Economic commentary

This commentary describes the main features of the economy at home and abroad as background to financial developments, and gives a more detailed account of points made in the general assessment.

- *Economic activity abroad remains weak. Some modest recovery next year seems likely, although prospects are uncertain.*
- *At home, spending has risen in the last year or so, but with little effect on output. Inflation has fallen sharply this year.*

The continued strength of bank lending to the private sector—both persons and companies—is noted. The PSBR, by contrast, has been declining.

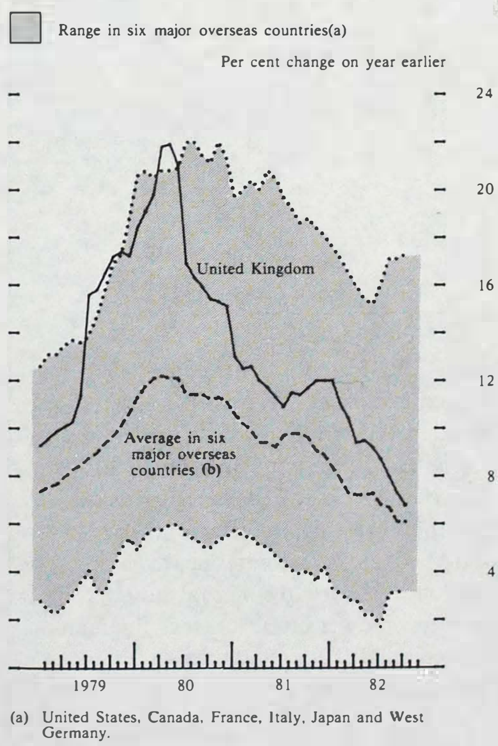
Real GNP or GDP
Percentage change, *seasonally adjusted*

	1980	1981	1982		
	Year	Year	Q1	Q2	Q3
United States	−0.4	1.9	−1.3	0.5	—
Canada	0.5	3.1	−2.3	−2.1	−1.0
France	1.1	0.2	−0.2	1.0	..
Italy	3.9	−0.2	1.3	−1.4	−3.0
Japan	4.2	3.0	1.0	1.3	+0.6
West Germany	1.8	−0.2	−0.2	−0.4	−1.5
Total	**1.3**	**1.6**	**−0.5**	**0.4**	..
United Kingdom	−2.4	−2.4	0.2	0.1	—(a)

.. not available.

(a) Bank estimate. Figures for the United Kingdom are the average measure of GDP.

The trend of **price inflation** *has been downwards.*



(a) United States, Canada, France, Italy, Japan and West Germany.
(b) GNP weights.

The world economy

The present situation—weak activity, falling inflation

The general assessment notes how forecasts made over the last year or two have been overoptimistic about the timing and strength of economic recovery in industrial countries. Most forecasts prepared in 1981 and the early part of 1982 suggested that output in the major countries would begin to revive from mid-year onwards, and then grow at about 2%–3% a year, with a further gradual easing of inflation. In the event, the weakness apparent in the first half of 1982 appears to be continuing in the second half and it now seems likely that activity this year will be about $\frac{1}{2}$% lower than in 1981. At the same time, inflation has come down more than expected: in the year to October consumer prices in the major industrial countries rose by a little over 6%.

Perhaps the main reason for the weakness in activity in the major OECD countries is that business has been subject to continued financial pressure which has reflected prolonged recession, a secular (as well as cyclical) decline in profit margins, and high nominal and real interest rates. Company spending on stocks and fixed capital turned down more rapidly in early 1982 than expected; real wages have grown only slowly; and unemployment has risen sharply everywhere (except Japan) as companies have shed labour. Export markets have also turned down, with not only developing countries but also some oil exporters reacting to the fall in their own export receipts by curbing imports. Output was particularly weak in North America and West Germany in the first half of the year; France and Japan showed some growth.

The policy background

When oil prices rose steeply in 1979, most governments adopted cautious monetary and fiscal policies—in contrast to the more diverse response in 1974. The initial setback to activity in industrialised countries was nevertheless smaller than in 1974–75, reflecting, no doubt, the cyclically weaker starting point in 1979. But while initially shallower, this recession has already continued longer than the previous one; and 1982 has not shown an upswing like 1976.

World economic prospects

The background to the latest Bank forecast of the world economy is described on the opposite page. The projections in the table suggest that, from a lower starting point than in earlier forecasts, GNP in the major overseas countries will revive in the first half of 1983 and thereafter expands at an annual rate of nearly 3%. They assume that financial conditions remain tight, and business and consumer confidence is slow in returning.

GNP and prices in the major overseas economies(a)

Percentage changes

	1981	1982(b)	1983(c)
Real domestic demand	**1**	**—**	**2¼**
of which:			
Consumption	1¼	1¼	2½
Investment	½	−3¼	1½
Stocks(c)	−¼	−¼	¼
Volume of net exports(d)	¾	−¼	—
Real GNP	**1½**	**−½**	**2¼**
Consumer prices	9½	7	6¼

(a) United States, Canada, France, Italy, Japan and West Germany.
(b) Partly estimated.
(c) Bank forecasts.
(d) Contribution to the change in GNP.

Lower inflation and recent falls in interest rates should promote some recovery in activity, through two main channels. First, lower inflation means that fiscal and monetary targets set in nominal terms (eg money supply, spending and borrowing objectives) allow greater room for real growth. Nonetheless, real interest rates are likely to remain rather high and fiscal policy relatively tight. Second, there may be some direct effect from lower inflation on the private sector's propensity to spend.

Even so, economic recovery seems likely to be slower than in earlier cycles. Real personal incomes in the major OECD countries should benefit from further gains in the terms of trade and some recovery in employment (which may still be insufficient to stop unemployment rising); any increase in real tax payments as incomes grow should be modest enough to be offset by an expected decline in saving ratios; and consumer spending could rise by 2%–3% in 1983.

Partly in response, company spending is also expected to revive, but only slowly, leaving fixed investment a smaller proportion of GNP in the major economies than at any time in the last ten years and bringing some further fall in stock-output ratios as companies try to strengthen their balance sheets.

