Economic commentary

This commentary discusses a number of themes of topical interest. They are:

- ***The world economy**—still subdued, though prospects look brighter.*
- ***UK prices**, affected by domestic costs and profit margins, and import prices (in turn influenced by movements in the exchange rate).*
- ***Personal income, spending and saving**—the point of interest being a large decline in the saving ratio, to which the fall in inflation has contributed.*
- *Other elements of **demand, and output** which so far has only partly responded to the revival of spending.*
- ***External trade and competitiveness** following the decline in sterling.*
- ***Company profitability and finance**, on which many of these factors bear.*

The world economy

Output in the major industrial economies fell last year, for the first time since 1975. In the second half of the year, output was flat, with declines in GDP in Canada, Italy and West Germany offsetting growth in Japan, the United Kingdom and the United States. As noted in the December *Bulletin*, this weakness in the world economy took forecasters by surprise, most of them having originally projected growth in the major industrial countries of $2\frac{1}{2}\%$–3% for 1982. In the most recent months, however, there have been signs of recovery, notably in the United States, where the index of leading indicators has risen in nine of the last ten months; provisional indicators suggest a rise in GNP in the first quarter of this year.

Real GNP or GDP
Percentage change

	1980	1981	1982(a)		
	Year	Year	Year	H1(b)	H2(b)
United States	−0.4	2.0	−1.7	−3.4	0.6
Canada	0.5	3.1	−4.8	−7.1	−3.7
France	1.2	0.2	1.5	1.6	0.1
Italy	3.9	−0.2	−0.3	3.6	−5.9
Japan	4.8	3.9	3.0	2.5	4.3
West Germany	1.8	−0.2	−1.1	−1.2	−2.7
Total	**1.4**	**1.8**	**−0.4**	**−1.1**	**0.3**
United Kingdom	−2.4	−2.4	1.1	1.1	1.8

(a) Bank estimate for the second half of 1982. Figures for the United Kingdom are for the average measure of GDP.
(b) Seasonally adjusted, at an annual rate.

Meanwhile, consumer price inflation has slowed unexpectedly sharply in these countries, averaging around 5% in the year to February, as low a rate as recorded in the late 1960s. Inflation in certain countries (eg Italy and France) remains rather high, and part of the overall improvement may reflect temporary factors, such as the fall in oil and other commodity prices—although much of it must reflect the counter-inflationary policies pursued in most countries. Where targets for monetary growth and fiscal deficits are formulated in nominal terms, a fall in inflation leaves scope for activity to recover.

Contributions to the change in GDP for the major economies(a)
Percentages

	1979	1980	1981	1982(b)		
	Year	Year	Year	Year	H1(c)	H2(c)
Consumer spending	2.2	0.6	0.8	0.7	0.7	1.0
Fixed investment:						
Construction	0.3	−0.5	−0.3	−0.3	−0.5	—
Non-construction	0.6	0.2	0.4	−0.3	−0.4	−0.3
Government consumption	0.3	0.4	0.3	0.3	0.1	0.5
Final domestic demand	**3.4**	**0.7**	**1.2**	**0.4**	**−0.1**	**1.2**
Exports(d)	0.3	0.8	0.6	−0.3	−0.6	−0.3
Total final demand	3.7	1.5	1.8	0.1	−0.7	0.9
Stockbuilding	0.3	−0.6	−0.2	−0.4	−0.2	−0.8
Total demand	**4.0**	**0.9**	**1.6**	**−0.3**	**−0.9**	**0.1**
Supplied by:						
GDP	3.4	1.1	1.5	−0.3	−1.0	0.3
Imports(d)	0.6	−0.2	0.1	—	0.1	−0.2

(a) United Kingdom, United States, Canada, France, Italy, Japan, West Germany.
(b) Bank estimates for the second half of 1982.
(c) Seasonally adjusted, at an annual rate.
(d) Trade outside the group of seven major economies. These figures are subject to wide margins of error, although the implied figures for *net* trade are more reliable.

All components of demand except government spending have grown much more slowly since 1979. GDP in the major industrial economies continued to expand, albeit very slowly, during 1980 and 1981. The fall in GDP in 1982 reflected reductions in fixed investment, stockbuilding, especially in the second half of the year (movements in stocks now having depressed activity for the last three years), and exports to countries outside the group. Consumer spending has continued to grow, but the increase has been much less rapid than in 1979 because of slower growth of real average earnings and (more especially) employment.

Pressures have been building up on the corporate sector in the major industrial countries since 1979. The growth of nominal (and real) wages following the rise in oil prices was restrained by tight policies, but labour productivity also slowed, and weak demand conditions meant that higher raw material costs could not be passed on to final prices. Despite this squeeze on profits, investment (other than in building) held up quite well until 1982, given very high real interest rates. Last year, however, investment fell in most countries (Japan and the United Kingdom being exceptions).

It is not clear how far this fall reflected the delayed effects of high interest rates rather than the repeatedly disappointed hopes of a recovery in demand. In any event, it would be unwise to expect investment to provide much of a boost to activity this year. But in North America and Japan there are clear signs of a recovery in the housing sector, which has been particularly badly hit in the last three years, and there could be some reversal of the stock cycle in the near future, for stock-output ratios have now reached historically low levels outside Europe.

World trade

Percentage change

	1979	1980	1981	1982(a)		
	Year	Year	Year	Year	H1(b)	H2(b)
World trade	6.7	1.3	0.7	−1.2	− 3.7	−4.1
UK export markets	5.1	3.7	1.9	−1.1	− 3.5	−4.3
of which:						
OECD	*8.2*	*0.8*	*− 2.8*	*0.4*	*0.8*	*−3.3*
Other	*−0.3*	*9.7*	*10.9*	*−3.9*	*−10.7*	*−6.1*

(a) Bank estimates for the second half of 1982.

(b) Seasonally adjusted, at an annual rate.

