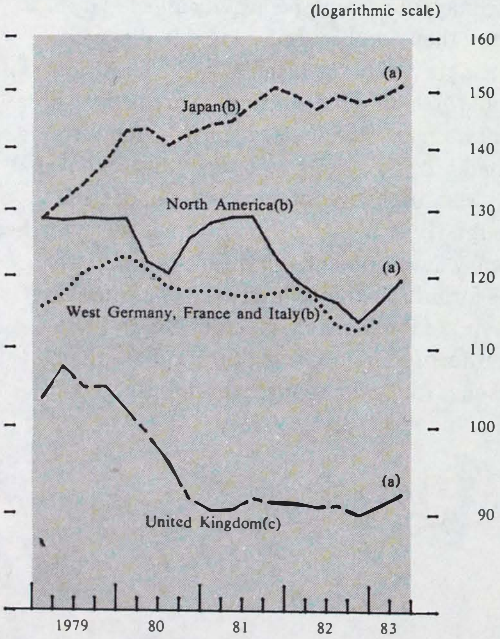
Economic commentary

Topics discussed in this commentary include:

- *The* ***world economy,*** *which shows signs of recovery.*
- ***Inflation abroad,*** *which continues to ease, despite rising (non-oil) commodity prices.*
- *The decline in* ***UK cost and price inflation.***
- *Recovery in the* ***domestic economy,*** *with* ***housing*** *currently a buoyant sector.*
- ***External trade,*** *where striking changes have occurred in recent years.*
- *The* ***distribution of income*** *between earnings and profits. Average real pre-tax earnings of those in work have risen in the recession, though real personal disposable income in total has fallen.*
- ***Private sector financial transactions,*** *where large increases in borrowing have accompanied growing holdings of financial assets in recent years.*

Industrial production *has recovered in the major countries.*



(a) Based on April data only.
(b) Excluding construction.
(c) Excluding North Sea oil and gas.

The world economy shows signs of recovery . . .

In the second half of last year, output in the major industrial countries showed little or no growth, though most forecasters had been expecting recovery to be under way. The reasons for this disappointment were discussed in the March *Bulletin* (pages 8–9). Only in Japan was there sustained growth, but even there it was well below past rates. Towards the end of 1982, however, signs of recovery were appearing elsewhere, most clearly in North America, where industrial production and leading indicators, such as orders, were beginning to revive. In addition, surveys were pointing to a return of business confidence in West Germany.

Since the turn of the year, signs of recovery have multiplied, and in most cases have been translated into higher activity. In the United States, for instance, GNP expanded by over $\frac{1}{2}\%$ in the first quarter, led by rises in consumer spending and housing, and a slower rate of destocking. Industrial production increased sharply, in May, to stand some 7% above the low point of last November, and the indications are that the growth of GNP quickened in the second quarter. In France and West Germany also, GNP is estimated to have risen by about $\frac{1}{2}\%$ in the first quarter; in West Germany, this was the first increase for over a year. In Canada, where the economy had contracted especially sharply since mid-1981, industrial production rose 6% in the first quarter. Growth continued in Japan, and the average measure of GDP grew by 1% in the United Kingdom.

. . . which is likely to continue

In its early stages, the upturn in the major economies is likely to reflect movements in stocks. But continued growth will depend upon final demand in the private sector. The latest Bank forecast suggests that the recovery in output seen so far should gain

Contributions to the change in GNP in the major economies[a]

Percentage points; at 1975 prices

	1981	1982	1983(b)	1984(b)
Real domestic demand	0.9	−0.1	1.9	2.5
of which:				
Personal consumption	0.7	0.7	1.4	1.1
Government consumption	0.3	0.3	0.3	0.2
Investment	0.1	−0.6	—	0.7
Stockbuilding	−0.2	−0.5	0.2	0.5
Net exports	0.5	−0.2	−0.4	−0.2
GNP	**1.4**	**−0.3**	**1.5**	**2.3**

(a) Canada, France, Italy, Japan, United Kingdom, United States and West Germany.
(b) Bank forecasts.

The volume of world trade and UK export markets

Percentage changes, annual rates; *seasonally adjusted*

	1982	1983(a)		1984(a)	
	Year	H1	H2	H1	H2
World trade	−1.1	−1.5	5.1	5.2	5.2
UK export markets	−1.0	−2.0	3.8	4.0	4.7
of which:					
OECD	*0.4*	—	*6.4*	*4.0*	*4.4*
Other	*−3.6*	*−5.7*	*−1.3*	*3.9*	*5.8*

(a) Bank forecasts.

momentum in the course of this year; during 1984 growth may be running at about 3%. Growth is not expected to be fast enough to bring an early decline in unemployment, however; and marked differences in performance are expected, with the European economies lagging somewhat behind North America and Japan, at least this year. Inflation is likely to ease further though perhaps not as rapidly as in the recent past. The fall in the dollar price of oil should contribute to this improvement; on the other hand non-oil commodity prices are likely to continue to strengthen (see box on page 160). More significant, however, will be developments in wages in the major economies, where there seems to be the prospect of some further deceleration.

The initial impetus to final demand is expected to come from personal sector spending. Real incomes should advance quite strongly, and, with saving ratios possibly declining further (reflecting, in the main, the fall in inflation), private consumption in the major economies may grow by just over 2% this year. By 1984, the growth in demand is expected to strengthen a little and to depend more on the corporate sector, whose spending, especially on fixed capital, may by then be recovering. Any further easing in nominal and real interest rates, reviving confidence, and some widening of profit margins may help to support this expansion.

The major OECD countries cannot expect much stimulus from the rest of the world over the next two years. While a fall in oil prices may have a beneficial effect on their domestic economies, it is likely to bring a substantial reduction in OPEC imports as some oil producers experience increasing financial pressures. Other commodity prices are now rising on average, but even so, many producers will face continuing financial constraints and are unlikely to spend much of their higher receipts on extra imports. Most of the smaller OECD countries (a number of which, like the developing countries, are facing severe external pressures) will depend mainly on exports to the major European countries to lead them out of recession and will not provide an independent stimulus. The United Kingdom is more dependent than most major industrial countries on markets in the smaller OECD countries or outside the OECD area, and consequently UK export markets may revive more slowly than world trade as a whole. These developments in world trade will probably have little net impact on the distribution of current account positions among the main country groups this year, although some shifts may occur within the group of major industrial countries. In particular, the United States will probably move deeper into deficit, while the surpluses of Japan and West Germany are expected to rise further, and the United Kingdom's to decline from last year's £4 billion.

The outlook remains uncertain in a number of respects. First, much depends on confidence, which, both in industry and among consumers, has been dented in recent years and may be difficult to restore. There are now signs, notably in the United States, but also in West Germany and the United Kingdom, of a more optimistic tone, but it will need to hold up if recovery is to get securely under way. Second, even though much plant may have become uneconomic and have been scrapped in recent years, a substantial margin of spare capacity must remain. This may discourage a sustained recovery in investment. Third, there is a special concern about the durability of recovery in the United States. So far, it has depended very largely on demand for cars and housing—both interest-sensitive—but real interest rates, though they have fallen

Commodity prices

The steep decline in primary commodity prices which began in late 1980 was arrested towards the end of last year. Since then, many prices have been rising quite strongly. Measured by the *Economist* commodity index, the rise from October to May was 26% in sterling terms, 16% in US dollars, and 15% in terms of SDRs. Changes in the main components are shown in the table.

