on CSO's analysis of supply of investment goods, ie domestic production plus net imports. The forecast has an ad hoc sectoral allocation of the CSO aggregate figures. Nonetheless, there seems little doubt that investment by the manufacturing and non-manufacturing industries rose very strongly in 1988, perhaps by 16 and 20 per cent respectively. This follows 6 per cent growth by manufacturing industries in 1987, and 22 per cent by non-manufacturing.

84. Total company stockbuilding is estimated to have been £1½ billion (at 1985 prices) in 1988Q4. Further stockbuilding of £½ billion is estimated for 1989Q1.

85. Non-North Sea industrial and commercial company profits (net of stock appreciation) rose by over 20 per cent in 1988, after average increases of 23 per cent in the preceding three years. Despite the strength of investment last year, ICCs net real rate of return probably rose slightly from its high 1987 level. (Chart 6.1). ICCs went into financial deficit in 1988 as a result of rapid investment growth and higher stockbuilding (Chart 6.6).



Company expenditure and income: the forecast

86. The June DTI Investment Intentions Survey published on 12 June revealed a yet more buoyant outlook for 1989 than the already bullish December 1988 Survey. In fact, the raw intentions data suggested a still more (even unbelievably) buoyant outlook than the final published figures. BSO statisticians discounted the raw data on the basis of past biases in the Intentions Surveys. BSO did not publish intentions for 1990, but further growth is indicated by the survey both for manufacturing (9 per cent) and distribution, construction and financial service industries (8 per cent). (The raw survey data indicated a fall in both sectors in 1990. But over the recent past, the record shows that investment intentions at this time of year have been too pessimistic.)

87. Responses to expected investment authorisation questions in the CBI Industrial Trends Survey, on the other hand, reveal some slackening of intentions since mid-1988, though the balances are still at historically high levels. The CBI data suggest a fairly buoyant outlook for manufacturing investment in 1989 as a whole, but with a noticeable slackening in the second half of 1989 and early 1990. The CBI's own assessment of the Trends Enquiry (reported in their April Economic Situation Report) is that manufacturing investment is likely to grow by 8 per cent in 1989, considerably slower than the DTI Intentions Survey.

88. A key issue for the forecast was whether the very bullish DTI survey data could be taken at face value. For 1989, the forecast projects a slow down in profits growth, a standstill in the growth of profit margins, and a continued worsening of the financial deficit (Chart 6.6). (The balancing item in the company sector is consistent with an even worse financial balance in 1987 and 1988 than suggested by income and expenditure data.) Moreover, the DTI and CBI Surveys were both conducted before the increase in interest rates in late May. Other things being equal, these factors might point to a more sluggish outlook than the surveys suggest.

89. On the other hand, the survey data undoubtedly indicate something about business confidence and expectations. Industrial and commercial companies' (ICCs) financial deficits may not be as constraining a factor for investment as in previous periods. Profits growth (net of stock appreciation) remains strong (averaging between 10 and 15 per cent over 1989-91). And the net real rate of return, though declining slowly after 1989, is still high by historic

standards, especially relative to past cyclical slowdowns. Moreover, the financial deficit of the ICCs' sector has a counterpart in a healthy financial surplus for the financial company sector. There should, therefore, be plenty of scope for financing investment plans if financial companies believe that high rates of return will persist: it may even be possible to cut the cost of investment by more leasing than is assumed in the forecast.

90. On balance, the outlook given by DTI Intentions for 1989 has been shaded down slightly, giving some weight to the forecast of activity, to company sector financial prospects, and to the CBI survey. Even so, manufacturing investment is forecast to rise by 12½ per cent in 1989 and non-manufacturing by 10½ per cent. For 1990 and 1991, however, the forecasts give much greater weight to the prospect of weaker output and the sustained financial deficit. A fall is projected in manufacturing investment through 1990 and in 1991, consistent with past strong cycles in investment (Chart 6.2). Non-manufacturing investment continues to grow, but only slowly (Chart 6.3).

TABLE 6.1: GROSS DOMESTIC FIXED CAPITAL FORMATION
(percentage changes on previous year)

	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
Business*	10½	15½	11	4½	-1
of which:					
North Sea	-22½	-9	39	24	-1½
Manufacturing	5½	16	12½	2	-8
Non-manufacturing	22	20	10½	6½	5
Private dwellings	6½	10	-10	-3½	6½
General government	-½	1	19	3½	1½
Total Investment	8	12½	6½	3	1

* Includes public corporations

Chart 6.2 Manufacturing investment

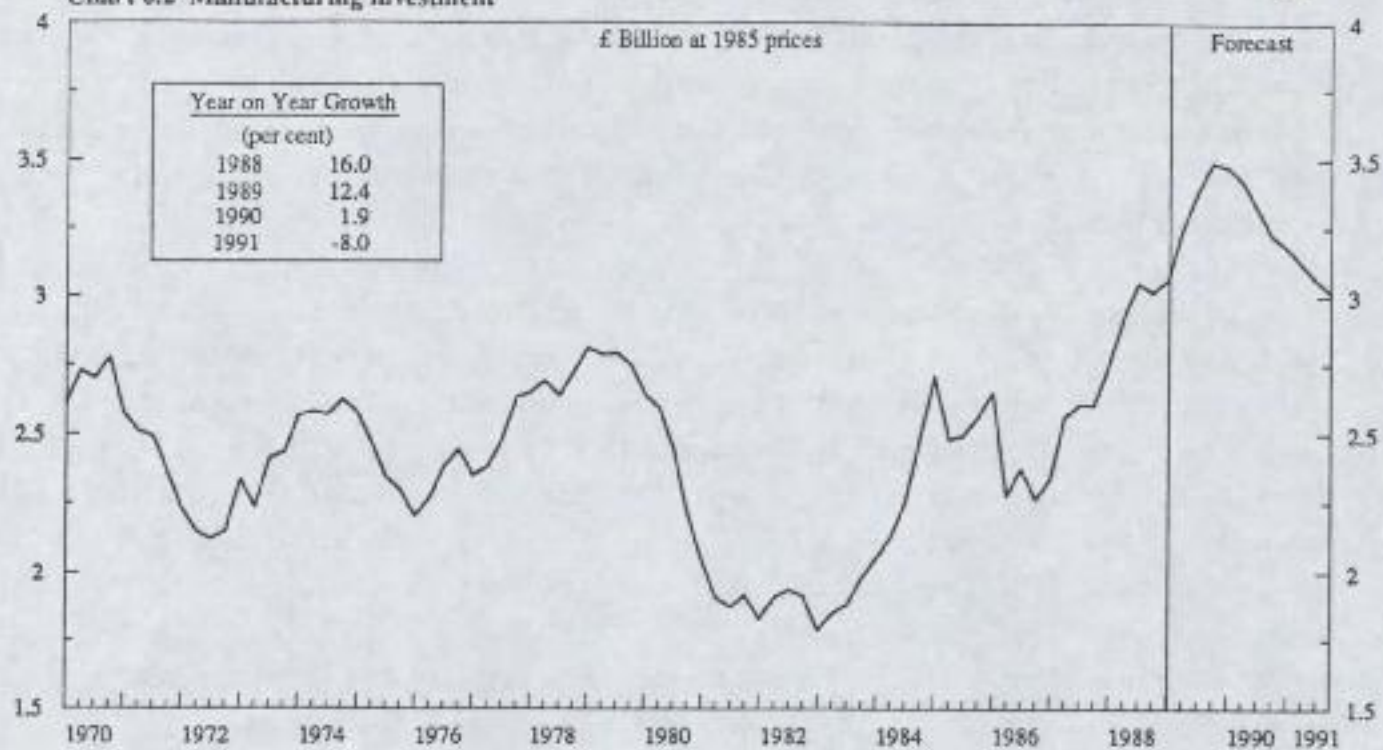
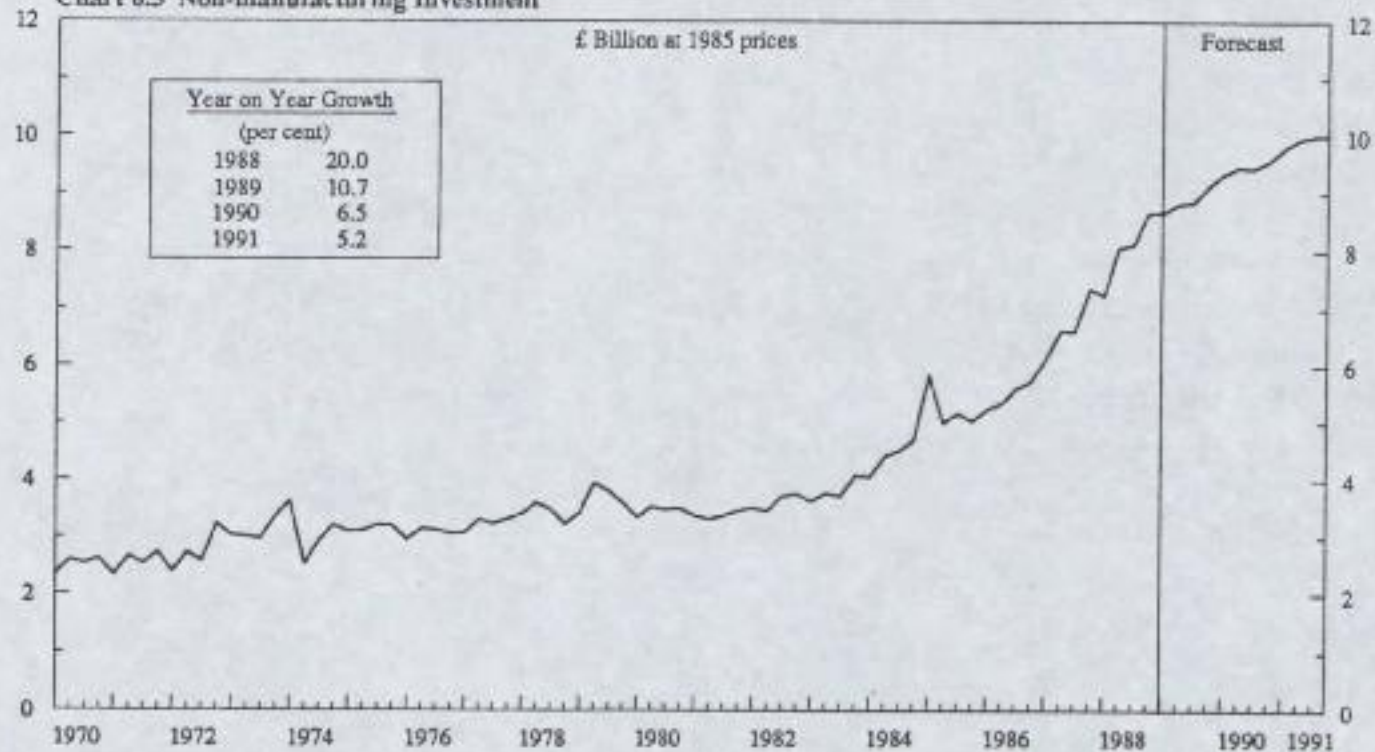
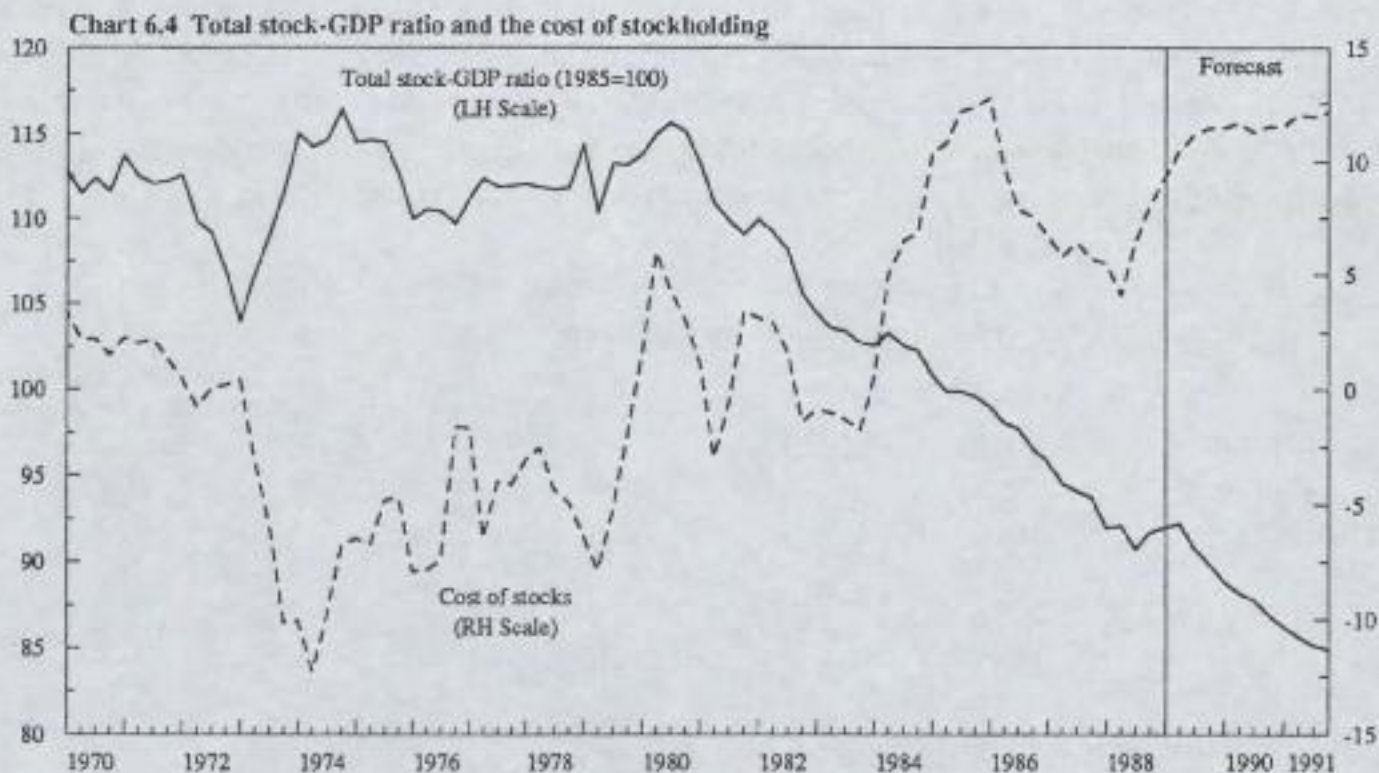


Chart 6.3 Non-manufacturing Investment



91. The increased stockbuilding in late 1988 and early 1989 is likely to have been largely involuntary. The April CBI Economic Situation report made that point explicitly, and pointed to destocking in the immediate period ahead. With weaker financial prospects and the rising cost of holding stocks (associated with high interest rates) the forecast is for some destocking through 1989H2 and 1990. The total stock: GDP ratio continues its long run downward trend throughout the forecast period, (Chart 6.4).



Company sector financial position

92. Non-North Sea ICCs profits (net of stock appreciation) are expected to rise by 15 per cent in 1989 and by 11 per cent in 1990. This is slower than the average 23 per cent growth over 1985-88 and reflects the deceleration in domestic demand and an associated gradual halt in margins growth. Net real rates of return are projected to decline in 1990 and beyond from the high levels of 1988 and 1989, but will still be high by the standards of the 1970s and early 1980s. Nonetheless, non-North Sea ICCs saving falls in real terms in 1989 (Chart 6.5). Along with the strong projected growth in investment this implies a further financial deficit in this year (Chart 6.6). Despite much slower investment growth in 1990 and some destocking, the deficit stays much about the same next year. The high level of borrowing associated with company spending reduces net liquidity to historically low levels (Chart 6.7).