Developments outside the OECD area account for much of the fall in the major countries' exports last year. Not only was there very substantial retrenchment by the developing countries, but the volume of OPEC exports fell (by 16% in 1982—equivalent to $2\frac{1}{2}$% of world trade) and led to sharp cutbacks in import growth in many of the oil producing countries too. This downturn in markets outside the OECD was itself partly a product of the continued recession in the industrial countries, which depressed the export revenues and hence the spending capacity of primary producers. Among the non-OPEC developing countries, the falls in imports were particularly large in certain of the major debtor countries of Latin America which faced severe financing difficulties. On average the volume of developing countries' imports declined by around 7%, but Brazil recorded a fall of 10%, while in Mexico and Argentina the reduction was around 30%. Despite such cutbacks, which reduced their combined current account deficit, developing countries' reserves fell by around $10 billion last year; financial considerations will continue to affect their imports this year. As a result, non-OECD import volumes fell in 1982, after two years in which growth had averaged around 10% (and had thereby accounted directly for nearly one third of the increase in output of the major countries).

Inflation in the major economies(a)

Percentage changes in local currency terms

	1980	1981	1982(b)	1982 Q4 on year earlier(b)
Earnings(c)	10.9	10.3	8.1	6.7
Productivity(c)	1.1	2.1	1.6	1.5
Unit labour costs	9.7	8.0	6.4	5.1
Import prices	23.8	10.4	3.5	4.4
of which:				
Oil	*67.5*	*25.1*	*6.2*	*7.7*
Food	*16.5*	*0.6*	*−2.5*	*−2.5*
Other commodities	*7.3*	*2.7*	*−2.0*	*−1.7*
Manufactures	*11.0*	*7.3*	*7.3*	*5.6*
Consumer prices	12.0	9.8	6.8	5.7

(a) United Kingdom, United States, Canada, France, Italy, Japan, West Germany.

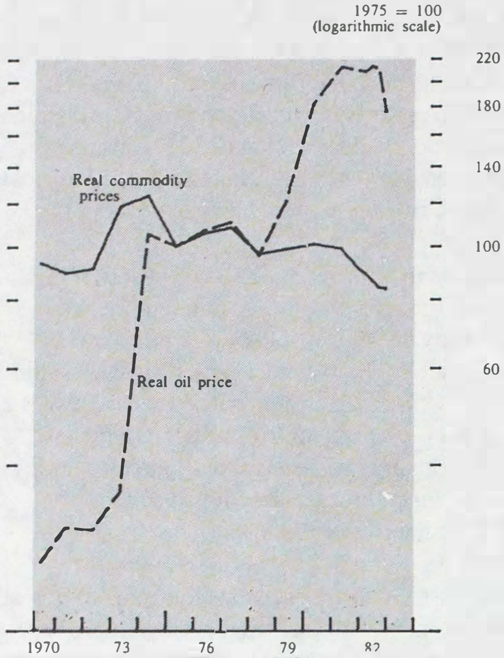
(b) Partly estimated.

(c) Per hour, whole economy.

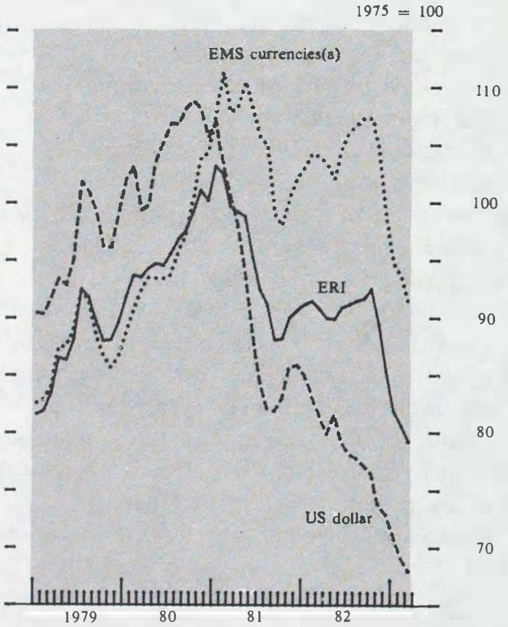
Whereas output growth has been less than generally forecast, the reduction in inflation in the main industrial countries has (perhaps partly as a result) been unexpectedly fast—not least in the United Kingdom. The growth of unit labour costs has almost halved since 1980, but the decline in import price inflation has been even more marked.

Since 1979, oil use in non-communist countries has declined by 13%, alongside 5% growth in GDP in the OECD area. At the same time, the supply of oil from non-OPEC sources has grown; and stocks of oil have been reduced during the recent mild winter, partly in expectation of lower prices. These developments have strained the ability of OPEC members to maintain their official prices. The OPEC agreement in March to set a production ceiling and to lower official prices (by $5 a barrel, or about 15%, for the marker crude) follows a year in which spot market prices have mostly stood well below official prices.

Real **oil** *and other* **commodity prices** *have weakened.*



Sterling exchange rates



(a) Sterling against the currencies in the EMS exchange rate mechanism, weighted in proportion to their share in the effective rate index.

Measures of inflation

Percentage changes on a year earlier

	1980	1981	1982	1983
	Year	Year	Q4	Jan.-Feb.
GDP deflator	**+18.4**	**+10.9**	**+ 6.8**	..
Unit labour costs— whole economy	*+20.8*	*+ 9.8*	*+ 3.3(Q3)*	..
Import prices				
Food, drink, tobacco	+ 4.1	+ 4.6	+ 3.6	+ 6.3
Basic materials	+ 6.9	+ 1.9	+ 0.6	+ 6.3
Manufactured consumer goods	+ 3.6	+ 7.6	+ 2.2	+ 8.0
Retail price index	**+18.0**	**+11.9**	**+ 6.2**	**+ 5.1**
Within which(weights):				
Fresh food(3.3)	*+ 6.4*	*+ 9.0*	*− 5.0*	*−10.1*
Nationalised industry prices(9.9)	*+24.8*	*+19.5*	*+14.5*	*+13.3*
Housing(14.4)	*+29.0*	*+18.1*	*+ 3.8*	*+ 0.4*
Clothing, household durables(14.1)	*+10.8*	*+ 3.1*	*+ 1.9*	*+ 2.3*

.. not available.