The recovery began among foods with cereals and soyabeans among the items recording gains in November. By May, twelve of the sixteen items in the food index were above their October levels, with maize and sugar up by around 50%. The industrial materials index continued to fall until December, but then recovered 18% in the next five months. Five of the twelve component series increased by more than 15% with rubber rising 41%. Outside the index, aluminium, nickel and cobalt, among others, recorded gains comparable with rubber, yet the pattern was still very mixed with a number of industrial materials, particularly metal ores, continuing to weaken.

The recovery of some food prices in November followed unfavourable weather. Droughts in Australia and South Africa became increasingly serious as the southern summer approached, and cereal prices, particularly maize, began to strengthen. In December, cocoa prices were also rather higher in response to dry weather in Brazil and West Africa. More recently, sugar prices have reacted to a sharp deterioration in crop prospects, in part reflecting a wet spring in much of Europe. But while important in the short term, these upsets to supply seem only to have had a modest effect on the global balance of supply and demand. World stocks of cereals, for example, are likely to end the 1982–83 season at the equivalent of 22% of annual supply, compared with 18% a year earlier, while US maize stocks could reach their highest level in relation to production since 1965. To explain the rise in prices it seems necessary to look beyond the present situation to prospects for the 1983–84 season.

The largest price increases have been mainly in markets where supply has already been substantially restrained, or where cuts are in prospect later this year. The US

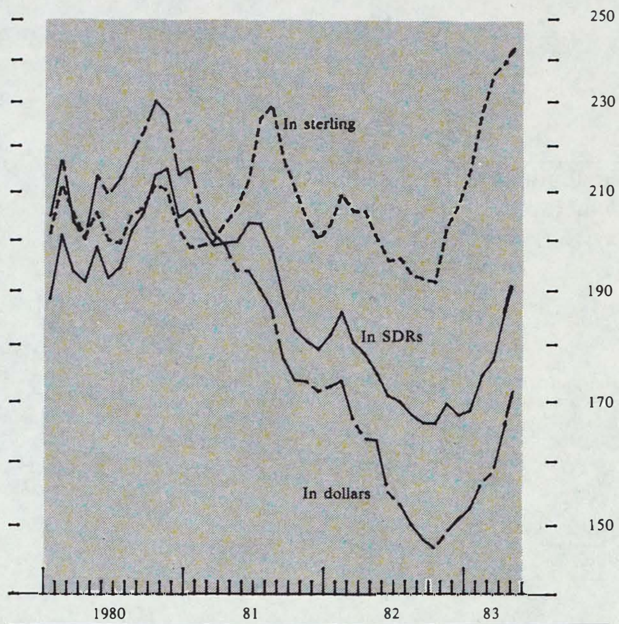
Commodity prices in SDR terms

Percentage changes

	Weights	Oct. 82–May 83	Dec. 82–May 83
Economist all items index	***100.0***	**+15.4**	**+14.4**
of which:			
Food	*62.3*	+16.3	+12.5
Beef	*4.5*	+12.0	+14.6
Wheat	*3.4*	− 0.1	− 3.8
Maize	*6.4*	+51.7	+35.6
Coffee	*18.3*	− 3.3	− 2.3
Cocoa	*6.4*	+24.5	+26.7
Sugar	*6.5*	+49.9	+47.5
Soyabeans	*7.9*	+18.0	+11.0
Industrials	*37.7*	+14.2	+17.6
Wool	*4.7*	+ 0.5	+ 5.8
Cotton	*4.9*	+15.4	+18.8
Copper	*11.4*	+19.5	+21.0
Lead	*2.7*	−13.7	− 3.3
Zinc	*2.4*	− 8.2	− 3.6
Tin	*3.3*	+ 7.9	+14.0
Rubber	*3.9*	+34.2	+40.8

Commodity prices—Economist all items index

1975 = 100
(logarithmic scale)



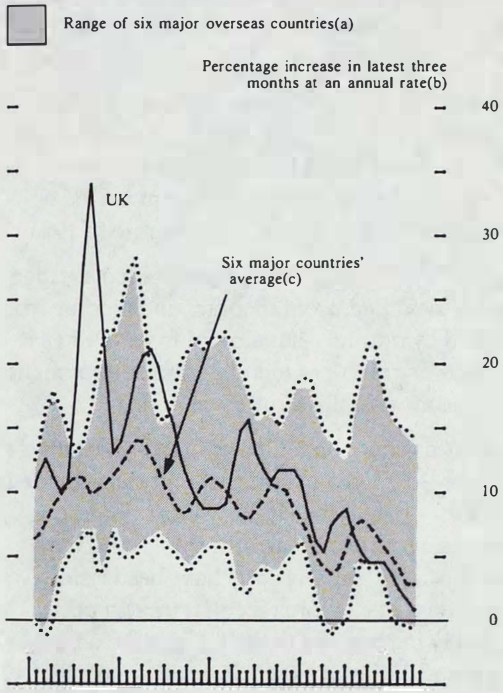
acreage reduction programme for 1983 has already had a major impact on market expectations and probably accounts for most of the December to May increase in the maize price, and the stronger position of soya—US maize output could be down by 30%, or by the equivalent of around two-thirds of the projected volume of world trade this year.

Among industrial materials, Western copper production fell 3%, and tin nearly 10% in 1982, while world cotton output has fallen 4% in the 1982–83 season, with the prospect of some further decline. For a number of commodities not covered by the *Economist* index, output has been even more sharply curtailed—nickel and aluminium production in 1982 were reduced by 21% and 14% respectively.

The evidence of revival in industrial demand is still sketchy. On the London commodity exchanges turnover has certainly increased, with business in a number of markets more than double its level a year earlier. Stocks held on the exchanges have, however, continued to rise suggesting that, so far, anticipatory buying by traders may have been more important in raising prices than increased demand from final users.

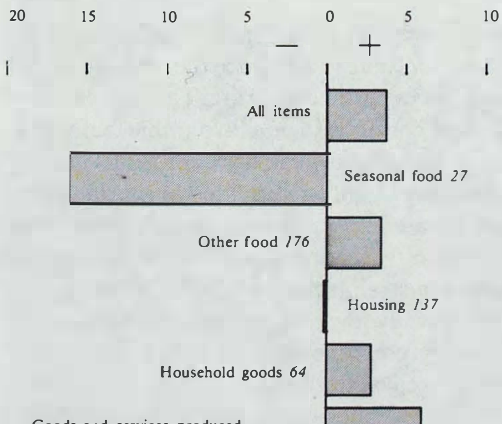
Price prospects clearly depend partly on the pace and timing of industrial growth, but also on the level and distribution of stocks and the response of commodity producers to higher demand. The cuts in metal production in 1982 prevented a major build-up of stocks, and in a number of markets stocks are now lower than at comparable stages of earlier cycles. Stocks of many agricultural products, by contrast, are high. Further ahead, prospects will also depend on how much and how quickly production capacity closed over the past year can be brought back into operation.