Table 6.2: COMPANIES' INCOME AND RATES OF RETURN

(a) Profit shares and rates of return

(per cent)	Total	Non-oil	Non-oil (excl-privatised) companies	Rate of return on assets, non- oil ICCs***
1986	14.5	12.3	11.2	8.9
1987	16.3	14.0	12.3	10.2
1988	16.8	15.3	13.4	10.6
1989	17.4	16.0	13.9	11.0
1990	17.9	16.6	13.7	10.4
1991	18.4	17.1	13.6	10.2

(b) Growth of profits and net income
(percent changes on a year earlier)

	Non-North Sea Industrial and Commercial Companies*		Financial Companies Net Income
	Gross Trading Profits**	Net Income	
1986	15.2	(15.2)	18.1
1987	18.8	(14.5)	29.7
1988	20.6	(20.5)	18.2
1989	14.9	(13.8)	0.2
1990	11.5	(6.2)	5.9
1991	10.5	(6.2)	9.7

* 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.

*** excluding companies to be privatised and British Steel.

Chart 6.5 Company saving and spending in real terms

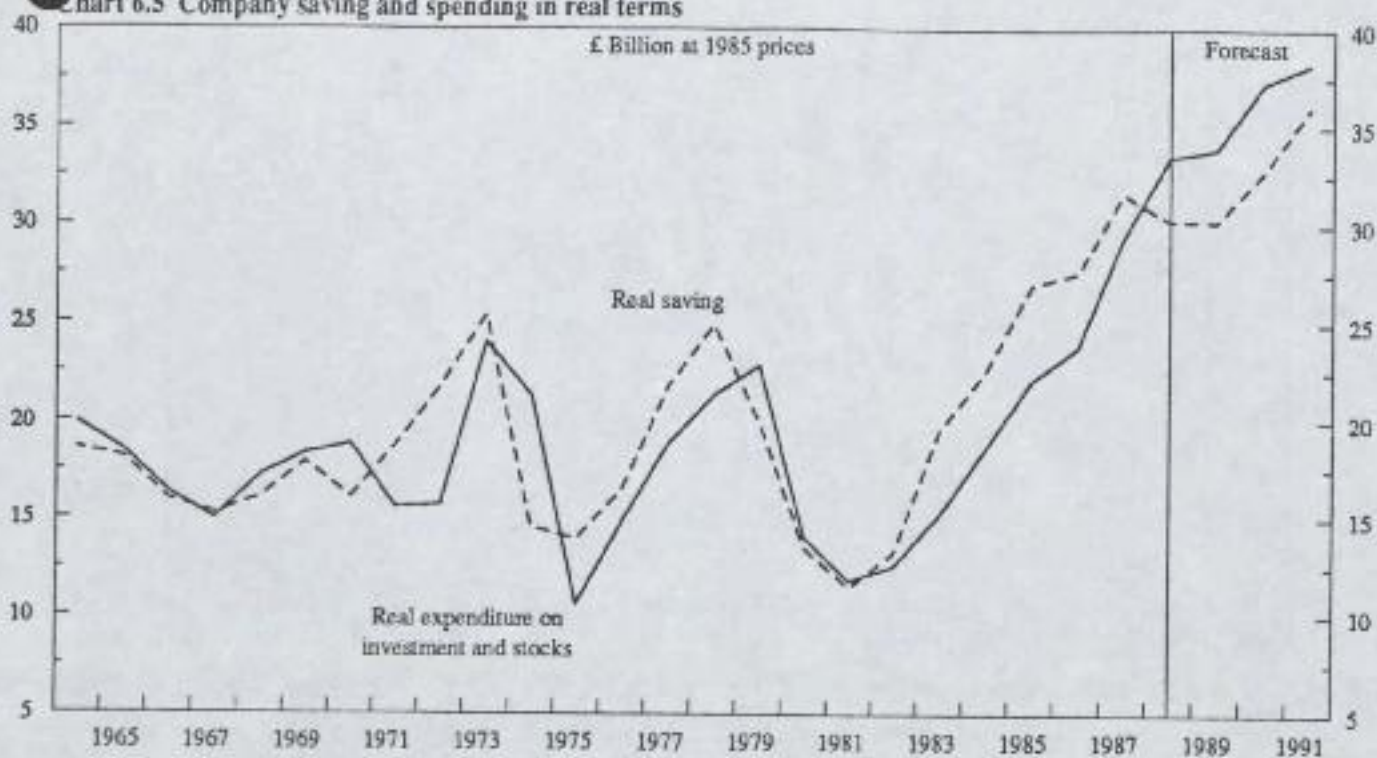


Chart 6.6 All ICCs' NAFA and borrowing requirement (share of TFE)

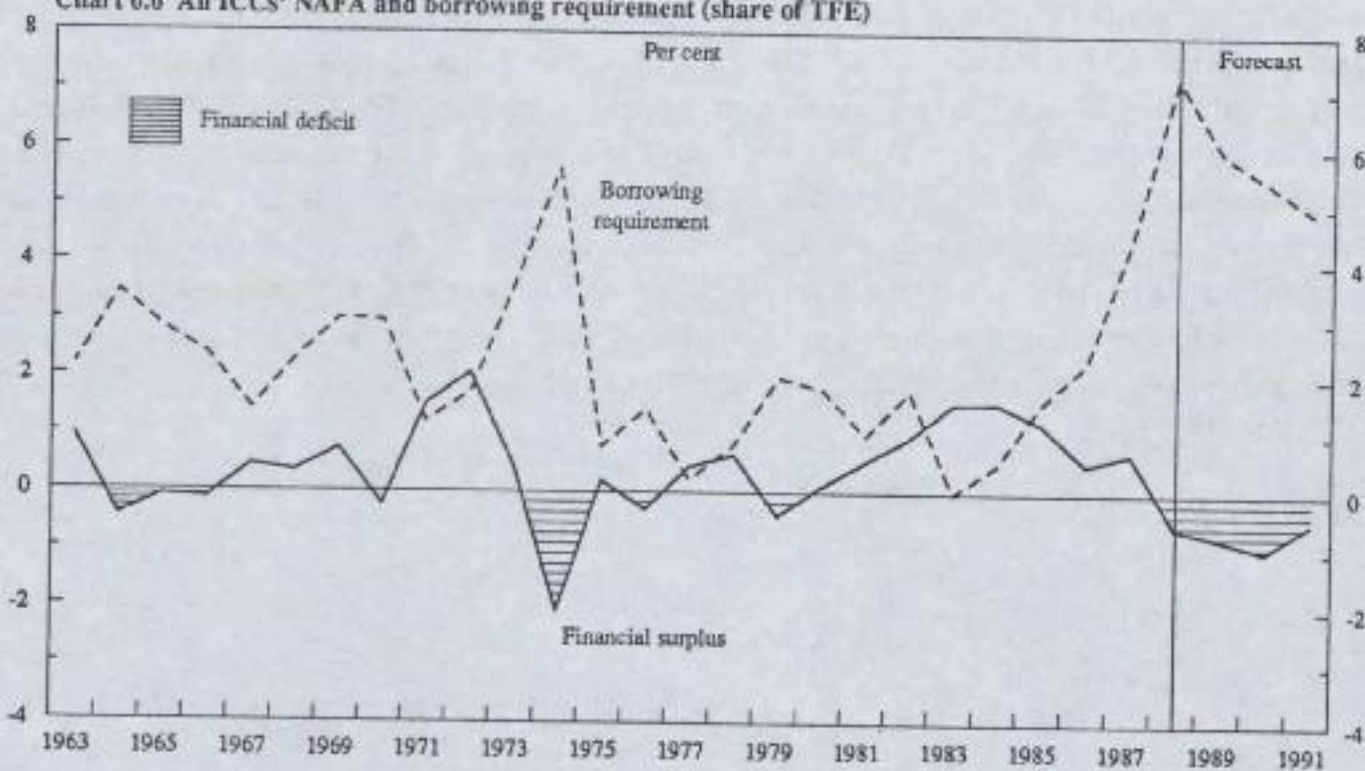
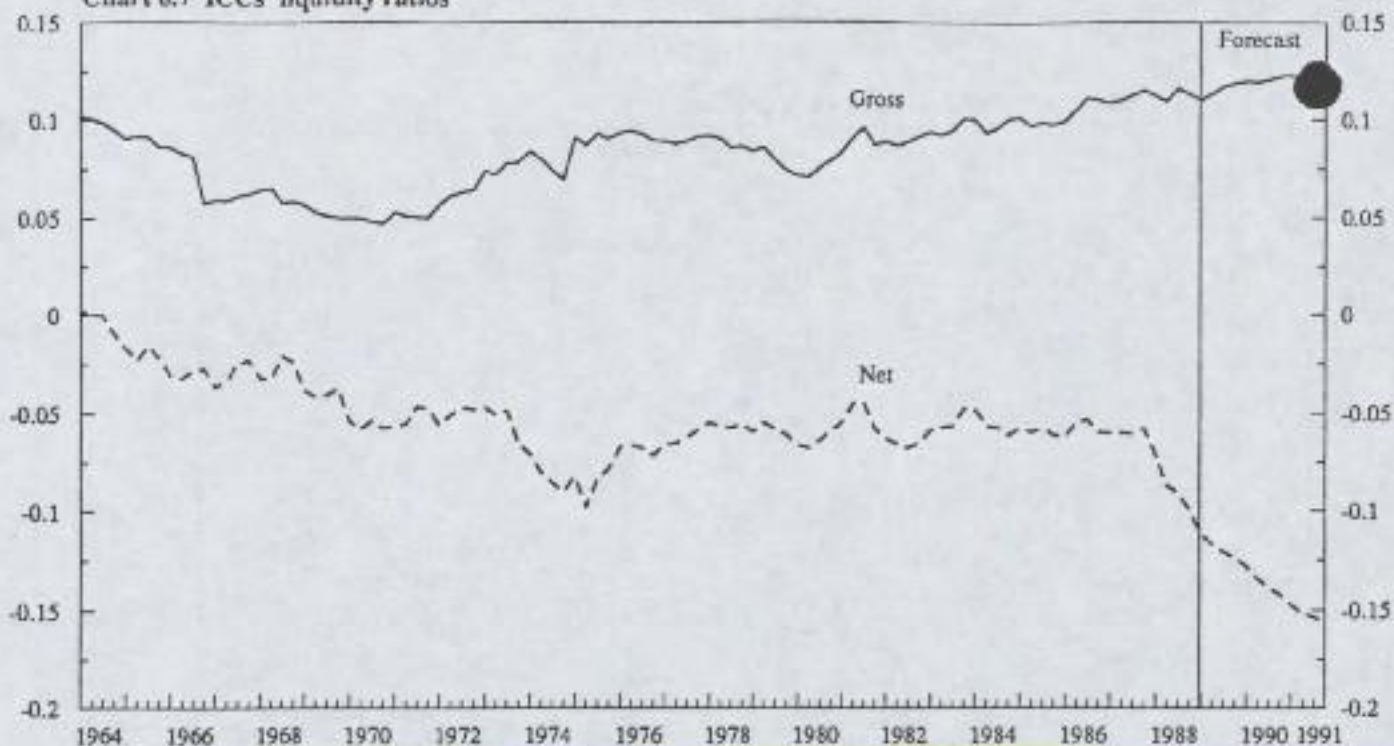


Chart 6.7 ICCs' liquidity ratios



93. This outlook raises the question, rehearsed in the winter forecast report, of whether companies will adjust more strenuously to this financial prospect than has been allowed for in the forecast. It would certainly be unusual for the company sector to run deficits over a run of years. In periods of more extreme recession than are forecast here, companies have always responded very quickly to avoid larger or persistent deficits. On the other hand business confidence and expectations may now be much more robust following the strong performance of the economy over the last seven years and supply side improvements. With continued high real rates of return in prospect, they may be more willing to run deficits to finance continued real spending growth than in earlier periods. But it is inevitably a risk on the threshold of a turning point in the economy that the company sector may react more than projected here.

(7) DOMESTIC DEMAND AND ACTIVITY

94. Domestic demand is expected to grow by 3 per cent between 1988 and 1989. It slows very sharply through the year; between 1988Q4 and 1989Q4 it grows by only $\frac{1}{2}$ per cent. Slow growth of personal consumption and investment, but especially destocking by companies, account for this sluggish prospect. Domestic demand growth picks up through 1990, though only to about 2 per cent, well below estimated productive potential. GDP is expected to rise $2\frac{1}{2}$ per cent in 1989 and $2\frac{1}{2}$ per cent in 1990.

Table 7.1

DOMESTIC DEMAND FORECAST: SUMMARY

	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1988Q4</u>	<u>1989Q4</u>	<u>1990Q4</u>	<u>1990Q4</u>
Consumers' expenditure	6.4	3.5	1.8	2.4	5.6	2.0	2.0	2.3
Public authorities consumption	0.5	0.1	0.5	1.3	0.1	-1.0	2.3	1.3
Fixed investment	12.2	6.5	3.1	0.9	10.3	6.3	0.2	1.8
Stockbuilding*	0.3	-0.5	-0.3	0.3	2.2	-2.3	0.5	0.2
Total domestic demand	6.5	3.0	1.6	2.2	7.2	0.3	2.1	2.2
Exports of goods and services	-1.0	4.5	6.6	4.1	-3.0	10.5	4.2	3.8
Imports of goods and services	12.0	6.8	2.9	2.3	12.1	1.6	4.2	2.3
GDP compromise measure	4.4	2.2	2.5	2.7	4.3	2.2	2.3	2.6
Non-oil GDP	5.2	3.1	2.3	2.7	5.4	2.2	2.6	2.6
Manufacturing output	7.1	4.3	2.5	3.2	7.1	2.6	2.2	3.2

* Change in stockbuilding as a percentage of GDP in the previous year.

(8) PRICES AND EARNINGS

Recent inflation trends

95. Inflation indicators have picked up sharply over the past year. The all items RPI inflation rate has risen from 4½ per cent in mid-1988 to just over 8½ per cent by May 1989. Most of this rise is accounted for by increased mortgage interest rates since last summer. But underlying RPI inflation (excluding MIPS) also picked up over the same period, from around 5 per cent to 6 per cent. Increases since March have been exacerbated by rises in petrol prices, the result of an increase in world oil prices and attempts by major UK producers' to rebuild profit margins.

96. Producer output price inflation (excluding food, drink and tobacco) rose slowly through 1988 ending up at 5 per cent in the year to the fourth quarter. It rose to 5.4 per cent by the end of the first quarter of 1989, but fell back very slightly to 5.2 per cent in May. Continued strong growth of profit margins associated with buoyant domestic demand has largely accounted for the rise over the past year.

TABLE 8.1: INFLATION INDICATORS
(per cent change on year earlier)

	Manufacturers output prices*	RPI		GDP (Market price) Deflator	
		All items	Less MIPS		
1987 Q3	4.5	4.3	3.6	5.4	
Q4	4.8	4.1	4.0	5.8	
1988 Jan	4.8	3.3	3.7	5.4	(1988Q1)
Feb	4.7	3.3	3.6		
March	4.7	3.5	3.8		
April	4.6	3.9	4.2	6.7	(1988Q2)
May	4.7	4.2	4.4		
June	4.7	4.6	4.7		
July	4.8	4.8	5.0	7.4	(1988Q3)
August	4.8	5.7	5.0		
Sept	4.9	5.9	5.2		
Oct	5.0	6.4	5.1	7.1	(1988Q4)
Nov	5.0	6.4	5.1		
Dec	4.9	6.8	5.1		
1989 Jan	5.3	7.5	5.5	7.9	(1989Q1)
Feb	5.3	7.8	5.7		
March	5.4	7.9	5.7		
April	5.3	8.0	5.9		
May	5.2	8.3	6.0		

* excl food, drink and tobacco.

