

## Economic commentary

Topics discussed in this commentary include:

- rapid recovery in the United States;
- rising commodity prices, but little effect as yet on UK import costs and domestic prices;
- recovery of the UK economy—moderate growth in output but domestic demand, particularly consumers' expenditure, has been growing more rapidly;
- the course of public sector finances;
- the substantial growth of personal borrowing in the United Kingdom in recent years, much of it on mortgages, sustaining consumer spending in the absence of growth in real personal incomes;
- some improvement in company profitability, and the behaviour of corporate borrowing.

### The world economy: recovery starts in the major countries.

After several false starts, there is now firmer evidence of some recovery in the world economy, especially in North America. In this regard there seems to have been an improvement in the outlook since the June *Bulletin*.

In the first quarter of 1983, GNP rose in six out of the seven major countries. This was the most widespread increase recorded for over three years; but its pace was less impressive, averaging only  $\frac{1}{2}\%$ , with scarcely any increase in output in Japan or Italy, and none at all in France. In West Germany and the United States, confidence recovered sharply, and output recovered the ground lost in the last quarter of 1982. (Developments in the United Kingdom are discussed on page 330.)

Since then, there have been further signs of recovery abroad, a little faster than was expected earlier this year. The evidence for this is most compelling in the United States, where GNP rose by over 2% in the second quarter, mainly because of a slower rate of destocking and a strong increase in consumer spending. The latter reflected both further increases in real personal income and a continued decline in the household saving ratio, which in June reached its lowest level for at least twenty years. Meanwhile, the US trade balance has deteriorated, partly because domestic demand has been buoyant, but also because competitiveness has worsened. Nevertheless, industrial production expanded by over 4% in the second quarter.

Preliminary estimates point to GNP growth in the United States continuing at a rapid pace in the third quarter. Many commentators now expect an increase in output of at least  $5\frac{1}{2}\%$  between the fourth quarters of 1982 and 1983. The pace of the recovery in its early stages put upward pressure on interest rates, already reflecting market concerns about recent monetary growth and the size of prospective budget deficits; but interest rates have fallen back in recent weeks.

### GDP<sup>(a)</sup> in the major economies

Percentage change from previous period at an annual rate; volumes

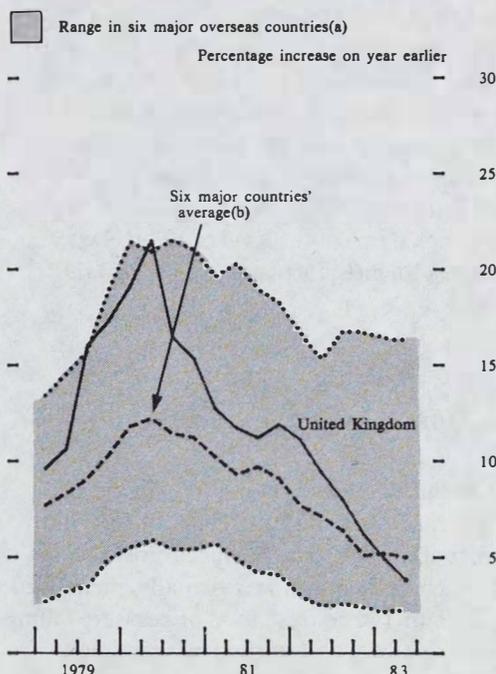
|                   | 1980       | 1981       | 1982        | 1983        |             |            |
|-------------------|------------|------------|-------------|-------------|-------------|------------|
|                   | Year       | Year       | Year        | H1(b)       | H2(b)       | H1(b)      |
| Canada            | 1.0        | 3.4        | -4.4        | -6.6        | -3.7        | 4.7        |
| France            | 1.0        | 0.3        | 1.9         | 1.8         | 1.2         | 0.7        |
| Italy             | 3.9        | 0.1        | -0.3        | 2.8         | -6.0        | -0.3       |
| Japan             | 4.8        | 3.8        | 2.9         | 2.5         | 4.3         | 1.7        |
| United States     | -0.3       | 2.6        | -1.9        | -3.8        | -0.6        | 3.3        |
| West Germany      | 1.8        | -0.2       | -1.1        | -1.8        | -1.8        | 1.6        |
| <b>Total</b>      | <b>1.3</b> | <b>2.2</b> | <b>-0.6</b> | <b>-1.6</b> | <b>-0.1</b> | <b>2.4</b> |
| United Kingdom(c) | -2.6       | -1.6       | 1.8         | 1.1         | 1.9         | 4.5        |

(a) GNP in some countries.

(b) Half year figures are seasonally adjusted. Figures for 1983 H1 are partly forecasts.

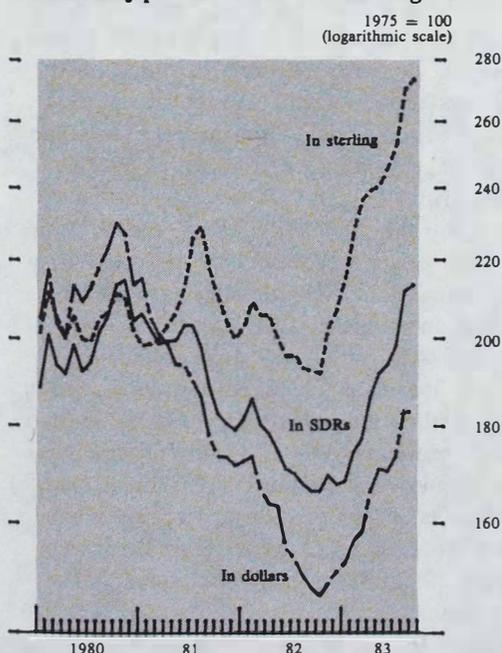
(c) Average estimate of GDP.

**Consumer price increases in the United Kingdom fell below the average in major countries in the second quarter.**



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

**Commodity prices<sup>(a)</sup> continue to strengthen.**



(a) The Economist all items index.

There were also signs of continuing growth in the second quarter in the other major countries. In Canada, GNP rose by nearly 2%, after a similar increase in the first quarter, and output rose by almost 1% in Japan. In Europe the picture was rather more mixed. GNP fell in Italy and probably rose only slightly in France, but in West Germany output recovered more strongly.

In the major countries taken together, the growth seen so far has been based mainly on movements in stocks, residential investment and consumer spending. Nonetheless, the outlook for activity and employment will depend in large part on a revival of corporate spending on fixed capital. With capacity utilisation and profitability low in many economies, the prospects at present are for only a modest pick-up in business investment towards the end of the year.

