Economic commentary

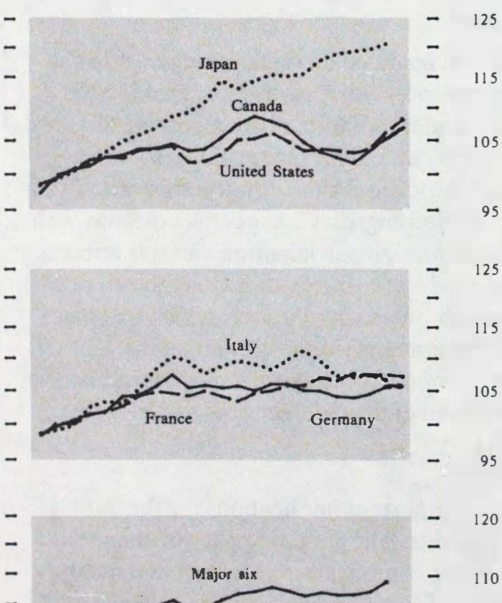
The main topics discussed in this commentary are:

- *The shape and extent of the upturn in the United States, and prospects for the world economy in the coming two years.*
- *Large changes in the pattern of UK external trade in recent years.*
- *UK inflation, where the underlying position still looks favourable despite some quickening of retail price inflation on the twelve month comparison.*
- *Resumed growth in retail sales; further increases in personal borrowing.*
- *Better profits and profitability, contributing to a marked improvement in companies' financial position: business fixed investment apparently recovering, but stocks drawn down again in the third quarter.*
- *A general slowing down in monetary growth in recent months, reflecting the course of government borrowing needs which are likely to exceed the Budget projection this year.*

GNP[a] *has picked up most strongly in North America.*

Seasonally adjusted

1978 = 100 (logarithmic scale)



(a) GDP in some cases.
(b) Average measure of GDP (partly estimated for 1983 Q3).

The world economy: *brisk revival in North America this year, and steady growth in Japan; disparate developments in the major industrial countries in the last four years.*

The US and Canadian economies have revived strongly this year, and steady growth has continued in Japan. Activity in Germany has also picked up; by contrast, activity in France and Italy remains weak. Prospects for economic activity in the major industrial countries are discussed on page 461.

In the four years or so since the second large increase in oil prices, the United States has experienced two downturns in activity and two periods of rapid growth (the second still in progress); the Japanese economy has grown with only brief interruptions; while the main continental European economies have grown little on the whole.

The timing and pattern of recession and upturn has therefore been far from uniform. Some countries at first weathered the steep increase in oil prices in 1979–80 and their economies grew quite fast (by 3% a year or more) up to mid-1981. The main sources of growth differed between countries—fixed investment in Canada, consumer spending in Italy, the trade balance in Japan (probably reflecting an especially strong competitive position). The other major overseas economies experienced slow growth in this period, although all were helped by growth in trade, especially with the oil exporting countries. But in all of them, a deterioration in the terms of trade squeezed real incomes, affecting consumption. The United Kingdom, meanwhile, went into deep recession, suffering a large fall in company spending on stocks and fixed investment, and was able to benefit less than most from import growth in oil exporting and developing countries; both these developments were largely attributable to a sharp loss of competitiveness up to early 1981,

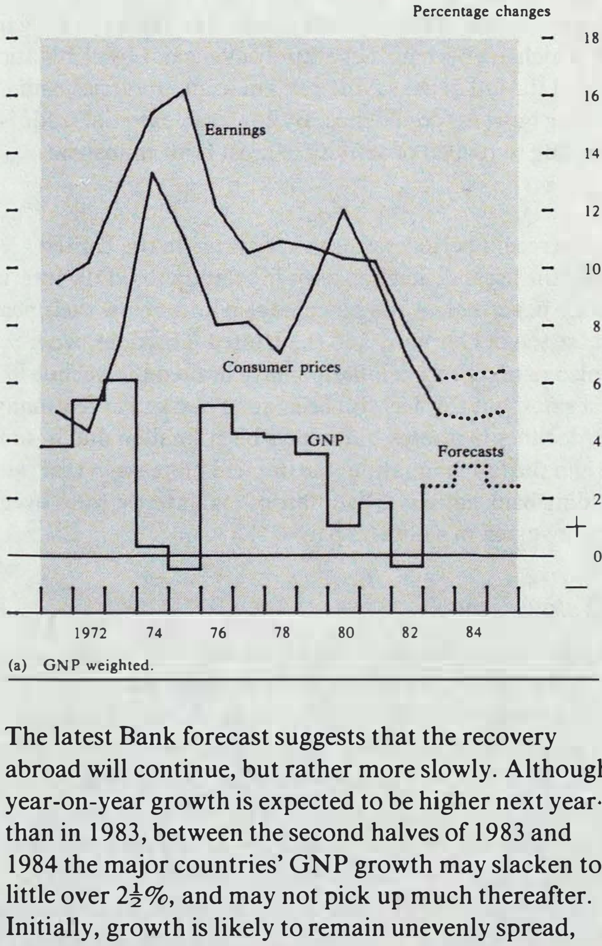
World economic prospects—latest Bank forecasts

Overall, activity in the major industrial countries has picked up faster than expected earlier in the year. Momentum in the private sectors of some should ensure further growth: personal incomes should benefit as employment begins to pick up; the rebuilding of stocks may continue and business fixed investment should strengthen in due course. Sustained growth cannot, however, be taken for granted. In the first place, inflation may not fall much further—the benefits of low inflation to consumer spending and business confidence should continue, but may not grow. Second, demand from outside the OECD area is likely to remain weak; the imports of non-oil developing countries are liable to be curtailed by shortage of finance, while the oil exporters have yet to adjust fully to their sharply lower revenues.

The major industrial countries are likely to continue to give priority to containing inflation. In aggregate, their fiscal plans for the coming year appear to represent a tightening from 1983, but they should, in time, create some scope for further reductions in interest rates.