Producer Prices

97. Producer price inflation is expected to moderate slowly to 5 per cent by the end of 1989. This is despite the fact that firms will be facing increased cost pressure. Sustained growth in pay together with some fall off in productivity growth will result in faster rising unit labour costs, and import costs will rise given the recent depreciation of sterling, which is assumed to be sustained over the next three years. But profit margins fall from recent very high levels and this keeps price inflation stable over 1989 despite cost pressures. Cost inflation abates thereafter and, with profit margins staying broadly flat, producer price inflation falls through 1990 and 1991.

TABLE 8.2 : 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*
1987 Q4	3.1	5.1	2.3	4.8
1988 Q4	1.8	5.1	2.4	5.0
1989 Q4	4.9	4.2	5.4	4.9
1990 Q4	4.3	5.4	3.8	4.3
1991 Q4	2.9	7.6	3.5	3.7

* Excluding food, drink and tobacco.

Retail prices

98. Retail price inflation, boosted by a succession of mortgage interest rate increases in the second half of last year, is likely to peak below 8½ per cent in the next couple of months. But the underlying rate (ie excluding MIPs) is still high at around 6 per cent. This partly reflects large nationalised industries' price increases in 1989-90, and a significant increase in local authority domestic rates (and the community charge in Scotland) of 10 per cent. Over the forecast period RPI inflation moderates from July as recent petrol price cuts take effect, and more significantly from August as last year's mortgage interest rate increases begin to drop out of the inflation rate calculation. The forecast is for some squeeze on retailers margins in the face of sluggish consumer spending.

99. Retail price inflation should fall to under 7 per cent by end-1989 and to a little under 6 per cent by end-1990. Underlying retail price inflation (excluding MIPs) should moderate to 5½ per cent by end-1989 and 5 per cent by end-1990 (Table 8.3).

TABLE 8.3: COMPONENTS OF THE RETAIL PRICE INDEX

	<u>1986Q4</u>	<u>1987Q4</u>	<u>1988Q4</u>	<u>1989Q4</u>	<u>1990Q4</u>	<u>1991Q4</u>
Mainly retailed items	4.0	4.3	4.9	4.9	3.7	3.9
Food prices	3.2	3.4	4.0	4.9	3.7	3.6
NI prices	2.9	2.1	7.4	7.5	8.0	5.8
Housing costs	7.1	7.0	16.5	14.7	13.9	7.3
Petrol	-12.6	1.3	- 0.1	6.0	3.8	4.6
Total RPI	3.4	4.1	6.6	6.7	5.7	4.7
RPI excluding						
Mortgage						
Interest payments	3.4	4.0	5.2	5.6	5.1	4.6

100. Table 8.4 sets out monthly RPI inflation until mid-1990, together with the path consistent with the FSBR forecast. Annex A has further details on the forecast for RPI inflation. The slight pick up in inflation from April 1990 reflects the conventional assumption on indexation of excise duties.

TABLE 8.4: MONTHLY PATH OF RPI INFLATION

(percent changes on a year earlier)

	<u>All items RPI</u>		<u>RPI excluding mortgage interest payments</u>	
	<u>FSBR</u>	<u>Summer</u>	<u>FSBR</u>	<u>Summer</u>
1989 Jan	7.5	7.5	5.5	5.5
Feb	7.9	7.8	5.7	5.7
Mar	7.9	7.9	5.7	5.7
April	7.6	8.0	5.7	5.9
May	7.7	8.3	5.5	6.0
June	7.8	8.3	5.5	6.0
July	7.6	8.2	5.2	5.8
August	6.2	7.4	5.2	5.7
Sept	6.3	7.3	5.2	5.6
Oct	5.6	6.8	5.1	5.6
Nov	5.6	6.7	5.1	5.6
Dec	5.6	6.6	5.1	5.5
1990 Jan		6.3		5.3
Feb		6.2		5.3
March		6.1		5.2
April		6.4		5.6
May		6.3		5.4
June		6.1		5.2

The GDP deflator

101. The market price GDP deflator rose 7.3 per cent in 1988-89, compared with 3.2 per cent in 1986-87 and 5.2 per cent in 1987-88. (The low figure for 1986-87 was mainly accounted for by the collapse in oil prices during 1986.) Although inflation in many of the individual component deflators increases from 1988-89 to 1989-90 (for example the consumers' expenditure deflator rises from 5.4 to 6.1 per cent, and the investment deflator rises from 4.6 to 7.7 per cent), the overall GDP deflator falls slightly to 7.1 per cent. This reflects the effect of the changing composition of expenditure within GDP (particularly the de-stocking which occurs through the year). A fixed weighted GDP deflator, on the other hand, would show a figure of 7 per cent in 1989-90 compared to 6½ in 1988-89.

102. The sharp fall in GDP deflator inflation in 1990-91 is largely a statistical illusion. It reflects the national accounts treatment of the abolition of domestic rates and the introduction of the community charge. The effect of this change is to take about 2 per cent of the growth of the GDP deflator (and money GDP) at market prices in 1990-91. Table 8.5 shows the figures on a standard basis, and adjusted for the community charge effect.

TABLE 8.5: GDP DEFLATOR AT MARKET PRICES
(percentage change on previous year)

	1987-88	1988-89	1989-90	1990-91	1991-92
FSBR					
Total	5.0	7.2	5.4	3.9	3.0
non-oil	4.5	7.2	5.4	4.0	2.9
June forecast					
Total	5.2	7.3	7.1(7.2) ¹	3.3(5.2)	4.6
non-oil	4.7	7.2	6.7(6.8)	3.4(5.3)	4.6

¹figures in brackets are adjusted to remove the 'Community Charge effect'

103. Table 8.6 sets out the separate components of the GDP deflator and their contribution to overall movements. The investment deflator rises particularly sharply in 1989-90 both because construction prices continue to rise faster than other prices in the face of sustained high demand and because of the extension of VAT to new construction.

TABLE 8.6: COMPONENTS OF GDP DEFLATOR

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

	<u>Consumers' expenditure</u>	<u>Investment & Stocks</u>	<u>Central government current expenditure on goods & services</u>	<u>Export</u>	<u>Imports</u>	<u>Total</u>
1987-88	3.8	6.6	5.7	3.4	2.0	5.2
1988-89	5.4	4.8	7.4	3.6	0.2	7.3
1989-90	6.1(6.3) ¹	7.5	8.8	6.5	5.1	7.1(7.2)
1990-91	2.3(5.3)	3.6	7.4	3.6	4.3	3.3(5.2)
1991-92	4.3	3.1	6.8	4.1	3.6	4.6

¹figures in brackets are adjusted to remove the 'Community Charge effect'

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

1987-88	3.6	2.2	0.7	0.6	-1.8	5.2
1988-89	5.7	3.0	1.2	0.4	-3.0	7.3
1989-90	4.0	1.3	1.0	2.3	-1.5	7.1
1990-91	1.3	0.6	1.2	1.7	-1.5	3.3
1991-92	2.6	0.6	1.1	1.3	-1.0	4.6

Settlements and Earnings

104. Private sector settlements have picked up noticeably since August 1988, though they are still less than might be expected given the buoyant labour market and high company profits. They averaged 7½ per cent in May, about a point and a half higher than a year ago. The average settlement figure for the period August 1988 to May 1989 is 7¼ per cent. According to the CBI data bank the main factor underlying growth in manufacturing settlements is the cost of living. For the service sector it is both the cost of living and the need to recruit and retain labour. Compared to the 1987-88 pay round it is generally true that downward pressures on settlements have weakened, though inability to increase prices is emerging as a possible constraint. But, against the background of continued high company profits, this is unlikely to inhibit settlements over the rest of this round.

105. Private sector underlying earnings growth has also picked up significantly in recent months. In April it stood at 9¼ per cent for the private sector and 9 per cent for manufacturing. However, drift in both

the manufacturing and private sector as a whole seems to have peaked around mid-1988 and has since been trending downwards.

106. Given labour market pressures and likely RPI inflation over the next few months, private sector settlements over the rest of the current pay round are expected to average closer to 8 per cent. This implies about 7½ per cent for the round as a whole. The 8 per cent rate at the close of the current round will probably set the tone for the opening months of the next pay round. But with the economy slowing down over the year; a likely squeeze on margins; moderation of inflation and an end to falling unemployment downward pressures in settlements can be expected to increase.

107. For the 1989-90 round as a whole settlements may average 7½ per cent again. With overtime also falling, earnings drift is likely to continue edging down and private sector underlying earnings growth is likely to moderate to 9 per cent.

TABLE 8.7: PRIVATE SECTOR SETTLEMENTS AND EARNINGS

(Contributions to changes on a year earlier)

	<u>1987Q3</u>	<u>1988Q3</u>	<u>1989Q3</u>	<u>1990Q3</u>	<u>1991Q3</u>
Settlements	5½	6	8	7	6½
Drift	2½	2½	1½	1½	1½
Increase in average earnings	8	8½	9½	8½	7½

108. With growing pressures for higher pay in both central and local government the forecast is for earnings in these sectors to grow by one per cent more than the private sector average in the next two pay rounds. This produces only a modest rise in the ratio of general government to private sector earnings from the current very low level.

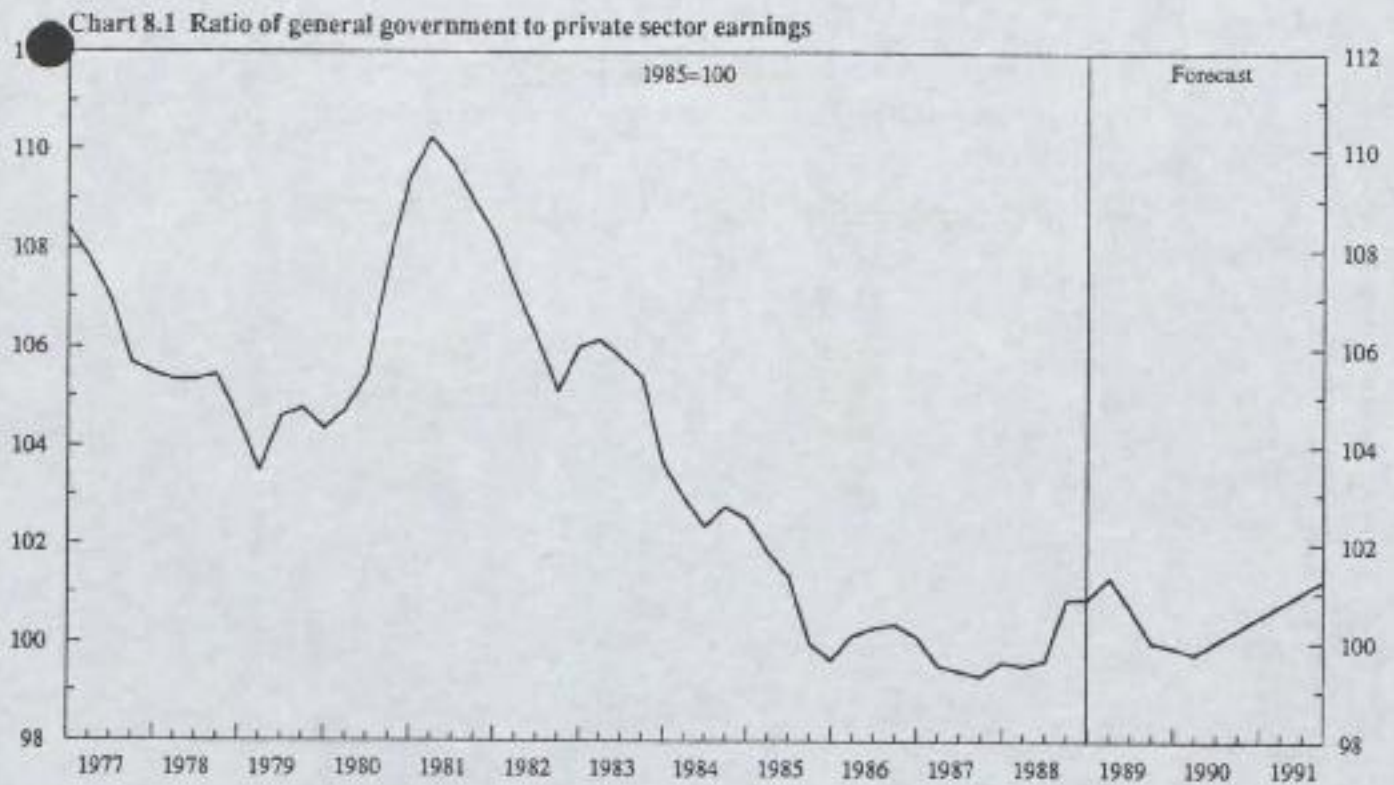


TABLE 8.8: PUBLIC AND PRIVATE SECTOR UNDERLYING AVERAGE EARNINGS
(Percentage changes over a year earlier)

	Central Government	Local authorities	Private sector
1987-88	7.8	7.7	8.2
1988-89	11.1	9.6	8.8
1989-90	8.7	8.3	9.6
1990-91	8.8	9.2	8.4
1991-92	8.7	8.7	7.6

Labour costs

109. Manufacturing unit labour cost growth picked up to over 2 per cent in 1988. With continued pressure on earnings and an expectation that the slow-down in output growth will reduce productivity gains, unit labour costs are forecast to rise faster in 1989. A similar pattern occurs in the economy as a whole, where labour costs are increasing at a higher rate because of lower measured productivity improvements.

TABLE 8.9: LABOUR COSTS
(Percentage increases on previous year)

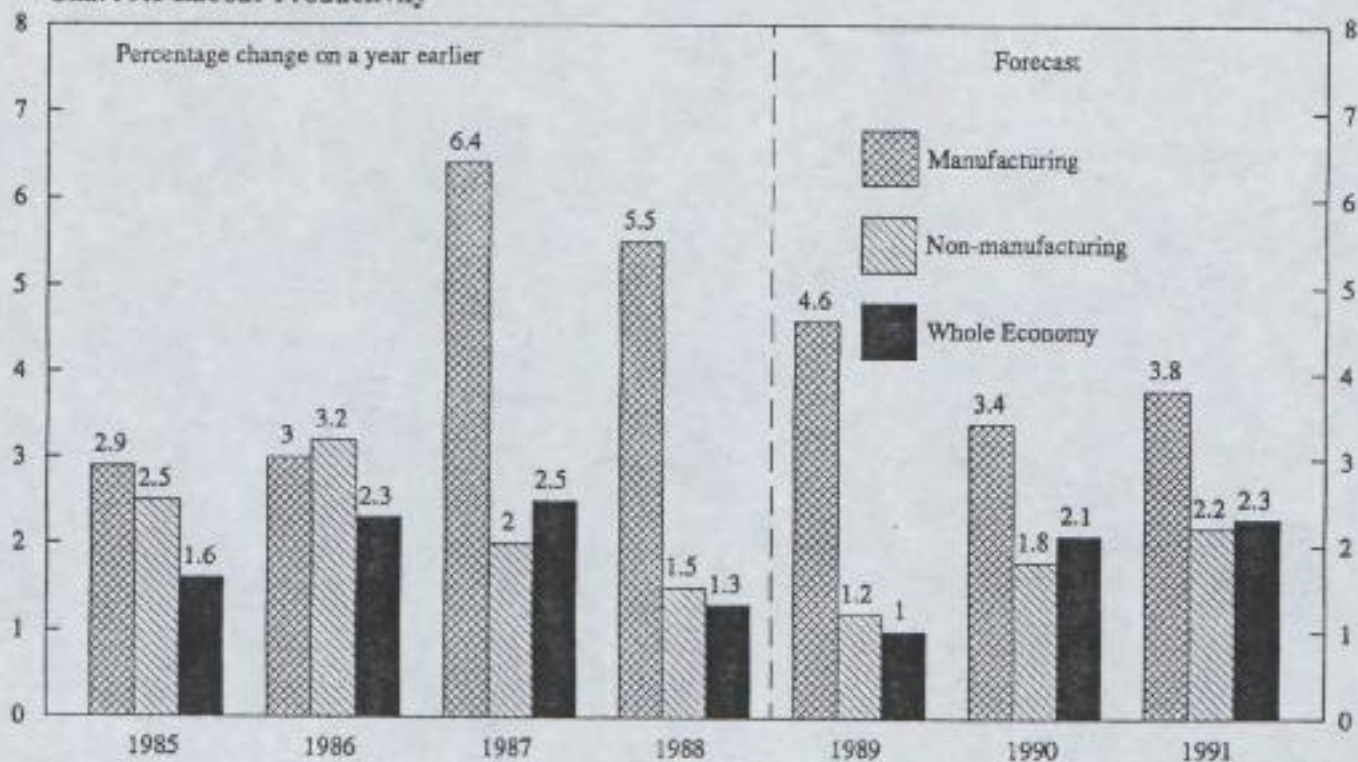
	<u>Manufacturing</u>	<u>Whole Economy</u>
1986	3.9	5.5
1987	1.0	4.4
1988	2.2	7.4
1989	4.1	8.4
1990	4.3	6.5
1991	3.2	5.5

(9) LABOUR MARKET

110. The large upward revisions to employment statistics published just before the Budget lowered estimates of productivity growth in the year to March 1988, by about 2 per cent and 1.5 per cent in the manufacturing and non-manufacturing sector respectively. Nonetheless, recent productivity growth in the non-oil economy has remained strong, particularly in the manufacturing sector. Productivity growth is likely to slow down sharply in 1989 as output growth itself moderates. However, employers are expected to maintain pressure for better productivity performance. They are assumed to shed 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.

