Economic commentary

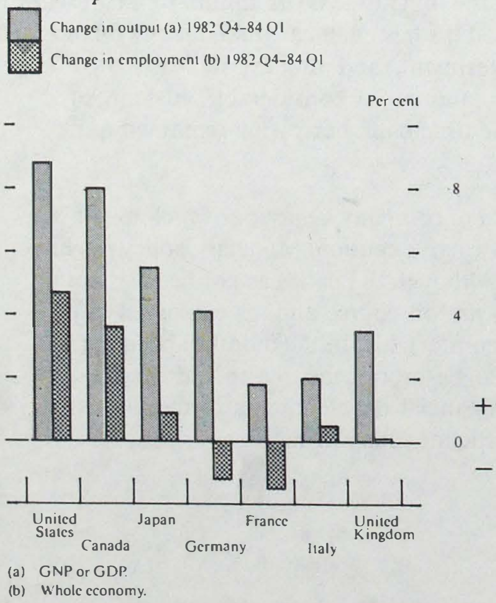
The impact of still higher US interest rates and the dollar on financial markets is discussed in other parts of the Bulletin. *Although these rises could have a dampening effect on domestic demand in other countries, the associated strong demand in the US economy so far has stimulated exceptionally rapid world trade growth. Activity in the major industrial countries has generally grown faster than expected and inflation remains subdued, but economic recovery outside the United States is still fragile.*

In the United Kingdom, even allowing for the immediate effects of the miners' dispute, the growth of output and demand seems to have become more hesitant, with higher net imports and a slower rise in industrial investment. Employment in the service industries continues to increase and there are some signs that the fall in manufacturing employment may have been checked; but unemployment has risen further.

Total domestic costs and retail prices continue to rise at about 4½%–5% while average earnings have been rising at an underlying rate of 7½%–8%. The rise in manufacturers' unit labour costs, seems to have accelerated since the end of last year, whereas in other industrial countries, where earnings have grown less, unit labour costs have generally been falling. The decline in sterling's effective rate has broadly compensated for this competitive disadvantage but it has also offset falls in the dollar price of many materials used by UK industry.

Although in financial surplus, both the personal and company sectors increased their bank borrowing in the first half of the year by more than they built up their deposits. Personal sector borrowing from building societies was also buoyant.

Strong **output and employment** *growth in North America has not been matched in Europe*



(a) GNP or GDP.
(b) Whole economy.

Recovery quickens in the major countries . . .

The recovery in the world economy continued in the first half of the year and broadened further. Although recently there have been some signs of hesitation, growth in the main industrial countries has generally been higher than expected so far this year. Encouragingly, faster growth has not been associated with a resurgence of inflation, which in the less rapidly growing economies has further abated and even in the more buoyant countries has remained subdued.

The combination of strong growth and only modest inflation is seen most clearly in the United States. GNP there grew by more than 7% at an annual rate in the second half of 1983, and by nearly 8½% in the first half of this year, but consumer price inflation has fluctuated narrowly between 3% and 4½%. Helped by the strength of the dollar and the weakening of world energy and commodity prices, the cost of materials and fuel used by industry rose by only around 3% in the year to June, while hourly earnings in manufacturing increased by 3½% over much the same period.

Another distinguishing characteristic of the US recovery has been the buoyancy of the labour market—in contrast to many other industrial countries where employment has, at best, shown little change unemployment is still rising. Employment in the United States increased from the beginning

GNP[(a)] in major industrial countries

Percentage changes on previous period (annual rates); at constant prices; *seasonally adjusted*

	1982	1983 Year	1983 H2	1984(b) H1
Canada	-4.4	3.3	7.0	3.6
France	1.9	1.0	1.1	1.8
Germany	-1.1	1.2	2.3	1.8
Italy	-0.4	-1.2	1.9	2.7
Japan	3.3	3.1	5.0	5.3
United Kingdom(c)	2.0	3.1	2.6	0.8
United States	-1.9	3.3	7.2	8.4
Total of 7 countries	**-0.3**	**2.5**	**4.9**	**5.2**

(a) Or GDP.
(b) Partly estimated
(c) Average estimate of GDP.