The major industrial countries as a group cannot expect external demand to revive their economies. Balance of payments constraints are likely to hold back import growth not only in debt-burdened developing countries (see page 492), but also in the oil-exporting countries, some of which are now in substantial deficit on current account. In sharp contrast to the experience of recent years, imports of countries outside the OECD may grow no faster than world trade next year. Current account balances for the major country groups may not shift very much, but there could be substantial movements within the groups. Analysis is, however, made difficult by the size of the world current account discrepancy, nearly $90 billion in 1982 (see page 356 of the September 1982 *Bulletin*).

It seems unlikely that inflation in the major industrial countries will continue to fall as fast as it has done. Their import prices should continue to be a moderating influence, with both oil and non-oil commodity prices likely to be weak. But wages growth may ease only gradually and may still be running at 7% on average in 1983; and companies are likely to attempt to rebuild profit margins if market conditions permit. Nevertheless, consumer price inflation could fall to barely 6% on average—but with large variations between countries.

These forecasts are highly uncertain. Activity could be stronger than they suggest. But—perhaps a greater source of concern—the forecasts could again prove optimistic. It is possible that consumer and business spending in the major economies will not respond in the expected way to lower inflation and interest rates. Disappointment of earlier hopes of economic recovery may have damaged business and consumer confidence so that spending plans continue to be deferred; and financing constraints (on business and deficit countries) might be more severe than allowed for in the forecast.

The volume of world trade and UK export markets

Percentage changes

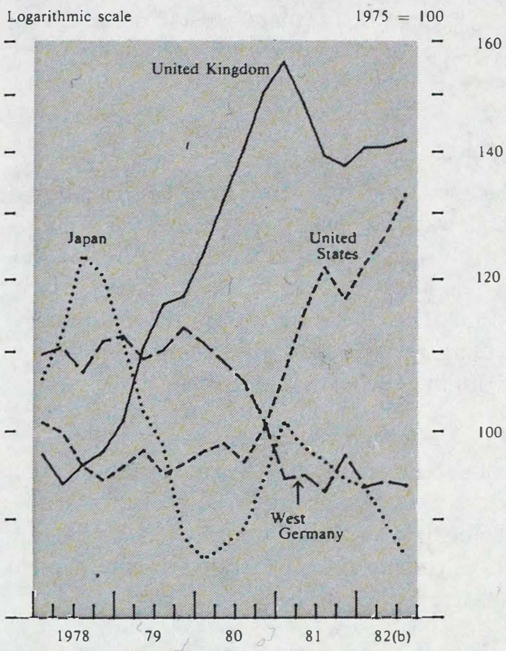
	1981	1982(a)	1983(b)
World trade	0.5	−0.3	3–4
UK export markets	2.1	−0.3	about 3
of which:			
OECD	*− 2.8*	*−0.1*	
Other	*11.3*	*−0.6*	

(a) Partly estimated.
(b) Bank forecasts.

In these circumstances, GNP growth in the major economies could turn out lower next year than suggested above; and price inflation would probably be lower too. The effects of more depressed conditions on employment and consumer confidence would be likely to reduce aggregate consumer spending. If there were again little or no growth in domestic demand in the major economies next year, exports of developing countries would suffer (although they would no doubt benefit from lower interest rates); financing constraints might tighten still further; and they would in turn be compelled to reduce imports.

The indebtedness of developing countries is discussed on page 492

Changes in competitiveness[(a)] *in recent years have been marked.*



(a) Relative unit labour costs in manufacturing normalised by the IMF—adjusted for cyclical influences and exchange rate movements.

(b) Third quarter figures are Bank estimates.

Contributions to the change in GDP

Percentages; annual rate; *seasonally adjusted*

	1979 (average)–mid-1981(a)	mid-1981–mid-1982(a)	1982 H2–1983 H2(b)
Consumers' expenditure	—	+ ½	+1½
Government current expenditure on goods and services	+ ¼	+ ¼	+ ¼
Gross fixed investment	−1¼	+ ¾	+1
Domestic final expenditure	**−1**	**+1½**	**+2¾**
Change in stocks	−2	+1¼	+ ¾
Total domestic expenditure	**−3**	**+2¾**	**+3½**
Exports (goods and services)	− ¼	—	+ ¾
Total expenditure	**−3¼**	**+3**	**+4¼**
Less imports	+ ¼	−1	−2
GDP measures:			
Expenditure	−3	+2	+2
Output	−2¾	+ ½	..
Average	−2½	..	+2

.. not available

(a) Average of second and third quarters. Figures for 1982 Q3 are partly estimated.

(b) Treasury forecast.

The reasons why the recovery has been delayed have a bearing on prospects. One factor is the course of interest rates, which rose strongly in 1981. Monetary policies have generally aimed at containing the inflationary impact of the rise in oil prices; until inflation had eased, this was likely to mean a period of high interest rates. These placed a burden on company finances and exacerbated the debt service problems of developing countries; they also discouraged investment and stockbuilding. These financial problems intensified as recession deepened, bringing lower sales and the weakest commodity prices in real terms for over thirty years.

Fiscal policy has also remained tight. Recession and inflation have nevertheless swollen fiscal deficits in many countries, enough in some cases to cause policy to be tightened further. Deficits may be reduced as inflation subsides in so far as nominal interest payments decline; a recovery in activity, adding to tax revenues and reducing social spending, would bring a major reduction.

Deepening recession, together with the diversity in balance of payments positions and exchange rate movements which has emerged, may have encouraged protectionist pressures. Changes in competitiveness have been very marked. Uncertainty over exchange rates has also affected international financial markets and contributed to financing problems.