Inflation has come down further in most industrial countries—this may have helped to reduce recorded saving ratios in a number of them. By July, the average year-on-year inflation rate in the major economies was running at 4½%, having been 10% as recently as 1981; lower dollar oil prices have helped (though the full benefits have been lessened by the continuing strength of the dollar). In the last year, inflation has fallen substantially in all major industrial countries other than Japan (where it was already down to 2½%) and Italy, where prices were still rising at an annual rate close to 15%. In recent months, earnings have grown only moderately in most major countries, suggesting that the short-term outlook for domestic costs remains good.

Non-oil commodity prices, by contrast, have strengthened further. By mid-September the Economist index had risen 27% in SDR terms (and by slightly less in dollars) from the low point reached last October. This represents a 10% increase from the levels reported in the last *Bulletin*.<sup>(1)</sup> The hot dry summer in the United States has seriously damaged cereal and soyabean crops, raising prices very sharply in July and August. With acreage under the US payment in kind (PIK) programme already being reduced, world supplies of both maize and oil seeds are likely to be tight throughout the 1983–84 season. By contrast, the pace of recovery in industrial material prices has eased somewhat in recent months. Spare capacity remains a constraint on prices—some plant has already reopened in response to higher prices—yet for some products such as aluminium, cautious supply responses are now leading to temporary shortages. Spare capacity for many industrial materials, and the relaxation of the PIK programme in the United States in 1984, may ultimately limit the pace of the recovery in raw material prices in the coming months. Nevertheless, the rises in prices which have already occurred may eventually affect inflation in the industrial countries. (So far there has been little or no effect on prices in the United Kingdom—see page 329.)

Recovery in the world economy should ease the position of several of the major debtor countries. At the same time, however, interest payments remain a burden, increased by the renewed appreciation of the dollar. Despite strenuous efforts to cut imports, several debtor countries remain in severe difficulties.

The developing countries are clearly now in a worse position than after the recession of 1974–75. Their terms of trade worsened in the

(1) There was an extended discussion of commodity prices in the June *Bulletin*, page 160.

### The impact of recession on developed and developing countries

Percentage changes; 1975 prices

|                                     | Recession  | Recovery   | Recession |      |      |
|-------------------------------------|------------|------------|-----------|------|------|
|                                     | 1973-75(a) | 1975-79(a) | 1980      | 1981 | 1982 |
| <b>OECD</b>                         |            |            |           |      |      |
| GDP in major seven(b)               | —          | 4.1        | 1.1       | 1.8  | -0.4 |
| GDP in other OECD countries         | 2.0        | 2.7        | 2.0       | 0.7  | 0.4  |
| Total GDP                           | 0.3        | 3.9        | 1.2       | 1.6  | -0.2 |
| <b>Non-oil developing countries</b> |            |            |           |      |      |
| GDP                                 | 4.8        | 5.5        | 4.8       | 2.4  | 0.9  |
| Imports                             | 0.2        | 6.7        | 7.0       | 5.9  | -7.6 |
| Terms of trade                      | -7.3       | 1.6        | -5.4      | -4.3 | -4.3 |

(a) Annual averages.

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

### Cost inflation

Percentage changes

|  | Weights in total final expenditure in 1982 | 1980 | 1981 | 1982 | 1983  |
|--|--|------|------|------|-------|
|  |  | Year | Year | Year | H1(a) |
| <b>Domestic factor costs per unit of GDP</b> |  |      |      |      |       |
| Income from employment                       | 45½  | +22½ | +10  | +5   | +4    |
| Profits etc(b)                               | 11½  | +14½ | +12½ | +16  | +28½  |
| Other income(c)                              | 11½  | +18½ | +11½ | +7½  | +7    |
| <b>GDP deflator</b>                          |  | +19  | +10  | +6½  | +6    |
| Taxes on spending less subsidies(d)          | 12   | +24½ | +20½ | +13½ | +3½   |
| Import costs(e)                              | 19½  | +10  | +7½  | +9½  | +9    |
| <b>TFE deflator</b>                          |  | +17½ | +11  | +7   | +6    |

(a) Increases from 1982 H1. Partly estimated.

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

(c) Income from rent and self-employment.

(d) The factor cost adjustment at current prices divided by the same at 1980 prices.

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

mid-1970s but imports, though sharply curtailed, continued to grow. The current account deficits which followed were mainly financed by higher bank borrowing. Domestic growth was unimpaired: output increased at a rate no lower than that recorded by these countries in the 1960s, whereas it fell sharply (from about 5½% a year) in industrial countries.

The second (1979-80) rise in oil prices and subsequent recession caught many developing countries with a large amount of outstanding debt. As demand for their exports weakened, their terms of trade worsened, as they had in 1974-75. Moreover, interest rates became strongly positive in real terms, while the dollar (in which most developing country debt is denominated) rose by nearly 40% in effective terms in the three years from mid-1980. The developing countries have now been forced to cut imports. The growth of their economies has fallen sharply. This year GDP may grow by little more than 1%, taking output per head in these economies back down to the level of 1979. Next year the position may improve, with most forecasts projecting GDP growth of around 3%-4%.

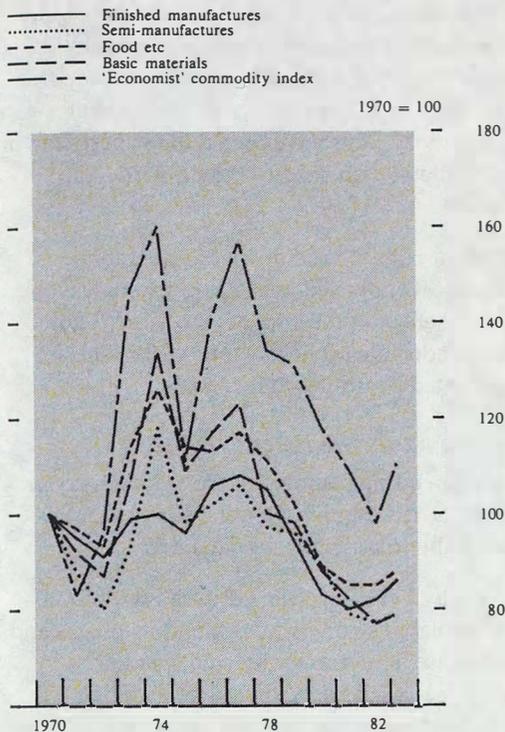
### UK inflation: some rise, but underlying cost developments in the United Kingdom continue favourable.