Consumer prices—*inflation falls to a low level.*



(a) United States, Canada, France, Italy, Japan and West Germany.
(b) Rough allowance is made for seasonal influences.
(c) GNP weights.

Retail prices
Percentage change May 1982–May 1983
Weights per 1,000 in italics



from their peaks, still remain high. Much may depend on prospects for the fiscal deficit. On the monetary side, interpretation of recent movements in the aggregates is difficult. They have been distorted to an unknown extent by financial innovation and shifts in investors' preferences. All this must leave some doubt about future pressures on interest rates. Moreover, there is considerable uncertainty about how long it will take for the past year's declines in real interest rates to affect other parts of the economy, and about the eventual size of their impact. Finally, serious international debt difficulties remain. The measures taken so far to maintain the flow of finance have been necessary to provide the opportunity for the most hard-hit countries to make necessary economic adjustments; but the resolution of their difficulties will clearly take time.

Not all the uncertainties lie on the side of a weaker recovery. There is a possibility that recovery may proceed more rapidly. Industrial confidence might, for example, be more quickly restored. The situation may be one in which any departure from a path of modest growth would prove self-reinforcing. On the one hand, a strong upturn could gain momentum; but, were growth to falter now, a prolonged period of stagnation could ensue.

Inflation in the major countries continues to decline . . .

Inflation has continued to decline rapidly in the major industrial countries. In 1982, the main influence was a sharp slowdown in their import costs. Commodity prices were falling for most of the year, although oil prices, while weakening in terms of the strong dollar, still showed a modest increase when expressed in the domestic currencies of the major countries as a group. 1982 also saw a gradual easing in the growth of unit labour costs. In the twelve months to April of this year, consumer prices rose by around 5% on average in the major countries. Inflation rates over this period ranged from 2% in Japan and 3.3% in West Germany up to more than 16% in Italy.

. . . and also in the United Kingdom

Cost and price inflation has slowed more in the United Kingdom than elsewhere.

The chart shows the year-on-year rise in various components of the RPI in the last year. Fresh food prices have fallen considerably on this comparison (although they may not continue to be so favourable), and the prices of many kinds of manufactured goods have increased very little. Last year's reductions in mortgage rates helped to keep housing costs stable.

The influences behind the slowing of inflation in the United Kingdom, and prospects for the coming months, can be discussed under four headings:

- Domestic labour costs—comprising pay, other costs of employing labour, and productivity.
- Profit margins.
- Import prices—industrial materials etc for working up, and food and other items for direct use.
- Various 'administered' items such as taxes, subsidies, local authority rents and rates.

These headings provide a convenient framework for statistical analysis: they are not independent causes of inflation, which is affected by general market conditions and financial policy.

Domestic factor costs, taxes on expenditure, and import prices

Percentage changes

	Weights in total final expenditure in 1982	1979	1980	1981	1982
Domestic factor costs per unit of GDP					
Income from employment	*46.1*	+14.7	+21.5	+11.1	+ 4.9
Profits etc(a)	*10.0*	+ 1.6	+11.3	+ 9.6	+13.7
Other income(b)	*11.5*	+17.2	+16.5	+11.6	+ 7.3
GDP deflator		**+13.4**	**+18.8**	**+10.8**	**+ 7.1**
Taxes on spending less subsidies(c)	*12.5*	+26.9	+24.0	+17.5	+12.4
Import costs(d)	*19.8*	+ 7.8	+ 9.8	+ 5.5	+ 5.4
TFE deflator		**+13.3**	**+17.2**	**+10.5**	**+ 7.1**

(a) Company profits and trading surpluses of public corporations and general government enterprises, net of stock appreciation.

(b) Income from rent and self-employment.

(c) The factor cost adjustment at current prices divided by the same at 1975 prices.

(d) The deflator for imports of goods and services.

Employment costs per unit of output(1) have risen more slowly in recent years—by under 5% last year, compared with 21½% in 1980. The growth rate of wages and salaries per employed person has fallen by more than half, and cuts in the national insurance surcharge (NIS) have reduced the non-wage cost of employing labour (indeed, by August, reductions in the NIS will be saving private sector employers some £2 billion per year, although rises in national insurance contribution rates and earnings limits will have offset part of this). Furthermore, the number of employees on whose account these costs are incurred has fallen more than output, reflecting the rise in productivity.

Profit margins of industrial and commercial companies (and trading surpluses of nationalised industries) are a small element in domestic factor costs. They rose much less than employment income in 1979 and 1980 but faster in the more recent period as profitability recovered somewhat from the very low rate of 1981.

Altogether, the growth of the GDP deflator—a weighted average of the increase in employment and profit incomes and income from self-employment, divided by output—has slowed from over 18% in 1980 to 7% last year. Slower growth of income from employment has contributed by far the most to this slowdown.

A wider measure of inflation than the GDP deflator is the deflator for total final expenditure—TFE at current market prices divided by the same at 1975 prices—which reflects, as well as domestic costs, the price of imports, rents and local authority rates, and expenditure taxes and subsidies. Import costs have been rising more slowly than domestic costs. (More recently, import costs have accelerated, probably in response to the fall in the exchange rate between last autumn and March this year; little or no effect from the recovery in many non-oil commodity prices has been felt so far.) Local rates have increased considerably in recent years; the average rise this year is the lowest for some time. Council rents have also risen rapidly until this year.

Interest rates are not included in the TFE deflator, but are an element in the retail price index. Building society mortgage rates (the interest rate represented in the index) have fluctuated widely in the last five years. They rose steeply between June 1978 and late 1979, dipped and then rose again over the following two years, and declined from 15% to 10% since March 1982 before rising to 11¼% in June 1983.

The smaller increases this year in local authority rents and rates and in specific duties will continue to influence the twelve-monthly rate of increase in retail prices until next spring. The influence of import prices is unlikely to continue to be a favourable factor as it was last year. So far as foodstuffs, fuel and basic materials are concerned, sterling prices are mainly determined by world prices and the sterling exchange rate.(2) Some primary product prices have risen (see the box on page 160); developments depend on world recovery and any supply constraints that may emerge after a prolonged period of historically low real commodity prices, which in some cases have caused productive capacity to be reduced. Oil prices, though they could well be steady over the coming period, are difficult to predict. The average price of manufactured goods in world trade is likely to rise by less than last year—possibly by about 4% in foreign currency terms; but the sterling price of

(1) Wages, salaries and employers' national insurance contributions and contributions to pension schemes divided by the output measure of GDP.

(2) The sterling price of food covered by the common agricultural policy is determined by the price fixed in terms of the European unit of account and the value of the 'green' pound.

