General assessment

After three years of virtual stagnation the economy of the industrial world has shown modest growth in 1983. Inflation has generally slowed to a pace last seen in the early 1970s. The UK economy, having suffered a steeper recession than most, is now among the leaders; and from having been among the most inflationary industrial countries it is now among the low inflation ones.

The greater fall of inflation in the United Kingdom has contributed to a stronger rise in consumer spending than in other countries; this has been an important constituent of the revival of demand and output. It seems likely that consumer demand will soon expand less strongly, though to date both the growth of retail sales and the pace of mortgage lending which has supported it, have remained rapid. Monetary trends need to be interpreted in the context of the continuing force of competition and institutional change in financial markets.

Developments in the world economy

There has recently been some slowing in the fall of inflation in the industrial countries. In the major countries consumer prices rose by $4\frac{1}{2}$ per cent in the year to October as against some 6 per cent in the previous year, but nearly all this improvement had occurred by March. Falling commodity prices had been an important factor bringing inflation down, but an unexpectedly fast increase in demand, together with supply problems in a number of markets, brought about a sharp reversal on a wide front in the first half of this year. Relative to prices of manufactured goods, non-oil commodity prices have changed little on average over the last few months. Although oil prices have fallen this year, any further contribution of primary product prices as a whole to the fall in inflation seems bound to be much smaller. With prices rising more slowly, wage rises have also declined; increases in average earnings in the industrial countries are now running at a rate several percentage points lower than before the second oil shock in 1979. This in turn has not only helped to reduce inflation but has also brought a welcome shift in the distribution of income towards profits.

Estimates of real interest rates in Germany, the United States and the United Kingdom are compared in the note on page 471.

Since late last year economic growth has resumed in the industrial world where output, after a slow start, has picked up to an annual rate of about 4 per cent in recent quarters, with the pace being set by the United States. While the expansion there has so far been helped by the stimulatory effect of the budget deficit, the prospective growth in the structural deficit is probably an important factor in bringing real dollar interest rates to historically high levels, and threatens the continuation of recovery. This has put upward pressure on real rates elsewhere. As a result, although

there has been some decline in nominal rates, with falling inflation and firm fiscal policies, interest rates have been higher than they need have been.

In general, the evolution of demand has been typical of this phase in post-war cycles. Consumption has been fed by falls in saving ratios in many countries, no doubt associated with the fall in inflation (but which, for that reason, may from now on be a weaker factor). Residential investment has been strong in North America, perhaps helped by falls in nominal interest rates: and in addition there has been a modest swing in the stock cycle. A sharp revival in business investment would not be expected at this stage in the cycle, but the increases in company profits and liquidity, together with a more general improvement in confidence as lower inflation seems secured, may now bring about a stronger growth in business spending than would be foreseen from the state of demand and capacity utilisation. Employment, though already rising, is growing at about the same pace as the labour force, so that unemployment, which has fallen markedly in the United States, is likely only to stabilise in other industrial countries.

In the developing world, growth has been sharply reduced in the last three years. In part this has reflected recession in the industrial countries, through falling export volumes and weak commodity prices. These factors have already been reversed to some extent but the debt problems of the developing countries represent a longer lasting constraint, both on their growth rates and on their demand for industrial countries' exports. Lower nominal interest rates, and oil prices, have helped many of these countries, although the rise in the international value of the dollar has worked the other way. Reserves were run down last year, but the scope for further falls seems very limited. The joint international effort by commercial banks, governments, central banks and international institutions, has maintained the flow of bank lending, but at a rate below that of 1982, itself well below the rate of previous years. In the face of these financial constraints the developing countries have already cut their aggregate trade deficit to half its 1981 level, but there may yet be a need for further adjustments in some cases.