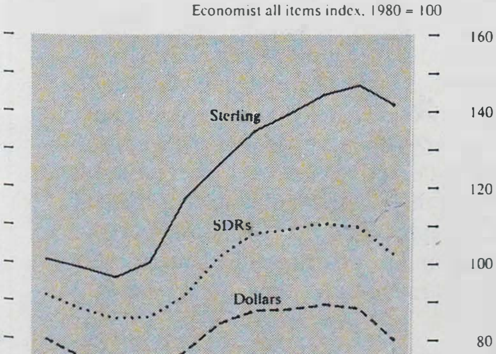
Contributions to the growth of GNP in major industrial countries[(a)]

Percentages of GNP (annual rates); at constant prices; *seasonally adjusted*

	1982	1983 Year	1983 H2	1984(b) H1
Private consumption	0.9	1.8	2.4	2.1
Government expenditure	0.3	0.2	—	0.4
Private fixed investment	-0.5	0.6	1.7	1.7
of which:				
Housing	*-0.3*	*0.5*	*0.6*	*0.2*
Other	*-0.2*	*0.1*	*1.1*	*1.5*
Stockbuilding	-0.4	0.1	0.9	1.7
Domestic demand	0.1	2.6	5.0	5.9
Net trade	-0.3	-0.2	-0.1	-0.7
GNP	**-0.3**	**2.5**	**4.9**	**5.2**

(a) Canada, France, Germany, Italy, Japan, United Kingdom and United States.
(b) Partly estimated.

Non-oil commodity prices *have fallen this year—though less in sterling terms*



(a) 1984 Q3 based on average of July and August.

of 1979 to the middle of last year by only 1%; by June this year it had risen a further 5%. The unemployment rate of 7½% in July was more than 3 percentage points below the peak reached at the end of 1982. These changes may reflect supply factors as well as the strength of demand. Between the first quarter of 1979 and the end of 1982, real hourly earnings fell by 6% while hourly productivity rose 4%; since then, up to the second quarter of 1984, real earnings have risen by some 1½% but productivity has risen by over 4%. These developments may have contributed to the strength of activity in two ways. Improved profitability has been accompanied by a much stronger recovery in business fixed investment than in the cyclical upturn of the mid-1970s. And the increase in employment, which may reflect the greater incentive for firms to hire labour when unit labour costs are falling, has contributed to strong growth in personal disposable income. The continuing strength of domestic demand is principally attributable to personal consumption and business fixed investment.

While the United States continues to be the most rapidly growing major economy, the recovery has strengthened and spread elsewhere. In Japan, output was expanding at an annual rate of 5% in the second half of 1983 and nearly 7½% in the first quarter of this year; industrial production rose by 12% in the year to June. Both domestic demand and net exports contributed to this performance. Japan's net trade position continues to benefit from rapid growth in exports to the United States and sustained demand in Far East markets, while corporate sector investment has also been encouraged by rising profits. Activity also seems to have been generally better than expected around the turn of the year in the major European economies but the underlying recovery remains fragile. Industrial unrest has, at least temporarily, checked the rate of growth in the United Kingdom and Germany more recently. Provisional figures suggest that in France, which has been recovering a little faster than predicted, GNP may nevertheless have fallen slightly in the second quarter. In Italy, however, output appears to have continued to recover from the depressed levels of mid-1983.

Despite the continuing and even growing strength of demand in the major industrial countries, non-oil commodity prices were fairly flat in the first half of this year, and have weakened more recently. Last year's price rises appear to have stimulated production increases in many primary products, first checking and then depressing prices of industrial materials especially. At the same time, high interest rates may well have been a factor discouraging industrial consumers from rebuilding stocks. Oil prices have also been depressed by some of these factors. (See page 306.)

The damping effect on inflation of (partly cyclical) improvements in productivity and subdued material and fuel prices in most industrial countries has been reinforced by continued wage restraint. Average earnings in manufacturing in the major seven industrial countries have been rising at an annual rate of around 5½% since the middle of 1983 and unit labour costs even fell, by 1½%, between the first quarters of 1983 and 1984.