111. Against this background and with output growth moderating, total employment is expected to rise at a much slower rate from now on than over the past two years. The outlook for employees in employment is weaker, but is partly offset by continued growth in self-employment. Manufacturing employment is projected to decline over the next three years, after rising since 1987Q2. Unemployment continues to fall (but at a much slower rate than recently) till end 1989, but starts rising slowly thereafter. The rise would have been faster but for expected slow labour supply growth, reflecting demographic effects, in 1988-1992.

Chart 9.1 Labour Productivity



(10) FINANCIAL CONDITIONS

Yield curve and funding

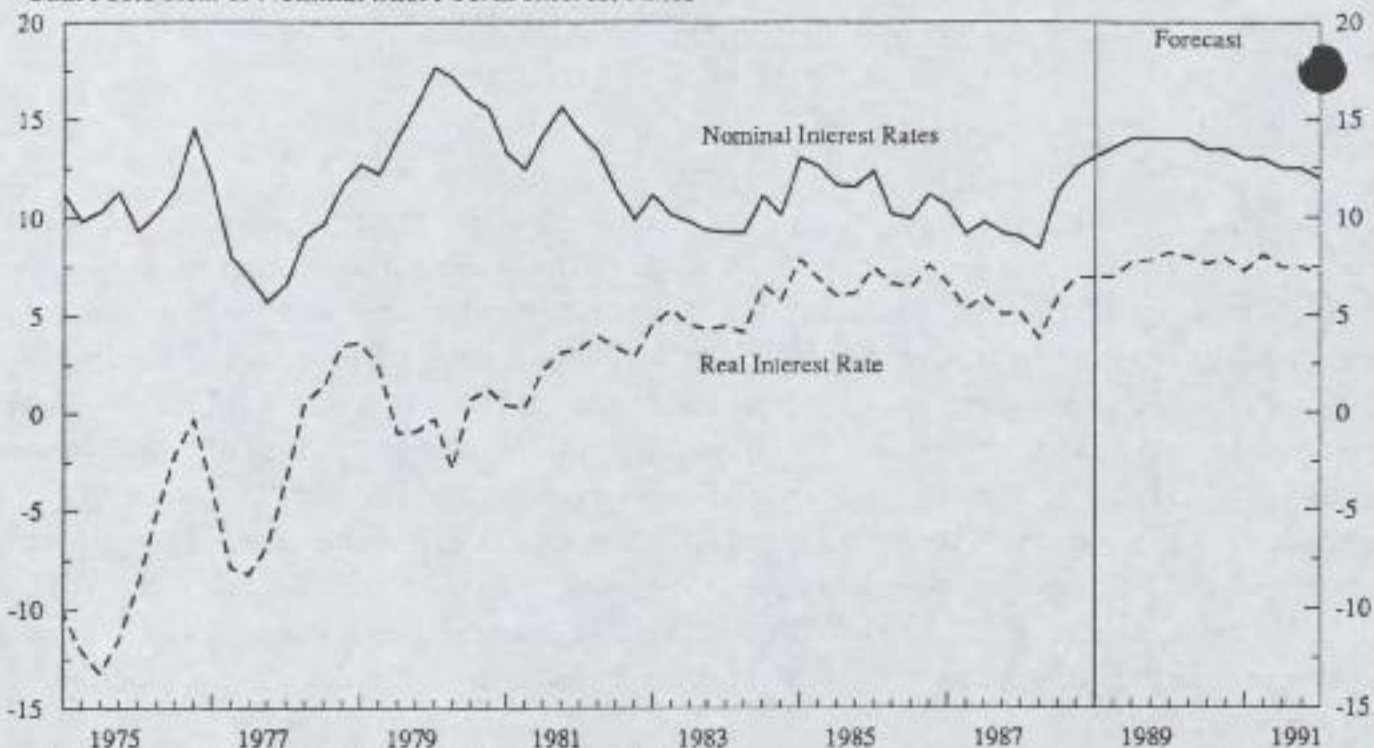
112. Over the past year short term interest rates have nearly doubled, yet long rates have hardly changed. The current, strongly inverted, yield curve is expected to remain a feature of the whole forecast period. The relatively high levels of inflation and money GDP growth during the forecast period require short term interest rates to be maintained well above the inflation rate. Over the period 1989Q1-1991Q1 real short rates as defined in Table 10.1 are projected to be around 7½ per cent on average. The only previous period of comparable high real short rates was from 1985Q1 to 1987Q1 when they averaged 6½ per cent. On the other hand, real short rates were high - averaging just over 5½ per cent - during the period of very strong growth and rising inflation in 1987 and 1988.

TABLE 10.1 : UK SHORT AND LONG INTEREST RATES
(per cent)

	3 month interbank (1)	20 year gilts (2)	Yield gap (2)-(1)	Real short rates (3)*
1986	11.0	9.9	-1.1	7.1
1987	9.7	9.5	-0.2	5.8
1988	10.3	9.4	-0.9	5.4
1989	13.7	9.7	-4.0	7.4
(June 21)	(14.0)	(9.9)	(-4.1)	(7.5)
1990	13.8	9.9	-3.9	7.9
1991	12.8	9.4	-3.4	7.5

* 3 month interbank rate deflated by RPI inflation excluding mortgage interest payments.

Chart 10.1 Real & Nominal Short Term Interest Rates



Note: The real interest rate is the 3 month interbank rate deflated by the RPI inflation rate excluding mortgage interest payments (MIPs). Figures for RPI inflation excluding MIPs are not available before 1975.

113. The large reverse yield gap partly reflects the shortage of long gilts, which is forecast to become more pronounced over the next two years. This follows from the current funding rule combined with large predicted PSDRs. The private sector is to a large extent filling this gap left by gilts. Total net issues of fixed rate sterling debt by ICCs and OFIs together amounted to over £7 bn. in 1988, with almost a further £5 bn. in 1989 so far. Both figures exceed the value of equities issued by ICCs over the same period. Other financial institutions (OFIs) are forecast to continue filling the gap in their portfolios resulting from the declining stock of gilts by increasing their holdings of ICCs' debt and overseas assets.

114. A new feature of this forecast is the growth in personal pensions. This will result in increased inflows to LAPFs and, in theory, should marginally raise equity prices as a result of the transfer from unfunded to funded pension schemes.

PSBR and funding

115. Table 10.2 shows the financing of the PSBR. National Savings are expected to make a negative contribution of £½ bn. per year to funding as sales fall short of redemptions.

SECRET

TABLE 10.2 : PSBR AND FUNDING
(£ bn)

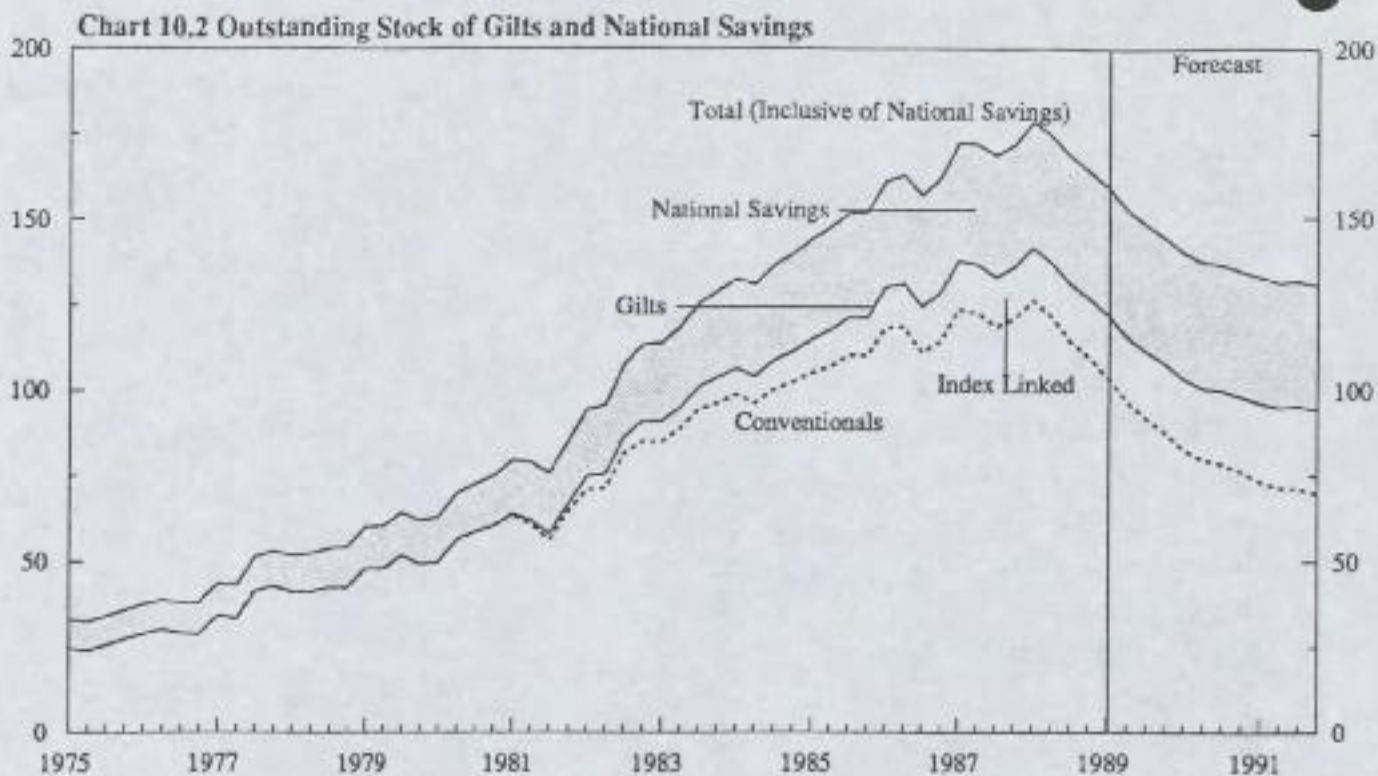
	1988-89	1989-90	1990-91	1991-92
1. PSBR	-14.4	-12.1	-9.3	-6.2
2. Change in Reserves	1.6	-1.2	0	0
3. Redemptions(a)	8.5	9.8	6.2	7.3
4. Total to be financed (= columns 1+2+3)	-4.3	-3.5	-3.1	1.1
5. National savings	0.6	-0.5	-0.5	-0.5
6. Other debt sales to nbnbsps(b)	-0.8	-0.3	-0.1	0
7. Other external	-0.8	0.8	0.2	0.2
8. Overfunding	2.5	-2.2	0	0
9. Debt sales to bbs(c)	-2.6	-1.2	-1.2	-1.2
10. Buying in of gilts (= columns 4-5-6-7+8+9)	3.4	6.9	3.9	-0.2
11. Reduction in outstanding stock of gilts (= columns 3+10)	11.9	16.7	10.1	7.1

(a) redemptions of market-held gilts;

(b) non-bank non-building society private sector

(c) banks and building societies

116. The £2.2 bn. forecast underfund in 1989-90 is required to offset the £2.5 bn. overfund in 1988-89, and the cumulated underfund of £0.3 bn. in the period up to the end of 1987-88. Another large PSBR in 1989-90 suggests that the stock of outstanding gilts may fall by around £17 bn., compared to £12 bn. in 1988-89. This increase partly reflects changes in the assumed level of intervention, which has added over £1 bn. to the required level of buying in so far this year, having reduced buying in by about £1½ bn. last year. It is assumed that net intervention will be zero from now on.

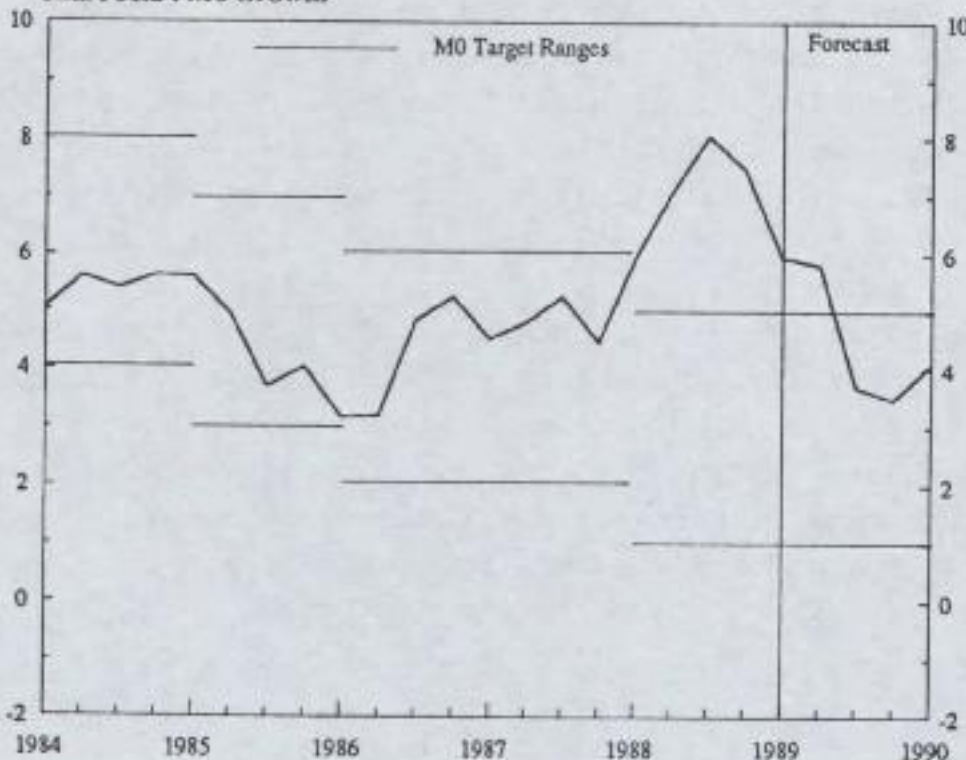


117. The outstanding stock of money market assistance had fallen to £3 bn. by the end of May and it is forecast to continue shrinking over the rest of this year, partly reflecting rising levels of bank deposits by local authorities and public corporations and further sales of gilts by the banks and building societies. These factors are expected to increase banks' liquidity in 1989-90 by around £1 bn. and £1½ bn. respectively. Banks' liquidity also rises as local authorities are expected to repay market debt to the banks, financed by about £3 bn. extra borrowing from the PWLB this financial year. Overall money market influences are forecast to add to banks' liquidity by around £8 bn. this year. One way of maintaining control over short-term interest rates in these circumstances is to expand the issue of Treasury bills. It is assumed that this policy will be followed and hence the outstanding stock of Treasury bills is forecast to rise by about £5½ bn. during 1989-90 and by a further £3½ bn. next year. The stock of assistance is assumed to be run down to a little under £2 bn. at the end of this financial year.