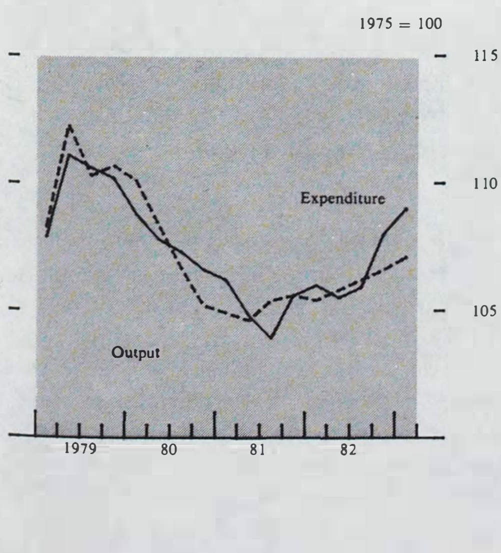
Contributions to the change in GDP in the current cycle

Percentages at 1975 prices; *seasonally adjusted*

	1979–1981 Q2/Q3	1981 Q2/Q3–1982 Q4	1982 Q4–1983 Q1(a)
Consumer spending	+ ¼	+2½	– ½
Government consumption	+ ½	+ ½	+ ¼
Fixed investment	–2½	+1	—
Domestic final spending	–1¾	+4¼	—
Exports (goods and services)	– ¾	+ ½	—
Total final spending	–2½	+4¾	—
Change in stocks	–3½	+ ¼	+2¼
Final expenditure (at market prices)	–6	+4¾	+2¼
Indirect taxes *less* subsidies	+ ¼	– ¾	—
Total (at factor cost)	**–5¾**	**+4**	**+2½**
Met by:			
Imports	– ¾	+ ½	+1¼
GDP (expenditure measure at factor cost)	–5	+3½	+1
Memo item:			
GDP (output measure)	–5¼	+1½	+ ½

(a) Provisional.

The **output measure of GDP** *shows a gentler recovery than the expenditure measure.*



manufactured goods imported by the United Kingdom may rise by rather more than this.[1]

The increase in the GDP deflator is likely to slow further. Pay deals in the current round appear to be averaging about 5½%, with some recent public sector deals affecting large numbers of people at around 5%; the gradual decline in settlements will continue to exert downward pressure on the growth of average earnings. The growth of productivity (very rapid in the first quarter) will depend partly on output: it could be sufficient to keep the increase in unit wage and salary costs in the whole economy to 3%–4% over the coming year, with quicker growth of productivity in manufacturing leading to a somewhat slower growth of costs in that sector.[2] How much of any cyclical element in the deceleration of wage costs would be reflected in prices or show up in profits is not clear. Experience suggests that many prices are determined by some notion of underlying costs; to that extent, the benefit of any cyclical gain in productivity would help to widen profit margins, which are still very narrow.

The UK economy shows signs of recovery . . .

Previous *Bulletins* have noted the recovery in domestic final spending in the United Kingdom since the middle of 1981. Between then and the fourth quarter of last year, spending increased by over 3½%.[3] The rise was led by consumers' expenditure which was strong in the second half of 1982 after a period of little change. Real personal disposable income was not rising, so the increase in consumer spending was accompanied by a sharp decline in the saving ratio; that may be partly attributable to the end of HP restrictions last summer, but probably owed more to slowing inflation which reduced the saving needed to maintain the real value of the personal sector's monetary assets.[4] Fixed investment also grew between mid–1981 and late last year; there was an increase in private housebuilding, and in some categories of industrial investment outside manufacturing industry.

Exports rose (though erratically) over this period. Although stocks were still being reduced heavily in the fourth quarter of last year, destocking was at a slower rate than in mid–1981. Altogether, total final expenditure at market prices grew by 3¼%—equivalent to nearly 5% of GDP—albeit from a depressed level.

The composition of expenditure (consumer spending, especially on durable goods, the strongest element) brought a large increase in indirect tax revenue which is deducted from spending at market prices to arrive at GDP at factor cost. Moreover, some of the extra spending was satisfied by imports. Nevertheless, at 3½% (2½% at an annual rate), the growth in the expenditure measure of GDP was appreciable.

The growth in output, barely 1½%, was markedly less and a wide gap opened between the output and expenditure measures of GDP. Industrial production (excluding oil and gas) actually fell over the period, and manufacturing output was its lowest of the recession in the fourth quarter of last year.

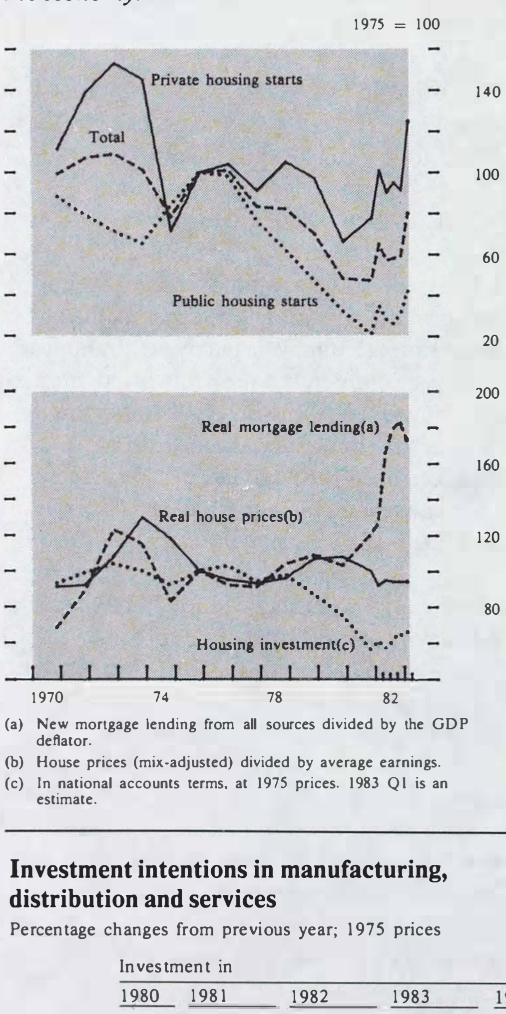
(1) Delayed responses to past exchange rate movements, and the degree to which foreign suppliers, in setting prices for the UK market, are influenced by their competitive position here, as well as by their own costs, were discussed in the March *Bulletin*, page 11.

(2) The further reduction in the national insurance surcharge in August will help to keep down labour costs but will not directly affect the GDP deflator.

(3) The 4¼% in the table measures its rise as a percentage of GDP.

(4) See the March *Bulletin*, page 13, and also the box on page 169 of this issue.

Housing *is currently a buoyant sector of the economy.*



(a) New mortgage lending from all sources divided by the GDP deflator.
(b) House prices (mix-adjusted) divided by average earnings.
(c) In national accounts terms, at 1975 prices. 1983 Q1 is an estimate.