Prospects for world recovery

The box opposite discusses recent projections for the world economy. Such projections rely on many fallible judgements and the picture they suggest could turn out to be optimistic or pessimistic. In present circumstances, the consequences would be more worrying if activity fell appreciably short of what is now expected rather than being stronger. It is possible, for example, that finance will be less readily available than the main forecast assumes, because banks and capital markets are reluctant to take the credit risk. It is particularly hard to assess the effect of such financing difficulties, which are novel on their present scale and likely to be discontinuous in their effects. Fiscal policy is another area of uncertainty. The main forecast assumes no change, but some governments may feel the need to tighten policy in an attempt to curb budgetary deficits. Moreover, business confidence may be weaker than allowed for. Both weaker private demand and tighter budgetary policy might, in the end, correct themselves, in part through the interaction of lower inflation and activity on monetary targets and objectives for public sector deficits expressed in nominal terms. But tight policies bear on the deficit position of other sectors, such as companies, and, on a world scale, developing countries. They may—if sufficiently severe—add to financial problems rather than relieve them.

The UK economy and financial developments

Overview of expenditure and output[(1)]

Domestic spending appears to have grown by 2½%–3% between the middle quarters of 1981 and 1982, about the same rate as its decline in the previous two years. Figures for the latest period are not complete, but it seems that consumer spending (strong in the third quarter), government current expenditure and fixed

(1) At 1975 prices.

investment all grew over the year, and stocks were reduced by a much diminished amount despite their fall in the third quarter. The trade balance weakened, however—the volume of imports of goods and services grew, whereas exports were virtually unchanged over the period—so GDP on the expenditure measure grew more slowly than domestic spending. At 2% or so, its growth was still considerably faster than the growth of output; the gap between the measures of GDP, which had closed around the middle of last year, reopened, adding to the difficulty of interpreting developments in the economy.

In the year to the second half of 1983, Treasury forecasts indicate another rise of 2% in GDP, with faster growth in domestic spending but a further deterioration in external trade. Personal consumption seems likely to provide the main boost to domestic demand; at 5½%, the forecast rise in fixed investment is quite strong, and some recovery in stocks is expected.

Personal income and consumer spending at 1975 prices[a]

Percentage changes; annual rates(b); *seasonally adjusted*

	1977–80	1981	1981 (average)–1982 Q2	1982 Q3 change in quarter
Wages, salaries, forces' pay	+3.7	− 3.6	−3.1	..
Employers' national insurance contributions	+3.4	+ 4.8	−3.7	..
Social security benefits	+5.8	+10.6	+3.4	..
Other income	+6.2	− 5.3	−2.4	..
Taxes on personal income(c) (increase −)	−0.5	− 2.0	−0.2	..
Real personal disposable income	**+5.5**	**− 2.2**	**−2.7**	**+0.5**(d)
Consumer spending	+3.5	+ 0.3	−0.4	+1.5

.. not available.

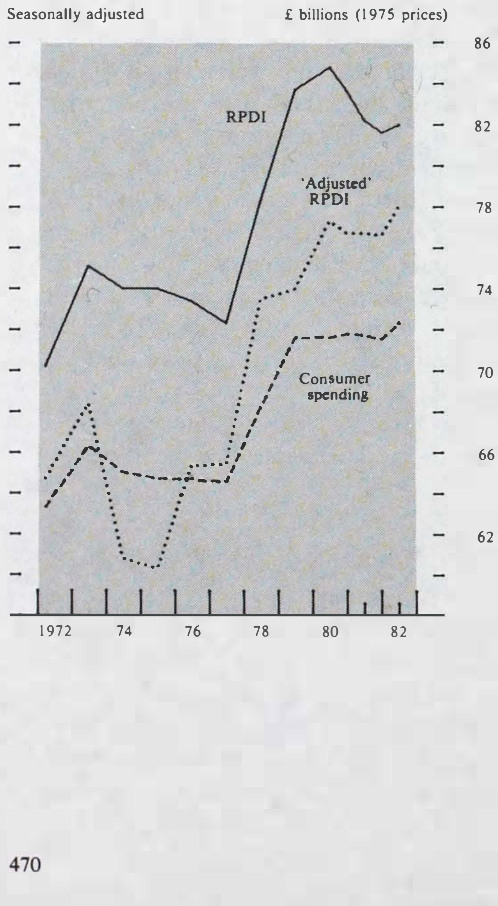
(a) Nominal amounts divided by the deflator for consumers' expenditure.

(b) Except 1982 Q3.

(c) Includes employees' national insurance contributions.

(d) Bank estimates

Lower inflation has increased **RPDI** *adjusted for inflation losses.*



Consumers' spending revives

Real personal disposable income (RPDI) grew rapidly between 1977 and 1980, when high wage increases coincided with a strengthening exchange rate, and then contracted up to the middle of this year. Consumer spending was nevertheless little changed in the three years to mid-1982. The recent upturn was encouraged by the removal of hire-purchase restrictions in the summer, demand for cars and household durables being most affected.

Wages and salaries (by far the largest component of personal income) have fallen in real terms since 1980—earnings per employed person have tended to rise faster than consumer prices, but employment has declined. While social security benefits have grown,[1] 'other' sources of personal income (from self-employment, rents, interest, dividends, etc) appear to have contracted.

There is evidence that the rate of inflation affects the amount of saving as people try to preserve the real value of their monetary assets.[2] RPDI may be redefined to include the loss on monetary assets (net of the gain on liabilities) arising from inflation. The recent decline in the rate of inflation has brought about some growth in RPDI when so adjusted,[3] while RPDI as usually defined has tended to fall (partly reflecting the fall in interest rates associated with declining inflation). Various other influences on consumption may also be important. Among them are the composition of income (the growing share of social security benefits in personal income is likely to mean higher consumer spending at each level of RPDI) and the availability of finance. The value of holdings of financial assets generally (including assets which are not fixed in money terms) may also affect future spending. After declining in the first half of the 1970s, mainly because of falls in the stock market, real financial wealth held by the personal sector was steady for some years before rising in 1981 and possibly increasing further this year.