UK performance in the world context

UK growth and inflation have recently been close to the overall averages of industrial countries, and better than in much of Europe. The economy appears to be growing at almost 3 per cent per annum and we now seem to have reached a point where unemployment is no longer rising, an important watershed. Comparative developments on wages and productivity have been striking. For many years up to the early 1970s, the growth of productivity in UK industry lagged behind that in other major industrial countries: performance deteriorated after the first round of large oil price increases in 1973–74, and the gap between the United Kingdom and other industrial countries widened. In the last three years, however, output per man-hour in UK industry has risen rapidly, and indeed has grown faster than elsewhere, although Japanese industry continued to perform well in this respect and the United States and Canada, where output has increased very fast, will also have registered rapid growth in productivity this year. On the other hand the rise in employment costs per man-hour in UK manufacturing industry remains somewhat above the international average. Taking these

developments together, UK unit labour costs have probably been increasing broadly in line with the average abroad. Although the fall in sterling's effective rate since the autumn of 1982 has contributed to an improvement in competitiveness, UK costs are still relatively high when measured in a common currency. Moderation in wage increases therefore remains very important.

There are as yet few indications of the trend of settlements in the new pay round. Although most settlements so far have been for slightly smaller nominal increases than last year, the decline is less than that in the inflation rate over the same period. It seems likely that the real earnings of those in work will again rise in the year ahead, even if overtime and productivity bonuses contribute less to the increase. The implications of such a rise for unit labour costs, and competitiveness, depend on what happens to productivity. There have been such large variations in productivity movements in the last ten years that the trends are not yet clear enough to provide a basis for confident projection. There are, however, signs suggesting some recovery of the trend towards the levels of the 1960s. The continuation of this recovery will depend in part on fostering constructive attitudes to technical change.

Profits have increased quite rapidly, with higher margins contributing more than rising output in the industrial sector, but with rising sales being the main factor in retailing. Though the figures are subject to substantial revision, the broad picture is clear: industrial and commercial companies' recorded profits grew by nearly 50% between the first halves of 1981 and 1983. The increase was even larger in non-North Sea operations, representing a rise of 35% in real terms and following a similar fall in the previous three years. The rate of profitability (again excluding North Sea operations) is probably over 6% in real terms, compared with 2%–3% in the first half of 1981; it is still, nevertheless, lower not only than in the 1960s but also than in 1978, and well below the level necessary for a healthy rate of investment.

Retail sales have continued strong although their monthly course has been uneven. While actual mortgage lending, unlike commitments, has dipped slightly since mid-year, so have housing starts, and a considerable proportion of these funds continues to be available for other expenditures. With the rise in building society liquidity, and indications of renewed interest by banks in mortgage lending, the supply of finance seems unlikely to become an effective constraint on consumer spending. The level of debt in relation to income could become such a constraint in due course; on the other hand, real household disposable incomes may well rise.

The changing pattern of trade is discussed on page 464.

The United Kingdom has moved into deficit in trade in manufactured goods this year; the recent improvement in competitiveness has not been sufficient to make up for adverse trends, particularly in import penetration, and has been offset to some extent by faster growth of final demand here than in many of our overseas markets. Thanks to continuing large net exports of oil, the current account as a whole is likely again to be in surplus this year, though to a considerably smaller extent than in the past few years. At the same time the process, facilitated by freedom from exchange controls, of institutions acquiring portfolio assets abroad has continued on a substantial scale. Production of oil is set to decline later this decade, and will take export volumes and earnings down with it. The return to be earned on net assets built up abroad

will be an important element in making good this decline in oil's contribution to the current account and national income.

Developments in UK financial markets

The combination of rising industrial profitability and the buoyancy of consumer spending has been associated with a marked change in the financial position of major groups within the private sector over the last eighteen months or so. Companies have moved into increasing financial surplus, and this has been associated with a much reduced net borrowing requirement. In contrast, the household sector is borrowing heavily to finance house purchase and consumer expenditure, and is now in financial deficit apart from long-term contractual saving through life assurance and pension funds. The changed pattern of financial balances has begun to influence the financial markets; with the generally reduced flow of loans to companies, banks have switched to lending to persons, including for house purchase, and become increasingly reliant on deposits taken via the wholesale market.