Investment intentions in manufacturing, distribution and services

Percentage changes from previous year; 1975 prices

	Investment in				
Date of survey	1980	1981	1982	1983	1984
Mid-1979	modest rise				
Mid-1980	−3	further fall			
Mid-1981		−3 to −6	some recovery		
Mid-1982			+2	More than +2	
Mid-1983				+3 to +4	+3 to +4
Outturn	−1	−7	+1½	..	..

The gap between the expenditure and output measure of GDP widened further in the first quarter: output rose by ½%, but the expenditure measure rose by 1% with a large change in stockbuilding only partly offset by higher imports. The expenditure measure in recent quarters may exaggerate the strength of recovery; at least over short periods, the output measure is probably to be preferred as an indicator of GDP.

. . . with prospects of continuing modest expansion

There are other indications that some recovery is under way. First, the CSO's index of longer leading indicators[1]—chosen for their ability to predict turning points in the economic cycle—has (apart from a few months in 1981) risen since mid-1980. Although the indicators do sometimes give false signals, there has not before been such a sustained rise in the index without a subsequent upturn in the economic cycle. Surveys of business opinion, results of which are included in the CSO's cyclical indicators, are suggesting guarded optimism. The CBI's regular surveys of about 1,700 firms in manufacturing industry have recently indicated higher output, stronger order books, smaller excess stocks and better sentiment—responses generally being the 'best' for some years.

The recovery seems unlikely, however, to be very strong. The growth in consumer spending will probably taper off. Further rises (necessarily) require higher spending power or a lower saving ratio; neither seems likely to contribute much. There is unlikely to be much if any rise in employment to contribute to aggregate spending power; further sizable increases in real average earnings seem improbable (and in any case might reduce activity in other ways by damaging competitiveness and profitability). As the saving ratio was already down to 10¼% in the fourth quarter (compared with 16½% two years earlier), it may not fall much further as inflation levels out—indeed, it may have risen in the first quarter.

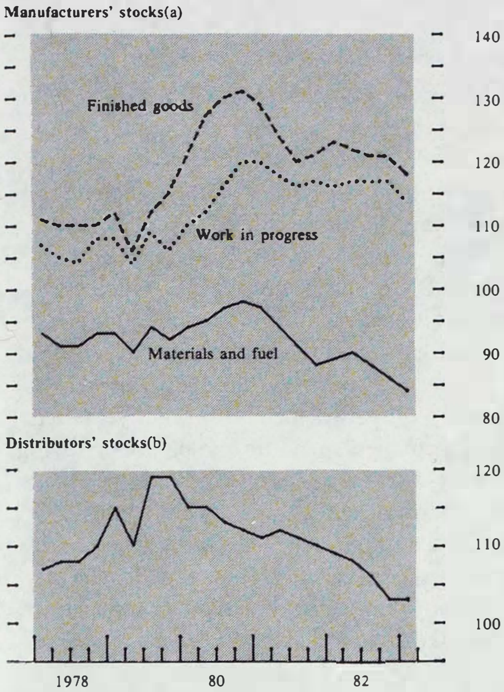
Housebuilding is a buoyant area of activity. In the first four months of this year, starts were 20% higher than a year earlier; the number of houses under construction has been increasing steadily for some time; and house prices seem to be rising at a rate of about 10% a year, having grown only slowly (or even declined) for a time from late 1980. Although the banks are holding down their mortgage lending, building society lending has increased rapidly so the total of mortgage finance has generally continued to grow. But investment in housing is quite a small component in GDP—2½% in 1982. Much of the recent growth has been in private housebuilding. Although strengthening, public housebuilding is still much less than it was a few years ago, in common with other forms of public investment.

The trend in industrial fixed investment has been flat since 1981. The Department of Industry's May survey of investment intentions was somewhat more optimistic than its predecessor, suggesting a rise of 3%–4% in both 1983 and 1984. However, the real profitability of industry's fixed assets was well below the real cost of finance last year—see page 238. While average returns on existing assets do not represent the expected return from new investment, especially where technology and relative costs have changed considerably, it is difficult to see very strong growth in industrial investment while existing returns are so low in relation to

(1) Comprising share prices, interest rates, business confidence (as indicated by CBI surveys), housing starts and company liquidity.

Stocks *were reduced last year, but may now have ceased falling.*

Seasonally adjusted End-1974 = 100



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

the cost of re-equipping. All the growth is in distribution and service industries: fixed investment in manufacturing has been falling since 1979, even after allowing for leased assets, and both Department of Industry and CBI surveys suggest that it will decline further before recovering later this year. Nearly all respondents to CBI surveys continue to report sufficient capacity to meet expected demand.

Manufacturers' and distributors' stocks fell in the three years to the end of 1982, by £3¾ billion (at 1975 prices) or 12¾% of their starting level. But the virtual end to destocking in the first quarter provided a stimulus to output. Some categories (notably manufacturers' stocks of raw materials and fuel) look low and a declining proportion of respondents to CBI surveys report excessive stocks. But even if stocks are substantially rebuilt, the effect on the growth of output (the extent to which imports are not drawn in) is likely to be temporary and smaller than in the first quarter of this year, when the turnround was equivalent to over 2% of GDP.

Prospects for the world economy, although better now than they seemed earlier this year, must still be considered uncertain—and much of the growth will be in areas to which the United Kingdom does not export large amounts. Exports were little changed in the first quarter; order books have improved, but there seems unlikely to be much export growth this year.

The 6% rise in the volume of imports of goods in the first quarter undoubtedly owed much to the behaviour of stockbuilding (and was from an unexpectedly low level), but the upward trend in imports does seem to have resumed. All in all, therefore, there is no reason so far to revise the view of modest growth in the next year or so.

Contributions to the change in GDP in this and earlier recoveries

Percentages at 1975 prices; *seasonally adjusted*
Changes expressed at an annual rate in italics

	1972 H1–1973 H1	1975 H2–1979 average	1981 Q2/Q3–1983 Q1(a)
Consumer spending	+ 4.5	+ 8.2	+2¼
Government consumption	+ 1.3	+ 0.9	+ ¾
Fixed investment	+ 1.9	+ 0.6	+1¼
Domestic final spending	+ 7.7	+ 9.7	+4¼
	+ 7.7	*+ 2.5*	*+2½*
Exports (goods and services)	+ 2.5	+ 5.9	+ ¾
Total final spending	+10.2	+15.6	+4¾
Change in stocks	+ 3.4	+ 2.9	+2½
Indirect taxes *less* subsidies	− 0.8	− 2.0	− ¾
Total (at factor cost)	**+12.8**	**+16.5**	**+6½**
	+12.8	*+ 4.1*	*+4*
Met by:			
Imports	+ 3.7	+ 6.6	+1¾
GDP (expenditure measure at factor cost)	+ 9.1	+10.0	+4¾
	+ 9.1	*+ 2.6*	*+2¾*
Memo items:			
GDP (output measure)	+ 7.5	+11.0	+2
RPDI	+ 7.4	+14.1	—
Change in saving ratio (percentage points)	+ 0.8	+ 1.6	−2¼

(a) Estimates.