Commodity prices

Increased demand in industrial countries had a marked initial impact on non-oil primary product prices; more recently, the supply of a number of products appears to have expanded and prices generally have weakened. Oil prices remain subdued.

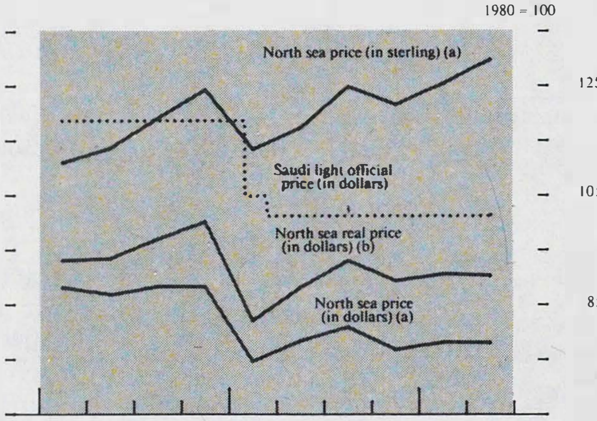
Oil prices

In the oil market, official prices were cut in the first quarter of 1983, the Saudi marker price dropping by $5 per barrel to $29.00 and the North Sea (Brent) price by $3.50 to $30.00. Currency movements have meant that the price of oil and energy in European countries has not fallen by as much as these cuts would suggest. Indeed, although the dollar spot price of North Sea oil in the second quarter this year was 11% lower than in the fourth quarter of 1982, the sterling price was 4% higher and in real terms the price of oil in the United Kingdom was only marginally lower than before the official price cut. In July, substantial spot discounts threatened to put official prices under pressure but spot prices have since recovered.

Demand for oil in OECD countries dropped sharply between 1978 and 1983, the ratio of oil consumption to GDP falling by over a quarter. Oil company stocks have also fallen from the high levels seen in 1980 and, while governments' strategic stocks have been rising steadily, stock movements have periodically exerted an influence on the market. OPEC's position has been further weakened by the growth of oil production in other countries; its share of supplies to the non-communist world has fallen from 65% in 1975 to 46% in 1983. OPEC members themselves recently appeared to be exceeding their production targets, contributing to the weakness of prices in the summer months.

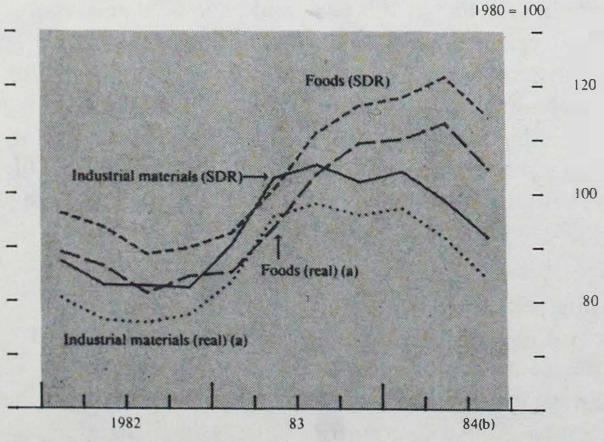
In aggregate, rates of energy and oil consumption may now have levelled out, but the decline in energy/output ratios may not have been arrested. In the year to June 1984 oil consumption grew by 6.5% in North America, but fell by 2.6% in Europe. The oil market remains fragile, but renewed production restraint, reaffirmation of the official price structure and seasonal increases in demand should for a time help to sustain prices.

Spot oil prices(a)



(a) Forties crude until end-March 1983. Brent thereafter.
(b) Price deflated by the $ price of world exports of manufactured goods.

Non-oil commodity prices—Economist sub-indices



(a) Dollar index deflated by dollar world price of manufactured exports.
(b) 1984 Q3 based on average of July and August.