To some extent the weakness of other commodity prices last year was a reaction to unfulfilled expectations of a recovery in industrial production, which had encouraged stockpiling and sustained prices until well into the second half of 1981. When prices fell below production costs, the output of metals in particular was cut back. Overall, however, real prices continued to decline— by perhaps 8% in 1982—and in the year as a whole were at their lowest in real terms for more than thirty years. In recent months, there have been signs that this decline is slowing and in some markets (especially for industrial raw materials) reversing— anticipating a recovery in industrial demand as well as reflecting earlier curtailment of supply. With some other commodities still heavily oversupplied, price movements seem likely to be very mixed this year.

Sterling

Sterling was firm in effective terms for a year or so until the autumn, but has declined by about 14% since mid-November. Possible reasons for the decline are discussed on page 34.

For most of 1981 and 1982, sterling was considerably firmer against the currencies in the EMS exchange rate mechanism than against the US dollar, which was generally strong. More recently, however, sterling has tended to be weaker against European currencies than against the dollar. The pattern of exchange rate changes may influence import prices, and so inflation, for reasons discussed in the next section.

UK inflation—recent developments and prospects

The sharp fall in retail price inflation, from 18% in 1980 to $5\frac{1}{4}$% in the year to February, has been paralleled to a varying extent in other measures of costs and prices.

Price movements among the components of the retail price index have been diverse: fresh food prices have fallen in the last year or so; housing costs have been steady on balance (with the decline in the building society mortgage rate from 15% to 10% a strong downward influence); and prices of household goods and clothing have risen very little. Price rises for goods and services supplied mainly by nationalised industries, although much lower than in 1980 and 1981, remained well above the average, partly because of the process of raising them to commercial levels (now virtually complete).

The GDP deflator measures all domestic costs (including profit margins) or the 'price' of value added in domestic production. In the fourth quarter of last year, it was less than 7% higher than a year earlier, whereas in 1980 it had increased by over 18%. Within this measure, the growth of unit labour costs, the largest element, probably fell by even more. Profits on the other hand have recovered from their very low level in 1980, although at 4% or so the real profitability of industrial and commercial companies is still historically low. The growth of average earnings has fallen by less than that of labour costs, from nearly 21% in 1980 to 8%–$8\frac{1}{2}$% by the end of last year.

In manufacturing industry unit wage costs have slowed down very sharply, and the cost of supplies has also grown less than in earlier years. The cost of home-produced fuel and materials bought in by manufacturers (including the profit margin or, in some cases, the

Labour and materials costs and selling prices—manufacturing industry

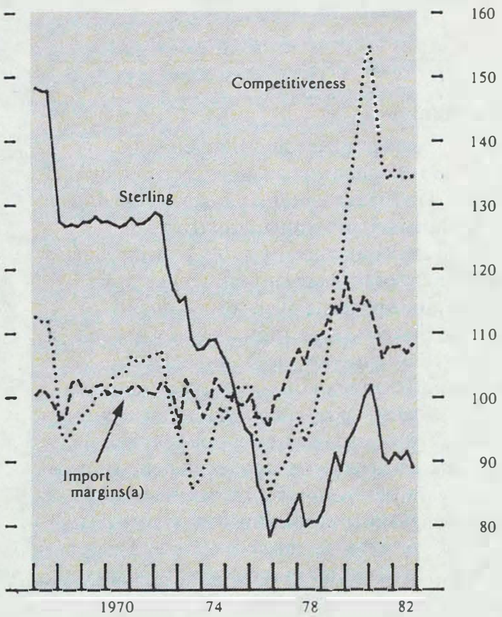
Percentage changes on a year earlier

	1980	1981	1982	1983
	Year	Year	Q4	Jan.-Feb.
Costs				
Unit wage costs	+22.6	+ 8.9	+6.7	..
Buying prices, fuel and raw materials	+19.9	+13.6	+6.0	+8.7
Weighted average(a)	+21.6	+10.7	+6.4	..
Selling prices	+16.3	+10.6	+7.7	+7.2

.. not available.

(a) Giving weights of 0.6 to labour costs and 0.4 to buying prices.

Profit margins on imports ***have responded to*** **UK competitiveness.**



(a) The unit value of imported manufactured goods divided by an index of estimated costs abroad.

surplus earned by a publicly-owned supplier) is already counted in the GDP deflator. On the other hand, some fuel and many raw materials (as well as manufactured goods for industrial use) come from abroad, and represent an element of costs which is external to the economy as a whole. Altogether, manufacturers' input costs—domestic and foreign—have slowed down more than selling prices, indicating that their profit margins have widened (before deduction of tax, interest charges, local authority rates etc).

Sterling prices of primary products are largely determined by the world price and the sterling exchange rate, without regard to market conditions in the United Kingdom.[1] The general weakness of commodity prices (still around their lowest in real terms for thirty years) has largely offset the decline in sterling from its peak in early 1981. Foreign suppliers of manufactured goods, on the other hand, appear to take account of conditions in the UK market and the competing prices of domestic producers in fixing their selling prices. The sterling prices at which manufactured goods are imported by the United Kingdom are thus not simply determined by foreign suppliers' costs and the sterling exchange rate; on the contrary, profit margins on imports appear to be affected by market conditions in the United Kingdom. In the mid-1970s, declines in sterling coincided with faster growth in UK costs and domestic prices (in sterling terms) than in costs abroad, and on the whole were not associated with marked changes in profit margins on imported goods. In the late 1970s and 1980, faster cost inflation in the United Kingdom coincided with an appreciation of sterling and the margin at which imports were sold in the United Kingdom over their overseas production costs greatly widened. The decline in sterling in 1981 occurred when UK domestic price and cost inflation was much the same as abroad; UK competitiveness therefore improved in line with the fall in sterling, and foreign exporters cut profit margins on their products.

The tendency of foreign exporters to pay heed to UK costs and prices is bound to dampen the inflationary effect of any decline in sterling which does not merely reflect greater cost pressures here. Even allowing for this, the fall in sterling in 1981 had an unexpectedly small effect on import prices to late 1982. Foreign suppliers may have been keen to protect their position in the depressed UK market. The pattern of exchange rate movements may also have been a factor. In 1981, sterling was steadier against the major continental currencies than against the US dollar (and appreciated against European currencies in 1982)—see the chart on page 10. Although the United States is an important competitor in third markets (reflected in the weight of the dollar in sterling's effective index), most of the United Kingdom's imports of manufactured goods come from other West European countries.