Inflation, as measured by the increase in retail prices in the latest year, reached a low point of 3.7% in May and June. In July and August, this measure rose above 4%. The prospects are for some further rise in the rate: whereas the index was virtually unchanged last summer and early autumn (when fresh food prices were falling, mortgage rates were coming down, and sterling was tending to rise), modest monthly increases are likely to continue and will raise the twelve-month comparison.

The GDP deflator (the measure of domestic factor cost) has recently been rising somewhat faster than the RPI, at an annual rate of about 5%, but could slow down further rather than accelerate. The main component is labour cost per unit of output, which in turn comprises the increase in average earnings, the change in productivity, and any change in taxes on labour. The rise in earnings continues to come down—the increase was some 7% during the 1982-83 wage round, compared with over 9% during the previous round and 20% in 1979-80. Earnings in manufacturing industry (up about 8½% in the past year) grew rather faster than the average in the economy, but productivity will also have grown faster in manufacturing industry—by perhaps 5½% in the year to the second quarter, when it was 15% above the recent low in late 1980. Altogether, unit wage costs in manufacturing have been broadly stable in recent months, and in mid-year were only 2% higher than a year earlier. The growth in labour costs in the whole economy (after allowance for changes in employers' national insurance contributions and in the surcharge) will have been somewhat faster than this. Profit margins, which were very narrow two years or so ago, have widened: on present estimates profits per unit of output, the main component of the GDP deflator apart from labour costs, rose by over 25% between the first halves of 1982 and 1983. (Estimates of profits are particularly uncertain and susceptible to revision.)

Since imports satisfy about 30% of final domestic spending, their cost is an important influence on domestic prices. In the first half

### Import prices are still rather low in relation to domestic costs<sup>(a)</sup>



(a) Unit values of non-oil imports, and the Economist commodity price index, divided by the GDP deflator. 1983 is the average for the first half.

of the 1970s, import prices of finished manufactures stayed within a 5% margin around the GDP deflator. They rose faster than domestic costs when sterling was weak in 1976-77, but fell substantially relative to domestic costs over the next four years, recovering only part of the ground since 1981.<sup>(1)</sup> The relationship between the GDP deflator and the prices of other categories of imports (food, basic materials and semi-manufactured goods—which often have a large primary commodity content) is influenced by the exchange rate but also by prices for primary products and manufactured goods in world markets. Prices of all these categories of imports have been very low in relation to domestic costs in recent years, because sterling has been generally firm and world commodity prices weak (last year they were at their lowest in real terms for over thirty years). In recent months, many commodity prices have risen sharply, but there is little sign so far that UK import prices have been affected.<sup>(2)</sup> Indeed, producer buying prices—the prices which manufacturers pay for fuel and raw materials—rose by barely 1% in the first eight months of this year.

Higher import costs could put some upward pressure on inflation. The outlook for domestic costs, however, remains favourable. The implementation of new pay settlements at lower levels than a year ago is still putting downward pressure on the annual increase in average earnings. The Government have announced a 3% provision for pay increases in cash-limited parts of the public services in 1984/85. No pattern for settlements has, however, yet been established in the new pay round. A substantial part of higher earnings is likely to be matched by productivity gains. Profit margins may recover further, but profits have only a small share in factor incomes and any effect on prices is unlikely to be large.

### Output: growing modestly, and a somewhat better tone in the labour market, though productivity continues to rise.

The output measure of GDP was little changed in the second quarter, at 3½% above the low point two years earlier. Manufacturing production fell back slightly, having grown quite strongly in the first quarter; it revived in July, and CBI surveys suggest that it will continue to rise in the coming months. (The expenditure measure of GDP, discussed in the next section, fell by 1¾% in the second quarter, but had earlier grown quite quickly.)

The number of people with jobs had continued to decline, but more slowly than before. The latest surveys of the number of people in work (relating to 1981) show an increase in the number of self-employed since 1979 and also indicate, especially for service industries, that quarterly estimates of the number of employees had been too low. The Department of Employment allow for continuing underestimation in their published quarterly statistics. Employment in service industries declined during the course of the latest recession, before rising slightly in the first quarter of this year; by contrast it grew in the mid-1970s recession. Employment in manufacturing industry fell further in the first half of this year, by 120,000, a rate of about 4½% a year. With average hours worked little changed, and manufacturing output rising at an annual rate of

### Employment and unemployment<sup>(a)</sup>

Thousands, seasonally adjusted

|                                      | 1979   | 1982   |        | 1983   |       |
|--------------------------------------|--------|--------|--------|--------|-------|
|                                      | June   | June   | Dec.   | Mar.   | June  |
| Employees in jobs <sup>(b)</sup>     | 22,570 | 20,740 | 20,480 | 20,450 |       |
| of which:                            |        |        |        |        |       |
| Manufacturing                        | 7,070  | 5,670  | 5,500  | 5,440  | 5,380 |
| Services <sup>(c)</sup>              | 13,210 | 13,040 | 12,960 | 13,020 |       |
| Self-employed <sup>(b)</sup>         | 1,840  | 2,160  | 2,210  | 2,230  |       |
| Employed labour force <sup>(b)</sup> | 24,720 | 23,220 | 23,010 | 23,000 |       |
| Unemployed <sup>(d)</sup>            | 1,180  | 2,670  | 2,840  | 2,920  | 2,990 |

(a) Great Britain.

(b) Including an allowance (made by the Department of Employment) for underestimation in 1982 and 1983.

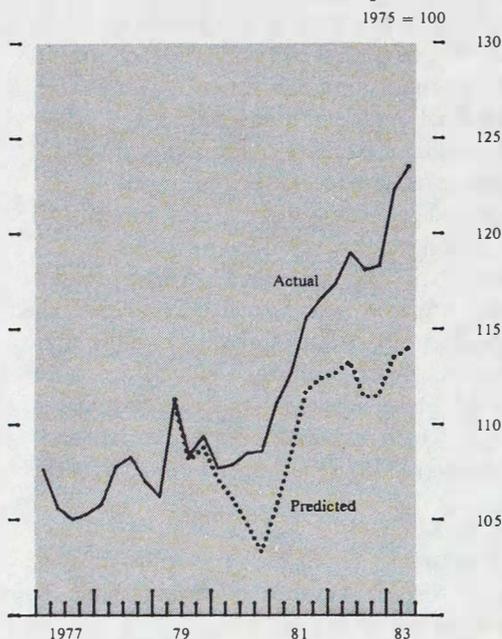
(c) Including public administration (about 1½ million people).