The recovery compared with earlier cycles

As in earlier periods of recovery in the early and mid-1970s, much of the revival in spending so far is accounted for by consumer spending and the change in stockbuilding behaviour. In the earlier cycles, however, rising consumer spending was associated with growing real personal disposable income—the present recovery is unusual in that RPDI has not risen (though changes in its composition may have raised the propensity to consume). Growth of government current spending on goods and services and fixed investment has been less important. On each occasion higher imports have satisfied a substantial part of the extra spending.

Another difference between this and previous recoveries lies in the behaviour of exports. In the first two cycles of the 1970s, growth of exports provided a significant stimulus. In the latest period, however, exports have been subdued because of the world recession and delayed effects of the substantial loss of competitiveness in 1978–80. (External trade is discussed in the next section.)

The background to the present upswing presents several other features, in addition to the initial depth of the recession, the state of the world economy and the relative weakness of UK cost competitiveness. Inflation has fallen to its lowest rate since the late 1960s; fiscal changes have reduced the PSBR in relation to GDP; and productivity in industry has improved more sharply than would have been expected from experience. The very depth of the recession and the constraint on pricing behaviour nevertheless caused profitability to fall to an unprecedented level, from which it has only partially recovered.

Financial developments in the recovery so far

The rapid reduction in stocks in the latter part of 1982 was reflected in a marked fall in the growth of bank lending to industrial and commercial companies.(1) This declined from £4¾ billion in the first half of 1982 to £2¾ billion in the second half. In the first quarter of this year, companies actually repaid debt to the banks, despite ending the rundown in stocks; to some extent the sharp increase in the PSBR probably helped their financial position. New stock market issues by public companies doubled in 1981 but then fell back until earlier this year, when they recovered. (As the chart on page 205 shows, however, the capital market has satisfied only a small part of companies' needs in recent years.) The link between changes in companies' spending and bank borrowing is therefore not always easy to trace. In the coming months, growing confidence may encourage companies to finance spending by drawing down liquid assets rather than borrowing more, and higher profits (and further capital issues) should provide part of the finance. Nevertheless, any rebuilding of stocks or increase in fixed investment seems likely to increase bank lending to some extent.

Personal borrowing from the banks has also tended to rise more slowly: new mortgage lending is likely to continue well below its 1982 rate since the banks have acted to contain the growth in their mortgage loans. Lending by building societies is currently at a high rate, and indeed has imposed considerable strain on their liquidity position.

Recent trade developments in perspective

The United Kingdom showed a total surplus on current account of some £10 billion in 1981 and 1982, and continued in surplus, although at a much diminished rate, in the first quarter of this year.(2) In addition, valuation changes added a further substantial sum to the value of the country's net external assets, which accordingly doubled from £18 billion to £37 billion over the two years (see the article on page 240).

Balance of payments flows in recent years have contained some significant developments. The change in trade in manufactured goods is very striking. Since 1976, the volume of imports of manufactured goods has risen by 80%, whereas the volume of exports has not changed. There has been a sharp fall in domestic production of manufactures.

Because the prices of UK manufactured goods have risen more than those of other countries on average, the decline in the share of total demand met by UK-produced goods would be less if the calculation were made at current prices. Nevertheless, there is still a loss of market share—and the relatively higher price of UK goods is a factor in competitiveness influencing future trade flows. The size of the change in relative prices is indicated by the

UK trade

	1976	1981	1982(a)		1983(a)
	Year	Year	H1	H2	Q1
					£ billions
Balance of trade in oil	−3.9	+3.1	+3.1	+6.1	+7.1
Non-oil trade balance	—	−0.2	−2.4	−2.4	−8.0
Current account	**−0.9**	**+6.0**	**+2.6**	**+5.5**	**+1.8**
			Index numbers (1975 = 100)		
Volume of non-oil exports(b)	109	118	121	117	118
of which, manufactures	*109*	*112*	*115*	*110*	*109*
Volume of non-oil imports(b)	109	140	153	149	160
of which, manufactures	*110*	*160*	*179*	*177*	*192*
Non-oil terms of trade	100	115	115	115	112
Ratio of export to import prices of finished manufactures	*96*	*120*	*118*	*116*	*113*

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

(1) Another factor was that lending had been inflated early in 1982 by payment of taxes delayed by the civil service dispute of the previous year. By April, recovery of delayed taxes was largely complete (see page 256) so growth in lending thereafter is likely to have been reduced for this reason.

(2) A surplus on current account (ie an overseas sector financial deficit) is, by definition, the financial surplus of all domestic sectors taken together. If sectoral positions are adjusted for the effect of inflation on the real value of net monetary assets (see box on page 169), the United Kingdom's financial surplus in the last two years was even larger.

rise of 15%–20% in the price of UK exported manufactures in relation to the price of manufactured goods in world trade generally since 1976, and also by the United Kingdom's own terms of trade in finished goods, which have improved by 18% over the period.

Trade in goods other than manufactures has improved more than enough to offset the deterioration. In particular, trade in oil, where the United Kingdom had a deficit of nearly £4 billion in 1976, showed a surplus of £7 billion (at an annual rate) in the first quarter of this year. When new investment in the North Sea was at a peak in 1976–77, North Sea activities were directly associated with growing imports of manufactured goods, because the import content of investment in the oil fields was high. Now that North Sea investment has fallen to around two-thirds of the peak, and domestic suppliers have more capacity, that effect has diminished, and a more powerful effect of North Sea developments on trade in manufactures is exerted by the exchange rate.

Influences on the exchange rate cannot be isolated with confidence, but there is every sign that oil market developments have had a strong effect, raising the rate sharply in 1979–80 and subsequently leading to some weakening, especially between last November and March. The earlier rise in the rate reflected the growing importance of domestic oil and gas production in the unsettled conditions of the world oil market in recent years. These and other factors, in the event only partly offset by the effect of abolition of exchange control in 1979, almost certainly contributed to the rise in the exchange rate and the loss of competitiveness seen during 1979 and 1980. In general, private investment abroad or the repayment of overseas debt is a productive way of benefitting from the oil and (through its likely effects on the exchange rate, competitiveness and profitability) is potentially complementary to domestic investment.

Volume of trade (other than in fuel and manufactured goods)

1975 = 100

	1976	1981	1982(a)		1983(a)
	Year	Year	H1	H2	Q1
Food, drink, tobacco					
Exports	103	137	139	142	158
Imports	102	97	105	98	102
Basic materials					
Exports	121	155	148	151	173
Imports	123	111	113	106	117
Services					
Exports	106	99	99	94	98
Imports	99	111	111	112	104

(a) Seasonally adjusted.