These considerations bear on prospects for import prices following the recent decline in sterling. An earlier article[2] suggested that a 10% fall in sterling which did not affect domestic labour costs would bring about a 6%–7% rise in the prices of imported manufactured goods after a year, and raise consumer prices by about 2% in that time. The effect of the 1981 depreciation on the prices of imported manufactured goods appears to have been only about half as large. That experience may not, however, be repeated; sterling has fallen by more against the main continental currencies

(1) The sterling prices of many foodstuffs, however, depend on prices fixed under the Common Agricultural Policy and the value of the 'green' pound, which need not vary with the market rate.

(2) 'Sterling and inflation', September 1981 *Bulletin*, page 365.

The Budget

Monetary targets and the PSBR

The Chancellor of the Exchequer announced in the Budget on 15 March:

- A target range of 7%–11% for the growth of narrow and broad measures of money, M_1 and sterling M_3 (and PSL_2), compared with 8% – 12% in the current target period (see also page 19).
- A PSBR of £8 billion in 1983/84, equivalent to about $2\frac{3}{4}$% of GDP—much the same percentage as the provisional outturn of £$7\frac{1}{2}$ billion in 1982/83.(1)

Various measures affecting the PSBR in 1983/84 had already been announced in the Chancellor's Autumn Statement in November. The most important were a reduction to $1\frac{1}{2}$% in the national insurance surcharge, to take effect in April (with transitional relief in the first calendar quarter of 1983); an increase in national insurance contributions, also from April; the uprating of pensions and social security benefits for the year to November 1983;(2) and various changes in other items of public spending.

The public expenditure planning total of £120.1 billion (in cash terms) in 1983/84 was later reduced to £119.6 billion in the Public Expenditure White Paper (Cmnd 8789).

The proposals made in the Budget, after allowance for indirect effects on public sector transactions, are estimated to add £1.6 billion to the PSBR in 1983/84, compared with what it would have been if tax allowances and thresholds and specific duties had been raised in line with inflation.

The main tax and expenditure proposals

- An increase of around 14% in the main personal income tax allowances and in the higher rate thresholds—about $8\frac{1}{2}$ percentage points higher than retail price inflation in the year to December 1982. The revenue cost (compared with the case in which the statutory indexation provisions had been implemented) is £1.2 billion in 1983/84 and £$1\frac{1}{2}$ billion in a full year.
- An increase in specific duties broadly in line with inflation, which will have an estimated impact of about 0.4% on retail prices.
- A further reduction of $\frac{1}{2}$ percentage point in the national insurance surcharge from August, the benefit—estimated at £215 million in 1983/84 and £390 million in a full year—being in effect confined to employers in the private sector.
- A reduction in (and eventual abolition of) advance petroleum revenue tax and more favourable tax treatment of new oil fields—worth £115 million in 1983/84 and a total of £0.8 billion in the coming four years.(3)
- Various other tax measures and spending proposals to help small firms and the construction industry and to encourage the introduction of new technology.
- An increase in child benefit, and some changes to help the unemployed.

The cost of spending proposals, amounting to about £240 million in 1983/84, will be met from the Contingency Reserve, requiring no increase in the public expenditure planning total for 1983/84.

Table 1
Contributions to the growth of GDP
Percentages
1975 prices

	1982 H1–1983 H1	1983 H1–1984 H1
Consumers' expenditure (at factor cost)	+1.8	+1.5
General government consumption	+0.1	+0.3
Total fixed investment	+0.8	+0.7
Exports (goods and services)	−0.4	+1.6
Final spending	+2.3	+4.1
Change in stocks	+0.1	+0.5
Total demand	**+2.4**	**+4.6**
Met by:		
Imports (increase +)	+0.8	+1.9
GDP	+1.6	+2.7

Outlook for the economy

The Industry Act forecast published on Budget day is summarised in Table 1. Higher real incomes (boosted by the tax changes proposed in the Budget) help to keep consumer spending rising; within fixed investment, increases in housebuilding are already indicated by rising housing starts, and the last Department of Industry investment survey pointed to higher capital spending by industry (outside manufacturing); and destocking seems very likely to end soon, perhaps to be followed by a modest rise in stock levels, although the extent and timing of this is very uncertain. The forecast for exports is based on rather buoyant markets abroad, growing by 6% between the first halves of this year and next. A 5% growth in imports implies some increase in penetration—not surprisingly, in view of the importance of consumer spending and the change in stockbuilding behaviour.

Table 2 shows the forecasts for inflation and the current balance. Higher import prices, as the effect of sterling depreciation is absorbed, contribute to faster growth of the RPI; inflation as measured by the GDP deflator, by contrast, slows down. Oil prices are assumed to be steady, and sterling to remain around its February level.

Table 2
Inflation and the current account balance of payments

		Forecast	Average error(a)
Inflation		*Percentages*	
Retail prices	1982 Q4–1983 Q4	+6	±2
	1983 Q2–1984 Q2	+6	±4
GDP deflator (market prices)	1983 (on 1982)	$+5\frac{1}{4}$	
	1983/84 (financial year) on 1982/83	$+5\frac{1}{2}$	
		£ billions	
Current account	1983	$+1\frac{1}{2}$	±2
	1984 H1 (annual rate)	+2	$\pm3\frac{1}{2}$

(a) Average errors from past forecasts.

(1) At the time of the last Budget, the PSBR in 1982/83 was projected to be £9.6 billion; in the Autumn Statement, it was put at £9 billion. Factors contributing to the lower outturn include unexpectedly high receipts from North Sea oil taxes, reflecting a higher sterling oil price, and underspending in some areas of public expenditure, notably capital projects by local authorities.

(2) Based on a forecast for inflation in the year to November 1982 made at the time of last year's Budget. The Chancellor announced that future November upratings will be based, not on a forecast for inflation, but instead on the actual increase in the retail price index in the year to the previous May.