The jointly recommended structure of building society interest rates has been progressively eroded by the introduction of special types of exempt account. The recent ending of this arrangement indicates a further increase in competition, both within the movement and also with banks, for retail deposits. The attractions of investment in housing, and of borrowing in the form of mortgages, are considerable, more especially because of the tax concessions on this form of borrowing. Hitherto the impact of this type of investment demand on financial markets has, from time to time, been limited by mortgage rationing, which now seems less likely to recur. In future, peaks in mortgage demand may be more fully met by the societies, increasing their need to attract deposits; this could at times become a factor exerting a degree of upward pressure on interest rates more generally. More immediately, however, it is possible that there may be more than enough mortgage funds available at present rates; indeed there may well be intensified competition to lend. It is very hard to predict the long run effects of the demise of rationing on such indicators as the ratio of mortgage debt to personal income, although the trend seems likely to be upwards.

The course of monetary growth in the present target period has been associated with large swings in the PSBR. Since the middle of the year the target aggregates have grown by about half the rate seen in the earlier part of the present target period. This deceleration was sufficient to bring sterling M_3 back within the 7%–11% target range; M_1 and PSL_2 have remained somewhat above it. To some extent the swings in the public sector's contribution to the counterparts of sterling M_3 have been offset by movements in bank lending. UK companies have more than doubled their drawings from the capital market this year, but the increase in internally generated funds, and the slower build-up of their gross liquidity, have been more important factors in explaining the decline in the rate of their borrowing from the banks.

Though in proportionate terms the increase in overseas borrowing in the UK capital market has much exceeded that of companies, it remains relatively small. Even if issues on the eurosterling market are included, non-resident sterling borrowing, at under £2 billion this year, is unlikely to have had much direct impact on UK

interest rates. The opportunity for funds to flow either way means, however, that domestic markets are affected by international forces; and action affecting domestic residents, on either side of the market, can be offset, to some extent, by external flows. Domestic real interest rates, like the relative prices of different goods, are strongly influenced by world markets. This influence operates more effectively at the shorter than the longer maturities. The recent fall in longer-term sterling yields relative to dollar yields on similar assets may thus reflect, in part, revised expectations about relative exchange or inflation rates, or possibly the relative scarcity of longer-dated gilts. The extent to which short real interest rates in the United Kingdom, the United States and Germany have moved together in recent years, including some when exchange controls were in force, is shown in the note on page 471.

The process of change under way in the securities markets seems likely to be accompanied by wider changes in the structure of the financial system, which in turn will probably require a period of active planning and preparation, both by those engaged in financial markets and by the authorities, in the year ahead. One of the principal elements in the agreement between the Government and the Stock Exchange is the undertaking to dismantle the system of minimum commissions. This could well lead to more far reaching changes which are difficult to foresee at this stage. The present separation of function between brokers and jobbers on the Stock Exchange, under which each operates only in a single capacity, has provided important safeguards for the investor, and if this basis of protection were to change, some form of enhanced disclosure to investors would seem essential. The concern of some Stock Exchange member firms to increase their capital, which is now small in comparison with international securities houses, may lead to new associations with financial intermediaries or institutions, straddling the conventional boundaries between different financial activities.

The changes in prospect in financial markets, in response to the release of market pressures previously restrained, should help to produce a more efficient and internationally competitive financial market in London. The City already provides a base for more foreign-owned financial institutions than any other financial centre, and this is one of its strengths. Changes to come may well bring a further increase in foreign participation; but it is important that this should be matched by the international involvement of strong groupings of British-owned institutions, which will no doubt emerge. Such developments would strengthen the competitive position of London in the world securities industry and increase both the output of financial services and invisible earnings.

Such developments have important implications for the Bank's oversight of financial markets. The gathering pace of change and innovation in these markets complicates the task of monitoring and interpreting monetary conditions, and also makes it the more essential that monetary developments be kept under restraint and on an orderly path.