(d) Including an allowance (130,000) for the effect of the budget provision. Figures since October 1982 represent the number of people claiming unemployment benefit, a change which reduces recorded unemployment by 170,000-190,000.

(1) The ratio of prices of imported finished goods to the GDP deflator is one reflection of competitiveness.

(2) In fact the relationship between the Economist index of world commodity prices and UK import prices is rather loose. There are important compositional differences, and the Economist index measures mainly spot market prices whereas many commodities are imported at prices fixed in long-term contracts (though often with escalation clauses) or are covered by the common agricultural policy.

**Productivity<sup>(a)</sup> in manufacturing continues to rise more than would have been expected.**



(a) Output per man-hour. The 'prediction' is based on relationships estimated from data for the period 1963-79 Q2.

3% between the fourth quarter of 1982 and the second quarter of this year, productivity in manufacturing rose rapidly in the first half of 1983. This rate undoubtedly overstates the underlying improvement, since the fourth quarter of last year was a low base for output and productivity. Nevertheless, work in the Bank<sup>(1)</sup> continues to suggest that the gap is widening between recorded productivity and what might have been expected from earlier experience. While productivity gains have been quite widespread in industry, motor vehicles, metal manufacture (mainly iron and steel) and engineering stand out.

Increases in unemployment have slowed down considerably; indeed the number (seasonally adjusted, excluding school leavers, and after allowance for the effect of the budget provision<sup>(2)</sup>) fell slightly in August, the first decline for nearly four years. The number of vacancies reported continues to increase.

**Demand: consumption leads the recent recovery.**

The growth of consumer spending resumed in the second quarter, after a small fall in the first. Although there was a further increase in stocks, it was much smaller than in the first quarter.

Consumer spending grew by 1½% in volume. Purchases of food, clothing and footwear increased strongly, and spending on gas and electricity was heavy because of unseasonably cold weather. Purchases of durable goods, which had grown sharply in the second half of last year, were little changed. Subsequently, in July and August, retail business eased off, but car sales were very strong.

Stocks had increased in the first quarter, a large turn-round after sharp reductions in the previous two quarters which must have contributed to the rise in output and also in imports early in the year. In the second quarter, stocks again rose though on a smaller scale. Manufacturers' stocks of finished goods rose, but wholesalers' stocks fell—a reduction of £130 million in retailers' stocks could perhaps be attributed to unexpected strength of consumer spending. Manufacturers' stocks of materials and fuel fell again, as they have done almost without interruption since late 1979—the cumulative fall amounts to £3 billion at 1980 prices, or nearly one quarter of the initial level, over a period in which manufacturing production has declined by about 15%.

Expenditure has fluctuated sharply in recent quarters—the large rises in recorded expenditure around the turn of the year, and the 1¾% fall in the second quarter, should probably be discounted—and half-year figures may be a better guide to the course of recovery. GDP on the expenditure measure grew by nearly 6% between the first halves of 1981 and 1983, most of the increase occurring in the latter part of the period. Despite the fall in the expenditure measure of GDP in the second quarter (when output was unchanged), recorded expenditure has risen nearly twice as much as output over the two-year period; and output has quickened less in the course of the period. The gap (up to the first quarter of this year) has widened following rebasing and revisions. The average measure of GDP—including the income measure which, like expenditure, has varied considerably in recent quarters—has grown by about 5½% over the two years. The pattern of recorded demand has changed. In the first year, domestic final spending (excluding stockbuilding) grew very little.

**Contributions to the change in GDP**

Percentages; 1980 prices

|  | 1981 H1-<br>1982 H1 | 1982 H1-<br>1983 H1 |
|--|---------------------|---------------------|
| Consumer spending                                    | - ¼                 | + 3                 |
| Government current spending<br>(goods and services)  | + ¼                 | + ¾                 |
| Fixed investment                                     | + ¾                 | + ½                 |
| Domestic final spending                              | + 1                 | + 4½                |
| Stockbuilding  | + 2½                | + ½                 |
| Exports (goods and services)                         | + 1½                | —                   |
| <b>Total final expenditure</b>                       | <b>+ 4¾</b>         | <b>+ 4¾</b>         |
| Imports (increase -)                                 | - 3                 | - ½                 |
| Taxes on spending less<br>subsidies (increase -)     | - ½                 | + ¼                 |
| <b>GDP (expenditure measure,<br/>at factor cost)</b> | <b>+ 1½</b>         | <b>+ 4½</b>         |
| <i>Memo items:</i>                                   |                     |                     |
| GDP (output measure)                                 | + 1½                | + 1¾                |
| GDP (average measure)                                | + 2                 | + 3½                |

(1) Described in a forthcoming Discussion Paper, 'Manufacturing productivity: a sectoral analysis' by Miss G M S Hammond and D J Asteraki. See also the December 1982 *Bulletin*, page 474.

(2) Men aged sixty and over on supplementary benefit now qualify for the long-term rate of benefit without having to sign on.