Prices, earnings and growth in the major economies[(a)]

Percentage changes



(a) GNP weighted.

The latest Bank forecast suggests that the recovery abroad will continue, but rather more slowly. Although year-on-year growth is expected to be higher next year than in 1983, between the second halves of 1983 and 1984 the major countries' GNP growth may slacken to a little over $2\frac{1}{2}\%$, and may not pick up much thereafter. Initially, growth is likely to remain unevenly spread, with Japan and Europe still lagging behind North America, but as revival slows there growth may converge. Public spending is likely to be contained in most major countries. Personal consumption is expected to grow more slowly than recently; widespread efforts to contain social security budgets will check the growth of personal disposable income, while further significant falls in saving ratios do not seem likely. In addition, growth of residential investment is projected to slow down sharply from the rapid pace seen in some countries this year. Meanwhile, business investment is showing signs of revival, although companies are likely to remain cautious in the face of modest overall growth.

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

Percentage points of GNP; at constant prices

	1982	1983(b)	1984(b)	1985(b)
Real domestic demand	0.1	2.9	3.3	2.3
of which:				
Personal consumption	*0.9*	*1.8*	*1.5*	*1.3*
Government consumption	*0.3*	*0.2*	*0.3*	*0.2*
Investment	*−0.7*	*0.5*	*1.0*	*0.8*
Stockbuilding	*−0.4*	*0.4*	*0.5*	*—*
Net exports	−0.5	−0.5	−0.2	0.1
GNP	−0.4	2.4	3.1	2.4

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

Some further decline in inflation is expected in countries where it is still above average, but in North America the modest tightening foreseen in labour market conditions may in time bring new inflationary pressure. It is difficult to say whether the recent surge in real non-oil commodity prices will resume: some markets remain oversupplied, while in others capacity should be available to meet the expected moderate growth in demand. The oil market is still very weak, with considerable excess capacity and large stocks.

World trade appears to be reviving, led by the major industrial countries. The imports of the developing countries and smaller OECD countries also seem to be recovering from very depressed levels but cutbacks by OPEC may still have some way to go. Overall, world trade may expand at an annual rate of 4%–5% during the next two years, a significant improvement on 1981–83. The current balances of the main country groupings are not expected to alter greatly over the forecast period. Nevertheless, the smaller OECD countries, where policy is expected to be kept tight, should make a steady improvement with their exports benefiting from the upturn in major countries' demand. Non-oil developing countries' deficits may fall a little further as world trade recovers in 1984 and 1985.

The volume of world trade and UK export markets

Percentage changes

	1982	1983	1984	1985
World trade	−1.0	0.5	4.7	4.4
UK export markets	−0.5	−1.0	4.1	4.1
of which:				
OECD	*0.4*	*2.3*	*3.9*	*3.9*
Other	*−2.1*	*−7.3*	*4.4*	*4.8*
Manufactured goods	*−2.9*	*−0.4*	*2.9*	*3.2*

Contribution to the growth of GDP in major industrial countries(a)

Percentage change at an annual rate; *seasonally adjusted*

	1979 Q2–1981 Q2	1981 Q2–1982 Q4	1982 Q4–1983 Q2
Consumer spending	0.7	1.1	2.5
Government consumption	0.2	0.4	−0.4
Fixed investment	0.2	−0.5	0.6
Stockbuilding	−0.4	−0.7	2.0
Net exports	0.9	−0.3	−0.7
Total	**1.6**	—	**4.0**

(a) As in the chart.

reflecting the strong exchange rate and a fast increase in labour costs.

While the UK economy began to revive in the latter half of 1981 and, more strongly, in 1982, most others went into recession. The upturn in the United Kingdom was induced initially by a change in stockbuilding behaviour, and then by stronger consumer spending, helped by a marked fall in inflation. For the other major economies, demand for exports was no longer a source of strength because many oil exporting and developing countries faced financing constraints. This coincided with a cyclical decline in company spending. Only in France and Japan among the major overseas economies did activity rise over this period.

As earlier in the United Kingdom, the recovery in other major industrial economies this year has mostly been led by domestic demand. Higher consumer spending reflects rising real incomes, brought about by better terms of trade and (in North America) by the growth of employment, and also in some cases a steep fall in the saving ratio, adding 1% or more to consumer spending in Canada, Germany and the United States. Housing investment has been strongest in North America, with spending up nearly 30% in the first two quarters of this year in the United States. As usual in the early stages of recovery, an end to destocking has also made a contribution.

In some respects (for instance, stocks), the upturn is clearly cyclical. Corporate spending on fixed investment is also picking up, for reasons which are perhaps not entirely cyclical. Lower inflation may be behind the fall in the saving ratio in some countries, and may be helping business confidence. By contrast, external trade is not contributing to revival of activity in most large industrial countries.

Growth in the recent period has been very rapid in the United States, where the fiscal deficit has risen in relation to GDP. Interest rates there are nevertheless 7–8 percentage points below their peak; this is the case too in Germany and the United Kingdom, where activity is also rising. Falls in inflation have limited the decline in real interest rates, but this has still been quite marked in Germany. Elsewhere, declines in interest rates have been smaller, and in some cases less than the fall in inflation: the implied increase in real rates may be holding back activity. (Estimate of real interest rates over a long period are given in a note on page 471.)

Inflation in the major economies

Percentage increase on a year earlier

	1980	1981	1982	1983	
	Year	Year	Year	Q1	Q2
Consumer prices					
Major overseas economies	12	9¾	6¾	4¾	4½
United Kingdom	18	12	8¾	5	3¾
Unit labour costs					
Major overseas economies	8¾	8	7½	5½	4¼
United Kingdom	21	8¾	5	3½	4¼
Import prices					
Major overseas economies	26¼	18¼	6¼	2	2
United Kingdom	14¼	8	8½	9¼	9¾

Inflation: *slows down.*

Inflation has slowed in the major overseas countries: the average increase in consumer prices was about 4½% in the year to mid-1983, compared with 12% in 1980 and around 7% last year. The rise in import prices for these countries has slowed even more sharply, from 26% in 1980 (in the wake of big increases in oil prices) to about 2% earlier this year. The growth in domestic labour costs has also moderated, mainly in the last year. As well as helping consumer spending and business confidence, slower inflation may have had the effect of easing fiscal and monetary policies framed in nominal terms (such as a target for government borrowing or growth of money supply).

