General assessment

This assessment discusses economic and financial developments and prospects in the United Kingdom against the background of economic recovery in the United States and the continuing international debt situation.

Developments in the world economy

There has been a strong recovery so far this year in the United States. There was a large rise in GNP in the second quarter, and though growth subsequently may prove slower, a rise of at least $5\frac{1}{2}\%$ between the fourth quarters of 1982 and 1983 is now quite possible. The growth in demand has been broadly based: consumer spending was strong, with rising real average earnings, increasing employment and a lower saving ratio; housing investment has risen, and business spending is increasing. Much of this reflects a spontaneous cyclical recovery. But it also seems that the direct fiscal effect has been expansionary, with the Federal deficit (after allowance for cyclical influences) having apparently widened in 1982, and likely to do so again this year. The growth of the monetary aggregates has been distorted by structural changes in the US financial system. Though the targets were adjusted to accommodate this, monetary policy, while recognising the need to foster growth, continues to be governed by anti-inflationary objectives.

The rise in US interest rates since the spring helped to raise the dollar exchange rate, which is now 40% higher in effective terms than three years ago. Both high interest rates, which are drawing in savings from abroad, and the strength of the dollar are associated with the prospect of the structural Federal deficit growing even as the economy recovers. The capital inflow is accompanied by a massive and growing deficit on current account. Though recently published increases in consumer and producer prices may understate the underlying trend, the pace of inflation has been greatly reduced.

Canada, with three-quarters of its exports (equivalent to about one fifth of GDP) going to the United States, has benefited from the US recovery, and domestic demand has also grown. Outside North America, recovery is proceeding at a much slower pace. Nevertheless, West German GDP has risen steadily this year, and surveys point to an improvement in the business climate there, while signs of increased domestic spending are evident in Japan. France and Italy, however, remain depressed. In Japan and West Germany, consumer price inflation has been running at around 2% – 3% in recent months; inflation in France and, especially, Italy has been considerably higher. The recent strength of the dollar and of commodity prices could add to other countries' inflation rates in coming months.

Spot commodity prices are now some 27% higher in SDR terms than last autumn. The recovery in industrial countries has been one factor. Other influences have been weather conditions, for example the drought in some food-producing countries, and the withdrawal of supply capacity in response to the very low level of prices last year. The rise in prices is, however, hesitant; in some cases it has been checked by interest rates (an important part of the cost of holding stocks), and in others by signs that some capacity is being recommissioned.

During the course of the recession, commodity prices had become unsustainably low. Although unhelpful to continuing progress against inflation, the recent rise in commodity prices will ease the position of many indebted developing countries. Domestic retrenchment in these countries has already brought a marked change in their balance of payments. Thus non-oil developing countries' current account deficits have fallen, from \$80 billion in 1981 and \$65 billion in 1982 to an annual rate of perhaps less than \$50 billion in the first half of this year. The fall seems to have been particularly marked in Latin America where both Mexico and Brazil have moved into substantial trade surplus. But higher demand from industrial countries is also essential to the debtor countries' success in extricating themselves from their difficulties. Meanwhile the pattern of financing has changed somewhat, away from bank loans and other sources of private capital towards official sources, notably the IMF.

Recovery, inflation and monetary growth in the United Kingdom

The different indicators of total economic activity in the United Kingdom give widely varying accounts of the speed of recovery. The expenditure measure of GDP, though indicating a setback in the second quarter, has, at 2.9% per annum, risen almost twice as fast in the two years to the first half of 1983 as has the output measure. But all the measures now suggest that growth in the last two years has been quicker than had previously been thought. Both expenditure and output figures also suggest that growth has been more rapid in the second year of recovery than in the first.

Measures of GDP

Percentage changes; in volume terms

	1981 H1–1982 H1		1982 Q1–1983 Q1		1982 H1–1983 H1
	Old figure(a)	New figure(b)	Old figure(a)	New figure(b)	New figure(b)
Expenditure	+0.5	+1.4	+3.7	+5.4	+4.3
Income	+1.3	+3.3	+1.8	+3.0	+3.3
Output	+0.9	+1.5	+1.6	+2.1	+1.9
Output excluding oil and gas	*+0.5*	*+1.0*	*+1.1*	*+1.4*	*+1.4*
Average of three measures	**+0.9**	**+2.1**	**+2.4**	**+3.6**	**+3.2**

(a) July 1983 *Economic Trends*; at 1975 prices.
(b) Central Statistical Office industrial production and GDP press notices, September 1983; at 1980 prices.