(3) At £8 billion, North Sea revenues are nevertheless expected to be higher in 1983/84 than was indicated in estimates published last year, because of changed assumptions about production in tax-paying fields and about the sterling price of North Sea oil. They represent about 6% of expected government receipts in 1983/84.

than against the dollar since last autumn, and a stronger UK domestic market may encourage foreign suppliers to resist further compression of their profit margins (although these are still quite wide).

Domestic labour costs, however, will be a more important influence on inflation than import prices. The CBI estimate that pay settlements in manufacturing industry in the three months to January averaged 5¾%, compared with 6¾% at the beginning of the wage round and 7% in the last round. (Partly because they reflect settlements over the last year or so, average earnings continue to rise somewhat faster than recent settlements.)

Reductions in the national insurance surcharge will reduce further the cost of employing labour by August, by 1% compared with a year earlier. Productivity in manufacturing industry was little changed in the third and fourth quarters of last year, having grown rapidly since late 1980, but the pause may be attributable to the fall in manufacturing production in the second half of the year.

Market expectations about inflation are implicit in the difference between yields on indexed and conventional gilt-edged stock, although the different tax positions of holders and the premium which indexed stocks command because they offer the certainty of a real yield prevent a clear indication from emerging. Because only certain categories of investor, notably pension funds, actually receive gross redemption yields, the 8% or so implied by the yield on a high-coupon conventional stock to an untaxed holder is the top end of the range. Taking a low-coupon conventional stock (or a high-coupon stock held by a tax payer) for comparison with an indexed gilt of similar maturity suggests a much lower expectation about inflation. The table shows a range of implicit expectations over the next five years or so, from under 2% to over 8%, and a change since mid-November of one percentage point or less.

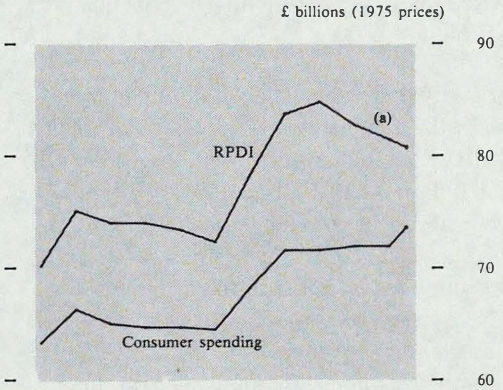
Implicit inflationary expectations [(a)]

Per cent

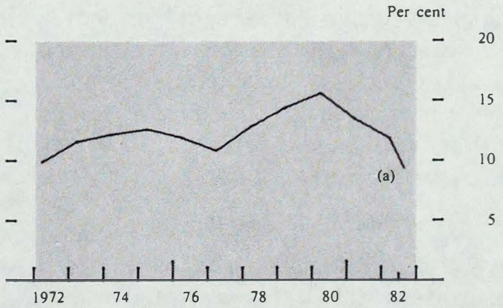
	Tax rate	1982 Mid-Aug.	1982 Mid-Nov.	1983 Mid-Feb.
Low coupon	0	4¾	5	4¾
	30	4¾	4¼	4¼
	60	4¼	3¾	4
High coupon	0	8	7½	8¼
	30	5¾	4	5
	60	2½	1¼	2

(a) Obtained by comparing the net yield on 2% Index-Linked Treasury Stock 1988 with the redemption yield on 3% British Transport Stock 1978–88 ('low coupon') and 12% Treasury Stock 1987 ('high coupon') for holders paying zero, 30% and 60% tax.

With **RPDI** *falling* **consumer spending** *has been unexpectedly strong . . .*



. . . and the **saving ratio** *has dropped sharply.*



(a) Partly estimated.

The decline in the saving ratio

Although real personal disposable income has been falling (and in the second half of last year may have been 3½% lower than in 1980), consumer spending has reached record levels. Thus the saving ratio has fallen sharply—perhaps to 9%–10% in the fourth quarter of last year, compared with 16½% at its peak in 1980, and below the average for the last decade. In seeking an explanation for this large fall, it is necessary to look at inflation and the stock of personal assets and liabilities as well as income. These factors together may explain most of the fall in the saving ratio.[(1)]

Personal income

Quite marked changes in the composition of personal income have coincided with the fall in RPDI. To some extent these are cyclical. The table shows 1972 and 1976, these years being at approximately the same stage in the cycle as 1982.[(2)] People with jobs have continued to enjoy gains in real income before tax. Indeed, the growth in real average earnings speeded up again in the second half of last year as inflation slowed more than the growth of earnings. It seems that the earnings of higher-paid workers have risen more than the average since 1976—in contrast to the earlier period.[(3)]

(1) It might be noted, however, that there is a large residual error in the personal sector accounts.

(2) As measured by the CSO's Index of Coincident Indicators, showing the deviation of activity from trend—which is difficult to estimate in present circumstances. Although at a similar level in 1978, the indicators were further away from the previous trough.

(3) Information on the distribution of earnings comes from the New Earnings Survey conducted by the Department of Employment.

Personal income, wealth, spending and saving

	1972	1976	1980	1982	
	Year	Year	Year	H1(a)	H2(a)
Real average earnings(b) 1972 = 100	100.0	107.3	112.3	114.8	116.3
	£ billions, 1975 prices				
RPDI	70.2	73.4	84.8	82.5	81.8
of which:					
Employment income	*59.6*	*67.0*	*71.7*	*68.5*	*68.0*(c)
Current grants	*9.2*	*11.0*	*13.4*	*15.5*	*15.8*(c)
'Other' personal income	*17.2*	*17.7*	*20.7*	*19.4*	*18.8*(c)
Taxes (a deduction)(d)	*−15.7*	*−22.3*	*−21.0*	*−21.9*	*−21.9*(c)
Consumer spending	63.3	64.7	71.6	71.9	73.5
Personal sector net financial wealth(b)(e)	148	87	98	100	
Saving ratio (per cent)	9.9	11.9	15.6	12	9–10

(a) At an annual rate.
(b) Nominal amounts are divided by the deflator for consumer prices.
(c) Q3 only. H2 figures for RPDI and the saving ratio are partly estimated; earlier figures may be revised.
(d) Includes national insurance contributions.
(e) At end period.