The slowdown in UK inflation since 1980 (see section on page 465) has been sharper than in other industrial countries, and the deceleration in unit labour costs, from over 20% to about 4%, much greater than elsewhere.

Balance of payments: *changing positions; developing countries in reduced current account deficit.*

Substantial changes have been recorded in current balance of payments positions. As a group, the major industrial countries moved from large deficit in 1980 to virtual balance the following year, but a modest deficit has re-emerged. The United States has gone into large deficit: $11 billion in 1982 and over $25 billion in the first three quarters of this year. Japan, by contrast, is in growing surplus: domestic spending there has grown less quickly than in the United States, and Japan has the better cost competitiveness. The other major countries are in broad balance on current account, an improvement in most cases from 1980 when higher oil prices were being felt.

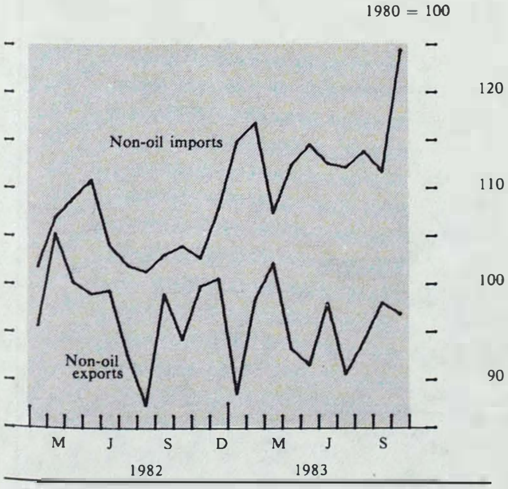
The current account balance of payments of groups of countries, and their borrowing, are further discussed in International financial developments on page 488.

Although balance of payments statistics are subject to considerable error,(1) broad developments among groups of countries can be traced. The large current surplus of the oil exporting countries in 1980 and 1981 has disappeared as their export volume has fallen by a third (a result of world recession and energy conservation) and oil prices have weakened. The current deficits of the non-oil developing countries, on the other hand, have come down from the peaks of 1980 and 1981. Their imports were cut back sharply last year, while their exports continued to grow, although very slowly; and the deterioration in their terms of trade which began in 1978 has halted this year. To a considerable extent the reduction in imports has been forced upon developing countries by debt problems, which in turn have been exacerbated by the world recession; as it is, the growth of their external borrowing has slowed very sharply in the last year or so, and they are now relying more heavily on borrowing from international institutions.

UK balance of payments: *reduced surplus on current account, with imports substantially higher than in 1982.*

The UK current account surplus has fallen from £5½ billion last year to an estimated £1.2 billion in the first nine months of this year. Most of the deterioration has been in trade in goods other than oil, and is largely in the volume of trade, the terms of trade having worsened only slightly.

Non-oil trade volumes *erratic with the deficit tending to widen.*



The volume of exports, other than oil, so far this year (January–October) has been on average some 2% lower than last year. The volume of imports (other than oil) in the first ten months of this year was 8½% above the rate in 1982. The increase since last year is widely spread across categories of goods.

The surplus on trade in services has been running above last year's rate, but net receipts of interest, profits and dividends have been well below, with a small deficit in the second quarter. Among capital flows, outward portfolio investment continues at £1½–2 billion a quarter.

The changing composition of UK trade is discussed on page 464.

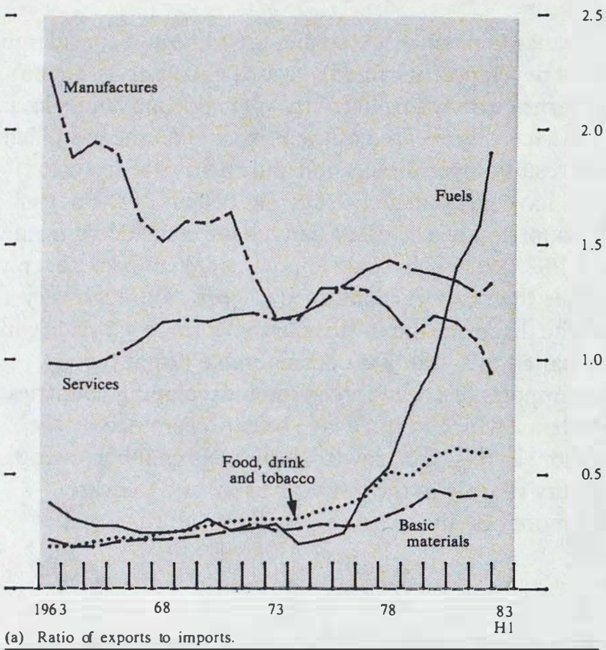
(1) Recorded current accounts for all countries should balance, but over the last year they have added up to a deficit of nearly $100 billion (see also page 488).

The changing commodity composition of UK trade

The United Kingdom has traditionally run a large surplus on trade in manufactured goods, and deficits in food, basic materials and fuel. This pattern has changed. Trade in manufactures is now in deficit; there is a surplus in oil; while the deficits in food and other commodities have shrunk in relation to GDP. Trade in services has moved into surplus.