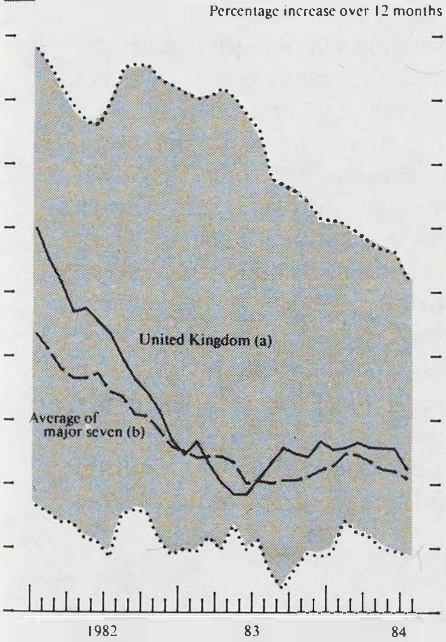
Non-oil commodity prices

The rise in non-oil commodity prices, which began towards the end of 1982, has been arrested and since May 1984 many prices have fallen. For agricultural products, particularly foodstuffs, upward revisions to forecasts for the new season's crops have depressed prices. Metal prices rose strongly until the end of 1983 but, with capacity generally underutilised, the rapid response of production contributed to subsequent falls. Stockbuilding has been discouraged by the unevenness of the recovery and the continuing strength of the dollar and of US interest rates.

The Economist index of non-oil commodity prices dropped by about 13% between end-May and end-August in dollar terms, although in SDR terms the fall was less (10.7%) and in sterling only 8.0%. Being based on spot market quotations, this index tends to be more volatile than the prices at which products actually trade. Many commodities are traded under longer-term contracts at prices which are adjusted more slowly. The UN index of non-oil commodity prices, which is less up to date, more closely reflects prices actually received by producers and may show a much smaller movement over recent months. Furthermore, some of the most volatile items at the end of 1983 had large weights in the Economist index but lower ones in the UN index (eg tropical beverages, with weights of 40.0% and 11.4% respectively in the foodstuffs sub-indices).

For the United Kingdom, sterling's depreciation has also served to offset the weakening of world prices. The prices of basic raw materials actually imported into the United Kingdom fell by $1\frac{1}{4}$% in SDR terms between May and July but rose in sterling terms by $1\frac{3}{4}$%.

Consumer price inflation *in the United Kingdom remains about average for major countries*



(a) Retail prices.
(b) Canada, France, Germany, Italy, Japan, United Kingdom and United States.

Consumer price inflation, which accelerated a little in the early part of this year, has fallen back on average to the 4½% rate recorded during most of 1983. However, some of the inflationary effects of the stronger dollar in countries outside the United States may not yet have been fully felt.

. . . *and spreads a little further in* the rest of the world

The unexpected vigour of activity in the major industrial countries and the associated rapid recovery in world trade has also benefited the rest of the world. Imports of the major economies (which had fallen in 1982) increased in volume by nearly 5% in 1983 and are estimated to have increased by a further 5%–6% in the first quarter of 1984 alone, although the limited statistics available for the second quarter suggest that there has since been considerable deceleration. Import growth in the United States, coupled with a persistently strong dollar, continues to swell the growing US current account deficit, which more than quadrupled to over $40 billion in 1983 and was perhaps as much again in the first half of 1984 alone. But in Germany and Japan the rise in imports has been accompanied by strong export growth. The Japanese current account surplus nearly tripled to around $20 billion in 1983, and has continued to grow so far this year. Germany's surplus has stabilised at nearly $4 billion in the past two years. The current account positions of Italy and France, where economic recovery was less advanced, were considerably improved in 1983.

Exports from the non-oil developing countries rose in volume by around 8% in 1983 while their import volumes, still constrained by financial pressures, fell a little further. With more stable terms of trade as commodity prices for a time improved, the non-oil ldcs' current account deficit was thus reduced from $67 billion in 1982 to $43 billion in 1983. During the first quarter of 1984, exports (particularly from south east Asian countries to the United States) may have grown by as much as 4% in volume and, although export growth may have slackened since, some individual countries still appear to be performing very strongly. Import volumes also appear to have started to recover, rising by 1¾% in the first quarter of the year. A continuing, albeit slowing, recovery in world trade should allow the non-oil ldcs to sustain more normal import growth while still permitting improvements in their external debt positions.

