General assessment

This assessment reviews the beginnings of economic recovery, and progress in reducing inflation, in this and other countries; and it discusses the prospects for inflation being further reduced in the year ahead.

The world economy

Recent data indicate an upturn in activity, quite strong in North America and more modest elsewhere. In the United States, GNP has risen by over 2% since the fourth quarter of last year, and by May industrial production was 7% higher than at the low point in November. In Canada there has been some recovery from an especially deep recession, while in Japan output has continued to grow, albeit at a moderate rate by past standards. The European economies, however, remain more subdued, though confidence is much improved in West Germany; and there has been a rise of demand, now influencing output, in the United Kingdom. Forecasts suggest that in the OECD area as a whole growth through the rest of this year and into 1984 may reach 3% per annum or even a little more.

The signs of recovery have been accompanied by continuing progress against inflation. Consumer price inflation in the OECD area fell, on a twelve-month basis, from about 13% in mid-1980 to around 8% in the middle of last year, and may well fall below 5% this year; in the three largest economies prices are rising even more slowly. The rate of increase in wages and unit labour costs seems likely to decline further, but the help from lower commodity prices is unlikely to be repeated: already, non-oil commodity prices have shown some hardening. Further rapid progress against inflation may thus become less easy to obtain.

Oil prices seem to have stabilised around the level agreed by the OPEC meeting in March. This stability has been one factor behind sterling's recovery from its low point before that meeting. It has also been associated with substantially reduced production. Together with lower prices, this has reduced the export earnings of OPEC members, and although the volume of their imports ceased growing in 1982 many of them are now in current account deficit.

Even though interest rates abroad have fallen, real rates still remain high. The gathering world recovery, with somewhat higher commodity prices, should, on the other hand, be helpful to developing countries, and especially to the major debtors. The export receipts of many of them should improve. Even so, the highly indebted countries will still have to curtail their imports and make other adjustments if the confidence of lenders is to be upheld, so that private finance may be forthcoming to complement IMF funds.

These imperatives for developing countries, and parallel sharp reductions in the imports of OPEC countries, mean that the industrial countries cannot expect a stimulus to come from the rest of the world for some time. Moreover, within the OECD, a number of the smaller countries are also facing difficulties. World recovery thus depends, even more than usual, on the strength of the forces making for revival within the major countries. So far this revival has depended mainly on personal spending and on an end to destocking. If it is to continue at a moderate rate there will have, in due course, to be some revival of corporate capital spending. But there remain substantial uncertainties on both sides. While disappointing growth could exacerbate the problems of indebted developing countries, and increase financial tensions, a further consolidation of the prospect for recovery, at a pace which did not appear excessive, could have widely beneficial effects on confidence and investment.

In the sectors producing internationally traded goods, which are substantial in most economies, the confidence to invest must be weakened by volatility in exchange rates. Swings in exchange rates have frequently borne little relation to developments in relative costs, yet have often persisted for periods longer than those for which forward markets can offer adequate cover. Partly for these reasons there remains widespread concern about exchange rate instability.

The domestic economy—prices and costs

Earlier this year the prospects for steadily reducing inflation appeared to have suffered a temporary set-back as a result of the fall in sterling in the four months or so to late March—though there were reasons (set out in the March *Bulletin*) for thinking that any set-back would be small. This view is now supported by the partial recovery in the exchange rate. The earlier decline in actual and expected inflation contributed to a fall in the personal saving ratio, and thus to the strength of consumer demand, last year. That is now being reflected in the recovery of output, discussed below.

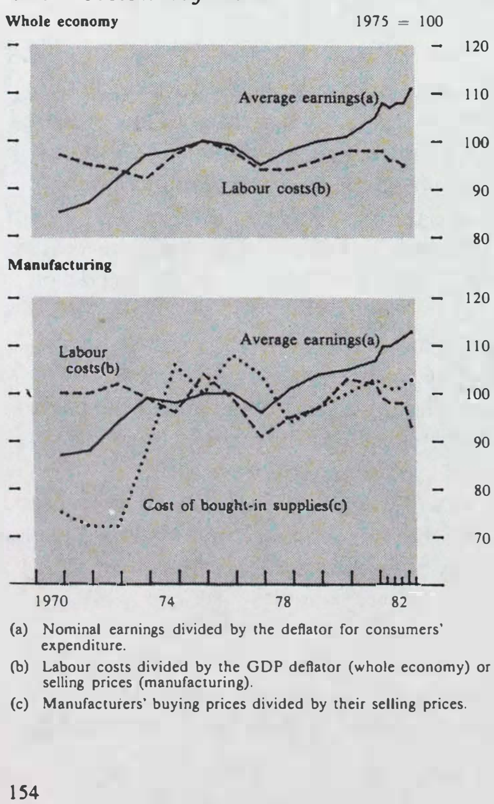
Underlying increase in average earnings[(a)]

		Percentages
In year to:	April 1980	21½
	April 1981	14
	April 1982	10¼
	April 1983	7¼

(a) Whole economy; adjusted for back pay and other timing factors.