Monetary aggregates and credit

118. M0 growth has slowed rapidly since the end of 1988 and is forecast to return within its target range before the end of this year, and to remain at around 3½ per cent over the rest of 1989. The erratically low figure for M0 in the first quarter of 1989 may result in M0 growth rising temporarily to around 4 per cent at the end of the financial year, but it is then expected to fall immediately to well under the upper band of the 1990-91 target, currently set at 4 per cent. For the current financial year as a whole, M0 growth is forecast to be around 4½ per cent, compared to 7 per cent last year. The slowdown to date seems to have reflected mostly the lower growth of consumers' expenditure, but the hike in interest rates since last summer has increased the opportunity cost of holding cash, and this should further slow M0 growth through the current financial year. Next year, M0 growth is forecast to fall further, to around 3 per cent, as growth of consumers' expenditure continues to be weak. The lower target band next year of 0-4 per cent means that M0 growth is still expected to be in the top half of its range.

Chart 11.2 : M0 Growth



12 month growth rates in 1988/89

1988	Apr	6.1
	May	6.4
	June	7.3
	July	6.9
	Aug	7.6
	Sept	8.5*
	Oct	7.7
	Nov	7.7
	Dec	7.7
1989	Jan	7.2
	Feb	6.6
	Mar	6.2
	(May)	(6.2)

* affected by Postal Strike

119. The growth of liquidity and credit is likewise expected to fall back over the forecast period. The former largely reflects a growing squeeze on the financial position of the personal sector, while the

slower growth of credit is the result of the high level of real lending rates to persons and ICCs and the much slower turnover in the housing market. M4 growth is forecast to fall from 18 per cent at the end of 1988-89 to 15 per cent at the end of this financial year while the growth of bank and building society lending to the private sector falls from 24 per cent to 18½ per cent over the same period.

Sectoral balances

120. The stagnation of the housing market, together with high real rates of interest on borrowed funds, results in slower growth of personal sector borrowing and lower levels of mortgage equity withdrawal. But the personal sector gross debt-income ratio continues to rise strongly as individuals run down their net financial wealth to maintain desired consumption levels. While the level of real short rates encourages a switch into liquid assets by net savers, the net debtors within the personal sector may resort to running down their holdings of liquidity to finance consumption, so that overall the personal sector's net liquidity ratio continues to decline over the forecast period.

121. ICCs are forecast to move further into financial deficit in 1989, as investment is expected to remain strong, which gives rise to another large net borrowing requirement this year. Despite their financial deficit, companies are expected to continue building up their gross liquidity. This combination of increased holdings of assets and liabilities in part reflects the observed narrowing of spreads between borrowing and deposit rates during the 1980s. However, companies' net liquidity is forecast to decline with their persistent financial deficits. The reverse yield gap makes debt finance relatively attractive to companies compared to bank borrowing, and the growth of bank lending to ICCs is forecast to slow down sharply compared to the very high levels of 1988. Equity issues are expected to recover compared to last year, but not to reach pre-crash levels.

(11) PUBLIC FINANCES

122. The outturn for 1988-89 was a PSDR of £14.4 bn., 3 per cent of GDP. The forecast is for a PSDR of £12 bn. in 1989-90 over £1½ bn. below the FSBR forecast.

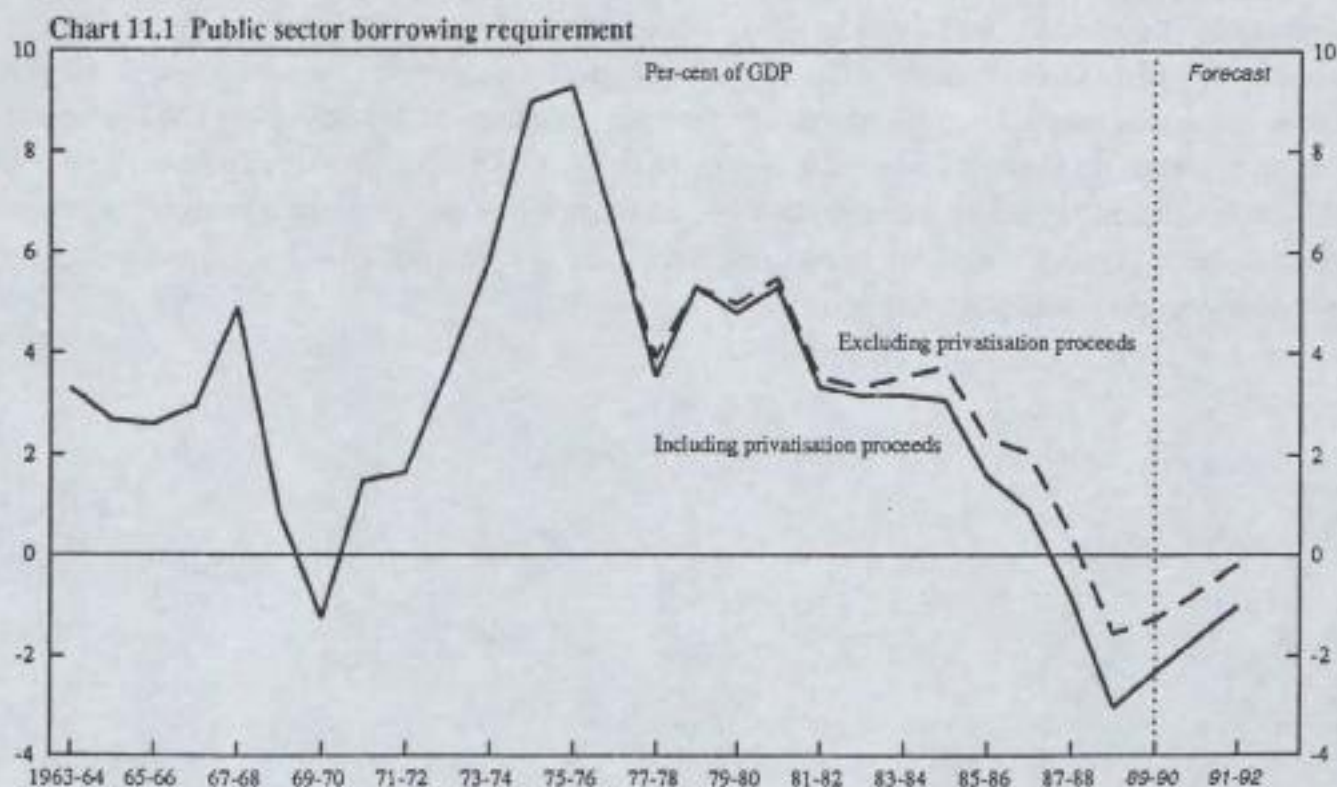
TABLE 11.1 : THE PSDR
(fbn)

	1988-89	1989-90	1990-91	1991-92
(a) PSDR	14½	12	9½	6
Privatisation proceeds	7	5½	5	5
Other asset sales	6	6	5½	5
PSDR less all asset sales	1½	½	-1	-3½

(b) Components of the PSDR

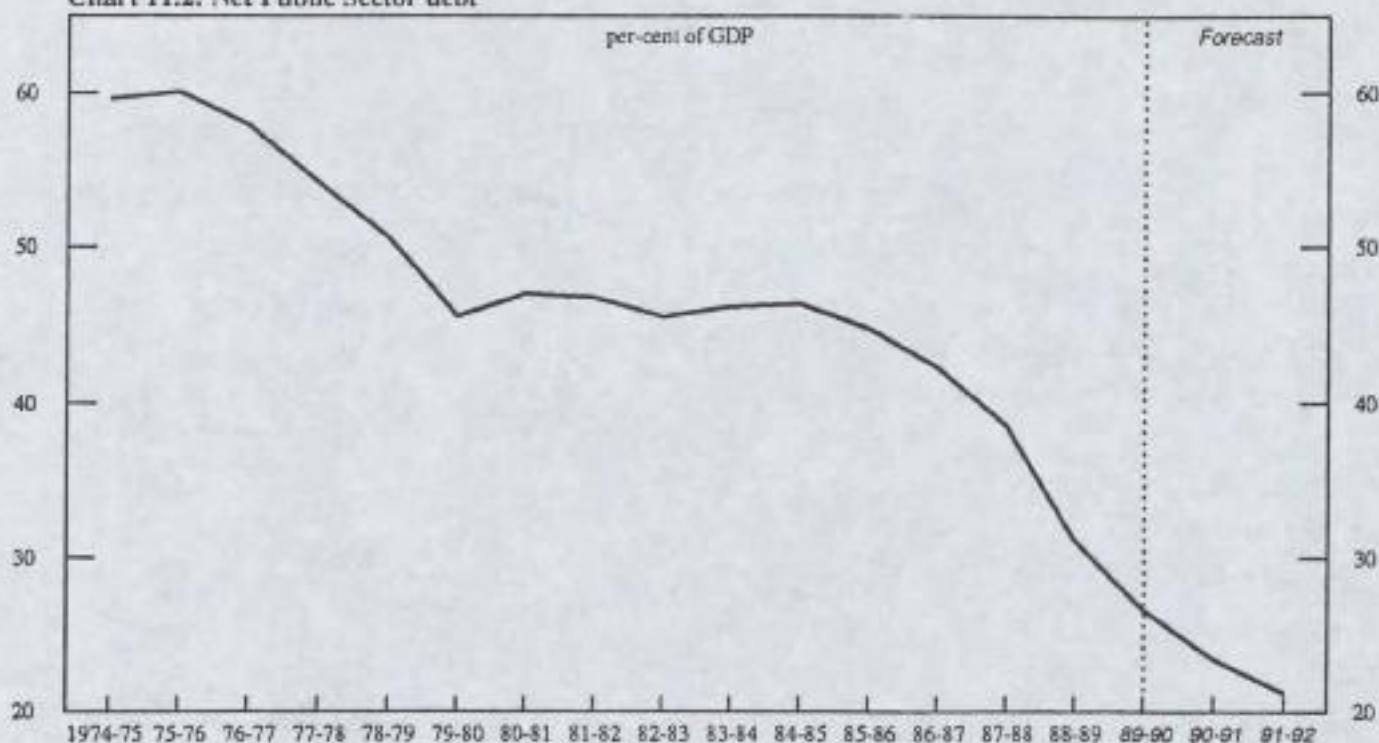
CGDR(O)*	13	9(10)	½(7½)	5½
LADR*	-½	1(0)	8½(1½)	1
PCDR	2	2½	½	-½

* Figures in brackets exclude the effect of grants to local authorities for the capitalisation of housing loans.



123. The stock of net public sector debt has fallen from 50 per cent of money GDP at the end of 1978-79 to an estimated 31 per cent of money GDP at end 1988-89. It is forecast to fall further over the forecast period.

Chart 11.2: Net Public Sector debt



124. Table 11.2 summarises the forecast for receipts, expenditure, and the fiscal adjustment. General Government expenditure in 1989-90 is similar to the FSB. The planning total is £1 bn. lower due to higher privatisation proceeds, lower social security expenditure and an assumption that the Electricity Council will not pay tax in 1989-90 (there is an offsetting reduction in receipts), but debt interest and other adjustments are higher. Receipts are also down, despite faster growth of money GDP, because the take-up of personal pensions has been larger than expected, increasing the level of national insurance rebates and incentive payments. Net national insurance contributions are forecast in 1989-90 to be £1¼ bn. lower in cash terms than in the Budget forecast.

TABLE 11.2: PUBLIC SECTOR EXPENDITURE, REVENUE, AND BORROWING
(£ bn)

	1989-90		1990-91		1991-92	
	FSBR	June Fore- cast	FSBR	June Fore- cast	FSBR	June Fore- cast
General Government Expenditure	194½	194½	205	210	216	226½
General Government receipts	206½	204	214½	219	224½	235
Assumed cuts in taxes (cumulative)	-	-	1	1	3	2
GGDR	12	9½	8½	8½	6	6½
PCs' overseas and market debt repayment	1½	2½	1½	1	0	-½
PSDR (per cent of GDP)	14 (2½)	12 (2½)	10 (1½)	9½ (1½)	6 (1)	6 (1)
PSDR excluding priv. proceeds (per cent)	9 (1½)	6½ (1½)	5 (1)	4½ (½)	1 (½)	1 (½)

125. Table 11.3 summarises the main changes since the FSBR to the forecast for 1989-90.

TABLE 11.3: MAIN CHANGES TO THE PSDR FORECAST FOR 1989-90 SINCE THE FSBR

	<u>£ bn</u>
<u>Lower General Government Receipts</u>	
- higher income tax from higher wages and salaries;	0.2
- lower NICs from higher incentive payments and rebates, partly offset by effect of higher wages and salaries	- 1.8
- higher ACT from faster dividend growth	0.4
- lower mainstream corporation tax from revised view of electricity industry's tax liability	- 0.3
- lower road fuel duty reflecting a higher share of unleaded petrol	- 0.2
- lower stamp duty from more depressed housing and equity markets	- 0.2
- lower other receipts, including removal of presentational adjustments	- 0.5
TOTAL RECEIPTS	<u>- 2.3</u>
<u>Little change in General Government Expenditure overall</u>	
- lower programme spending, from lower social security and lower electricity EFR, partly offset by higher local authority expenditure;	- 0.6
- higher privatisation proceeds	- 0.5
- higher interest payments largely from removal of FSBR presentational adjustments	0.4
- changes to other adjustments, mainly because a lower EFR increases PCs' debt repayment to market	0.8
TOTAL GGE	<u>0.1</u>
Higher public corporations' market debt repayment largely from non-payment of tax by electricity	0.8
TOTAL CHANGE IN PSDR FORECAST	<u>- 1.7</u>

Public Expenditure

126. The forecast for GGE in 1989-90 is the same as the FSBR. But the forecasts for 1990-91 and 1991-92 are well above PEWP/FSBR levels. This partly reflects higher inflation and partly the pressure for some catch up in real spending. In real terms however the forecast level for GGE is somewhat lower than earlier internal forecasts.