OPEC countries have generally benefited less from the world recovery so far, being adversely affected by the still subdued demand for oil. The smaller industrial countries, too, were slower to emerge from recession. These two groups of countries are particularly important in UK trade (accounting for 47% of UK exports in 1983), which may partly explain why UK exports have been growing less rapidly than world trade. In the second half of last year UK markets grew at an annual rate of around 5% compared with an 8% rise in the volume of world trade as a whole. The growth of UK markets accelerated in the first quarter of this year (to perhaps 10% at an annual rate) but world trade in general grew even more rapidly (at an annual rate of almost 15%). In the second quarter, provisional figures suggest that the growth of both world trade and UK markets slackened considerably.

World trade and UK markets

Percentage changes on previous period (annual rates); at constant prices; *seasonally adjusted*

	1982	1983		1984(b)	
		Year	H2	Q1	Q2
Import volumes					
Major seven countries(a)	-0.5	4.8	13.5	22.9	4.4
of which, United States	*-3.4*	*9.9*	*26.8*	*59.1*	*2.8*
Other OECD countries	2.8	1.7	4.5	..	..
Oil exporting countries	2.5	-11.0	-12.1	..	..
Other developing countries	-6.6	- 0.3	10.3	..	..
Total	**-0.3**	**2.0**	**8.2**	**15.4**	**5.9**
UK markets	0.4	0.4	5.4	13.1	5.7

.. not available.

(a) Canada, France, Germany, Italy, Japan, United Kingdom and United States.
(b) Partly estimated.

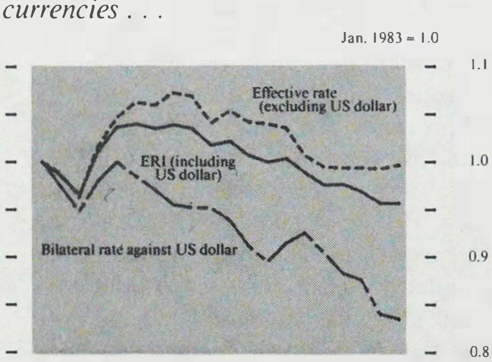
Changes in effective exchange rates[a] and short-term interest rates since January 1983

Percentages

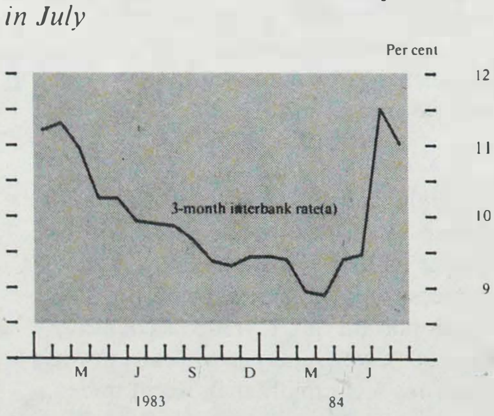
	Level in Jan. 1983	Total change(b) from January 1983 to: 1984 Jan.	Mar.	July	Aug.
Canada					
ERI	*89.5*	+ 3.3	−0.5	− 1.5	+ 0.3
Interest rate	*10.1*	− 0.3	+0.6	+ 2.9	+ 2.2
France					
ERI	*74.7*	−12.0	−9.6	−12.1	−12.1
Interest rate	*12.6*	− 0.3	—	− 0.8	− 1.2
Germany					
ERI	*128.2*	− 3.9	−0.6	− 3.0	− 3.7
Interest rate	*5.8*	+ 0.3	—	+ 0.3	+ 0.2
Italy					
ERI	*53.4*	− 9.3	−8.6	− 9.7	−10.5
Interest rate	*19.1*	− 1.0	−1.7	− 2.2	− 2.3
Japan					
ERI	*145.9*	+ 8.0	+8.8	+ 5.4	+ 6.2
Interest rate	*6.5*	− 0.1	−0.1	− 0.2	− 0.2
United Kingdom					
ERI	*81.9*	—	−1.1	− 4.4	− 4.3
Interest rate	*11.2*	− 1.7	−2.3	+ 0.3	− 0.1
United States					
ERI	*118.5*	+11.1	+6.6	+15.0	+15.5
Interest rate	*8.4*	+ 1.1	+1.7	+ 3.2	+ 3.1

(a) Effective exchange rate index (ERI). 1975 = 100.
(b) Percentage changes in exchange rate index and percentage point differences in domestic three-month interest rate since January 1983.