Over the last three years, the rate of increase of wages has fallen progressively. So far in the present pay round, settlements appear to have averaged some 5%–6%, 1%–2% lower than last year, and seem to have fallen slightly during the round as the rate of inflation has declined. Average earnings are likely to have risen by some 7% over the course of the round, about 2% less than in the previous year. The growth of earnings will nevertheless have outstripped price inflation, as in each of the last five years. If changes in taxation and national insurance contributions are taken into account, the real take-home pay of those in work, which had fallen, rose on average by over 3% in the last year to stand just above its level of two years ago. While the purchasing power of those who have lost their jobs in the current recession has been reduced, that of those who have continued to work—taken as a whole—has not.

Real earnings ***are increasing . . . but*** **unit labour costs** ***have fallen.***



(a) Nominal earnings divided by the deflator for consumers' expenditure.
(b) Labour costs divided by the GDP deflator (whole economy) or selling prices (manufacturing).
(c) Manufacturers' buying prices divided by their selling prices.

Nevertheless, thanks chiefly to rising productivity, the real cost of labour per unit of output has declined since 1981. This development has contributed to some recovery in profit margins and to the improvement of industry's international cost competitiveness; and must in due course help to sustain employment.

It is clearly important that the trend to lower pay settlements should continue in the coming pay round. There appears to be some tendency now to see the progressive reduction in the size of wage settlements in recent years as something that cannot be continued, but such a view may be mistaken. Throughout this recession, both in this country and abroad, the general tendency has been for inflation, once it started to fall, to decline faster than generally expected. One consideration pointing to a more optimistic view is that the rate at which consumer prices are rising—which is one factor in wage settlements—is likely to remain much below what it was a year ago. Again, the competitive and financial pressures on firms, which have been varied but typically intense, are unlikely to ease very much; firms' survival will continue to depend on their remaining competitive. There ought therefore to be a good chance of achieving a further significant reduction in the level of settlements in the next round. Settlements are likely to vary widely between firms—proportionately more widely than for a long time. This may make wage bargainers less inclined to look back to previous changes in industry-wide or nation-wide averages as a yardstick for individual settlements. That would help further to diminish the inertia of persistent inflation.

Given such restraint in wage settlements, the rate of price increase could progressively be brought down to a very low level, which would then be capable of being maintained through a phase of recovery lasting several years. Progress on these lines requires a monetary policy which continues to provide room for real growth and increased employment within a framework which engenders confidence that inflation will be progressively reduced.

The upturn in demand and output

As previous *Bulletins* have noted, final domestic demand has been growing since mid-1981. In the latter part of last year, consumer spending, in particular, was very strong. Yet output grew only slowly—indeed in the fourth quarter of last year manufacturing production reached its low point of the recession. Much of the growth in demand was for a time met out of stocks.

Although the course of final demand provided a measure of encouragement, business sentiment remained rather pessimistic until the early months of this year. Since then, although experience has been patchy, the mood seems to have changed. The better tone is associated with a recovery in industrial (and in particular manufacturing) production—variable from month to month, but nevertheless now on average well above the depressed fourth quarter. A very sharp change in stockbuilding around the turn of the year, equivalent to 2% of GDP, certainly helped to raise output (as well as imports) in the first quarter. While slightly below the exceptionally high level of the fourth quarter, consumer spending remained firm, retail sales in April and May set new records, and housebuilding has also been buoyant.

Such a strong stimulus from stockbuilding behaviour is unlikely to be repeated; nor may there be an immediate resumption of the earlier fast growth of consumer spending, which depended on a sharp fall in the saving ratio. Trends in the external trade position are obscured by month-to-month variability but seem to be adverse. On the other hand, business surveys suggest a revival of private industrial investment this year and next, despite the existence of much spare manufacturing capacity and the still unsatisfactory level of profits. The growth in housebuilding looks firmly established. Altogether, therefore, there seems no reason to change forecasts of gradual growth of output over the next year.

Company profitability is discussed in an article on page 232.