Despite rising real average earnings, total income from employment has recently been falling in real terms, after rapid growth up to 1980. The reason is the sharp decline in the number of people with jobs. Reflecting this, social security benefits have grown rapidly, with items other than pensions increasing by 50% between 1976 and 1981.[1] 'Other' personal income has lately tended to fall in real terms, although part of it, recorded income from self-employment, may be underestimated. The decline in nominal interest rates will have depressed the interest component of this category of income in 1982.

These changes in the distribution of income may have had offsetting effects on saving and it is not clear where the balance between them lies. For a given RPDI, more real income in the hands of high rather than low earners will have tended to raise saving and lower consumer spending. On the other hand, a larger share of social security benefits and a lower share of 'other' income will probably have reduced saving and increased consumption.

Less ambiguous is the effect of the fall in RPDI that has occurred (partly as a result of lower net interest receipts which in turn reflect lower inflation). Lower income may explain perhaps 2 points of the 7 percentage point reduction since 1980 in the proportion of income saved.

Inflation and financial wealth

A further 1–2 points of the reduction in the saving ratio may be accounted for by the slowdown in inflation other than through its effect on RPDI. In the five years to 1980, consumer prices almost doubled. The real value of the stock of savings fixed in money terms was therefore severely cut, and a high rate of saving helped to restore some of these losses. By 1982, the rate of inflation had halved, and people were probably expecting further falls to a lower level which would be sustained.

There has been a fall not only in the real value of liquid financial assets but also in the real value of personal sector financial wealth as a whole. At the end of 1972, personal sector net financial wealth amounted to about £150 billion (at 1975 prices). By 1980, it had been cut by over a third (after some recovery since 1976): and this in spite of a financial surplus (net acquisition of financial assets) between 1973 and 1980 which added £50 billion at 1975 prices to net financial wealth. There were two main reasons for the fall in real terms. Inflation appears to have reduced the real value of net assets fixed in nominal terms by some £70 billion. The remainder was lost because share prices fell in real terms and because nominal interest rates rose, reducing the market value of fixed-interest stock. To some extent high saving may have sought to remedy these losses, although the effect of changes in stock market prices on consumer spending and saving is very uncertain, partly no doubt because many of the assets are held at one remove (through life assurance companies and pension funds). Since 1980, personal sector net financial wealth has recovered slightly.[2]

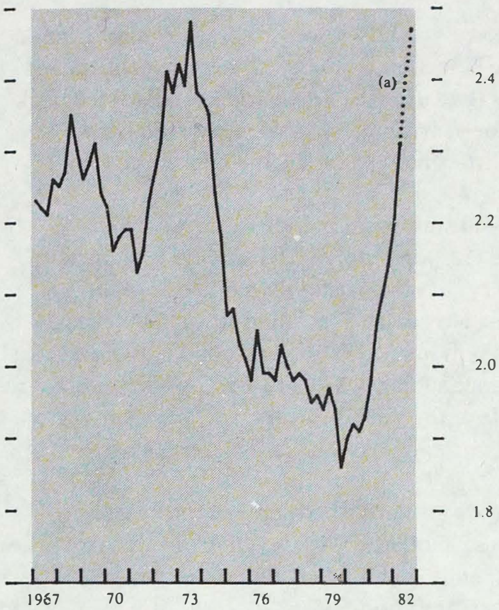
Availability of loans

Consumer spending may also have been influenced by readier availability of personal loans over the last few years, and by the abolition of HP controls last summer.

(1) Details of personal income are not available for 1982.

(2) End-year figures for personal sector holdings of tangible assets excluding consumer durables (about three quarters being houses) show a different pattern from financial assets—a rise in their real value between 1972 and 1980 and a decline (to some £160 billion at 1975 prices) in 1981, when their real value was slightly higher than in 1975.

The debt/income ratio *of the personal sector has increased sharply.*



(a) Bank estimates from 1982 Q2.

Personal sector saving

Percentage of personal disposable income

	1972 Year	1976 Year	1980 Year	1982 H1(a)	1982 Q3(a)
Committed saving	10.0	10.7	11.0	11.1	11.8
Discretionary saving	− 6.2	− 2.6	− 0.5	− 4.5	− 7.2
of which:					
Acquisition of liquid assets	*10.8*	*6.5*	*9.9*	*9.0*	*8.0*
Borrowing for house purchase (−)	− *7.6*	− *5.7*	− *5.4*	− *7.8*	− *8.9*
Other borrowing (−)	− *8.6*	− *4.3*	− *5.1*	− *5.3*	− *6.6*
Gross domestic fixed capital formation	5.9	4.8	4.2	5.0	5.2
Total personal saving(b)	**9.9**	**11.9**	**15.6**	**11.8**	**9.6**

(a) Bank estimates; seasonally adjusted.
(b) Not the sum of the previous items, because capital transfers, capital gains tax and unidentified transactions are left out.

Growth of spending on durable goods (including cars) in the second half of last year points to an effect from ending HP restrictions. This effect may have been strengthened because spending on durables had earlier been rather low, suggesting there was some pent-up replacement demand. Consumer credit granted by banks, finance houses and retailers may have grown by some £0.9 billion in the second half of last year at 1975 prices. But lending to the personal sector for all purposes has been growing rapidly for some time, and although HP derestriction may have provided a stimulus, it is probably only a minor explanation for the strength of lending for consumption last year. The flow of new lending to the personal sector grew by nearly 50% in real terms between 1978 and 1982 when it exceeded £8 billion (at 1975 prices): it was the equivalent of over 11% of consumer spending last year, compared with about 8% in 1978.

Most of the growth in lending since 1978 has been on mortgages, lending on which, at 1975 prices, has risen from £3¾ billion in 1978 to some £6 billion last year. But the housing market has been subdued in recent years, suggesting that much new mortgage finance may have been used ultimately for purposes other than house purchase.[1] The banks have considerably increased their share of lending to the personal sector. Greater competition between financial institutions to lend to the personal sector must account for some of the increase in personal borrowing—it is estimated to have contributed some 1½–2 percentage points to the reduction in the saving ratio since 1980, although this estimate cannot be regarded as precise.