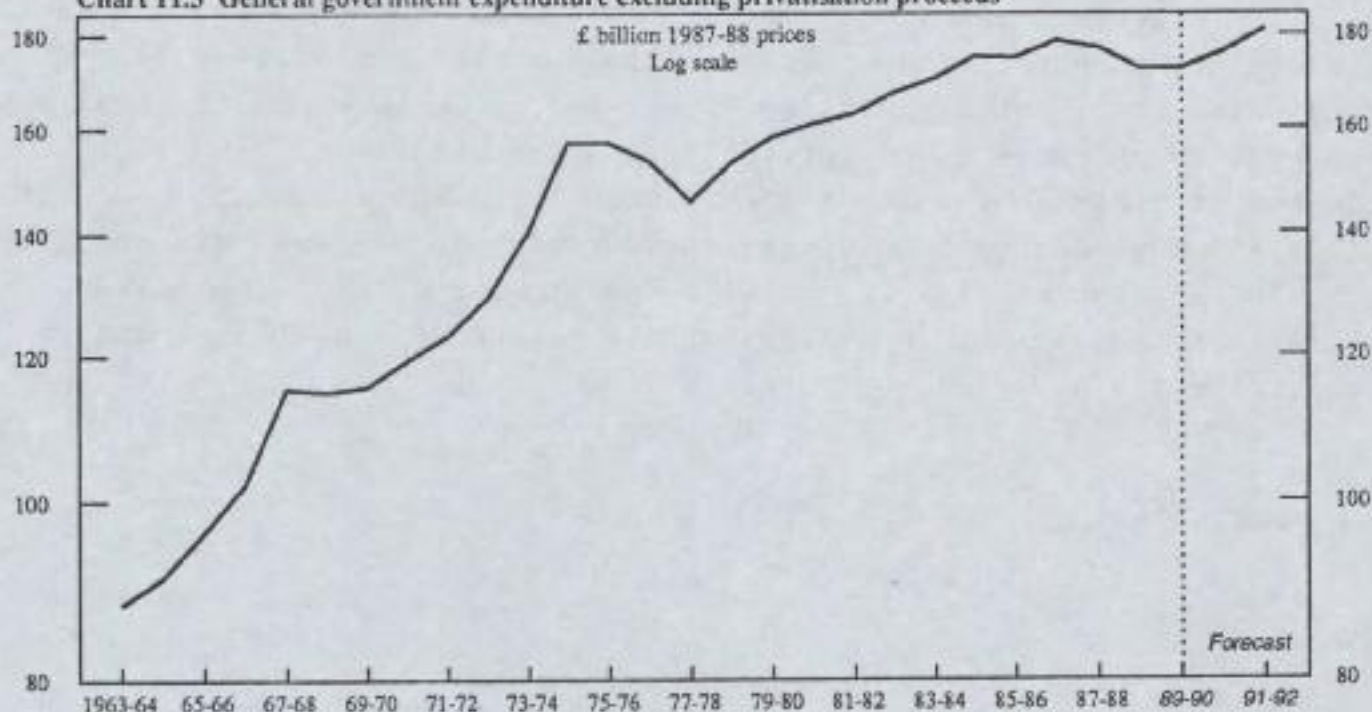
TABLE 11.4: PAST AND CURRENT FORECASTS OF GGE
EXCLUDING PRIVATISATION PROCEEDS (£ bn.)

Forecast	1988-89		1989-90		1990-91		1991-92	
	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*	Current Prices	Real Terms*
PEWP 1986	179	174	-	-				
June 1986	186	177	-	-				
PEWP 1987	185	178	193	181				
June 1987	190	181	203	183				
PEWP 1988	188	180	198	183				
Jan 1988	188	180	200	182				
FSBR 1988	188	180	198	182	207	184		
June 1988	187	177	200	179	210	182		
Oct 1988	187	175	199	176	211	178		
Jan 1989	186	174	198	175	211	179		
PEWP 1989	187	176	199	178	210	182	221	186
June 1989	187	172	200	172	215	176	232	181

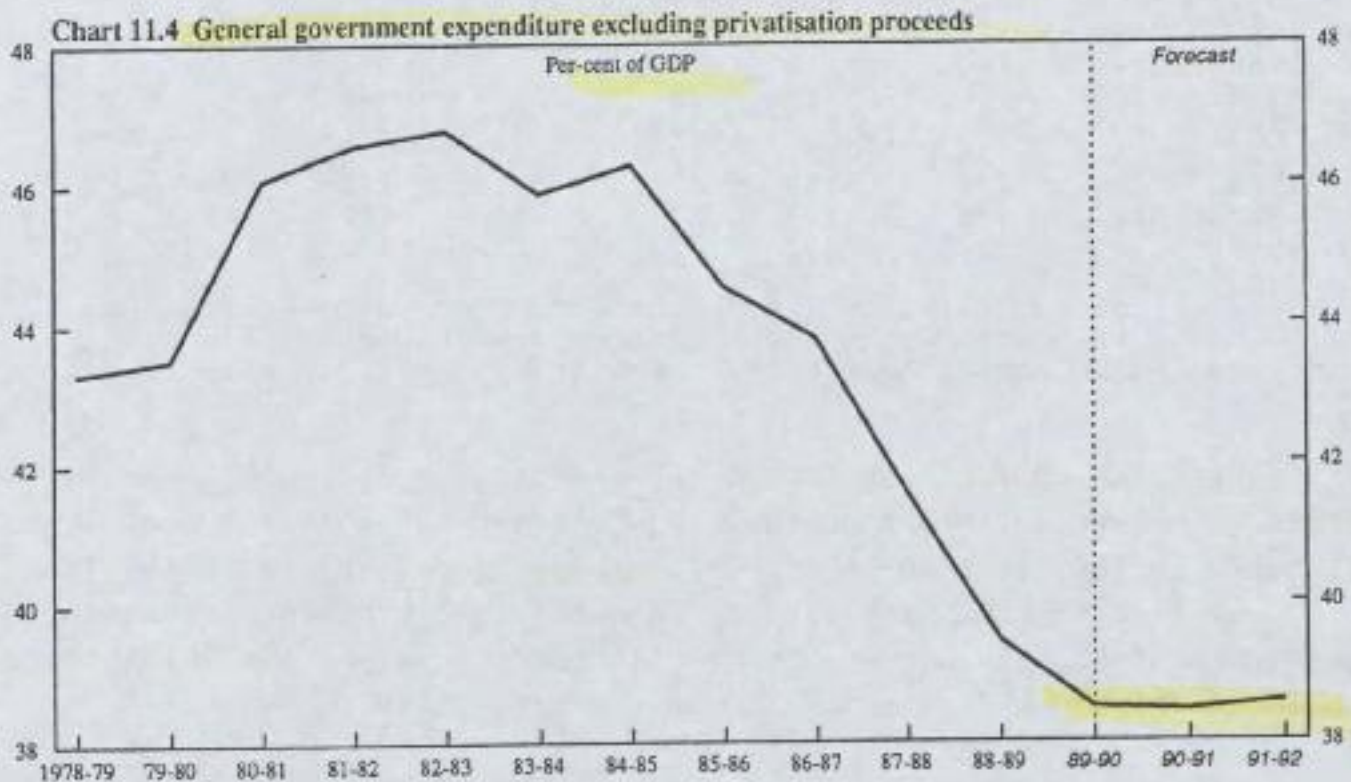
* 1987-88 prices, adjusted to remove the effect on the measured GDP deflator of the introduction of the community charge ie. figures here adopt same approach as FSBR, treating CC as if it were rates.

127. Public expenditure has fallen in real terms over recent years. GGE excluding privatisation proceeds is forecast to be 3½ per cent lower in real terms in 1989-90 than in 1986-87. It is forecast to rise in real terms in 1990-91 and 1991-92 by an average 2½ per cent (excluding debt interest the forecast increase is over 3½ per cent a year). This is more than in the PEWP but from a much lower starting point.

Chart 11.3 General government expenditure excluding privatisation proceeds



128. The projected fall in 1989-90 in the ratio of GGE excluding privatisation proceeds is larger than in the FSBR because money GDP is higher. The figures for measured money GDP will be reduced by about 2 per cent in 1990-91 by the introduction of the community charge. Other things being equal this would increase the GGE ratio by $\frac{1}{2}$ percentage point. Adjusting for this distortion the ratio is forecast to show no further falls in 1990-91 and 1991-92.



129. The forecast calculates both the old and new planning totals from individual components of expenditure. The forecast for 1989-90 is that the old planning total outturn will be £1 bn. below the level in the 1989 PEWP, partly due to an extra £ $\frac{1}{2}$ bn. privatisation proceeds but also due to a projected further shortfall on social security. The forecasts for 1990-91 and 1991-92 however are for levels considerably in excess of the PEWP. Much of the excess is on central government's own expenditure and nationalised industries. Not surprisingly therefore a similar pattern is forecast for the new planning total.

TABLE 11.5: FORECASTS OF THE PLANNING TOTAL
£ bn.

	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>
<u>Old Planning Total</u>			
1989 PEWP	167.1	179.4	191.6
Forecast Outturn	166.0	184.4	202.5
Forecast less PEWP	- 1.1	+ 5.0	+ 10.9
<u>New Planning Total</u>			
Survey Baseline*		175.5	187.6
Forecast Outturn		178.5	195.2
Forecast less baseline		+ 3.0	+ 7.6

* including notional Reserves set at £7 bn. and £11 bn. in 1990-91 and 1991-92 respectively in order to keep consistency with published GGE figures

130. The upward pressure on central government's own expenditure arises particularly on pay and investment. The forecast has central government earnings rising 1 per cent a year more than the private sector average from 1990-91. Central government investment is forecast to rise in the three years to 1991-92 by an average of 26 per cent a year in cash terms and 11 per cent a year in volume terms. Such rates of increase are high by past standards. Even so the level of investment forecast for 1990-91 and 1991-92 is well below departments' aspirations. The forecast takes the view that departments will in practice have great difficulty in increasing the volume of investment as rapidly as wished. The capital projects could well be undertaken, but the work will take longer than departmental bids envisage. Nevertheless price increases for such projects could well be above the overall inflation rate. Any slippage on volume is likely to be greater than on cash expenditure.

131. The forecast of social security expenditure assumes that "underlying growth" of expenditure in 1989-90 will be less than assumed in the PEWP, following the very low growth in 1988-89. This, together with lower unemployment than assumed by PEWP, produces an underspend of £½ bn. in 1989-90. Thereafter underlying growth is similar to that assumed in the PEWP. But with higher upratings in 1990-91 and 1991-92, and some policy increases, cash expenditure is above the PEWP.

132. On the assumption that local authorities' expenditure is close to their budgets in 1989-90, their current expenditure is expected to have risen in the three years to 1989-90 by an average 1½ per cent a year in real terms. Authorities in England and Wales are likely to take the opportunity of the introduction of the community charge in 1990-91 to raise

their spending by a relatively large amount. The extent to which they do this could be limited by a tough grant settlement. The forecast assumes that grants within AEF/AEG rise by 6½ per cent in cash terms, 1½ per cent in real terms. Expenditure is forecast to rise by 3 per cent in real terms. Taking into account the projected buoyancy of the NNDR and an assumption of little change in LAs' balances, a 17 per cent rise in the community charge (over average domestic rates per head in 1989-90) is forecast. The average level for the community charge in 1990-91 is £319.

133. 1989-90 could be the peak year for local authority capital receipts. The new capital control regime due to start in 1990-91 reduces the incentive to sell assets and the depressed state of the housing market could reduce personal sector demand to buy council houses. The forecast assumes therefore that the level of capital receipts falls in cash terms from a peak in 1989-90, but still remains above the level in the 1989 PEWP.

134. The outlook for the Local Authority Borrowing Requirement (LABR) is dominated by capital grants from central government for the capitalisation of housing debt. These amount to £1 bn. in 1989-90 and an assumed £7 bn. in 1990-91. The effect of these grants, which do not score in the new planning total, is to reduce the LABR and increase the CGBR(O), with no net effect on the PSDR. (See Table 11.1.) The size of these grants is such that net debt repayments, ie. LADRs, are forecast. But even if these grants are excluded, LAs are forecast to be close to balance in 1989-90 and to make small net repayments in 1990-91 and 1991-92.

135. Much of the pressure for extra public investment in future arises in the nationalised industry sector. The forecast assumes that investment by those industries remaining in the public sector throughout the forecast period rises in 1990-91 and 1991-92 by an average 14 per cent a year in cash terms, 10 per cent a year in volume terms. These are higher levels of investment than in existing plans, but well below departmental aspirations. The investment will inevitably lead to higher external finance. Public corporations as a whole are substantial net repayers of debt at present. The prospective rise in investment and the privatisation of the electricity industry which has a negative EFR are likely to mean a return to net borrowing by public corporations. The forecast also allows for substantial increases in investment - 20 per cent a year in volume terms - by the water industry after privatisation.

136. The forecast level of general government interest payments is a little higher - less than £½ bn. - than in the FSBR, but follows a similar falling profile.

Chart 11.5 General government debt interest

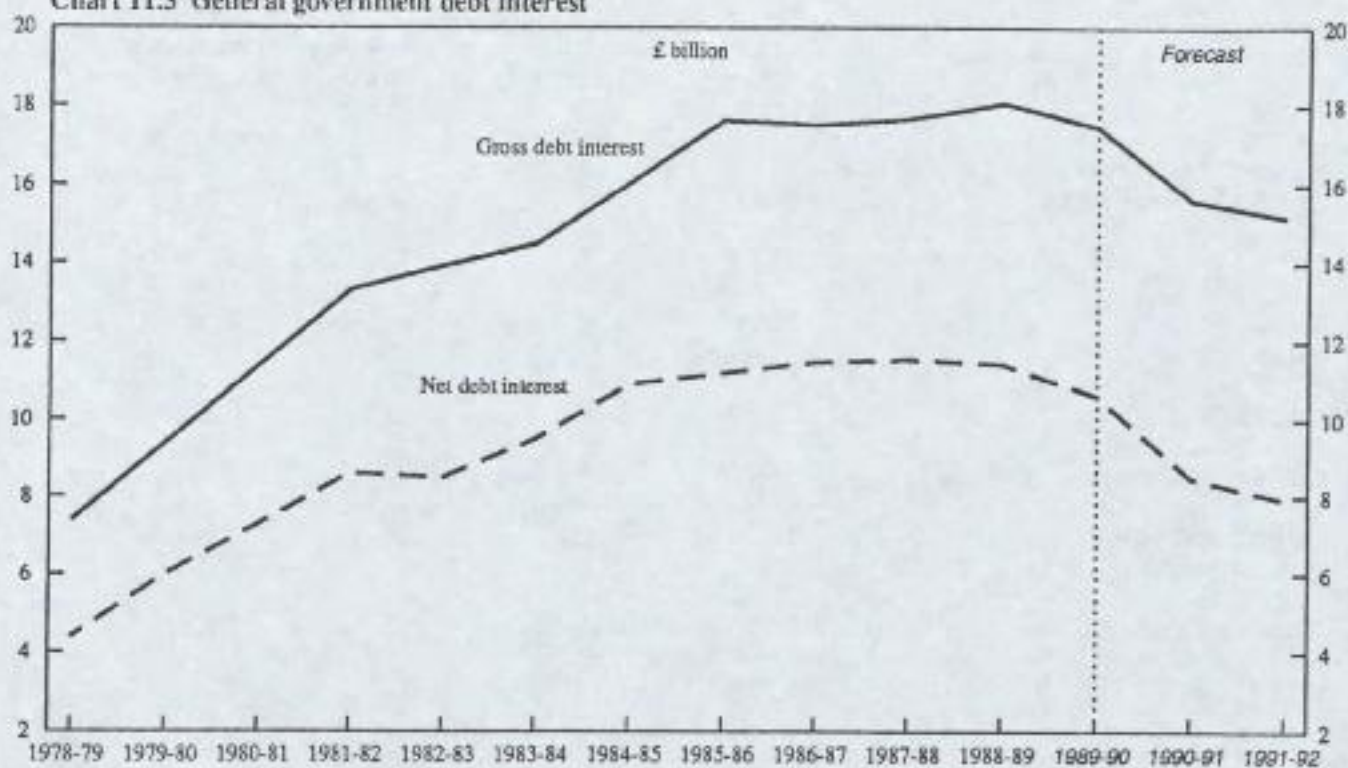


TABLE 11.6: FORECAST ADDITIONS TO EXPENDITURE PLANS*

£ bn.