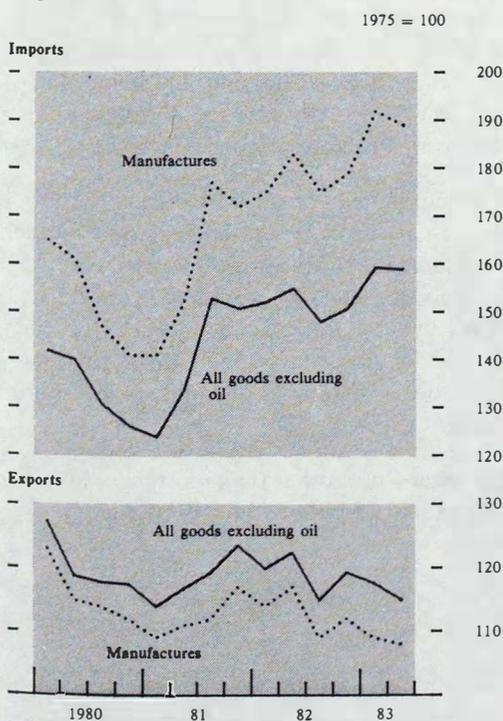
## UK visible trade

|   | 1980                       | 1981 | 1982  |       | 1983  |
|---|----------------------------|------|-------|-------|-------|
|   | Year                       | Year | H1(a) | H2(a) | H1(a) |
|   | £ billions                 |      |       |       |       |
| Balance of trade in oil   | +0.3                       | +3.1 | +3.1  | +6.1  | +6.5  |
| Non-oil trade balance   | +0.9                       | -0.1 | -2.4  | -2.5  | -8.2  |
| Current account   | +3.2                       | +6.5 | +3.5  | +7.4  | +0.9  |
|   | Index numbers (1975 = 100) |      |       |       |       |
| Ratio of volume of non-oil exports to imports(b)                        | 89                         | 84   | 79    | 78    | 73    |
| of which, manufactured goods  | 76                         | 70   | 65    | 62    | 57    |
| Non-oil terms of trade  | 112                        | 115  | 115   | 115   | 112   |
| Ratio of export to import prices (unit values) of finished manufactures | 116                        | 120  | 118   | 117   | 114   |

(a) At an annual rate; seasonally adjusted.

(b) Excluding the usual erratic items.

## Exports appear to be flat or declining; imports have risen.



The behaviour of stocks (a modest rise in early 1982, after sharp reductions the year before) provided a boost, though imports, no doubt partly in consequence, grew rapidly; and exports rose from a low level. The faster recovery in the second half of 1982 and first half of 1983, by contrast, was accompanied by a brisk rise in final domestic spending, in turn dominated by an increase of  $4\frac{1}{4}\%$  in consumer spending. Fixed investment also grew: details are not yet available, but only a small part of the increase was accounted for by the manufacturing, construction, distribution and financial sectors, where fixed investment rose by barely 1% in total; building activity indicates a rise in housing investment over the period.

## The trade position: some deterioration.

The surplus on current account was reduced to under  $\pounds\frac{1}{2}$  billion in the first half of this year, from  $\pounds 3\frac{3}{4}$  billion (revised up from  $\pounds 2\frac{3}{4}$  billion) in the second half of 1982.

Visible trade showed a deficit of  $\pounds 850$  million, after a  $\pounds 1,780$  million surplus in the earlier period. The surplus on trade in oil increased slightly but the deficit on other trade widened to over  $\pounds 4$  billion, with a sharp deterioration in volume and some fall in the terms of trade; within this, trade in manufactured goods moved into deficit. The volume of non-oil imports rose by 7%, in part no doubt reflecting the turn-round in the behaviour of stocks, while exports rose by under 1% between the two half years.

There has been considerable variation in the month-to-month figures, but the trend of exports appears at best flat, whereas overseas markets probably grew in the first half year. Replies to the July and August CBI surveys suggest renewed caution about export prospects. One feature is that nearly a quarter of exporters mention quota or licence restrictions abroad as factors limiting their exports. Imports moved to a higher level earlier this year; the growth was spread between industrial materials, components and consumer goods. The recent worsening of the visible trade balance has occurred despite some improvement in competitiveness.

Trade in services, by contrast, improved in the first half of this year, with the estimated volume of exports up and imports quite sharply lower. Exports of financial and travel services did particularly well; the fall in the volume of imports of services was widely spread. Interest, profits and dividends continued in surplus in the first half of this year, although at a somewhat lower rate than the record surplus in 1982 (see page 350).

The balance of payments as a whole is discussed on page 349.

## Public sector finances: steps taken to prevent a borrowing overrun.

At the time of the Budget, the PSBR in 1983/84 was projected at  $\pounds 8.2$  billion (equivalent to about  $2\frac{3}{4}\%$  of GDP). Within this, the central government was expected to borrow  $\pounds 11.5$  billion, of which  $\pounds 4.2$  billion was for on-lending to local authorities and public corporations.

In the second calendar quarter—the only period for which complete figures are yet available—the PSBR amounted to  $\pounds 3.9$  billion (not seasonally adjusted). In the same period, the central government borrowed  $\pounds 3.7$  billion to cover its own transactions, and a further  $\pounds 2.1$  billion or so for the same purpose

**Public borrowing**

£ billions

|                             | 1982 |     |     | 1983 |     | July-Aug. |
|-----------------------------|------|-----|-----|------|-----|-----------|
|                             | Q2   | Q3  | Q4  | Q1   | Q2  |           |
| CGBR (unadjusted)           | 3.1  | 2.5 | 4.8 | 2.2  | 5.5 | 2.2       |
| of which, on<br>own account | 3.2  | 0.9 | 3.0 | —    | 3.7 | 2.1(a)    |
| PSBR:                       |      |     |     |      |     |           |
| Unadjusted                  | 2.8  | 1.7 | 3.0 | 1.6  | 3.9 | ..        |
| Seasonally<br>adjusted(b)   | 1.1  | 1.6 | 2.5 | 3.9  | 1.8 | ..        |

.. not available.

(a) Calculated by deducting from the CGBR monthly lending by the National Loans Fund.

(b) Constrained to equal unadjusted figures over the financial year.

in July and August.<sup>(1)</sup> At some £5.8 billion, the central government's borrowing (after deduction of NLF loans) in the first five months of this financial year was £1.3 billion more than in the same period of 1982/83.

These figures are not seasonally adjusted. The PSBR and the CGBR (on own-account) normally run at a higher rate early in the financial year than later, and seasonally-adjusted estimates for the second calendar quarter suggest a PSBR of only £1.8 billion, and an own-account CGBR of £1.5 billion—amounts which are not high in relation to the budget projection for the financial year. (The seasonal factors used to derive these estimates are, however, due to be revised shortly.) The best judgement is that public sector borrowing was running ahead of budget estimates in the first few months of the current financial year. The government accordingly announced in July an increase of £½ billion in asset sales and measures to remove a similar amount of spending beyond the planned total, which, when taken together with the introduction of end-year flexibility for central government capital programmes, are expected to reduce public expenditure by over £1 billion in 1983/84. The government's objective for 1984/85 is to contain departmental spending plans within the planning total of £126½ billion set out in the Public Expenditure White Paper earlier this year.