Industrial fixed investment relatively high

Industrial fixed investment, having fallen in the second quarter, revived in the third, when according to provisional estimates it was

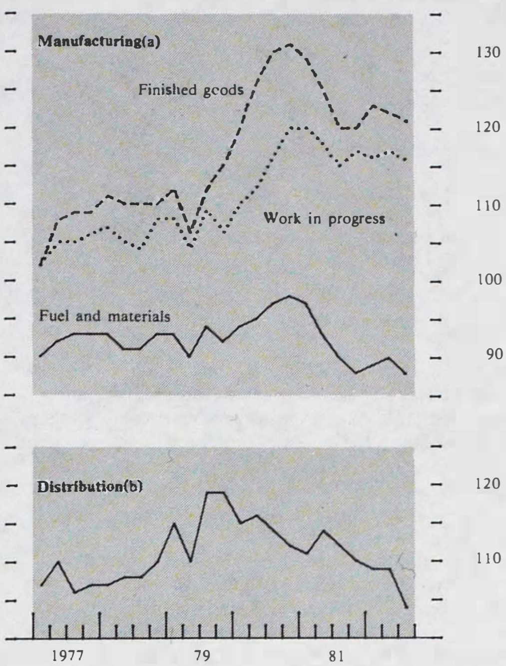
(1) In the second quarter of this year current grants from the Government were equivalent to 26½% of wages and salaries, compared with 20½% in 1977.

(2) 'Monetary assets' is used here to mean those assets, the redemption price or value of which is fixed in money terms.

(3) The adjustment is made by applying the notional loss suffered by the personal sector on net monetary liabilities, expressed at 1975 prices, to RPDI. That for 1982 is based on a projection. For the calculation of inflation losses and gains, see 'Inflation-adjusted saving and sectoral balances', in the June 1982 *Bulletin*, page 239.

Manufacturers' stocks *of finished goods still look high, but their stocks of fuel and materials are low in relation to output.*

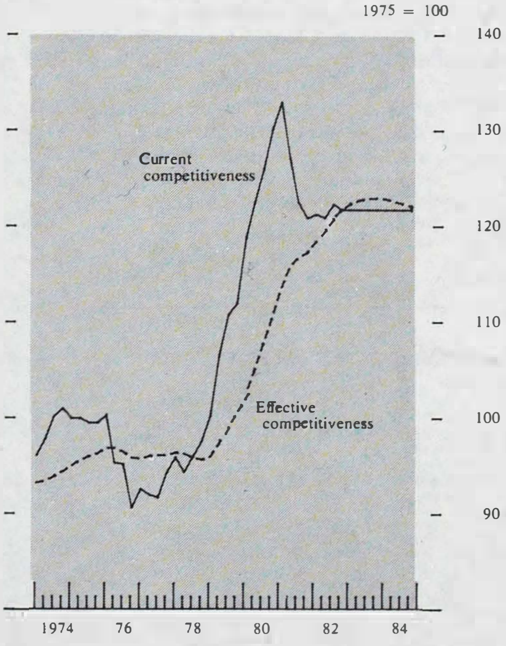
Seasonally adjusted End-1974 = 100



(a) Ratio of stocks to output.
(b) Ratio of stocks to retail sales.

Current and effective competitiveness of UK manufacturing[(a)]

1975 = 100



(a) Concepts are discussed in an article on page 369 of the September 1982 *Bulletin*.

Real domestic demand
Percentage change

	1980	1981	1982(a) H1	1982(a) H2(b)
United Kingdom	−3	−1½	2¾	1½
Six other major economies(c)	½	1	−¼	½

(a) Seasonally adjusted, at an annual rate.
(b) Bank estimates and forecasts.
(c) United States, Canada, France, Italy, Japan and West Germany.

once more above the quarterly average in 1981. Within the total, investment in assets for use by manufacturing industry (including leased assets) was little changed, and remained below the rate in 1981. Nevertheless, even manufacturing investment is quite high given low output and the real return on existing assets.

Stocks fall once more
Provisional estimates show a fall in stocks in the third quarter. Manufacturers cut their holdings by £330 million, having held them virtually unchanged in the first half of this year; distributors' stocks fell by £80 million.

Of the reduction in manufacturers' stocks, £140 million was in fuel and raw materials—a category of stocks which already seemed low in relation to output. The reduction in their stocks of finished goods, and in distributors' stocks—£170 million altogether—might have been an involuntary response to unexpectedly strong consumer spending in the third quarter, although replies to CBI surveys (confined to manufacturing industry) have continued to suggest excessive stocks of finished goods which might be further reduced.

External trade—changing influences
Although the cumulative effect of earlier losses of competitiveness is large, it has probably almost ceased to grow. The chart shows competitiveness (adjusted for cyclical effects on labour costs in manufacturing industry) and estimates of effective competitiveness—a summary measure of current and earlier changes, combined with weights appropriate to their effect in each period on manufactured exports and imports.

The benefit to the trade balance of earlier and deeper recession in the United Kingdom is being reversed. Domestic demand has been rising this year, whereas in other major economies it has levelled out. Together with developments elsewhere, the consequences for UK export markets have been pronounced. In 1981, UK markets expanded by over 2% (4% for manufactured goods). Markets in the OECD area were contracting, but those in the developing world remained very buoyant. In the first half of this year, however, UK export markets have shrunk by perhaps 4% (at an annual rate). North American and OPEC markets were weak, and imports by the developing countries fell, apparently sharply. CBI surveys show more respondents quoting economic conditions abroad as a factor likely to limit export growth, evidence which is consistent with prospects for the world economy outlined on page 468.

In the circumstances, it is not surprising that exports (excluding oil and the usual erratic items) have been tending to decline this year.

Last year, the volume of imports (excluding oil and the usual erratic items) grew substantially, partly in response to a slowdown in destocking. This year, there has been no clear trend. For while domestic demand has grown, the improved competitiveness of 1981 (affecting imports more quickly than exports) will probably have been a restraining influence.