The first year of recovery was characterised by a boost from stockbuilding, partly offset by a weaker trade balance, and by some recovery of fixed investment from a low level. The feature of the last year, however, has been the strength of consumer spending, up by $4\frac{1}{4}$%, adding 3% to GDP. Around the turn of the year a sharp change in stockbuilding gave a stimulus equivalent to nearly $2\frac{1}{2}$% of GDP but, with the increase in stocks much reduced in the second quarter, that stimulus seems again to be temporary. Housing investment probably recovered further in the year to the first half of 1983 but industrial investment appears to have been little changed, remaining below the rates of 1979 and 1980.

Consumer spending and borrowing

The economic recovery that has so far occurred has several features which call for comment and appraisal. Apart from the role played by stockbuilding, recovery in the last year or so has been consumer led. Consumer spending rose although personal disposable income was flat in real terms: the saving ratio has fallen fairly sharply. Earlier, inflation had eroded the value of monetary assets held by persons and the rise in the saving ratio—to about 15% in 1980—probably represented a desire to build them up again. Now that inflation has fallen off, the ratio has fallen below 10% and spending has risen.

Reduced inflation has thus facilitated a consumption-led recovery. Consumption has indeed helped to lead the economy in most past recoveries in this as in other industrial countries; and in present circumstances, also, this seems inevitable. A lead from exports has been inhibited by the rather muted world recovery so far, and the competitive position of British industry, while excess capacity in industry tends to discourage a strong lead from the side of investment. The revival of consumer demand has therefore been welcome, though recovery, if it is to carry through, now needs to be more broadly-based.

To an unusually large extent also, recovery in the recent period has been credit-financed. Mortgage lending to persons by banks and building societies has been on a scale far larger than required to finance additions to the privately owned housing stock; and consumer credit lending has risen, in part encouraged by the abolition of the remaining hire purchase controls last summer. Readier access to borrowing was probably an additional stimulus to spending in that it enabled consumers to reduce their rate of saving without, apparently, reducing their accumulation of financial assets.

A credit-financed expansion could be a cause for concern if it exceeded due limits. The level of personal sector debt has increased rapidly and is already high by UK standards. But comparison with the United States might suggest that personal sector gearing and indebtedness, especially against the housing stock, could rise yet further. Debt may nevertheless now rise less rapidly: borrowers may come to worry about the level of their debt, or its ratio to income, or the burden of servicing costs. A credit expansion of the sort that has taken place may thus in large part be of the nature of a financial stock adjustment, inevitably limited in duration. But the building societies, which have recently restored their competitive position in the market for deposits, are in a position to continue lending at a high rate and consumers on their side appear likely to wish to continue availing themselves of this opportunity.

A different possible source of concern is that credit-financed spending may be concentrated in particular areas where it risks raising prices, and that this could have implications for expectations and price inflation more generally. Increases in house prices are perhaps the likeliest example. Though the growth of mortgage lending has been striking, a small but significant part of these funds has been used to buy council houses. These sales must have had a moderating influence on the rise in house prices, which seems to have been roughly 10% over the last twelve months. Figures for the second quarter suggest that the pace has not quickened: it does not appear to have had any large effect so far on inflationary expectations, perhaps because house prices had previously fallen behind.

The cyclical pattern of sector finance

The leading sectors in a recovery are likely to experience an initial worsening of their financial position (ie a reduction in financial asset accumulation or an increase in indebtedness), as the consumer sector has been doing recently. As a counterpart to increased consumer spending, there is likely to be an improvement in the financial position of the company sector, and this has also been the case.