### Personal sector finances: saving ratio falls as strong borrowing continues—especially on mortgages.

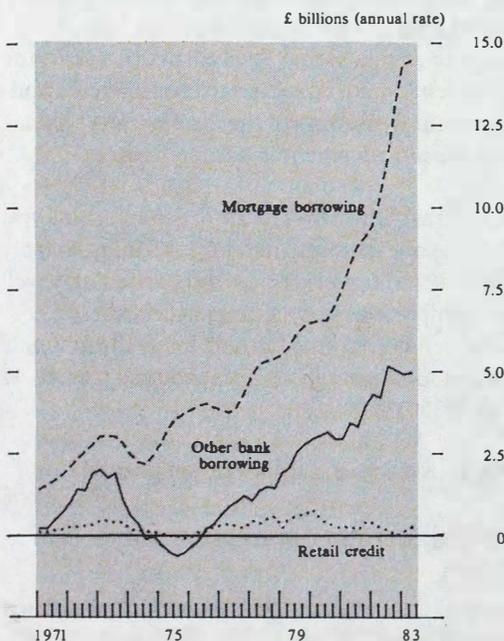
Since last year, consumer spending has been increasing strongly. Real personal disposable income has been flat or slightly down, so that the saving ratio has fallen from some 13% to under 10% (after a peak of 15% in 1980).<sup>(2)</sup>

Much of the decline in the saving ratio may be attributed to slower inflation, for that has reduced the amount which people need to save in order to preserve the real value of their net monetary assets.<sup>(3)</sup> The extent to which lower saving is accompanied by higher borrowing, rather than by lower holdings of (financial or real) assets, will depend on the cost of borrowing, the return on assets, the opportunities available, and tax considerations.

The chart indicates the magnitude of changes in lending to the personal sector (which includes unincorporated businesses). Much the strongest form of personal borrowing lately has been on mortgages—currently at a rate of about £14 billion a year. The amount of mortgage lending outstanding is now about £80 billion, dwarfing other forms of lending to persons. Some three-quarters of it is from building societies, and 15% from banks, whose share has grown sharply in recent years.

Bank lending to the personal sector other than mortgages has risen to an annual rate of about £5 billion. Such borrowing slackened considerably in the mid-1970s recession; indeed bank

### Mortgages have provided most of the personal sector's growing borrowing.

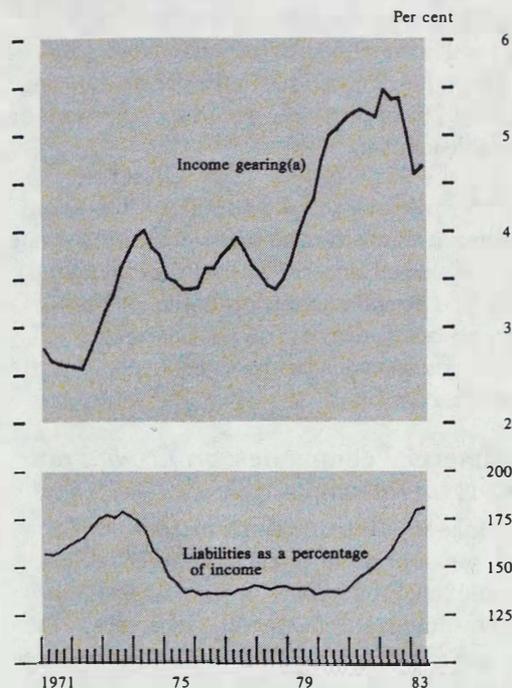


(1) Monthly figures for the CGBR are not split between own-account borrowing and borrowing to finance loans to other parts of the public sector. An approximation to own-account borrowing can be gained, however, by deducting monthly lending by the National Loans Fund from the CGBR.

(2) Personal saving is the difference between personal disposable income and consumer spending. It consists of investment in tangible assets (mainly houses—durable goods are included in consumer spending), the acquisition of financial assets and, as a negative item, borrowing. The saving ratio is saving expressed as a percentage of personal disposable income. Because estimates of income and spending are subject to error and revision, estimates of the difference between them are far from secure and may be substantially revised.

(3) Financial assets, net of liabilities, whose values are fixed in nominal terms. Estimates of the effect of inflation on the real value of net monetary assets were presented in the June *Bulletin*, page 169. See also 'The personal saving ratio' March 1975 *Bulletin*, page 53, and 'The consumption function in macroeconomic models: a comparative study' by E P Davis *Bank of England Discussion Papers—Technical Series, No 1*.

**Personal debt has returned to its early 1970s level in relation to income; interest payments are a heavier burden.**



(a) Personal sector interest payments as a percentage of personal disposable income.

### Additions to the private housing stock<sup>(a)</sup>

Annual averages

|         | Value of net additions to private housing stock<br>£ billions, 1980 prices | Of which, new houses<br>Percentage |
|---------|--|------------------------------------|
| 1966-70 | 3.3  | 100                                |
| 1971-75 | 4.3  | 91                                 |
| 1976-80 | 4.0  | 79                                 |
| 1981    | 4.7  | 60                                 |
| 1982    | 5.9  | 47                                 |
| 1983 H1 | 6.6  | 51                                 |

(a) These figures should be regarded as rough approximations.

### Equity withdrawn from the private housing market<sup>(a)</sup>

Annual averages.

|         | £ billions, 1980 prices | As percentage of net mortgage advances |
|---------|-------------------------|--|
| 1966-70 | 0.5                     | 15                                     |
| 1971-75 | 2.8                     | 39                                     |
| 1976-80 | 3.0                     | 42                                     |
| 1981    | 3.9                     | 45                                     |
| 1982    | 5.6                     | 49                                     |
| 1983 H1 | 5.7                     | 47                                     |

(a) These figures should be regarded as rough approximations.

debt was repaid on balance in 1975 and 1976. A feature of the current economic cycle, however, has been the absence of any fall in this category of lending.

Other forms of personal sector borrowing, mainly from retailers, have not grown in recent years, even in nominal terms, as consumers have turned to cheaper sources of finance.

The ratio of personal sector debt to income is high, at around the peak of the early 1970s. The proportion of personal disposable income spent on interest payments is currently about 5%—almost twice as much as a decade ago, in part because interest rates are higher. The burden of interest payments must have increased more than this comparison suggests: whereas for a time in the early 1970s interest on any loan could be offset against tax, the concession is now limited to interest on mortgages up to £30,000 (£25,000 before this year).

### The use of mortgage finance

In recent years the net flow of mortgage lending has substantially exceeded the value of net additions to the housing stock owned by the personal sector. Further work has been done to improve estimates of the magnitudes suggested in an earlier article;<sup>(1)</sup> the figures are nevertheless still to be regarded as approximations.