	1990-91		1991-92	
	Survey Base- line	Forecast Claims on Reserve	Survey Base- line	Forecast Claims on Reserve
<u>Allocated to programmes</u>				
1. Social Security	49.9	0.7	53.0	2.1
2. CG pay	31.7	2.1	33.1	3.7
3. Other CG current	29.6	1.4	30.8	2.6
4. Net EC	2.0	0.5	1.6	0.6
5. CG investment	5.4	0.7	5.3	2.1
6. Other CG own expenditure	15.0	1.3	15.4	2.2
7. Grants to LAs	24.5	0.8	25.2	2.2
8. NNDR	11.5	0.9	11.8	1.5
9. LA credit approvals	3.4	0.7	3.5	0.8
10. Public corporations	0.5	1.1	2.0	0.8
11. Total programmes	173.5	10.1	181.6	18.6
12. Privatisation proceeds	-5.0	0.0	-5.0	0.0
<u>13. Expenditure met from notional Reserve</u>				
(i) allocated to programme baseline	0.0	7.1	0.0	10.9
(ii) unallocated	7.1	0.0	10.9	0.0
<u>14. Underspend (-) Required Addition to Reserve (+)</u>				
	0.0	3.0	0.0	7.6
<u>15. LA self-financed expenditure, debt interest etc.</u>				
	29.4	1.8	28.3	3.3
16. GGE	205.0	4.8	215.8	10.9

* On a new planning total basis

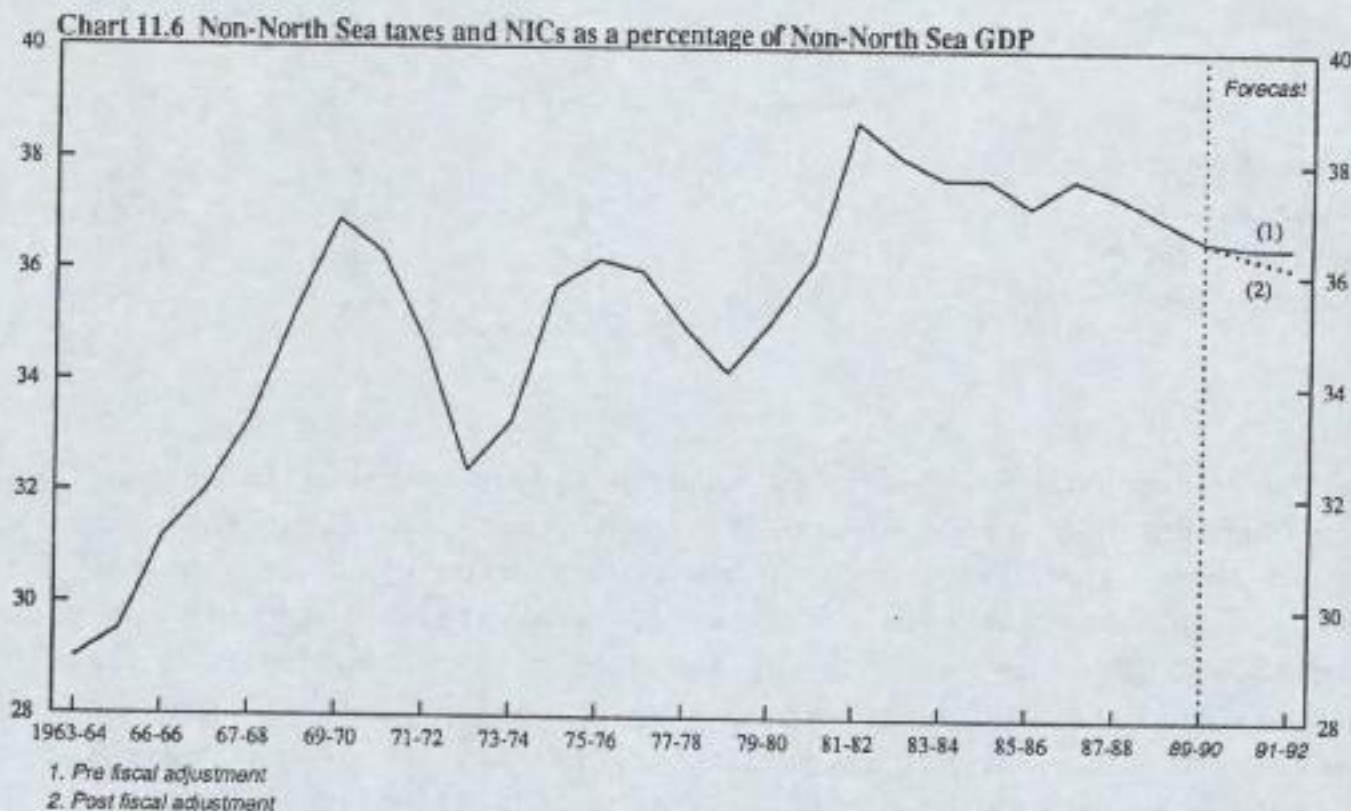
(c) Receipts

137. Latest data suggests that the non-oil tax burden may have fallen by $\frac{1}{2}$ to $\frac{3}{4}$ per cent in 1988-89, a little more than estimated in the FSBR. A similar fall is forecast for 1989-90 compared with no change in the FSBR. This downward revision is mainly due to faster money GDP growth, but also reflects the assumption that the Electricity Council will not pay tax in 1989-90. The non-oil tax burden is forecast to fall slightly in 1990-91 before fiscal adjustment mainly because of the lagged effects of the 1988 and 1989 Budgets (independent taxation and NICs reform respectively).

TABLE 11.7 : NON-OIL TAXES AND NICs AS A PERCENTAGE OF NON-OIL GDP*

	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92
FSBR						
(a) pre-fiscal adjustment					36.9	36.7
(b) post-fiscal adjustment	37.7	37.7	37.4	37.4	36.7	36.1
June Forecast						
(a) pre-fiscal adjustment					36.5	36.5
(b) post-fiscal adjustment	37.7	37.4	37.0	36.6	36.3	36.2

* adjusted to remove effect of community charge - see footnote to table 11.4



138. The main features of the outlook for taxes are:-

- the sharp deceleration in the growth of corporation tax in 1990-91, a feature of both the Budget and internal winter forecasts;
- the slow growth of national insurance contributions in both 1989-90 and 1990-91; while this was a feature of the Budget forecast, it is now more pronounced.

139. Corporation tax receipts in total are forecast to rise over 20 per cent in 1989-90, the same as the average increase in the four previous years. But they are forecast to rise only 5½ per cent in 1990-91 and 2½ per cent in 1991-92. The main reasons for this are much slower growth of ICC profits, both absolutely and relative to the growth of investment, and the build-up of writing down allowances as a result of the 1984 reforms. The effect is that the average rate of tax paid by ICCs is forecast to fall sharply, probably to levels not experienced since the introduction of the reforms. Financial companies' profits however, helped by high interest rates, are forecast to rise sharply, pushing up their average tax rate. But financial companies' tax bill is small relative to ICCs. For the company sector as a whole therefore the average tax rate is projected to fall.

TABLE 11.8 : EFFECTIVE CORPORATION TAX RATE

	1988-89	1989-90	1990-91	1991-92
Industrial & commercial companies	16	16½	12½	10½
Financial companies	12	15	18½	18½
All companies	15	16	14½	14

140. The forecast for national insurance contributions in 1989-90, which takes account of the reforms to employees' contributions that were announced in the 1989 Budget, has been revised up to reflect the faster growth in the wage and salary bill. However this has been completely overshadowed by the effects of the much higher than expected take-up of personal pensions. At Budget time, only ¼ million personal pensions were projected for 1988-89, but in practice by 17 May, the closing date for such pensions to be back-dated to 1987-88, some 3¼ million applications had been received. The resulting cost in cash terms in 1989-90 is estimated to be

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more than £2 bn. in excess of the Budget forecast. In later years, the removal of this year's incentives means that growth in the number of new personal pensions is likely to be slower.

ANNEX A: THE COMPOSITION OF RPI INFLATION

This annex examines recorded and forecast RPI inflation in more detail than in the main report. Main features to note are:

- Mortgage interest payments (MIPs) underlay much of the pick up in all-items RPI inflation over the past year, and contribute significantly (though at a declining rate) to the inflation prospect in 1989 and 1990. Even with a stable mortgage rate this component rises faster than the all-items RPI because of the very strong growth in average mortgage debt over the past three years.

- Apart from MIPs, housing costs generally have risen much faster than the RPI itself. Rates have risen significantly over the past four years, including the increases from April 1989. There is a particularly large forecast increase in 1990 due both to the high initial level of the community charge in April 1990 and to the "index household effect" of the community charge. The "index household effect" arises because index households (ie those whose expenditure is covered by the RPI) exclude pensioners and the wealthiest 5 per cent (who normally pay much higher domestic rates than index households). Index households will thus have to pay a greater proportion of the community charge than the proportion they paid of domestic rates. It is worth 3½ per cent on the rates/community charge component of the RPI and up to 0.2 per cent on the all-items RPI.

- Nationalised industry prices rose slowly in 1986 and 1987, falling quite markedly in real terms. They picked up sharply in 1988, and are assumed to rise faster than general RPI inflation over the forecast period; very big increases in water charges contribute most to this outlook. Increases in water charges will be effective from 1 April each year and the increase will be determined by the annual RPI inflation rate in the previous November plus 6 per cent. This will accentuate the real rise in water charges (ie relative to the RPI)

when general RPI inflation is coming down, as it is in the forecast. For example, the rise in water charges in the year to 1990Q4 is forecast to be 12.7 per cent, while the all-items inflation rate is only 5 per cent. This differential reflects the fact that the 12.7 per cent for water charges is 6 per cent plus the annual inflation rate in November 1989 (inflation in 1989Q4 is projected at 6.7 per cent). (After privatisation water charges will, with a short lag, no longer be part of the nationalised industry component, though they will still be part of the all-items RPI index.)

- "Retailled" price inflation (broadly goods and services traded across the counter) also picked up through 1987 and 1988, though much less than housing costs or, in 1988, nationalised industries' prices. Petrol prices have been volatile, while there has been a slowly rising trend in food price inflation. Other retailled price inflation has also picked up (though fairly slowly), reflecting strongly rising personal consumption. "Retailled" price inflation comes down fairly quickly during 1990 (petrol prices are likely to fall in the July 1989 retail price figures), with the projected slow-down in personal demand growth.
- Housing costs abate only slowly next year, with strong increases in the community charge largely offsetting lower growth in MIPs. And nationalised industry prices continue to rise in real terms, especially water charges. It is mainly the influence of "retailled" prices that accounts for the decline in the all-items RPI inflation rate during 1990.
- The one point rise in underlying RPI inflation (ie excluding MIPs) between end-1987 and end-1988 was mainly due to nationalised industry prices, local authority rents and rates and other housing costs (insurance, DIY materials etc). The increase through 1989, however, is largely accounted for by "retailled" prices. The fall in underlying inflation through 1990 is primarily due to the deceleration in retailled prices.

Memorandum item - Output prices

- Producer output prices also give a good indication of "core" or underlying inflation. They picked up in 1987 as oil prices recovered from their low levels in 1986. Output price inflation hovered at 4½ per cent between 1987Q4 and 1988Q3 (faster than RPI inflation); and picked up to 5 per cent at the end of the year and to 5.4 per cent in the first quarter of 1989. Sustained growth in profit margins contributed notably to these developments.

- But producer output price inflation has slipped back slightly to 5.2 per cent in May. It is likely to go on falling slowly to 4.9 per cent by end-1989 (with a small fall in margins) and to edge down by ½ per cent a year thereafter.

TABLE A1: EVOLUTION AND PROSPECTS FOR RPI INFLATION
(percent changes on year earlier)

	Weight*	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4	1991Q4
<u>RETAIL PRICES</u>							
<u>HOUSING</u>							
MIPs	6.0	4.2	6.4	36.4	25.4	14.6	5.5
Rent	3.2	6.1	6.2	8.3	9.5	10.8	9.0
Rates/Community Charge	4.2	13.6	7.7	8.4	9.6	20.8 ³	9.4
Other	3.4	5.1	5.4	9.3	7.8	6.8	6.5
<u>Total</u> ¹	16.8	7.1	7.0	16.5	14.7	13.9	7.3
<u>NATIONALISED INDUSTRIES</u>							
Electricity	2.6	0.7	- 0.6	8.6	6.5	7.2	3.8
Water	0.7	8.2	6.9	8.1	13.7	12.7	11.7
Other	1.3	3.3	3.3	5.4	4.8	6.7	6.2
<u>Total</u> ²	4.6	2.9	2.1	7.4	7.5	7.9	5.8
<u>MEMO ITEM:</u>							
Gas	2.2	1.3	- 4.5	6.0	3.5	2.8	3.9
<u>"RETAILED" PRICES</u>							
Food	15.4	3.2	3.4	3.9	4.9	3.7	3.5
Petrol	3.4	-12.6	1.3	- 0.1	6.0	3.8	4.6
Other	57.6	4.0	4.3	4.8	4.9	3.7	3.9
<u>Total</u>	76.4	2.9	4.0	4.4	5.0	3.7	3.8
TOTAL RPI INFLATION	100	3.4	4.1	6.5	6.7	5.7	4.7
TOTAL RPI INFLATION excl MIPs	94	3.4	4.0	5.1	5.6	5.0	4.7
<u>OUTPUT PRICES</u>							
Producer output prices (excluding food, drink, and tobacco)		3.7	4.8	5.0	4.9	4.3	3.7

¹ excluding water

² excluding gas from 1987Q1, buses from 1989Q1

³ includes 3.5 per cent for 'index household effect', worth about 0.15 per cent on the all-items RPI.

* Weights at Jan 1989

ANNEX B: NATIONAL AND SECTORAL ACCOUNTS

The inconsistencies in the national and sectoral accounts in recent quarters remain large, though they are smaller than at the time of the Winter forecast, when adjusted accounts were used. Substantial upward revisions to expenditure data, particularly investment, just before the Budget largely eliminated the differences between the GDP measures in 1986 and 1987, and reduced them in 1988. Nevertheless, growth of the expenditure measure in 1988 remained well below the other two measures, and there was no improvement in the discrepancies in the sectoral accounts.

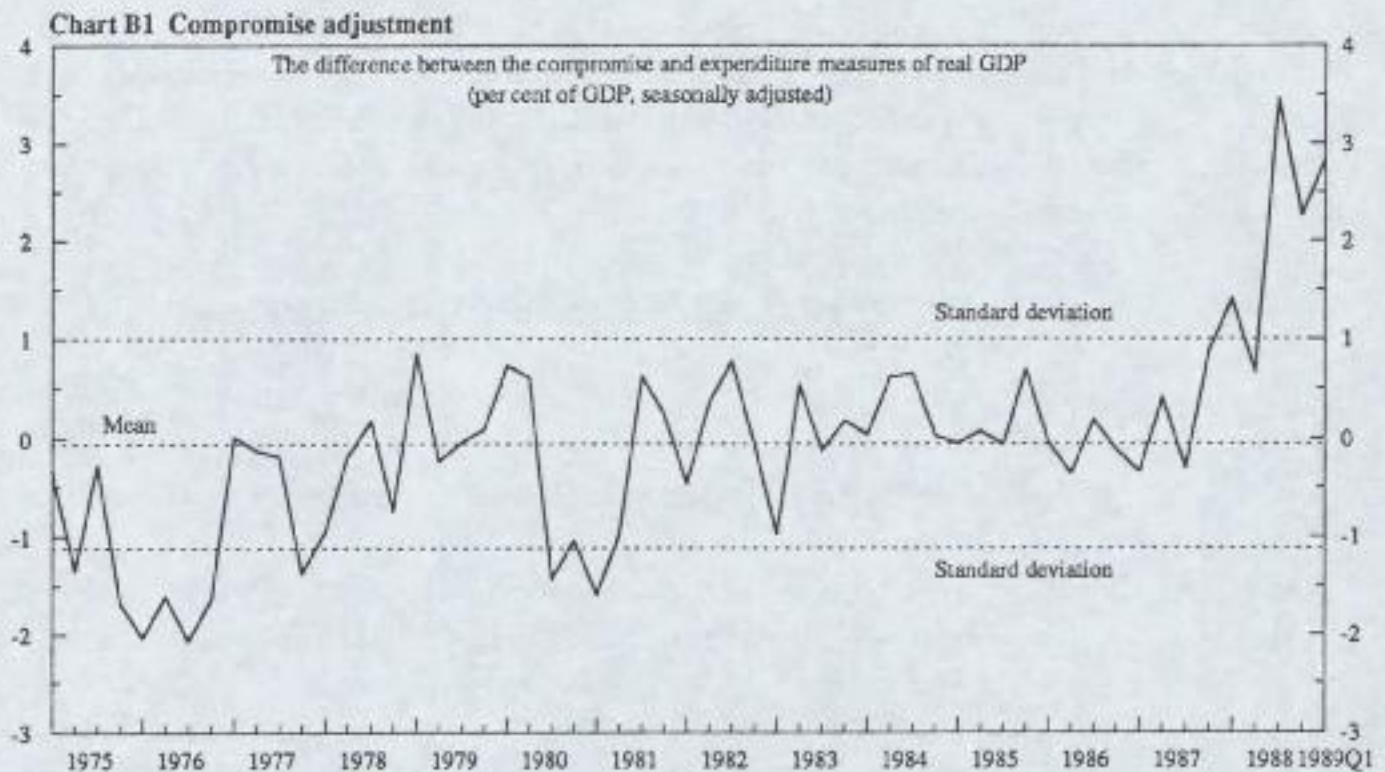
2. The CSO press notice for GDP in the first quarter of 1989 (published June 20) included only small revisions to the expenditure and income measures in 1988, while growth of the output measure was revised up by $\frac{1}{2}$ per cent to $4\frac{1}{2}$ per cent. GDP(E) is still estimated to have grown by under $2\frac{1}{2}$ per cent, more than $1\frac{1}{2}$ points less than the other two measures (Table B.1).