Sterling[a] *continued to fall against the dollar but was steadier against other currencies . . .*



. . . while **domestic interest rates** *peaked in July*



(a) Average of daily rates.

Most countries continue to pursue monetary and fiscal policies designed to prevent any resurgence in inflationary pressures while providing room for further sustainable growth in demand and output. Exchange rate depreciation, however, has been seen as a threat to anti-inflation objectives and a number of industrial countries have therefore felt obliged, at least on occasion, to modify their policies in response to developments in the United States. The strength of domestic demand and the large fiscal deficit but rather restrictive monetary policy in the United States, together with tensions within the US banking system, have put strong upward pressure on US interest rates and the dollar. Reactions in the other major countries have varied, although several have conceded either higher interest rates or lower exchange rates—with consequences for domestic demand or inflation—than they might otherwise have sought. On the other hand, at least for the time being, the strength of domestic demand in the United States and the strength of the dollar have provided a stimulus to exports and domestic activity in the industrial countries and elsewhere. (World current account developments are discussed further on page 329.)

Acute pressure on **sterling and UK interest rates** *in July, but interest rates ease in August*

In the ten months from August 1983 to June this year, sterling's effective exchange rate index showed a fairly steady depreciation (except for a brief pause around the turn of the year) of, on average, ¾% a month. Since April the fall has largely been due to the strength of the US dollar; sterling has mostly held its ground against other major currencies in recent months.

From the middle of June renewed strong upward pressure on US interest rates and the dollar began to be felt on the sterling money and foreign exchange markets. Over the following three weeks, as the markets also reacted nervously to news of industrial unrest and erratically high UK money supply figures for June, sterling's effective rate fell by 2½% and UK short-term interest rates rose by almost 3%. The London clearing banks responded by raising their base rates, in two steps, from 9¼% to 12% and most building societies raised their mortgage rates (which are a component of the retail price index), on average by 2½ percentage points, to 12¾%, with effect from 1 August. By the middle of August, money-market and bank base rates had fallen more than half of the way back and in early September they were about 1¼% higher than in June. Mortgage rates, however, stayed at their higher levels, one consequence of which was to add ¾% to the retail price index in August. The effective exchange rate showed some recovery in the latter part of July but later fell back, principally because of further strengthening of the US dollar, and by mid-September it was 3% lower than in June.

Output and demand *at home falter*

The miners' dispute, which escalated in March from overtime ban to strike, has affected both output and demand, making it particularly difficult to gauge the underlying pace of economic activity since then. Nevertheless, there are some signs that, aside from the immediate effects of the miners'

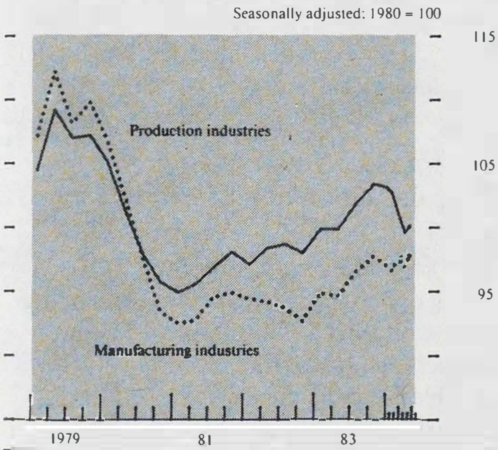
Growth of GDP and industrial production

1980 = 100, seasonally adjusted
Percentage change on previous quarter in italics

	1983	1984	
	Q4	Q1	Q2
Recorded GDP(O)	105.0	104.8	104.8
	1.1	*−0.2*	—
'Underlying' GDP(O)(a)	105.0	105.3	106.1
	1.1	*0.3*	*0.8*
Recorded industrial production	103.4	102.5	100.1
	1.5	*−0.9*	*−2.3*
'Underlying' industrial production(a)	103.4	104.1	103.7
	1.5	*0.7*	*−0.4*

(a) Recorded index adjusted for official estimates of coal strike effects.