Additions to the stock of private housing comprise:

- newly-built private houses;
- sales of council houses (and houses owned by new town corporations etc) to the private sector;
- improvements to the private housing stock, which count as capital spending in the national accounts (as opposed to repairs and maintenance, recorded as current expenditure), less demolitions of private houses.

Among these, new building has become less important while purchases of houses from the public sector and house improvements have grown in importance; together they exceeded the value of new building in 1982.

The difference between the flow of mortgage lending (net of repayments) and the value of additions to the privately-owned housing stock—equity withdrawn—has become very large, perhaps £7 billion at an annual rate in the first half of this year. If the rising amount of mortgage loans is used to finance exchanges of a fixed stock of second-hand private houses, some owners (or their heirs) must be withdrawing equity and spending the proceeds on things other than housing,<sup>(2)</sup> repaying other forms of borrowing or acquiring financial assets. Thus although most borrowers will use their loan to finance their house purchase, the personal sector as a whole must use these very large sums for other purposes.

A steep increase in equity withdrawal appears to have occurred at the beginning of the 1970s. The more recent high rate of equity withdrawal, which has not coincided with a strong rise in house prices, is probably a consequence of the freer availability of mortgages since the banks entered the mortgage market on a large scale. This year there has been some tightening of lending conditions; a small fall in the rate of net mortgage lending in the

(1) See the September 1982 *Bulletin*, page 390.

(2) Not necessarily on consumer goods—some of the flow may finance small businesses.

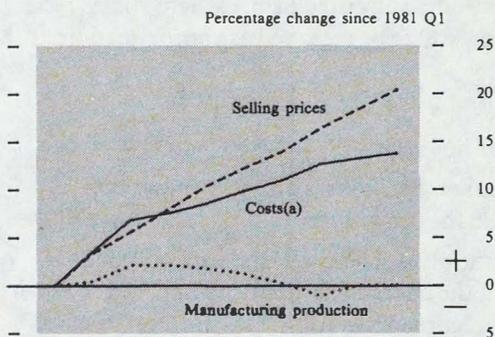
**Personal sector borrowing and acquisition of financial assets**

£ billions; figures at 1980 prices in italics

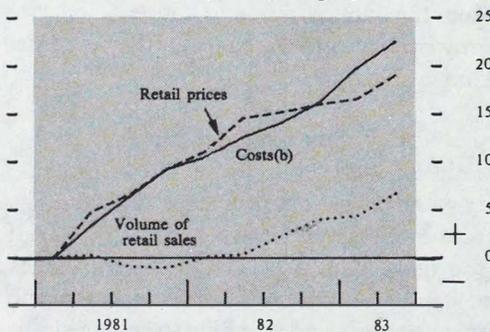
|                                 | 1977-               | 1979-               | 1981                | 1982                | 1983              |
|---------------------------------|---------------------|---------------------|---------------------|---------------------|-------------------|
|                                 | 1978 (a)            | 1980 (a)            | Year                | Year                | Q1 (b)            |
| Borrowing                       | 7.0<br><i>9.6</i>   | 10.9<br><i>11.8</i> | 14.5<br><i>13.1</i> | 19.3<br><i>16.0</i> | 4.9<br><i>3.9</i> |
| Acquisition of financial assets | 14.8<br><i>20.2</i> | 25.6<br><i>27.5</i> | 29.2<br><i>26.3</i> | 29.6<br><i>24.6</i> | 6.1<br><i>4.9</i> |

(a) At an annual rate.  
(b) Not seasonally adjusted.

**Profit margins appear to have improved in manufacturing...**



**... though retailers may be dependent on increased turnover for higher profits.**



(a) A weighted average of unit labour costs and buying prices for fuel and materials.  
(b) A weighted average of import prices, manufacturers' selling prices, and labour and other costs (based on information published by Messrs. Simon and Coates).

first half, together with an estimated increase in the value of new houses completed, has resulted in a decline from last year's level of equity withdrawn as a percentage of mortgage lending.

Some of the equity withdrawn is no doubt spent on consumption. The amount of equity extracted was negligible in relation to consumer spending in the 1960s; in 1975-80, it averaged over 2%; last year it was 4%. Adding in personal sector non-mortgage borrowing suggests a total flow of loans to the personal sector, other than to finance the value of additions to the private housing stock, equivalent to about 7% of consumer spending last year—or 6% of personal disposable income.

Until recently, heavy borrowing by the personal sector has been accompanied by substantial acquisition of financial assets, the rate of which has however levelled off since 1980. Contractual saving (through life assurance and pension funds, under the SAYE schemes etc) has probably continued to grow, but the accumulation of other financial assets has probably been reduced in the last two years or so.

**Industrial and commercial companies: profits, but not yet investment, recovering strongly.**

Companies' profit margins appear to have widened despite continued competitive pressure on domestic and export selling prices. The growth of unit labour costs has fallen sharply (helped by cuts in the national insurance surcharge), and increases in the cost of fuel and materials continue to be modest. The improvement in margins seems to be confined to production industries; in retailing, at least, margins may even have narrowed. Nevertheless, the increase in the volume of sales has probably allowed distributors to share in a general recovery of profits. Real profitability outside the North Sea sector remains low, however, compared with the early 1970s and with other industrial countries.

Although profits in the first half of 1983 were over 25% higher than a year earlier, retained income—the remainder after taxes, interest and dividend payments—had shown no clear rise, up to the first quarter.<sup>(1)</sup> Among the uses of company funds, fixed capital investment has been a steady £15-16 billion a year (at current prices—representing a decline in real terms). The behaviour of stocks has been very uneven—reductions of around £3 billion a year, but with pauses in the first half of 1982 and again earlier this year.

Investment overseas is sometimes believed to reduce companies' ability or incentive to invest in productive capacity at home. Home and overseas investment may indeed be competitive in the sense that they can provide alternative sources of production, and that they are competing claims on limited financial and managerial resources. (In other important respects they may be complementary.) But the rate of direct investment abroad by UK companies has not been growing—indeed, in 1982 it was lower than in the previous three years, both in absolute terms, at £4 billion, and in relation to domestic investment, at 26%. This is not entirely surprising since exchange controls were designed to influence the financing of direct investment abroad and not the level of investment itself.<sup>(2)</sup> The strength of the dollar in the last

(1) These remarks relate to all industrial and commercial companies, including North Sea operations.  
(2) See 'The effect of exchange control abolition on capital flows', September 1981 *Bulletin*, page 369.