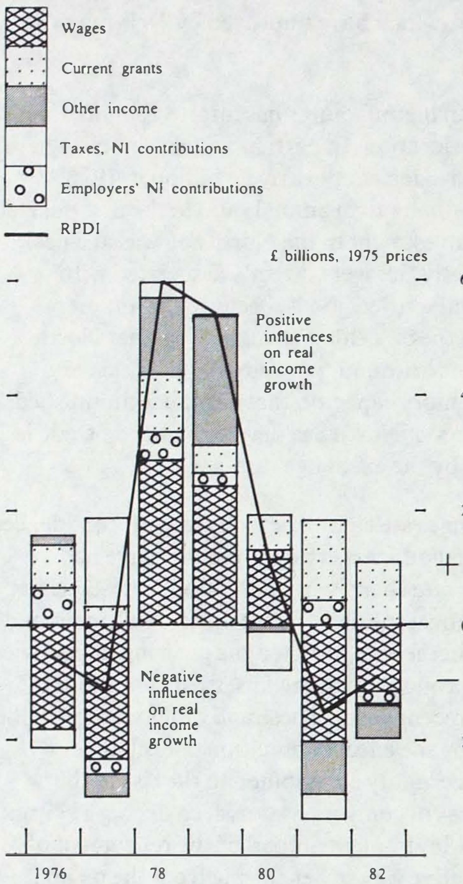
Broadly speaking, trade in foodstuffs and raw materials has tended to improve in recent years, partly perhaps because of structural changes (for example, the effect of the common agricultural policy on food production and demand). This has not been true recently of trade in services, some components of which (notably tourism and shipping) have deteriorated; costs in the United Kingdom have risen relative to those abroad, and (in the case of shipping) world recession and changes in the structure of the world shipping industry have played a part.

The United Kingdom went into recession before most other industrial countries, and activity was more deeply depressed, which must have reduced imports by more than exports. But domestic spending has been growing in the last two years or so, whereas until recently it has been slack or declining elsewhere. In such a deep recession, following considerable changes in relative costs and prices which must have pervasive effects on activity, cyclical effects cannot be isolated with any confidence; nevertheless, recession in the United Kingdom and abroad must have enlarged the UK trade surplus since 1980, though probably with diminishing force since the latter part of 1981.

Changes in income shares

Slower growth of income from employment has already been noted, in the context of the decline in inflation since 1980. Profits, by contrast, fell steeply to 1981 but have risen since.

Real personal disposable income *has contracted in the last two years—mainly through fewer jobs.*



Pay, productivity, income shares and profitability in manufacturing industry

	Average earnings	Productivity	Unit wage and salary costs	Share of employment income in value added	Real profit-ability
	Percentage changes, annual rate				Per cent
1971–73	+12.3	+5.8	+ 6.4	72.7	7.9
1974–76	+19.8	+1.3	+19.4	79.9	3.9
1977–79	+13.4	+1.2	+11.9	74.8	5.9
1980	+17.9	−1.4	+22.6	79.2	3.4
1981	+13.2	+5.2	+ 8.9	81.3	2.2
1982	+11.1	+4.3	+ 5.3	..	3.3
1983 Q1(a)	+ 8½	+ 5	+ 3½	..	..

.. not available.
(a) Increase on 1982 Q1; partly estimated.

The total wage bill (the hatched area of the chart) rose in real terms in 1978–80 but declined in 1981 and 1982. In the first quarter of this year it was probably again slightly lower than a year earlier. The fall since 1980 is wholly accounted for by the reduction in the number of jobs: real average wages and salaries have risen almost continuously, and quite quickly since the middle of last year. By the first quarter of this year real wages were perhaps 9% higher than in early 1980, and 17% above the earlier low point in 1977. From the point of view of the wage earner it may be more relevant to look at average earnings divided by the tax and price index; this measure suggests a fall in real post-tax pay in 1981 but a rise since last summer.

As a consequence of higher unemployment, current grants paid by the Government have increased substantially in real terms as more people have become entitled to claim; nevertheless, real personal disposable income has declined in the last two years after rapid growth in 1978–79 (although the low point may have been passed). Taxes and employees' national insurance contributions made a negative contribution to changes in RPDI in 1980–82.

Profits earned from North Sea operations have helped sustain profits of industrial and commercial companies as a whole. Even so, profits (net of stock appreciation) fell in real terms in 1980 and 1981; omitting North Sea operations, they fell very steeply as the economy moved into recession, real profitability falling below 3 per cent.[1] Real profits and profitability have recovered somewhat since but remain low.

The changes in factor shares have been especially marked in manufacturing industry, where, as in the economy as a whole, real average earnings have grown almost without interruption since 1977. Until 1980 or early 1981, the cost of labour and of bought-in supplies was increasing in relation to selling prices; this pressure on profit margins, coinciding with falling output, caused profits to decline. More recently, however, despite the continued growth of real earnings, productivity gains and, to a lesser extent, cuts in the national insurance surcharge have significantly reduced the real cost of employing labour. Employment income took over 81 per cent of total income generated in the manufacturing sector in 1981; though later figures are not yet available, they will probably show a fall, reflecting the improvement in real profitability in the sector in 1982. This gain in profitability is unusual in that it occurred without any increase in manufacturing production.

Private income, spending and financial transactions in recession and recovery

The March *Bulletin* noted the strength of consumer spending in the second half of last year, despite a decline in RPDI from the peak in 1980. Figures in the box on page 169 support the view put forward then, namely that declining inflation was reducing the amount of saving which people needed to make in order to maintain the real value of their monetary wealth. The sharp decline in the personal sector's financial surplus in nominal terms since 1980 is in that sense illusory—adjusted for inflation, the financial surplus remained high last year. The fall to the end of last year in the saving ratio as conventionally defined (without allowance for the effect of inflation on the real value of financial wealth) is therefore not surprising.

(1) 'Real profits' are profits in nominal terms scaled by dividing them by the GDP deflator. The calculation of 'real profitability' is explained on page 232; it attempts to allow for the effect of inflation on the appropriate deduction for capital consumption and also on the replacement value of trading assets.

Inflation-adjusted saving

Inflation affects the real value of those financial assets and liabilities which are fixed in money terms (described as 'monetary assets' and 'monetary liabilities'). This note presents updated estimates of this effect for different sectors.

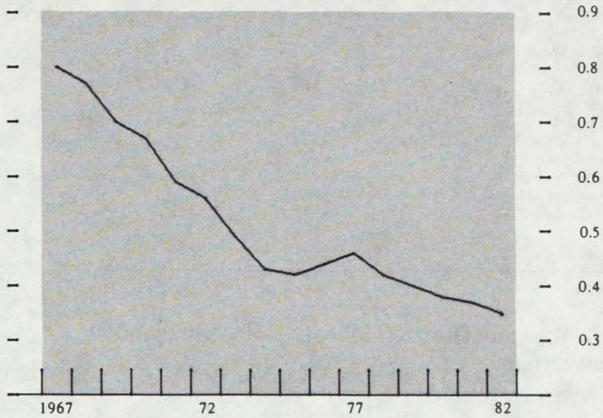
Mid-year estimates of net 'monetary assets/liabilities', in sterling and foreign currency, are calculated for each sector. The notional inflation loss/gain on these assets/liabilities—that is the fall in the real value of the assets or liabilities due to inflation—for each sector is the sum of:

- The notional loss/gain on *sterling assets/liabilities* —calculated by applying the change in the consumers' expenditure deflator to the stock of monetary assets/liabilities denominated in sterling.
- The notional loss/gain on *foreign currency assets/liabilities*—calculated by applying the change in the consumers' expenditure deflator to monetary assets/liabilities denominated in foreign currency and adjusting for any change in sterling's effective exchange rate.