Visible trade as a whole was in large surplus last year and, although the balance of non-oil trade has deteriorated sharply, has continued

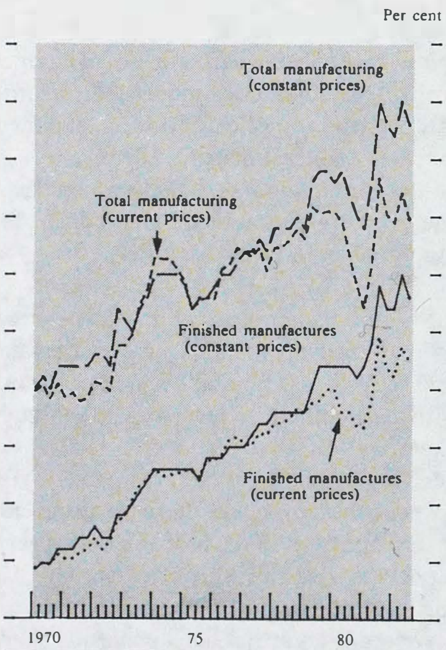
Import penetration in the United Kingdom

The proportion of domestic demand for manufactures which is met by imports has greatly increased. The extent to which this represents a decline in trade performance, rather than integration with world markets, is controversial.

Import penetration (the ratio of imports to final sales) varies among industries. The ratio of imports to domestic sales in 1980 in the food and drink sector was 14%; in bricks, pottery, glass and cement it was 9%. By contrast, import penetration in instrument engineering was 61%; in radio and electronic components it was 52%.

Chart 1 shows import penetration for both finished manufactures and the whole manufacturing sector (including semi-finished goods and manufactured food). Both ratios are shown in constant (1975) and current prices. Volume and value ratios can diverge: in 1981 the constant price ratio for total manufactures was 7 percentage points higher than the current price ratio, domestic prices of manufactured goods having grown faster than import prices since 1978. The current price ratio is the more relevant to the balance of payments, whereas immediate consequences for domestic output and employment are more apparent from the constant price ratio.

Chart 1
Import penetration



Problems of measurement

Different classifications (the Standard Industrial Trade Classification for imports; the Standard Industrial Classification for domestic output) prevent the exact matching of imports to sales. Furthermore, some measures of total domestic expenditure on manufactured goods (including those used in the current price ratios quoted) include sales within industries, and so overestimate final domestic expenditure on manufactures and understate import penetration. The measures shown in Chart 1 attempt to eliminate double counting by using input-output data (but this relates to 1974). However constructed, the measures tend to move together; attention should focus on changes rather than levels.

Impact of domestic demand on imports

The table compares four models of the UK economy and shows the effect on imports of a 1% increase in the relevant expenditure category. Definitions of imports differ, so identical results are not to be expected. The low elasticities in the London Business School (LBS) model may be explained by a lesser response of non-manufactured goods and services to domestic spending. In the National Institute of

The effect on import volumes of a 1% increase in expenditure

Percentages

Model	Import category	After one year	Long run(a)
NIESR	Imports of non-oil goods	1.9	1.9
LBS	Imports of non-oil goods and services	0.8	1.0
Bank	Imports of finished manufactures	1.7	1.2
HMT	Imports of finished manufactures	1.6	1.6

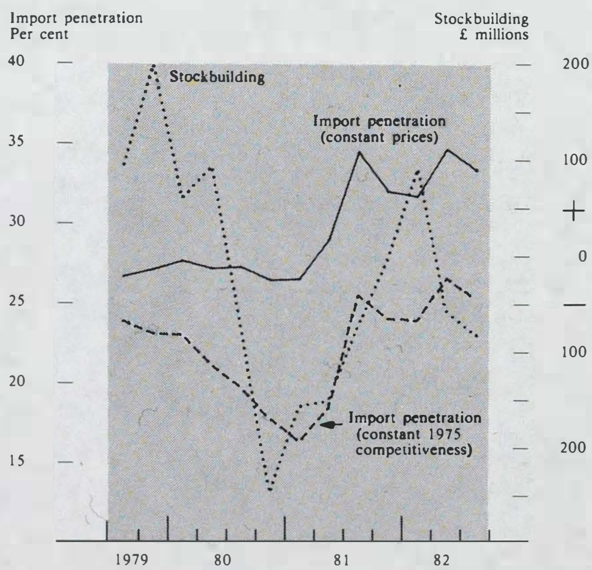
(a) Neglecting feedbacks through the rest of the model.

Economic and Social Research (NIESR) model, which also covers non-manufactured goods though not services, the absence of a time trend may raise the elasticities. Whatever the deficiencies of relating imports to the passage of time, the increase in import penetration seems unlikely to be attributable entirely to growing domestic expenditure, and in the Bank and Treasury (HMT) equations time trends currently contribute 7.5% and 5.7% a year respectively to import penetration.

In all four models, most of the response of imports to a change in demand occurs within one year. In the Bank model the initial effect of a change in expenditure exceeds the final effect, and imports are thus a kind of buffer: it takes time for domestic output to respond to a change in spending, and imports fill the gap. Changes in stocks are another buffer: in the LBS and HMT models stockbuilding of finished and semi-manufactured goods exerts an additional short-run influence, so that a change in final demand of which stockbuilding is a part results in a short-run response which is larger than the long-run response.

During 1980 the fall in the import penetration of finished manufactures (after allowance for changes in competitiveness) was accompanied by a substantial reduction in such stocks (Chart 2); the rise in import penetration in the middle of 1981 occurred at a time when the rate of destocking was falling rapidly. The relationship between domestic production, stocks, imports and final domestic demand is likely to be complicated. Stocks could fall because of an unanticipated increase in spending. If, as recently, stock-sales ratios seem initially high, companies might be content not to replenish their stocks in the face of such spending; in other circumstances, imports could rise rapidly as stocks are rebuilt.