The growth in lending to the personal sector has sharply increased the ratio of debt outstanding to personal income—by more even than occurred in the early 1970s. This follows a very large fall in the ratio in the middle and late 1970s.

Committed and discretionary saving[2]
Saving is the difference between disposable income and consumer spending, or, put another way, the acquisition of financial assets *less* borrowing *plus* the purchase of tangible capital assets like houses. It is sometimes of interest to divide saving (excluding acquisition of tangible assets) into a committed and a discretionary part. 'Committed' saving may be defined as the acquisition of financial assets under some form of contract (eg, through life assurance and superannuation schemes, and SAYE) plus scheduled repayment of borrowing. The remaining 'discretionary' element is usually negative but was considerably more so in 1982 than in 1980; the acquisition of liquid assets was rather smaller and new borrowing was much larger in relation to personal disposable income. Committed saving, as would be expected, varies much less in relation to income.

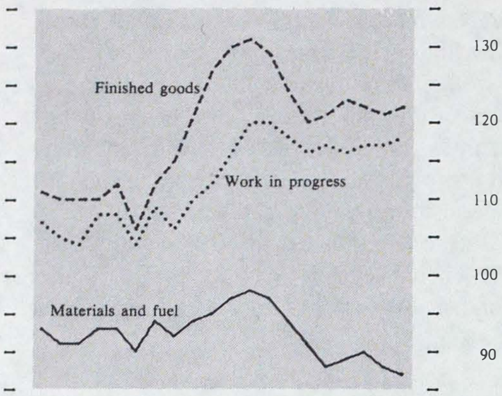
Demand and output

Consumer spending was not the only source of growing demand in the second half of last year. Although housing starts fell back from the high first quarter level, the number of houses under construction—a better guide to activity—rose through the year:

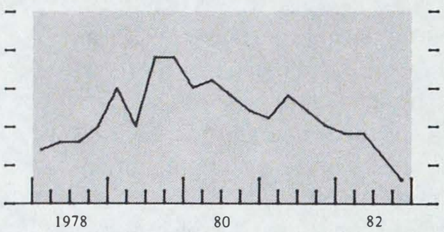
(1) This issue was discussed in 'Mortgage lending and the housing market', September 1982 *Bulletin*, page 390.
(2) An article in the November 1981 *Economic Trends* gave annual estimates of committed and discretionary saving for 1963–80. Figures for recent years have been revised since the article was published. Contractual saving is treated as 'committed' from the start, although the decision to undertake a contract to save is a matter for discretion.

Whereas **manufacturers' stocks**[(a)] *of finished goods remain high, stocks of fuel and materials look low in relation to output . . .*

Seasonally adjusted End-1974 = 100



. . . **distributors' stocks**[(b)] *have fallen further.*



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

Demand and output 1979–1982

Percentage changes, except stockbuilding; *seasonally adjusted*
Figures in italics are contributions to the change in GDP

	1979 (average)–mid-1981(a)		mid-1981(a)–1982 H2	
Consumer spending	+ ¼	—	+ 2½	*+1¾*
Government current spending on goods and services	+ 2	*+ ½*	+ 2½	*+ ½*
Fixed investment	−12	*−2½*	+ 5	*+1*
Domestic final spending	− 1¾	*−2*	+ 3	*+3½*
Exports (goods and services)	− 2	*− ¾*	—	—
Final spending	− 1¾	*−2½*	+ 2¼	*+3½*
Stockbuilding (£ billions)	−£1.9bn	*−3½*	+£0.3bn	*+ ¾*
Imports (increase −)	+ 1¾	*+ ½*	− 1	*− ¼*
Taxes on spending (net of subsidies) (increase −)	+ 3	*+ ¼*	− 6¾	*− ¾*
GDP (expenditure measure)		**−5**		**+3**
GDP (output measure)		−5¼		+1½

(a) Average of 1981 Q2 and Q3.

and fixed investment by manufacturing, distribution and service industries was 2% higher in the second half than in the first. Domestic final spending increased by 2½%.

Exports of goods rose strongly in the fourth quarter; their volume was nevertheless slightly lower in the second half, and exports of services also fell. (Quarterly movements in exports have been very variable.) Altogether, final spending grew by some 1¼% in the second half of the year—equivalent to nearly 2% of GDP.

The expenditure measure of GDP, however, grew by under 1½%. None of the difference is accounted for by higher imports; indeed the volume of imports (like exports, very variable of late) fell back in the second half of the year. But stocks were reduced very sharply, having been little changed in the first half of the year.

Not all of this further substantial reduction in stocks will have been involuntary, since respondents to CBI surveys (confined to manufacturing industry) have consistently reported holding excessive stocks of finished goods. The fall in stocks of fuel and materials (nearly £0.4 billion, or 6%, in the second half of the year) is harder to explain, since such stocks were already low in relation to output in the middle of the year. Industry may have run them down further in expectation of lower oil and materials prices.

Higher taxes on spending also absorbed some of the increase in final demand: some 'real' increase in tax revenue resulted from the growth in consumer spending and the change in its composition towards cars and other durable goods.

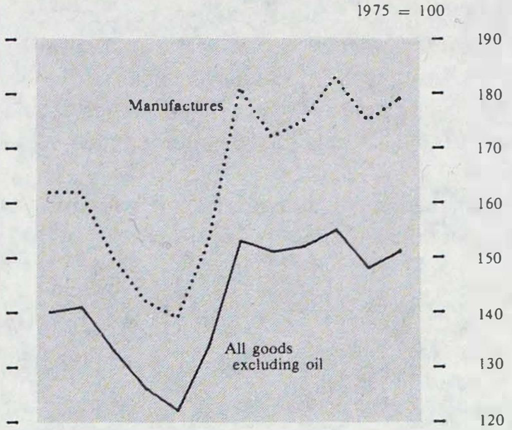
The growth of total output, at ¾% in the second half of last year, was barely half that of GDP on the expenditure measure—a pattern which has been evident for some time, as the table of changes in GDP since 1979 shows. Consumer spending and fixed investment have been quite strong elements in demand since mid-1981. In 1982 as a whole, the strongest constituents in fixed investment were private investment in new dwellings, and investment in distributive and service industries (excluding assets leased to manufacturers), up by 7%. Investment in assets for use in manufacturing industry fell by about 8%, to 25% below the peak in 1979.