Companies' experience in the present period of partial recovery bears important resemblances to the upswing which followed the recession of the mid-1970s. In both cycles the onset of recession saw a substantial fall in industrial and commercial companies' net liquidity, in each case associated with an acceleration in companies' borrowing from the banks. On each occasion, companies reacted by cutting spending and stocks. This produced some improvement in net liquidity by the later stages of the two recessions; and during the initial phases of the subsequent upturns it was built up further, as companies continued to destock. In the mid-1970s upturn there then followed a phase when fixed and inventory investment increased, and profitability also improved. Profits indeed increased sufficiently to allow net liquidity to continue to improve; and there was no substantial acceleration in companies' borrowing from banks.

In the current phase of recovery, corporate bank borrowing has remained near the low rate to which it fell earlier in the year, and net liquidity has recovered; and it could be that companies will be able to finance increased spending on capital projects over the next few quarters without greatly increased reliance on the banks. That would be important both in broadening the recovery and in reining back the pace of monetary expansion.

The counterparts to monetary growth are various elements in bank lending—including here the unfunded portion of the PSBR. It is misleading, however, to regard these elements as wholly separate influences. As is widely recognised they are often in practice closely related and tend, in part, to offset each other. Thus personal sector borrowing has partly gone to finance expenditure—that has eased companies' financial positions and recently moderated companies' borrowing. In the period, perhaps now ended, when persons were rebuilding their inflation-eroded holdings of financial assets, the assets they wished to acquire will to some considerable extent have been liabilities of the banks and thus included in sterling M_3.

The net effect of private and public financial transactions was a growth of the broad monetary aggregates at annual rates of 12%–15% in the first half of the current target period. The recent slowing of this growth reflects, in part, the profile of the PSBR and will need to be maintained for the remainder of the period. The velocity of circulation of money will have fallen further this year. It has been declining for three years after having risen in the late 1970s.

Prospects for prices

The domestic factors tending to reduce the pace of price rises now seem likely to be more favourable than international factors, which may have ceased to produce the significant assistance of the recent past.

Manufacturing productivity has recently been rising unexpectedly fast, and this could continue. At the present time, therefore, confidence and expectational factors are likely to be especially important in determining the pricing behaviour of companies. If firms became convinced that, over the medium term, demand and output were going to recover more strongly, they could be encouraged to pitch their prices lower on the basis of a more optimistic assessment of the underlying productivity trends. In turn, lower prices could stimulate demand. In this way, optimistic expectations could validate themselves—and despite the implied short-term restraint on profit margins, the upshot could, in the event, be enlarged profits. To the extent that any such faster growth in output went with increases in productivity, the employment effect would be diminished. There would, however, be a further general lowering of inflation, which might increase consumer demand and improve competitiveness and, indirectly, help with the serious problem of unemployment.

In some degree this process is already visible. Alongside more moderate pay settlements, rising productivity, resumed this year after a pause in the second half of 1982, has brought wage costs in manufacturing to a level only 2% higher than last year. In the economy as a whole, wage costs per unit of output have risen by perhaps 4%–5% over the same period—the smallest increase for many years. Profit margins are continuing to widen, but not so much as to offset the effect on prices of the slowdown in wage costs. The rise of the GDP deflator (the broadest measure of domestic costs which includes profit margins) has slowed and could slow further even though there is likely to be some pick-up in consumer price inflation.

Consumer prices are affected not only by domestic costs but also by international factors. These, having earlier helped inflation down, are now operating less strongly, or going into reverse. The rise in world prices of commodities to a more normal relationship with prices of manufactured goods (however desirable from an international point of view) is an unfavourable factor for domestic prices in the immediate future. It is important that the underlying rate of domestic cost inflation, especially wages, should not react adversely to this prospect. So far at least, the effects on UK import prices have been minor; and the present recovery in the economy is moderate, with levels of slack so large that it may be expected that downward pressure on wage and price increases will persist.

The risks to inflation could become more serious if, at some stage, expansion, however generated, were thought likely to become over-rapid. Equally serious would be a failure of domestic supply to respond to even moderately growing demand which would imply a further deterioration in the current account. The best route to an adequate supply response would be consolidation of confidence in a non-inflationary recovery, both domestically and worldwide. That can only be built progressively as recovery proceeds.