Chart 2
Finished manufactures: import penetration and stockbuilding



UK trade

	1975	1980	1981	1982(a) H1	1982(a) Q3
£ billions					
Balance of trade in oil	−3.1	+0.3	+3.1	+3.2	+5.0
Non-oil trade balance	−0.3	+0.9	−0.1	−2.3	−3.6
Current account	−1.5	+2.9	+6.0	+3.2	+4.1
Index numbers (1975 = 100)					
Ratio of volume of non-oil exports to imports(b)	100	89	84	79	76
of which, manufactured goods	*100*	*75*	*70*	*65*	*61*
Non-oil terms of trade	100	112	115	115	115
ratio of export to import prices (unit values) of finished manufactures	*100*	*118*	*120*	*118*	*117*

(a) Seasonally adjusted, at an annual rate.
(b) Excluding the usual erratic items.

Pay, productivity and labour costs in manufacturing industry

Percentage change(a)

	Pay settlements	Average hours worked	Average earnings	Productivity (output per head)	Unit wage and salary costs
1979	+10	+ ½	+13¼	− ¼	+14¼
1980	+16	−3	+21½	−3	+25¼
1981	+ 9	+ ½	+12½	+7	+ 5
1982	+ 7	—	+ 9½	+4¼	+ 5

(a) Pay settlements are CBI estimates of averages for the wage round ending in July of the year shown. Other columns show percentage changes between the third quarters of successive years.

so, Trade in oil has moved into substantial surplus, with production still growing and domestic demand falling. The non-oil terms of trade remain strong, reflecting not only the weakness of primary product prices (the United Kingdom is a net importer of commodities) but also the high price of our exports of manufactured goods in relation to other countries'.

Output remains low

With the deterioration in the trade balance offsetting part of the growth in domestic demand, output has remained subdued. Indeed, between the middle quarters of 1981 and the third quarter of this year, GDP on the output measure grew by under ¾%. CBI surveys give no indication that manufacturing production is set to rise in the next few months—the majority of respondents expect to produce the same, with the balance of the remainder tipped in favour of those expecting to produce less. Order books are low.

The number of jobs continues to fall. In manufacturing, employment fell by 5½% in the year to September; it has fallen by 22% since mid-1979 when production was at a peak. (New survey evidence suggests that employment in the economy as a whole is higher than previously thought). Adult unemployment remains around 3 million.[1]

Cost and price inflation still slowing down

Pay settlements in the 1981–82 wage round averaged about 7%. CBI reports suggest that the average settlement in manufacturing industry was also about 7%, with 90% of pay deals falling in the range 4%–10%. Early settlements in the 1982–83 pay round, although relatively few, are averaging about the same or slightly lower, in some cases following the rejection of union advice to hold out for more. A few agreements have been made for more than a year. Pay settlements in manufacturing industry have fallen sharply since 1980. The link between settlements and average earnings is rather tenuous, even with allowance for delay in implementation, since average earnings are also affected by hours worked, changes of all kinds in the composition of the labour force, promotions, bonus and productivity schemes etc. The course of average earnings, however, is clear: the rate of growth has more than halved in the last two years. With productivity appreciably better, the growth in wage and salary costs per unit of output in manufacturing industry has fallen very steeply—from 25% to about 5% a year. The growth of unit labour costs (wider than pay) in the economy as a whole is also estimated to have fallen markedly.

Rises in fuel and raw material prices have also slowed down, and other factors have helped to reduce inflation: good crops have restrained food prices; the growth of housing costs has come down and will have been reduced further with the implementation on 1 December of the two percentage point reduction in mortgage rates announced in November; the prices of imported consumer goods have risen less over the last year (despite the effect of the fall in the exchange rate in 1981); and rises in nationalised industry charges have also been smaller.

Perhaps surprisingly, given market conditions, profit margins have widened. Nevertheless, in October, retail prices were barely 6¾% higher than a year earlier.

(1) In November, a new method of recording unemployment was introduced, covering only those receiving benefit; at 2.9 million, the figure was smaller than it would have been on the old basis.

The Treasury forecast a 5% rise in retail prices over the coming year. The prospect for administered prices (rents and rates as well as nationalised industry charges) is of fairly modest increases during 1983, broadly in line with other price movements. Lower wage settlements this pay round and continued productivity growth (albeit at a slower rate than over the last two years) should permit low rates of price increase during 1983, even with some further rebuilding of profit margins. The proportion of respondents to CBI surveys expecting to raise prices in the next few months is unusually low.

Productivity growth—why and where?

In manufacturing, slower growth in earnings accounts for over half of the slower growth in wage costs. The remainder is due to the growth of productivity (output per man-hour), which in the third quarter was some 12% higher than at the end of 1980.(1)

The normal path of productivity is modest underlying growth (about $1\frac{1}{2}$% per year between 1974 and 1979) with considerable cyclical variation. When manufacturing output fell steeply in 1980, however, productivity did not fall anywhere near as much as expected, and this 'gain' (of about 5%) was maintained in 1981 when output levelled out. In the last year, productivity has risen by about $1\frac{1}{2}$% more than expected.

Various reasons have been advanced for the exceptional growth of productivity in manufacturing industry. One is that the rise in labour costs up to 1980 led firms to invest in labour-saving machinery. Another is that firms have been unusually pessimistic about the depth and duration of this recession, or conversely, that they had been over-optimistic before, leading to a greater shakeout than would normally have resulted from the actual fall in output. There is no evidence of these effects before 1979, but financial pressures arising in the recession may have compelled firms to review manning levels and induced their work force to accept more efficient methods of working. Finally, part of the exceptional growth may reflect changes in the composition of manufacturing industry. Thus, closures may have been concentrated on firms and plants with below average productivity, leading to a rise in the average. This effect will always be present in a recession—the least efficient capacity will tend to be closed down first—but it may have been unexpectedly pronounced this time. It gives rise to improvements in measured productivity which do not reflect changed working practices (and ceases to add to productivity growth when closures return to their normal rate).