External trade and competitiveness

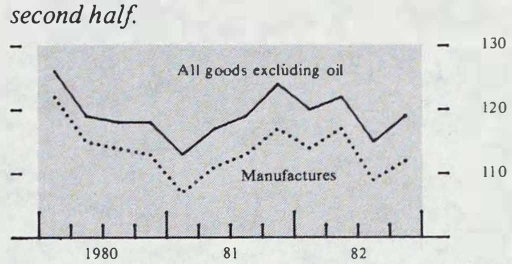
The volume of exports of manufactured goods (about 85% of all UK exports of goods other than oil) rose by 1% last year, although world markets declined. Nevertheless, in the second half of the year exports were lower than in the first half and 5% below the average in 1980, with little change in overseas markets on balance in the meantime. The loss in market share was much as Bank estimates would have indicated from the effective loss of competitiveness. The volume of exports of goods and services as a whole rose by ¾% last year, but in the second half was about 2½% below the rate in 1980.

Earlier rapid growth in the volume of imports did not continue into last year despite the strength of consumer spending (especially on cars and other durable goods in which the import content is usually high). Improved competitiveness during 1981 probably reduced imports in 1982 (changes in cost competitiveness appear to affect imports more quickly than exports), and the resumption of

The volume of **imports** *levelled out last year . . .*



. . . and **exports** *were lower in the second half.*



Industrial and commercial companies—source and use of funds[(a)]

£ billions, quarterly rate; *seasonally adjusted*

	1981		1982	
	H1	H2	H1	Q3
Profits(b)	+7.0	+7.9	+8.2	+8.7
Undistributed income(b)	+3.2	+3.4	+3.0	+3.5
Fixed investment	−3.8	−3.7	−3.8	−3.8
Destocking(+)(b)	+1.1	+0.6	+0.2	+0.8
Financial surplus + / deficit−	**+0.7**	**+0.4**	**−0.5**	**+0.8**
Trade investments etc	−0.4	−2.1	−0.6	−1.7
Acquisition (−) of financial assets	−1.8	−1.2	−0.1	−0.6
Borrowing (+)	+1.0	+4.2	+3.1	+2.6
Unidentified	+0.6	−1.3	−1.8	−1.0

(a) Sources of funds +, uses −. Undistributed income *less* fixed investment *plus* destocking does not add to the financial surplus/deficit because some items are excluded.

(b) Excluding changes in the valuation of stocks.

destocking was no doubt also an influence. Nevertheless, towards the end of last year imports were lower than would have been expected, taking cost competitiveness and domestic spending into account. The squeeze, already noted, on foreign suppliers' profit margins may have been an influence: import prices did not rise to the extent expected following the decline in sterling in 1981 (tending to increase import penetration), and the resulting squeeze on profit margins may, by late 1982, have begun to affect the effort that foreign suppliers put into selling in the UK market.

The volume of non-oil exports fell steeply in January, but recovered in February. Non-oil imports in each month were 10% above the low fourth quarter rate; the increase was spread among most commodity groups.

Relative prices (rather than costs) may affect trade flows, but costs explain them better in econometric studies.[(1)] Labour cost competitiveness was probably little changed in the first three quarters of last year. Costs may have increased a little less than abroad; on the other hand, sterling rose 2% in effective terms. Since the third quarter of 1982, however, competitiveness has probably improved by over 10%, reflecting the decline in the exchange rate—making an improvement of perhaps 20% since the end of 1980. To judge from pay deals in the current round so far, and wage developments abroad, the gain is likely to be maintained this year. The effect of such large movements in the real exchange rate, alongside the structural change in industry in recent years, is hard to predict, but replies to the February CBI survey indicate an improvement in export order books since last autumn.

Profitability and the financial position of companies

The weakness of industrial production last year must have depressed profits, but low increases in fuel and raw material prices, the slowdown in wage increases, and the growth of productivity (whether a lasting increase in the rate or not) all helped them to recover. Despite a fall in the third quarter, profits (excluding those arising from North Sea operations, and net of stock appreciation) rose by about 15% in the year as a whole; real profitability recovered to about 4%, still historically low but much higher than in early 1981.

Profits figures are subject to substantial revision, and too much should not be read into quarterly changes. Indeed, recorded company transactions as a whole are clearly incomplete, as shown by the size and variability of the unidentified item in the sector's accounts.

Renewed heavy reductions in stocks helped industrial and commercial companies to return to financial surplus in the third quarter (statistics of their financial position in the fourth quarter are not yet available); lower interest payments were also a factor. They nevertheless borrowed over £2½ billion, but at the same time added to their holdings of liquid financial assets after a pause in such acquisitions in the second quarter.

Most of the increased borrowing by companies in the third quarter came from the banks. In the fourth quarter, however, business

(1) It is desirable to allow for cyclical changes in productivity in calculating competitiveness (see 'Measures of competitiveness', September 1982 *Bulletin*, page 369). In present circumstances, however, cyclical effects are very difficult to calculate, and references in the economic commentary are to actual changes in competitiveness. Use of estimated trend productivity would make competitiveness appear somewhat weaker.

borrowing from the banks was substantially reduced—helping to reduce the rate of monetary growth since the autumn. Companies borrowed some £$\frac{1}{2}$ billion—only a quarter as much as before: and bank lending to unincorporated businesses, at £0.3 billion, was also well down on recent periods. Further reductions in stocks and higher profits must provide much of the reason. The quarterly Department of Industry survey of about 200 large companies points to an improvement in their liquidity, but overall the financial position of the business sector remains fragile, with no let-up last year in the rate of liquidations.