The Common Agricultural Policy and North Sea oil and gas partly explain these developments. Agricultural production has been stimulated, while the marked loss of cost competitiveness in 1978–80, partly related to oil, strongly affected manufacturing. Nevertheless, the favourable trend in food was apparent well before entering the European Community, and deterioration in the manufacturing account is long-established (Chart A). The loss of manufacturing's market share (in volume terms) at home and abroad has been almost continuous in the past twenty years (Chart B). The extent to which this reflects cost and price competitiveness is unclear. Other influences include barriers to trade, changes in consumer tastes and in technology, and competition from newly industrialised countries. The share of total imports of goods in expenditure has increased less markedly than for manufactures alone, and the UK share in export markets for all goods has also declined by less; these trends have been consistent with a broadly unchanged balance of visible trade, world trade having expanded about two and a half times as fast as domestic spending.

Chart A
Relative value[a] of trade in main categories



(a) Ratio of exports to imports.

Shares in trade, output and employment[a]

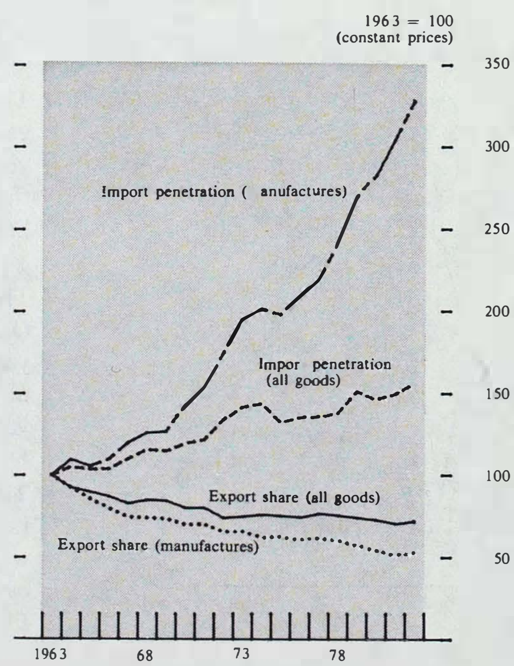
Per cent

	Exports	Imports	GDP	Employment
Food, drink, tobacco, basic materials and fuels				
1963	12	47	14	12
1972	8	30	12	9
1982	23	25	17	8
Manufactures				
1963	62	27	29	33
1972	58	42	28	32
1982	51	52	21	24
Services				
1963	26	27	50	49
1972	31	26	54	54
1982	24	20	56	63

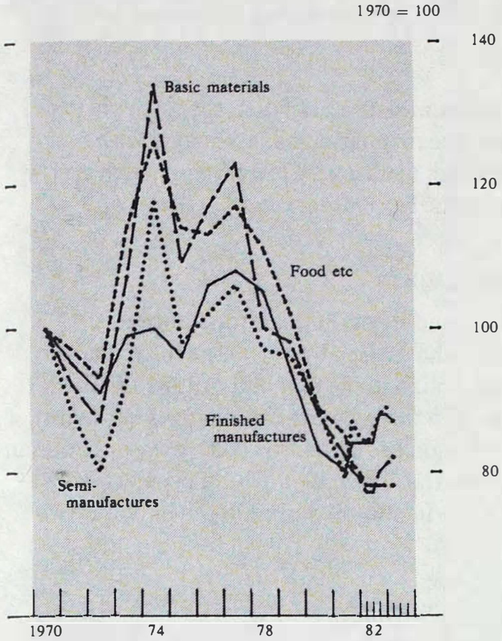
(a) Data are derived from different sources and are not fully consistent. The shares do not add to 100 per cent because some categories (eg miscellaneous trade and construction) are omitted.

These developments have been accompanied by a fall in the contribution of manufacturing to total domestic product and its share in employment. The corresponding increase in the importance of food, fuels and basic materials in exports and domestic product in the last ten years has not been reflected in employment (mainly because North Sea oil and gas accounted for 6 per cent of GDP in 1982 but employed only 26,000 people). The share of employment in the services sector (including public administration) has, by contrast, grown faster than the sector's share in GDP; the problems of measuring output and trade in the services sector are, however, severe.

Chart B
Import penetration and export share in world markets



Import prices *remain low in relation to domestic costs.* [(a)]



(a) Unit values of non-oil imports divided by the GDP deflator.

Influences on labour costs in manufacturing industry

Percentage changes from a year earlier[(a)]

	1980	1981	1982	1983
Pay settlements(b)	+16	+ 9	+ 7	+ 5¾
Average earnings	+21	+12½	+10	+ 9
Productivity (output per man-hour)	− ½	+ 7	+ 4	+ 6½
Unit wage costs	+23	+ 5	+ 5	+ 2½
Unit labour costs	+26½	+ 6	+ 3½	—
Background factors:				
Output	− 9½	− 3½	− ½	+ 1½
Employment	− 6½	− 9½	− 5	− 5
Hours worked per operative	− 3½	+ ½	+ 1	+ ½

(a) Third quarter on third quarter—approximately the timing of a pay round. Figures for the latest year are partly estimated.

(b) As compiled by the CBI.

Components of inflation

Percentage changes from a year earlier

	Weights (per cent) in total final expenditure in 1982 in italics	1980 Year	1981 Year	1982 Year	1983 H1
Domestic factor costs(a)					
Income from employment	*45½*	+22½	+10	+ 4½	+ 4
Profits etc(b)	*12½*	+ 5½	+ 8½	+ 8	+22½
Other income(c)	*11½*	+18½	+11½	+ 7½	+ 6½
GDP deflator		**+19**	**+10**	+ **6½**	+ 7
Other components of final expenditure					
Taxes on spending less subsidies(d)	*12*	+25½	+19½	+12	− 1½
Import costs(e)	*19½*	+10	+ 7½	+ 7½	+ 9
TFE deflator		+17½	**+11**	+ 7	+ 6
Deflators for domestic expenditure:					
Consumer spending		+16½	+11	+ 8½	+ 6
Fixed investment		+19	+ 9½	+ 2	+ 3½

(a) Nominal amounts divided by an index of the volume of GDP. These are components of income; differences between the income and expenditure measures of GDP make for some inconsistency in the table.

(b) Company profits and trading surpluses of public corporations and government enterprises, net of stock appreciation. Profits from North Sea operations are included.