The longer-term trend in UK trade performance

Over the past seven years, the volume of manufactured exports, although volatile in the short run, has remained fairly level, and has shown no persistent tendency to rise or fall. When world trade was expanding UK exports failed to share in that expansion; more recently they have not felt the full force of world recession. Such a tendency for UK exports to do relatively well when world trade is slack (and vice versa) is of long standing. In the most recent phases of relatively rapid, and then slower, world growth, large movements in UK labour cost competitiveness have been such as to reinforce these shifts in market shares.

The volume of manufactured imports, by contrast, has shown a long-term tendency to increase, but their path has been strongly influenced by the UK stock cycle. Imports rose particularly sharply in 1981, when there was a pause in destocking, but were then fairly flat through last year; and their further increase this year may again reflect a turnround of stockbuilding in the economy. Between 1976 and the start of the present year — two dates which are broadly cyclically comparable — they rose by three quarters. The recent deterioration in the balance of non-oil trade, which has been less dramatic than that for manufactures alone, has gone along with some fall in the non-oil terms of trade. These have been the major factors in reducing the current account surplus in the first part of this year.

Imports and stockbuilding

	Change in stockbuilding	Change in volume of imports of manufactured goods
	£ billions, 1975 prices	*Percentages*
1980 H1	−1.2	− ½
H2	−0.8	−11½
1981 H1	−0.2	+ 1½
H2	+1.0	+19
1982 H1	+0.4	+ 2½
H2	−0.7	− 1
1983 Q1(a)	+0.5	+ 8½

(a) Changes between the quarterly average in 1982 H2 and 1983 Q1.

Financial and monetary developments

Developments in the economy have been reflected in changes in the financial position of the corporate and personal sectors over the last year — where, despite considerable statistical uncertainties, the underlying developments seem clear.

In the second half of last year, the corporate sector's financial position became easier, in part because of the massive run-down of stocks. This was reflected in an increase in net liquidity: companies built up gross liquid assets more rapidly than before, and increased their borrowing from the banks more slowly. Monetary statistics suggest that this process has continued this year, even though the financial relief from destocking may have come to an end.

The growth of personal sector borrowing from banks may also have slowed a little, particularly borrowing to finance consumption. Although new bank lending for house purchase has moderated since last autumn, building societies' advances have increased even more rapidly, so that total outstanding housing finance has continued to increase at a very rapid rate. One result has been the rise in housebuilding activity; private housing starts in the first four months of this year were 25% above last year's average. House prices have continued to rise at a rate close to 10% a year — considerably faster than general price inflation, but after a period of slow growth in house prices.

The improvement in the financial position of companies in the first quarter was probably helped by the rapid expansion of public sector borrowing as the financial year ended. Although the pace of bank lending was reduced, the net effect was a higher rate of monetary growth; and the broad measures of money increased rapidly in banking April (which spans the financial year end). The sudden increase in public sector borrowing was largely unforeseen; the PSBR for 1982/83, expected at the time of the last Budget in mid-March to be around £7½ billion, is now put at £9 billion (which, however, is still below the £9½ billion projected in the 1982 Budget). And, despite heavier sales of public sector debt, particularly of gilt-edged, these were insufficient fully to offset the monetary consequences of higher public borrowing. The wider monetary aggregates, however, grew less rapidly in May.

In recent years there has been a continuing tendency for the money supply to grow faster than nominal incomes: velocity has fallen faster than historical precedent would have suggested. In part recession may have increased the precautionary demand for liquid balances. But here, as in other countries, the tendency has also reflected financial innovations. There has been greater competition among financial institutions, encouraged by a general process of deregulation which many countries have been pursuing. In the United Kingdom, until recently, it is the growth of the broader aggregates that has been most affected: there has been increased competition for personal sector savings. In other countries, narrow money has been more affected: new deposit instruments (now beginning also to make an impact here) have offered better yields or greater convenience in transactions. The quantitative impact of these structural changes is difficult to assess in advance, and this has inevitably caused problems for the interpretation of monetary data in a number of countries. Both here and abroad, therefore, the exercise of considerable judgement is required. It has been found necessary to assess monetary conditions in the light not only of the evolution of the monetary aggregates but of other available evidence.

See Operation of monetary policy on page 171.

As the earlier discussion has suggested, the various indicators of UK monetary stance may, at present, be heavily affected by temporary factors, and they point to some extent in different directions. Though the growth of the broader aggregates slowed in May, the growth of all three targeted aggregates in the first three months of the present target period has been clearly above the target range. The rapid growth of the broader aggregates has its counterpart both in a very high level of mortgage finance and in unexpectedly high public borrowing; it remains to be seen whether the latter is a temporary development. On the other hand, the immediate prospects for inflation have improved over the same period, partly as a result of the higher exchange rate. In these circumstances the authorities did not resist the modest fall in market interest rates that took place earlier this month.