Productivity gains in selected industries

Per cent

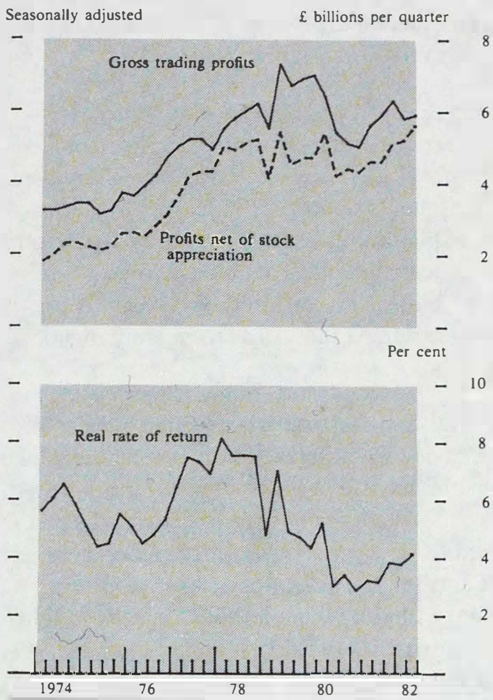
	Share in manufacturing output in 1975	Exceptional gain in productivity 1979 Q2–1982 Q1(a)	Share of exceptional gain in all manufacturing industry
Metal manufacture	7	16	16
Vehicles	10	14	21
Engineering	24	10	37

(a) The improvement in productivity over and above estimated trend and cyclical changes.

Whatever its cause, the improvement in productivity over and above expected trend growth and cyclical effects appears to have been unevenly distributed among sectors of manufacturing industry. Though disaggregated data may not be very reliable, the table suggests that three sectors—metal manufacture (mostly iron and steel), vehicles and engineering—with a share of about 40% of manufacturing production, have contributed about three quarters of the gain. Of these, metal manufacture is dominated by the British Steel Corporation, and British Leyland accounts for a large share of vehicles. In both these concerns, special factors, including redundancy schemes, have been important. It is impossible to tell to what extent the gain in the very large engineering sector arises from compositional changes or improved working practices.

(1) The August 1982 National Institute Economic Review contains articles on various aspects of productivity.

Profits *of non-North Sea industrial and commercial companies have recovered from a low level.*



Influences on profits in manufacturing industry

Percentage changes at an annual rate

	1979 average–1981 H1	1981 H1–1981 H2	1981 Q3–1982 Q3(a)
Output	− 9¼	+ 4½	−1½
Unit labour costs	+17	+ 3½	+5
Buying prices(b)	+16¾	+15¾	+3¾
Average of labour and material costs(c)	+16¾	+ 8¼	+4½
Selling prices	+13¾	+10	+8

(a) Partly estimated.

(b) Prices paid by manufacturing industry for fuel and raw materials.

(c) The weights given to labour costs and buying prices are 60% and 40% respectively.

Financial transactions of the personal sector

£ billions, annual rates; *seasonally adjusted*

	1980	1981 H1	1981 H2	1982 H1	1982 Q3
Financial surplus +/ deficit —	18½	18	14½	14	..
Acquisition (−) of financial assets	−27½	−32½	−25	−28	..
of which, sterling bank deposits	*− 6.3*	*− 5.0*	*− 2.3*	*− 5.6*	*− 2.0*
Borrowing (+)	11	13½	15	16½	..
of which, sterling borrowing from banks	*3.3*	*5.3*	*7.2*	*9.5*	*11.7*
by persons and households	*1.6*	*3.1*	*5.6*	*6.2*	*8.9*
by unincorporated businesses	*1.7*	*2.2*	*1.6*	*3.3*	*2.8*

Company profitability better but still low

The level of activity and the margin between costs and prices influence corporate profitability. In the first half of this year, industrial and commercial companies' profits are estimated to have risen by 17½% from the very low level of a year earlier. Excluding North Sea operations, where a lower oil price affected receipts, profits rose by 22%, and the real rate of return rose from about 3% to 4%. Nevertheless, this is still an extremely depressed rate by earlier standards; in the 1960s profitability was over 10%, and it averaged 5% even in the 1975–1976 recession. Moreover, the improvement will not have been uniform—in some sectors, real profitability may have remained as low as ever.

It is possible that these figures understate profitability. The cost of closing plants and declaring redundancies can be high. Although in some ways such measures resemble capital spending—an immediate cost is incurred to rationalise production, with the prospect of a later pay-off—the cost is treated in the national accounts as a current item, reducing profits and profitability. Furthermore, the measure of the capital stock will be overstated if companies scrap capital equipment faster than assumed in the calculation of the figures in the national accounts. These factors may explain part of the disparity between the estimate, based on national accounts sources, of a 3%–3½% real rate of return in 1981, and the average current cost rate of return of 7%–8% calculated from a sample of companies' accounts.[1] The latter figures, on the other hand, probably overstate profitability. Companies may in many cases have written down buildings and equipment at a faster rate than they lose economic efficiency; the treatment of regional development and other grants may also cause the capital stock to be undervalued; the 250 major companies from which the data were taken may well be more profitable on average than the corporate sector as a whole; and their accounts include income from overseas activities and non-trading income, both of which may have been more profitable than production and trade in the United Kingdom. Given these difficulties, it is safer to look at changes in real profitability rather than the level.

The main factors influencing profit margins of companies in manufacturing industry are shown in the table; margins shrank between 1979 and the early part of 1981, but have since recovered, especially in the past year or so. Margins of distributors are harder to assess, because less is known about costs. The retail prices of certain manufactured goods, notably household durables, clothing and footwear have risen much more slowly than manufacturers' selling prices and the prices of imported consumer goods, indicating some pressure on retail margins. Unlike manufacturing production, however, the volume of retail sales increased by 3% in the year to the third quarter.

Personal sector financial surplus falls and borrowing rises

With consumer spending sustained, despite a tendency for RPDI (as usually defined) to fall, and private spending on new houses recovering this year, the financial surplus of the personal sector has declined from £18½ billion in 1980 to an annual rate of £14 billion in the first half of this year. The surplus was probably further reduced in the third quarter. The personal sector has continued nevertheless to acquire financial assets at a high rate while borrowing growing amounts, notably from banks which have

(1) See 'Current cost accounting', in the September 1982 *Bulletin*, page 376.