(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.

UK inflation: *import prices still rather low in relation to domestic costs...*

Until 1981, import prices were tending to rise less than domestic costs (the GDP deflator). This trend was then reversed, but in recent months import prices have again tended to be subdued.

The prices of imported manufactured goods appear to be determined partly by foreign producers' costs and partly by the prices of competing goods produced in the United Kingdom. The prices at which most primary commodities are imported, on the other hand, appear to be determined by world prices and not to be affected much by UK costs or market conditions in this country (prices covered by the Common Agricultural Policy are subject to separate influences). When sterling was rising, from 1977 to early 1981, the prices of all imports fell sharply in relation to domestic costs, moderating the effect on prices of rapidly inflating domestic costs. The decline in the exchange rate since 1981 (amounting to about 20% in effective terms) has tended to raise import prices in relation to domestic costs, but not by very much: much slower increases in UK production costs and domestic industry's selling prices have helped to restrain the prices of imported manufactured goods, and primary commodity prices were exceptionally weak worldwide until autumn 1982. Import prices have risen in relation to domestic costs since 1981, but they remain unusually low by the standards of earlier years (see chart).

...the rise in labour costs has been markedly reduced...

The growth of domestic labour costs has slowed considerably. Pay increases have fallen in each of the last three years, but the growth of average earnings over the 1982–83 pay round, at 7¾%, was not much less than the 9% recorded in the previous year. The rise in productivity, however, was greater, and the increase in unit wage costs was therefore considerably diminished. The effect was especially marked in manufacturing industry where, partly because of more overtime, average earnings rose by 9% but wage costs per unit of output increased by only 2%–3%, compared with 5% in 1981–82 and 23% in 1979–80. Profit margins, the main element, apart from labour, in domestic factor costs, narrowed until early in 1981 but have since widened.

The various elements in costs should not be regarded as independent causes of inflation. Rather, inflation must to a large extent be influenced by the stance of fiscal and monetary policy and market conditions; an accounting analysis of the components is shown in the table.

There have also been disparate movements in the average prices of different categories of domestic expenditure. The price deflator for fixed investment has risen by markedly less than that for consumer spending since 1980, although earlier experience suggests neither a trend nor a cyclical pattern. Low increases or falls in the prices of many high-technology products (particularly in the field of micro-electronics) may be part of the explanation.

... and inflation is expected to remain subdued.

In the fourth quarter of this year, retail prices are expected to be 5% higher than a year earlier; over the coming year, the increase is forecast by the Treasury to be slightly lower, at 4½%. With most early settlements in the new wage round a little lower than last

Employment in Great Britain[a]

Thousands; *seasonally adjusted*

	1979	1982	1983		
	June	June	March	June	Sept.
Employees in:					
Production industries(b)	9,000	7,350	7,060	6,970	6,930
Service industries(c)	13,210	13,040	13,030	13,110	..
Self-employed	1,840	2,160	2,230	2,260	..
Total in civilian work(d)	**24,400**	**22,890**	**22,660**	**22,680**	..

.. not available.

(a) Figures since 1982 include an adjustment (made by the Department of Employment) for probable underestimation.

(b) Mining, manufacturing, construction, gas, water, electricity.

(c) Including public administration.

(d) The above, plus employees in agriculture.

Average weekly hours worked per operative in manufacturing (Great Britain)

1962=100; *seasonally adjusted*

Mid-1979	Mid-1980	Mid-1981	Mid-1982	1983 June	1983 Sept.
93.6	90.9	89.0	90.6	90.8	91.7

Shares in personal income

Per cent

	1972	1977	1982
Income from employment	69	69	65
Income from self-employment	10½	9	8½
Rent and other property income	9½	9½	11
State pensions and other social security benefits	10½	12	15
Less			
Taxes and national insurance contributions	−18	−22	−21

year (though the national agreement in engineering is slightly higher), moderate pay increases and productivity growth are likely to keep increases in the GDP deflator to much the same as retail price inflation.

The rate of inflation on any measure has fallen very sharply in the last three years. The decline in inflation has coincided with a recovery of output—though from a very low level—which is now starting to be reflected in the labour market.

Output: *continues to grow.*

After a pause around the middle of the year, total output is provisionally estimated to have risen by 1% in the third quarter, and was 4¼% above the trough in the first half of 1981. With North Sea oil and gas excluded (on the grounds that changes in the rate of extraction have little effect on the labour market), measured output has increased by 3% since the first half of 1981. This upturn follows a fall of about 6½% in non-oil output in the previous two years.

The labour market: *levelling out.*

Changes in output tend to be reflected promptly in average hours worked; changes in employment and vacancies usually come later. In the current upturn, employment (which may have levelled out in the middle of this year after sharp falls)[1] and average hours worked in manufacturing (which have been creeping up since 1981) have followed the usual cyclical pattern. The strong rise in vacancies from the middle of 1982 began earlier than would have been expected from previous experience, and has led the Central Statistical Office to drop vacancies from their lagging economic indicator. Unemployment continued to rise (after adjustment for various changes affecting the basis of the count) until July, but has fallen slightly in three of the last four months. All this points to some stabilisation of demand for labour.

Incomes: *no recovery yet in RPDI, though average earnings continue to rise faster than prices...*

Real personal disposable income (RPDI)[2] has changed little since 1981. There has been no repetition so far of the very rapid increases which occurred during previous recoveries, in 1973 and 1978–79. These earlier episodes were marked by sharp increases in pay, running well ahead of prices, as well as by rising employment.

The proportion of RPDI represented by income from employment and self-employment has declined in the last decade. By contrast, the share accounted for by state pensions and social security payments has greatly increased. Altogether, current grants from the government accounted for almost 16% of pre-tax income in the first half of this year, compared with 15% last year and about 11% a decade ago. Higher unemployment is the main reason but the change from tax allowances to child benefits is also a factor.