Figures for the years 1971–79 are presented as three-yearly averages, with subsequent years shown individually. It can be seen that *average* notional losses/gains in the latest period, 1980–82, are little changed from the previous six years. This reflects the fact that, although sectoral assets/liabilities have continued to grow in nominal terms, the rate of inflation has fallen, from an average of 19% per annum in 1974–76 to about 10% per annum. The foreign currency deflator, after rising sharply in 1977–80, has also increased more slowly (or fallen) in the latest two years.

Of particular interest is the public sector, where there is a decline in the notional gain since 1980. As well as lower inflation, a small decline in net monetary liabilities last year—arising from funding by index-linked national savings and gilts (which are not counted as monetary liabilities) and an increase in monetary assets in the form of commercial bills held by the Issue Department of the Bank of England—has contributed to the outcome. Nevertheless, the inflation gain to the public sector remains large and has exceeded the nominal PSBR (average £9.4 billion) over the latest three years. In real terms, the public sector continues to repay debt; as the chart shows, this is reflected in a continued decline in the public sector debt/GDP ratio.

Market value of public sector net monetary liabilities as a proportion of GDP[(a)]



(a) Expenditure estimate of GDP at market prices.

There is also a decline in the inflation loss of the personal sector (which includes life assurance and pension funds) since 1980: the reduction in inflation has more than offset the increase in nominal net monetary assets. The average notional gain to the company sector (comprising industrial and commercial companies, banks and other financial institutions, but excluding life assurance and pension funds) has increased in the latest three years, because of a large increase in net monetary liabilities, in part taking the form of commercial bills held by the Issue Department of the Bank of England. Fluctuations in the foreign currency deflator complicate the link between net monetary assets of the overseas sector and notional losses. The average loss during 1980–82 was lower than in the previous period and corresponds to lower average deflators for both sterling and foreign currency assets; but the inconsistency between the sectoral estimates of net monetary assets/liabilities in the latest years raises doubts as to the size of the fall.

Notional loss/gain on real value of net monetary assets/liabilities by sector: 1971–1982[(a)]

£ billions; *percentages in italics*

	1971–1973	1974–1976	1977–1979(b)	1980(b)	1981(b)	1982(b)
Sectoral net monetary assets(+)/liabilities(−) mid-year estimates:						
Personal sector	45.6	59.1	82.9	110.6	124.1	130.1
Company sector	− 9.2	−14.9	−13.6	− 24.0	− 32.6	− 41.2
Public sector(c)	−40.8	−54.1	−78.8	− 95.1	−105.1	−103.4
Total domestic sectors	− 4.4	− 9.9	− 9.4	− 8.5	− 13.6	− 14.5
Overseas sector	4.4	9.9	9.7	8.0	8.8	13.7
Change in consumers' expenditure deflator (Q4 on Q4)	*8.5*	*19.3*	*12.5*	*13.3*	*10.4*	*7.0*
Notional loss on net monetary assets (gain on net monetary liabilities)						
Personal sector	− 3.9	−11.2	−10.7	− 14.3	− 12.4	− 9.1
Company sector	0.7	2.6	2.0	3.9	2.8	2.8
Public sector	3.4	9.6	10.2	12.2	11.0	7.3
Total domestic sectors	0.3	0.9	1.5	1.7	1.4	1.0
Overseas sector	− 0.3	− 0.9	− 1.5	− 1.5	− 0.3	− 0.9
Memo item: *Deflator for foreign currency assets (Q4 on Q4)*	*2.6*	*7.8*	*16.5*	*25.0*	*− 1.3*	*6.3*

(a) Estimates were last presented in the June 1982 *Bulletin*, page 241. The methodology was set out in the Bank's *Discussion Paper No 6*, 'Real' national saving and its sectoral composition, by C T Taylor and A R Threadgold, and summarised in the June 1980 *Bulletin*, page 196.

(b) Bank estimates. The sectoral estimates of net monetary assets are not wholly consistent.

(c) From December 1978, gold in the official reserves is valued taking account of market prices, and is treated as a non-monetary asset.

Personal sector financial transactions

£ billions

	Acquisition of financial assets	Borrowing	Financial surplus (+)/ deficit (–)	
			Nominal terms	Inflation adjusted(a)
1971–73(b)	6.7	4.0	1.6	–2.3
1974–76(b)	10.4	3.6	5.3	–5.9
1977–79(b)	18.5	8.4	9.2	–1.4
1980	27.5	11.0	18.5	+4.2
1981	29.7	14.6	16.9	+4.5
1982	28.9	19.5	13.0	+3.9

(a) See the box on page 169. The coverage of the inflation adjustment does not coincide exactly with the personal sector.

(b) Annual averages.

Industrial and commercial companies' financial transactions

£ billions

	Acquisition of financial assets	Borrowing	Financial surplus(+)/ deficit(–)	
			Nominal terms	Inflation adjusted(a)
1971–73(b)	1.8	3.4	+0.7	+1.4
1974–76(b)	1.3	2.2	–1.0	+1.6
1977–79(b)	1.6	3.4	–0.1	+1.9
1980	4.2	10.7	–1.4	+2.5
1981	5.7	10.6	+2.0	+4.8
1982	1.6	10.2	+0.7	+3.5

(a) See the box on page 169. The coverage of the inflation adjustment does not coincide exactly with industrial and commercial companies.

(b) Annual averages.

A feature of the decline in the saving ratio has been a sharp increase in personal borrowing alongside continued acquisition of financial assets. The strength of borrowing and financial investment cannot easily be explained in terms of past behaviour. It probably owes something to growing competition for personal business within the financial system, on both the lending and borrowing sides.

Like the personal sector, industrial and commercial companies have borrowed at a very high rate in recent years, with no clear sign of a fall in new borrowing until late 1982. Companies have also acquired substantial amounts of liquid assets at times—indeed, their capital gearing (the ratio of net debt to trading assets) has tended to fall (see the note on page 232), and in the first quarter of this year the liquidity position of 200 large companies sampled by the Department of Industry was stronger than for most of the previous four years.

Because their monetary liabilities exceed their monetary assets, inflation adjustment has a modestly favourable effect on companies' financial position—turning it from rough balance on average in nominal terms to moderate surplus. Since 1980, companies have made strenuous efforts to reduce stocks and to control capital spending. Financial considerations have undoubtedly been a stimulus, though it is difficult to say how much they have counted. Fixed investment at least has nevertheless remained somewhat higher than would have been expected from past relationships with output and from the rate of return on existing assets.