Mortgage lending

£ billions, annual rates; *seasonally adjusted*

	Banks	Building societies	Other	Total
1977	0.1	4.1	0.1	4.4
1978	0.3	5.1	0.1	5.5
1979	0.6	5.3	0.7	6.6
1980	0.5	5.7	1.2	7.4
1981	2.2	6.3	1.0	9.6
1982 H1	4.7	6.3	1.2	12.3
Q3(a)	5.4	7.9	1.2	14.5

(a) Partly estimated.

increased their share both of mortgage lending and consumer credit. The rate of bank lending to the personal sector in the first three quarters of 1982 was three times as much as in 1980 and most of the growth was to persons and households (rather than to unincorporated business). Within the total, mortgage lending increased especially rapidly: several banks have now taken steps to reduce its growth. The growth in mortgage lending as a whole, especially since 1980, contrasts sharply with the low (if stronger) rate of housebuilding and slowly increasing house prices.[1]

The decline in the saving ratio (from $15\frac{1}{2}\%$ in 1980 to perhaps $10\frac{1}{4}\%$ in the third quarter of this year) has taken the form of increased borrowing rather than slower accumulation of (or even a reduction in) financial assets. It is not wholly clear why this has happened, but possible explanations include greater competition for personal savings; readier availability of finance; precautionary borrowing; and, perhaps, a disparity within the personal sector, with some borrowing more while others in a stronger financial position accumulate assets.

Industrial and commercial companies still borrowing heavily

Appropriations (taxes, dividends, interest payments) by industrial and commercial companies have kept pace with the recent growth in their income. Furthermore, company spending on stocks and fixed capital is estimated to have grown by over £2 billion between the first halves of 1981 and 1982. Consequently, companies' financial surplus of about £1 billion (smaller than earlier thought) gave way to a deficit of similar size in the first half of this year. Borrowing increased much more than the change in companies' financial position, mainly because large amounts of tax, which had been held up by the Civil Service pay dispute in 1981, were paid over in the first half of this year.[2] Sterling lending by UK banks accounted for more than the whole increase in company borrowing. A very large balancing item in the accounts (£0·8 billion in the first half of 1981 and £2.3 billion with opposite sign a year later) makes it difficult to reconcile the estimates of income and expenditure and of financial transactions more closely.

Financial transactions of industrial and commercial companies

£ billions, annual rate; *seasonally adjusted*

	1980	1981 H1	1981 H2	1982 H1	1982 Q3
Financial surplus +/ deficit —	$-1\frac{1}{2}$	2	$1\frac{1}{2}$	$-2\frac{1}{2}$	..
Trade investments (—) and changes in tax balances(a)	-3	$-\frac{1}{2}$	$-6\frac{1}{2}$	-4	..
Acquisition (—) of financial assets	$-4\frac{1}{4}$	-7	-4	-1	..
of which, sterling bank deposits	*−2.4*	*−3.4*	*−2.4*	*−0.1*	*+0.9*
Borrowing (+)	11	4	17	12	..
of which, sterling borrowing from banks(b)	*6.0*	*+0.1*	*8.5*	*8.7*	*7.5*

.. not available.

(a) Including investment abroad and in other UK companies and net trade credit as well as the difference between accrual and payment of tax.

(b) Including Issue Department net purchases of commercial bills.

In the third quarter, companies once again borrowed heavily from the banks, although at a somewhat lower rate than in the year to mid-1982. The Department of Industry's survey of the liquidity of about 200 large companies showed a deterioration especially in the manufacturing sector.

Lower interest rates have recently reawakened interest in the company debenture market, although the amounts involved are still small in relation to bank borrowing. But for many companies, because of their size, financial position, or the costs involved, a bond issue is not an alternative to bank borrowing.

The growth of money supply is discussed in Operation of monetary policy on page 478

Bank lending and public sector transactions

Total sterling lending by banks to the private sector—persons, unincorporated businesses, industrial and commercial companies, and non-bank financial institutions—has grown strongly in recent years.

The weaker financial position of the (non-bank) private sector this year mirrors the reduced surplus on the balance of payments and a smaller financial deficit of the public sector. The PSBR has fallen

(1) See 'Mortgage lending and the housing market', in the September 1982 *Bulletin*, page 390.

(2) In striking the financial surplus or deficit, most taxes are counted as they accrue.

Private and public sector borrowing and money supply[(a)]

£ billions

	Bank lending in sterling to private sector(b)	PSBR	Sterling M_3
1977	3.2	6.0	4.1
1978	4.8	8.4	6.8
1979	8.5	12.6	6.6
1980	10.0	12.2	11.0
1981	11.2	10.6	9.1
1982 H1(c)	18.6	2.9	8.4
Q3(c)	20.9	5.9	5.0

(a) This table is based on calendar quarterly statistics.
(b) Including Issue Department purchases of commercial bills.
(c) Seasonally adjusted, at an annual rate.

reflecting growing oil revenues (£2$\frac{1}{4}$ billion in 1979/80, rising to perhaps £7 billion this financial year) but also strict financial policies. Moreover, the PSBR last year turned out lower than projected at £8.8 billion against £10.6 billion. This happened despite weaker economic activity than forecast, which by itself would have increased government spending and reduced revenues.

In the Chancellor's autumn statement, the PSBR in 1982–83 was projected at £9 billion, £$\frac{1}{2}$ billion less than forecast at Budget time. The revised figure reflects a number of announced policy changes—including the proposed special reduction in national insurance payments in the first quarter of next year (amounting to £350 million). Local authorities and nationalised industries are being encouraged to increase their capital spending closer to the levels planned for this financial year and the deferral of regional grant payments has been ended.

The Chancellor of the Exchequer's autumn statement set out revised spending plans and revenue projections for 1983/84. After allowance for various proposals—including a reduction to 1$\frac{1}{2}$% in the national insurance surcharge, with the benefit in effect confined to employers in the private sector—and on conventional assumptions about tax rates, thresholds and bands, the PSBR was put at some £7 billion in the absence of further fiscal changes, £1 billion less than the 2$\frac{3}{4}$% of GDP indicated at the time of the last Budget.