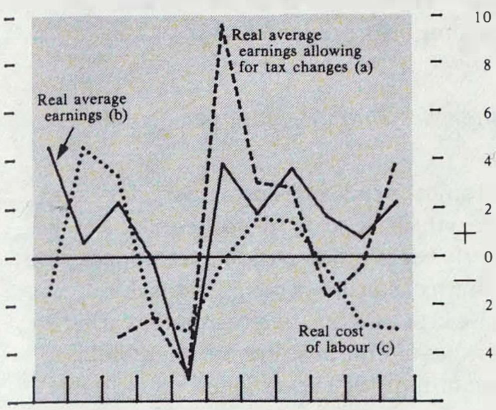
Income from employment and self-employment taken together accounted for some 80% of personal income before tax in 1972, but for under 74% last year. Income from employment has been subject to opposing tendencies. Average earnings of those in work

(1) There is some uncertainty about the recent trend, in that recent figures for the numbers working in service industries, and the self-employed, are partly estimated.

(2) As conventionally measured, without allowance for the effect of inflation on the real value of monetary assets.

The cost of employing labour *has declined even though* **real average earnings** *rose.*

Percentage change on previous year



(a) Average earnings deflated by the tax and price index.
(b) Average earnings deflated by consumer prices.
(c) Whole economy's unit labour costs divided by the GDP deflator.
(d) Estimate based of first three quarters.

Personal income, consumer spending, and saving

1980 = 100; *percentages in italics*

	Real personal disposable income		Consumer spending	Saving ratio
	As conventionally measured	Adjusted for inflation loss(a)		
1979	98.6	100.7	100.7	*12.9*
1980	100.0	100.0	100.0	*14.8*
1981	97.5	97.5	100.1	*12.5*
1982 H1	97.1	99.6	100.0	*12.3*
H2	96.7	99.9	102.9	*9.3*
1983 H1	97.2	100.8	104.3	*8.7*
Q3(b)	97.5	104.1	105.7	*8.0*

(a) Bank estimates. The adjustment is for the effect of inflation on the real value of net assets fixed in nominal terms (see the June *Bulletin*, page 169).
(b) Partly forecast.

have increased in real terms, but the number in work has declined, at least until earlier this year. The exact growth of real average earnings in recent years depends on the choice of deflator. Measured against retail prices or the deflator for consumers' expenditure, average earnings have risen each year since 1978; using the tax and prices index, real earnings have been less smooth, though the rise since the low point in 1977, at $18\frac{1}{2}$%, is greater than if taxes are not taken into account.

. . .but real employment costs are still falling.

Despite the increase in the purchasing power of earnings, last year the real cost to employers of hiring enough labour to produce a unit of output[1] was lower than in any year since 1973; and it will have fallen again this year. Rising productivity is the major reason for the difference between the course of real earnings and the cost (in this sense) of employing labour; cuts in the national insurance surcharge from $3\frac{1}{2}$% before the 1982 Budget to 1% since August will also have helped. The picture in manufacturing industry is broadly the same. Unit wage and salary costs have fallen in relation to manufacturers' selling prices, though on this measure the real cost of labour in the third quarter of this year, while over 5% lower than in 1980, was still some 8% higher than in 1977. Competitive pressure on industry's selling prices has probably intensified since 1977; changes in competitive conditions seem to have borne more strongly on firms than on their employees, despite stimulating productivity growth and moderating wage claims. (The position of companies is discussed on page 468.)

Consumer spending: *still rising, supported by continued growth in personal borrowing.*

Despite the weakness of disposable income as conventionally measured, consumer spending has been rising strongly; the reduction in losses on the real value of personal wealth held in monetary form, reflecting the decline in inflation, is thought to have been a factor.

The recent strength of consumer spending began in mid-1982 and followed about eighteen months of little change. Since mid-1982 it has grown by about 5%, with spending on durable goods up by over a quarter. A fall in retail sales in the summer suggested that consumer spending might be losing steam, but they recovered strongly in the early autumn, and the first results of a new monthly survey of retailers and wholesalers carried out jointly by the CBI and the Financial Times suggest further growth.

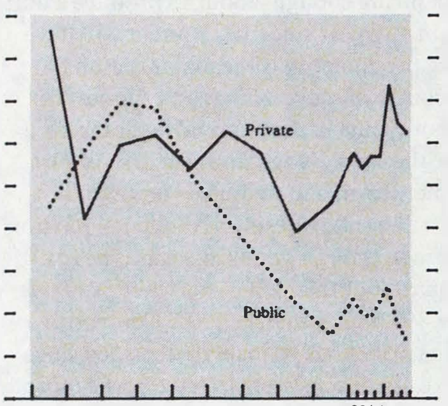
With little change in RPDI over this period, the saving ratio has fallen, from over 12% in the first half of 1982 to about 8%. Falling inflation has meant that people need to save less in order to maintain the real value of assets with fixed money values. The decline in the saving ratio has been manifested, not so much in reduced holdings of financial assets, as in a strong growth of personal borrowing, in which mortgage borrowing from building societies and banks has been dominant.[2] The flow of mortgage lending this year has been somewhat below the rate in the second half of 1982. There are signs, however, that mortgage lending may quicken again in the next few months. The societies are now

(1) Defined as the cost to the employer of labour to produce a unit of output divided by the 'price' of that output—in the economy as a whole, unit labour costs divided by the GDP deflater.
(2) See the September *Bulletin*, page 333, and also 'Mortgage lending and the housing market', September 1982 *Bulletin*, page 390.

responding to very large recent inflows by lending more (their commitments to lend were already a record), while renewed interest in mortgage lending is evident among some banks. Non-mortgage lending to persons by the banks has also grown rapidly, by about £$\frac{3}{4}$ billion a quarter (over twice as much as in 1980).

Altogether, the flow of personal borrowing in excess of the value of additions to the privately-owned housing stock has doubled, from £6 billion in 1980 to £12$\frac{1}{4}$ billion in 1982, and has continued at that rate in the first nine months of this year. It is now equivalent to about 5% of personal income before tax.