Table B.1: Measures of GDP at constant factor cost

	<u>Expenditure</u>	<u>Output</u>	<u>Income</u>	1985 = 100 CSO (Unweighted) <u>average</u>	HMT compromise <u>measure</u>
1987	107.5	107.8	107.2	107.5	107.5
1988	110.3	112.6	111.7	111.5	112.3
1988 Q1	109.7	111.4	112.1	111.1	111.0
Q2	111.0	111.9	111.2	111.4	111.6
Q3	109.2	113.3	111.9	111.4	112.9
Q4	111.2	113.9	111.8	112.3	113.5
1989 Q1	110.7	114.1	113.2	112.7	113.7
Growth rates (percent changes on a year earlier)					
1987	4.1	4.8	4.2	4.3	4.3
1988	2.6	4.5	4.2	3.7	4.5
1989Q1	1.0	2.4	1.0	1.4	2.4

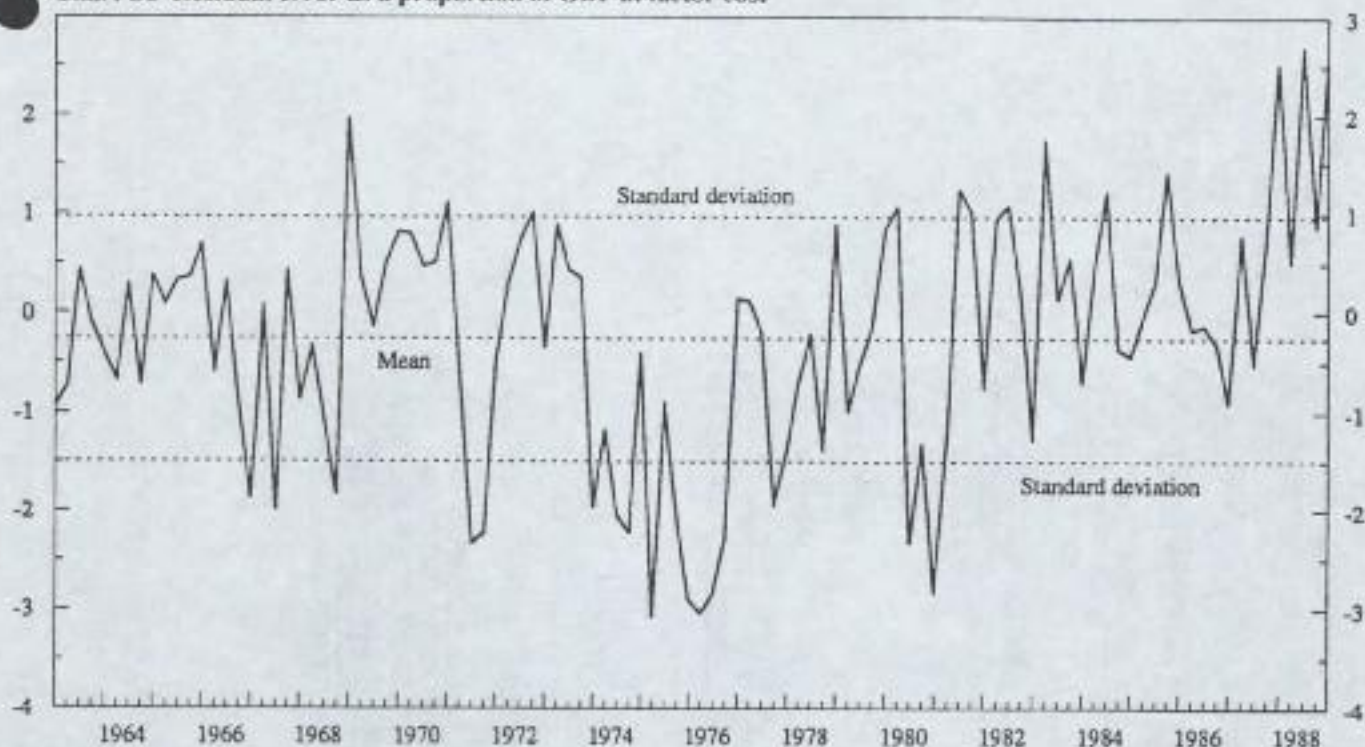
3. The output measure of GDP probably gives the best measure of recent movements and of changes over short periods. This forecast is a compromise measure of GDP which is the unweighted average of the three measures while they are reasonably consistent - to the end of 1987 - and moves in line with GDP(O) thereafter. This was the procedure used in the FSBR.

4. Between the fourth quarter of 1988 and the first quarter of 1989 the output measure rose slightly. However, the expenditure measure fell $\frac{1}{2}$ per cent while the income measure rose by $1\frac{1}{2}$ per cent. As a result the compromise adjustment - the difference between compromise GDP and the expenditure measure of GDP - widened from 2 per cent of GDP in 1988 to 3 per cent in the first quarter of 1989 (Chart B.1).



5. Similarly the residual error - the difference between the current price income and expenditure measures - rose from $1\frac{1}{2}$ per cent of GDP in 1988 to $2\frac{1}{2}$ per cent in the first quarter. These are very large discrepancies, though less than the 4 per cent of GDP at the time of the publication of the 1988Q3 GDP figures last December.

Chart B2 Residual error as a proportion of GDP at factor cost



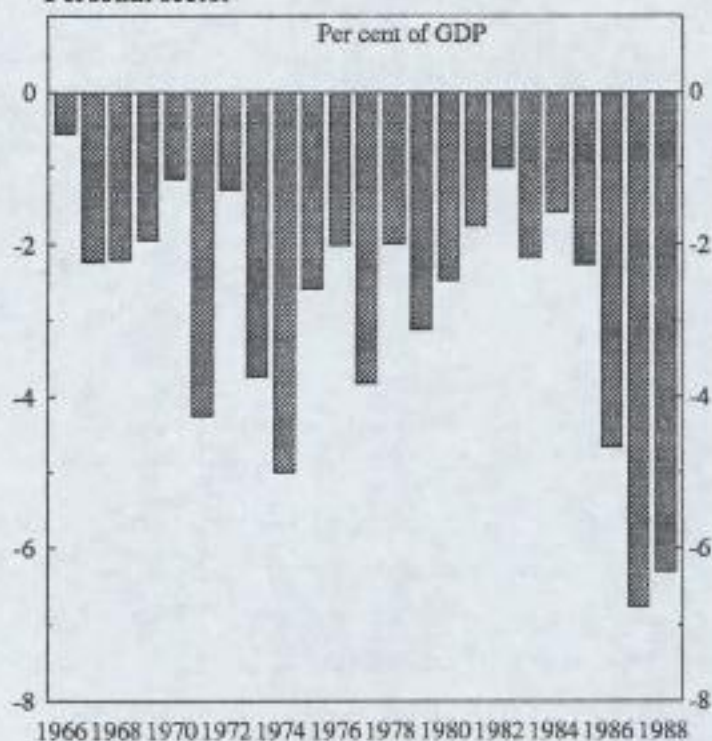
6. At one stage it looked as if the latest estimates of the measures of GDP would be closer than they have turned out. Had we known in time that the discrepancies would be as large as have been published, we would have adjusted the data, as we did in the Winter forecast, by allocating the compromise adjustment and the residual error to components of income and expenditure. The main changes would have been upward adjustments to the expenditure components. The CSO have already made very substantial upward revisions to investment since we last adjusted the accounts. If we had adjusted the data for this forecast we would, therefore, probably have allocated less of the remaining discrepancy to investment and more to other components - stockbuilding, net trade and consumption.

7. On the basis of the compromise measure, growth in 1988 is estimated at 4½ per cent but slows to 2½ per cent in the year to 1989Q1. Accidents in the North Sea have depressed whole economy output recently - non-oil GDP is estimated to have grown by 4 per cent in the year to 1989Q1, and at an annual rate of 3 per cent since the third quarter of 1988.

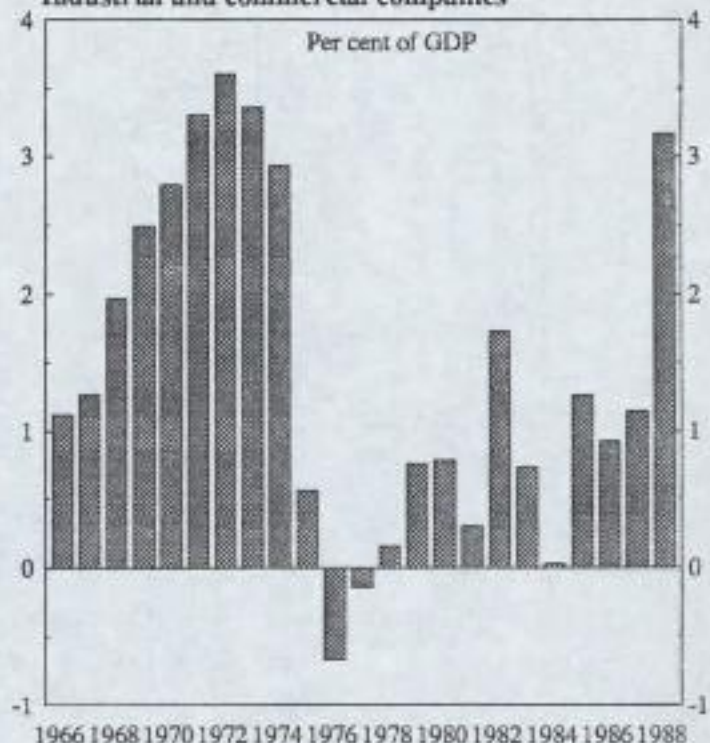
8. Complete sectoral accounts data for 1989Q1 are not yet available; nor have the latest revisions to expenditure, income or financial accounts data for 1988 yet been carried through to the

Chart B3 Sector balancing items

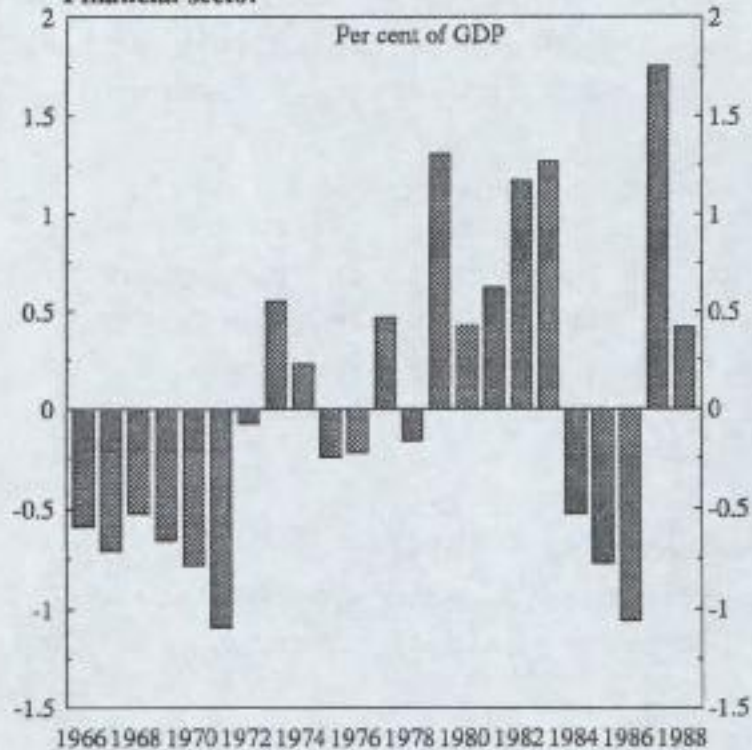
Personal sector



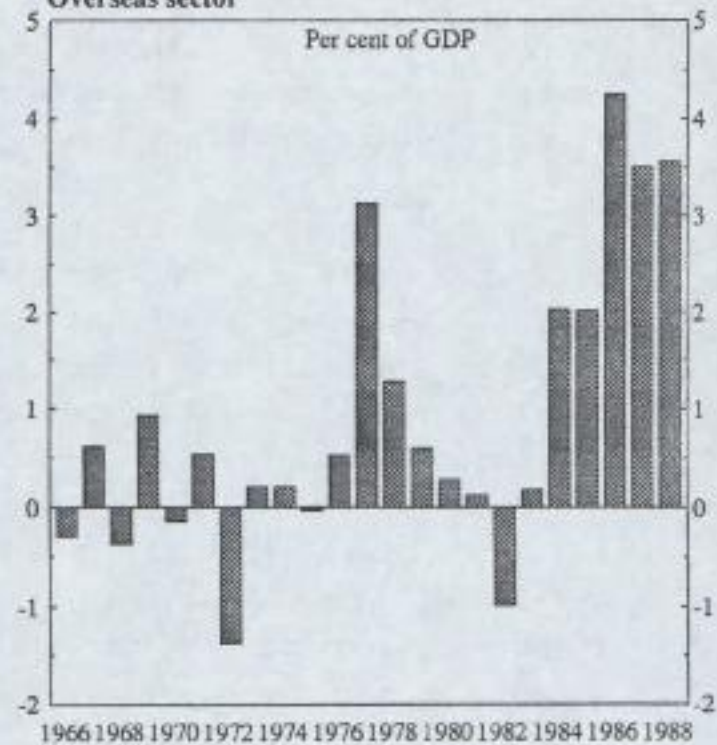
Industrial and commercial companies



Financial sector



Overseas sector



sectoral financial surpluses/deficits or balancing items. However, on the basis of the sectoral data consistent with the national accounts published at Budget time, there is no sign of any improvement in the coherence of the accounts (Chart B.3). The personal sector and overseas balancing items remained very large in 1988 - 6½ and 3½ per cent of GDP respectively - and the ICCs balancing item rose sharply. The latter suggests that, despite substantial upward adjustments to investment made by the CSO (largely on the basis of their supply estimate), company sector expenditure (including stockbuilding) may still be under-recorded. The overseas balancing item is consistent with some under-recording of net current account credits and more substantial under-recording of net inward capital flows to the UK.