### Industrial and commercial companies' home and overseas investment and profits

£ billions

|  | 1978       | 1979       | 1980       | 1981       | 1982       |
|--|------------|------------|------------|------------|------------|
| <b>Gross investment</b>                        |            |            |            |            |            |
| Fixed investment                               |            |            |            |            |            |
| at home  | 12.2       | 14.1       | 15.7       | 15.0       | 15.6       |
| Assets leased                                  | 1.1        | 1.3        | 1.9        | 1.7        | 2.4        |
| Outward direct investment                      | 3.0        | 4.6        | 4.4        | 5.3        | 4.0        |
| <i>Memo item: outward portfolio investment</i> | <i>1.1</i> | <i>0.9</i> | <i>3.2</i> | <i>4.2</i> | <i>6.2</i> |
| <b>Profits</b>                                 |            |            |            |            |            |
| Home profits (net of tax and depreciation)     | 15.3       | 18.2       | 14.9       | 14.1       | 15.4       |
| Earnings on direct investment abroad(a)        | 2.9        | 5.4        | 4.6        | 4.9        | 4.4        |

(a) Net of depreciation at historic cost.

### Industrial and commercial companies' borrowing and acquisition of financial assets

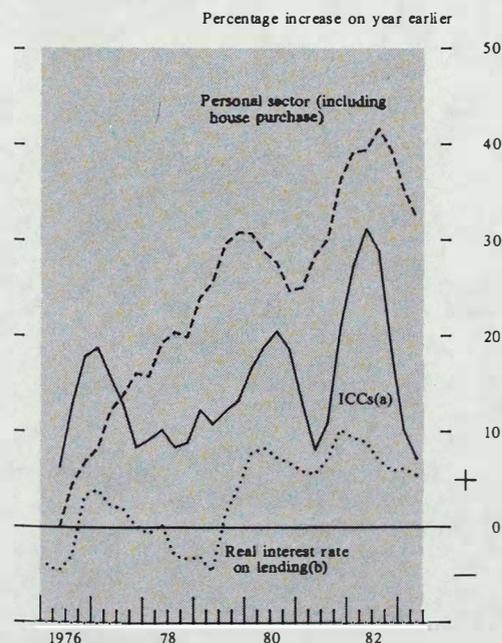
£ billions; figures at 1980 prices in italics

|                                 | 1977-1978(a)      | 1979-1980(a)      | 1981<br>Year      | 1982<br>Year      | 1983<br>Q1(b)     |
|---------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
|                                 | Borrowing         | 4.6<br><i>6.5</i> | 7.9<br><i>8.6</i> | 9.7<br><i>8.8</i> | 9.4<br><i>8.0</i> |
| Acquisition of financial assets | 2.9<br><i>4.1</i> | 2.3<br><i>2.5</i> | 6.6<br><i>6.0</i> | 1.2<br><i>1.0</i> | 1.2<br><i>1.0</i> |

(a) At an annual rate.

(b) Seasonally adjusted.

### The growth of bank lending has slowed this year from a very rapid rate.



(a) Industrial and commercial companies. Including commercial bills taken up by the Issue Department of the Bank of England.

(b) Clearing banks' base rate plus 2%, less the increase in consumer prices over the following year (a forecast for the most recent periods).

two or three years, which made direct investment in the United States appear expensive, may have been a factor. At all events, the rather low ratio of overseas to home investment last year suggests that overseas investment was not a serious constraint on domestic investment.

By contrast, outward portfolio investment has increased considerably since the end of exchange control in 1979.<sup>(1)</sup> It makes little claim on the resources of industrial and commercial companies, however, as it is predominantly carried out by other sectors. It may make domestic funds slightly more expensive, but any discouragement to domestic investment is likely to be more than offset by the effect of the capital outflow on the exchange rate and cost competitiveness, tending to encourage activity and benefit profits.

For some companies, growing earnings from overseas operations may have compensated for poor profits at home, but this does not appear to be the case for companies as a whole—last year, earnings on overseas investment were the lowest since 1978, equivalent to about 29% of home profits (compared with about a third on average in 1980 and 1981).

At times in the recent past, industrial and commercial companies have, like the personal sector, simultaneously borrowed on a large scale and added to their holdings of financial assets. Most of the borrowing (including acceptances) has been from banks. While use of the capital market has revived somewhat, it has been a much less important source of funds in recent years than it used to be. Significant amounts have been raised by equity issues but fixed-interest borrowing has remained low, probably because of uncertainties about the course of interest rates and inflation. In the first half of this year, the £1.1 billion (net) that industrial and commercial companies have raised in the stock market must have reduced resort to the banks and helped companies' liquidity. More settled financial conditions should encourage both equity and bond finance, which might take some further pressure from the banking system.

### Bank lending to the private sector: high growth in recent years.

The rapid growth of bank lending in recent years may be explained in various ways. Abolition of the 'corset' in June 1980 removed a constraint on the banks' lending business. The very depth of the recession induced companies to continue borrowing, either for precautionary reasons or in some cases to meet necessary outgoings. Uncertainties about interest rates and inflation, and generally low equity prices in real terms, have discouraged use of the capital market and increased companies' demand for the variable-interest finance which the banks provide; and competitive innovation has led the banks to expand the facilities they offer to meet companies' financing needs. As for lending to the personal sector, the growth of the banks' mortgage business has been especially rapid. (The effect of deregulation and competition on the banking system was the subject of a recent conference of central bankers and supervisory authorities from eleven countries which is reported in articles on pages 358 and 363.)

(1) See the June *Bulletin*, page 240. The comparisons between companies' home and overseas investment and earnings are not exact, and direct investment includes overseas investment of this nature by non-bank financial institutions and public corporations, whereas the home investment is by industrial and commercial companies. The inconsistencies are thought to be small.

The rate of growth of bank lending has slackened in the first half of this year. The banks have taken steps to contain the growth of mortgage finance. Sharper than the slowdown in their lending to the personal sector, however, has been the decline in the growth of their lending to industrial and commercial companies—probably a reflection of companies' better financial position in a consumer-led recovery, and perhaps also a consequence of greater recourse to the capital market. The rapid growth of bank lending has coincided with rather high real interest rates, at least as compared with the 1970s. Last year's level of 4%–4½% appears, however, to have been no higher than levels ruling at times in the late 1950s and the 1960s.