Housing starts *at a peak in the first quarter of 1983.*

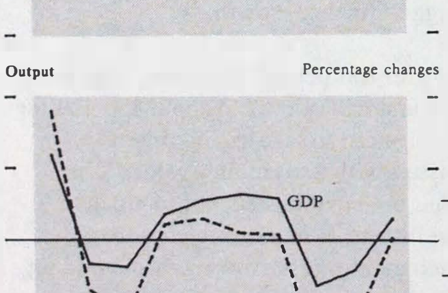


(a) Seasonally adjusted, at an annual rate.

Housebuilding: *rather subdued, despite the growth of mortgage lending.*

After the usual seasonal adjustments, housing activity does not appear to have maintained the pace set in the early months of the year, but this may be partly because new building techniques have affected the seasonal pattern of starts and completions. Less ambiguously, the increase in starts from twelve months earlier (24% in the first quarter) has diminished. Private housebuilding activity in the first ten months of 1983 nevertheless comfortably exceeded last year's rate, with starts 20% higher; public sector activity, by contrast, is at a low ebb. House prices (after allowance for the composition of properties changing hands) appear to have been rising at an annual rate of 10%–12% since mid-1982, well above the general rate of inflation but with no apparent tendency to accelerate.

The share of profits in value added *has picked up as output has firmed.*



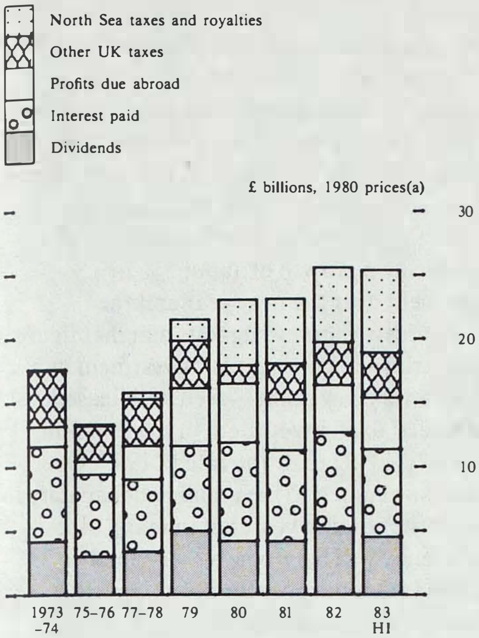
Companies: *the share of profits in GDP rising and their general position improving.*

As would be expected, shares of employment income and profits[(1)] in GDP have changed markedly over the cycle. Thus, in the downward phase of the recession the share of employment income in GDP rose (although real employment income fell as declines in employment more than offset increases in real average earnings), and the share of profits and trading surpluses of public corporations fell. But there has been a reversal in the last three years: in the first half of 1983, the share of profits etc in total income was back to 18$\frac{1}{2}$%, from 15% in 1980, and the share of employment income had been reduced from 68$\frac{1}{2}$% to 65%. (The remainder is mainly income from rent and self-employment.)

Cyclical shifts tend to be most marked in the industrial and commercial sector. The share of profits in total income arising in this sector is very variable; so too is the share of its value added in total GDP. Nowadays, the income figures for all industrial and commercial companies are influenced by strong growth of profits from North Sea operations. If North Sea operations are excluded, the usual cyclical pattern is clear: the share of profits in value added in the industrial and commercial sector declined from 26% in 1978 to 21% in 1980 and 1981, recovering slightly in 1982 (figures for 1983 are not yet available). The reduction in the profit share was, however, slightly less than in the mid-1970s, although the recession was deeper. With value added in the sector also fluctuating as a share of GDP, non-North Sea profits in real terms have swung about very sharply, falling by 35% between 1978 and the first half

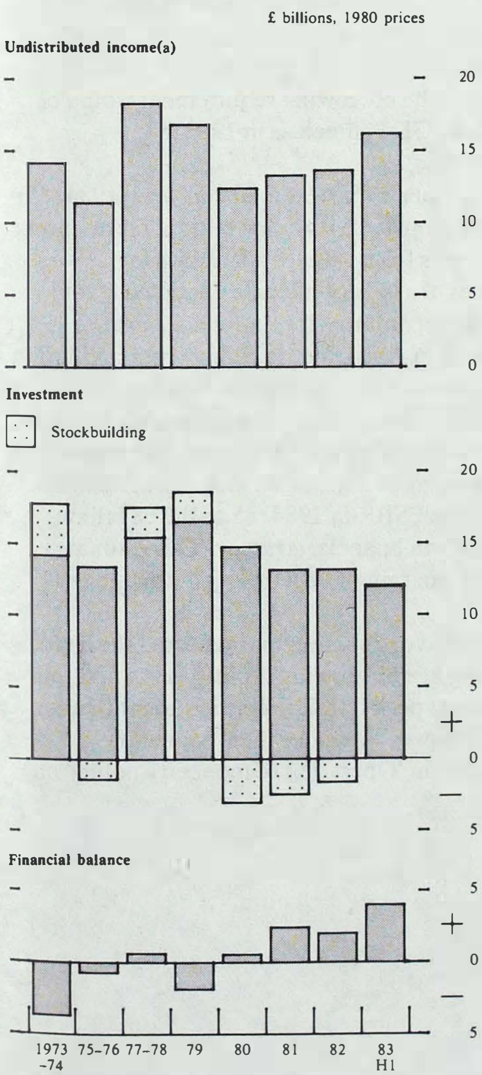
(1) Profits estimates are very subject to revision.

Industrial and commercial companies' appropriations



(a) Nominal amounts are divided by the GDP deflator.

An improvement in **companies' undistributed income** *has been used mainly to improve liquidity.*



(a) Nominal amounts are divided by the GDP deflator.

of 1981, and rising by a similar percentage in the following two years—with considerable implications for the financial position of the company sector.

The rate of real profitability has also varied considerably.[1] It fell from over 7% in 1978 to around 3% in early 1981, but has since recovered to some 6%. Even at 6%, however, real profitability is much lower than a decade ago, and low by international standards.

Other sources of income (interest on financial assets, rent etc) have helped to smooth out the flow of income to companies.[2]

Meanwhile, taxes and dividend distributions have tended to grow, and undistributed income is still less in real terms than in the late 1970s. North Sea taxes and royalties now bulk large among tax payments; indeed, payments of corporation tax by other companies have become quite small. Companies' attempts to maintain dividends in real terms must, at least up to last year, in many cases have led them to pay out more than inflation-adjusted profits.[3] Interest payments did not change much, in terms of 1980 prices, up to last year; they have fallen somewhat this year.

Although undistributed income fell in real terms between 1978 and 1980, companies' financial position did not deteriorate as much in the recent cycle as it did in the mid-1970s; and they have been in substantial financial surplus (exceeding £5 billion in nominal terms) since mid-1982.[4] Companies have certainly been under financial pressure, however: low profitability and financial constraints will in many cases have been the main factors behind the steep reductions in stocks and the curtailment of investment plans which in turn have helped to restore their financial position. Industry's stocks of fuel and raw materials have been especially sharply cut, by some 25% (at 1980 prices) between the end of 1979 and the end of September this year—a period in which manufacturing production has declined by about 15%. It is not clear to what extent stocks will be rebuilt, since new methods of stock control may well have permanently reduced desired stock/output ratios. Other considerations, such as real interest rates (after allowing for expected changes in the price of stocks), the possibility of disruption to supplies and the tax treatment of stock appreciation, will also continue to be important influences on stockholding.

No doubt partly in response to their improved finances, companies' borrowing fell in the first half of this year, and its form changed. Companies repaid debt to the banks, but raised quite substantial amounts on the capital market. In recent months, they have renewed their recourse to banks, but have continued to raise money by capital issues. By the end of September, their liquidity position, to judge from the 200 or so large companies sampled by the Department of Industry, was as strong as at almost any time in the last decade: the ratio of their liquid assets to liquid liabilities had risen to 130%, from 71% a year earlier, a striking change,

(1) 'Real' profits here means nominal profits, net of stock appreciation, converted to 1980 prices through division by the GDP deflator. 'Real profitability' means nominal profits, net of stock appreciation and capital consumption in replacement cost terms, as a percentage of the value of trading assets at replacement cost. (Uncertainty about this last magnitude adds uncertainty to the estimates.)

(2) The following remarks cover all industrial and commercial companies, including North Sea operations. For the sector as a whole the strong growth of North Sea profits has offset much of the earlier decline in profits from other activities.

(3) See 'Company profitability and finance', June 1983 *Bulletin*, page 232, and 'Current cost accounting', September 1982 *Bulletin*, page 369.

(4) A large unidentified item in the company sector accounts should be noted.

Industrial and commercial companies' financial transactions[a]

£ billions, 1980 prices(b)

	Financial surplus (+)/ deficit (−)	Borrowing from banks(c)	Capital market borrowing	Acquisition (−) of liquid assets
1978	**1.3**	3.3	0.7	−3.2
1979	**−1.9**	4.8	0.9	−0.8
1980	**0.6**	6.3	0.9	−3.5
1981	**2.4**	5.1	1.7	−4.3
1982	**1.9**	5.8	0.9	−2.2
1983 H1(d)	**4.0**	−0.8	2.2	−2.3
Q3(d)	..	4.7	3.0	..

.. not available.

(a) Not all items are shown.
(b) Nominal amounts, divided by the GDP deflator.
(c) Including Issue Department transactions in commercial bills.
(d) At an annual rate; seasonally adjusted.

corroborated (for the manufacturing sector) by the CBI's quarterly survey in October.

The improvements in profits and the financial position of companies may herald stronger capital spending. In the third quarter, the volume of industrial and commercial fixed investment was 2% above the low rate in the first half of the year, and the highest quarterly figure since late 1980. It was still, however, nearly 10% below the rate in the peak year of 1979. Manufacturing investment (about a third of the total) also rose. Replies to the October CBI survey indicate a growth of about 5% in manufacturing fixed investment over the next year and the December Department of Industry survey suggests a higher figure (within 7% growth in industrial and commercial investment as a whole). Revival starts from a very low point—even with leased assets included, manufacturers' fixed investment in the first nine months of this year was nearly 40% below the rate in 1979. Over 90% of the CBI's respondents claimed to have sufficient capacity to meet expected demand over the coming year, but in many cases investment to improve efficiency will be profitable. In October 73% of CBI respondents mentioned this purpose for investing while only 17% would be investing to increase capacity.

Public finances: *the PSBR in 1983/84 now expected to exceed the Budget projection.*

In his autumn statement, the Chancellor of the Exchequer indicated that the PSBR in the current financial year is expected to be about £10 billion, compared with the Budget projection of £8.2 billion. At £10 billion, the borrowing requirement would be equivalent to about $3\frac{1}{4}$% of GDP, much as in 1982/83.

Outline public expenditure plans for next financial year (1984/85) were announced. The planning total is £126.4 billion, representing little change in volume terms from this year; it allows for £1.9 billion of special sales of assets (which are deducted from spending). The lower and upper limits for national insurance contributions will be raised in April, but no change in contribution rates or in the national insurance surcharge was announced. Taking account of these measures, and allowing for specific duties and direct taxes to be revalorised in line with prices, the Chancellor estimated that, on present prospects, a small increase in taxation would be needed to keep the PSBR in 1984/85 to the £8 billion projected in the medium-term financial strategy. This estimate is, however, subject to a wide margin of uncertainty at this stage.

The monetary aggregates have to some extent reflected the course of public sector borrowing needs, growing rapidly in the first four months of the current target period (mid-February to mid-June) but expanding at a much slower rate since then. Monetary developments are discussed in 'Operation of monetary policy' on page 477.