Output of the production industries *has been affected by the coal dispute*



Contributions to the change in GDP

Changes in components as a percentage of GDP

	1982	1983			1984	
		Year	Q3	Q4	Q1	Q2(a)
Consumer spending	0.7	2.9	1.3	0.2	−0.4	0.6
Government consumption	0.2	0.6	−0.1	0.3	−0.2	—
Fixed investment	1.3	0.9	0.2	1.0	1.3	−0.7
of which:						
Public	—	*0.7*	*0.3*	*0.1*	*0.3*	*−0.9*
Private	*1.2*	*0.3*	*−0.1*	*0.8*	*0.9*	*+0.2*
Stockbuilding	0.8	0.7	0.7	−0.2	−0.8	−0.3
Exports	0.3	0.3	−0.3	1.6	0.7	−0.3
Total final expenditure	**3.3**	**5.5**	**1.8**	**3.0**	**0.7**	**−0.7**
Imports	−1.1	−1.6	−0.1	−1.5	+0.1	−1.0
Factor cost adjustment	−0.7	−0.4	+0.1	+0.1	—	−0.1
GDP(E)	**1.4**	**3.4**	**1.8**	**1.5**	**0.8**	**−1.8**
Memo item						
GDP(O)	*2.0*	*2.9*	*1.8*	*1.1*	*−0.2*	—

(a) Provisional.

strike, the recovery may have slowed in the first half of 1984. Industrial production, which on the latest official estimates had fallen by almost 1% in the first quarter, fell by an estimated 2¼% in the second. The fall was due to the loss of coal output and other immediate effects of the dispute, such as the reduction in value added consequent upon higher input costs in the electricity and steel industries. Taking these into account, production in the first half of 1984 would appear to have been some 1% higher than in the second half of 1983. On the same comparison, the index of manufacturing output, on which any effect of the miners' dispute is thought to have been slight so far (largely confined to output of mining machinery and steel), has been flat. But this picture is based on estimates which in the past have been subject to sizable revisions and is at variance with recent CBI surveys which suggest that manufacturers' output and order books have been expanding, albeit perhaps at a slightly slower pace in recent months. Output of the whole economy (GDP output measure), which fell slightly in the first quarter, was unchanged in the second. Allowing for the effects of the miners' dispute, total output in the first half of 1984 appears to have been about 1¼% higher than in the second half of 1983; between the two halves of 1983 output had grown by 2½%.

The recovery in demand had seemed to be broadening around the turn of the year, with industrial investment picking up strongly and the net trade position improving, while consumer spending slackened. In the second quarter this process appears not to have been sustained. The expenditure measure of GDP fell sharply. Although consumer spending revived, total fixed investment fell. Partly as a consequence of the fall in coal production, stocks were run down further and the net trade position deteriorated.

The volume of consumer spending in the second quarter, although recovering from the first quarter fall, was only 2½% higher than a year earlier but retail sales (which account for roughly half of consumers' expenditure) were 4% up over the same period, with particularly strong growth in sales of clothing and footwear. More recently, higher interest and mortgage rates appear to have had no immediate impact on retail sales, which remained fairly buoyant in July and August.

Industrial fixed investment had been growing very fast at the end of 1983 and in the first quarter of 1984. It appeared to mark time in the second quarter. After the exceptionally rapid growth of the previous two quarters, investment in the construction, distribution and financial service industries fell but was still about 12% higher than a year earlier. Investment in manufacturing, on the other hand, which had surged in the fourth quarter of 1983, has grown at a fairly steady rate of around 3½% a quarter so far this year and the 12% growth in 1984 indicated by the Department of Trade and Industry's May survey of investment intentions could now be achieved even with no further growth in the second half of the year. The rate at which manufacturing industry has been acquiring fixed assets[1] is nevertheless lower than in past recoveries. Despite the fall in the second quarter, investment by the construction,

(1) Including leased assets.

distribution and service industries looks set to exceed comfortably the DTI survey figure of 8% for the year as a whole. The same survey pointed to more modest increases in industrial investment next year. The more recent quarterly CBI survey of trends in manufacturing industry has suggested that in early June a substantial number of manufacturing firms were planning to authorise new capital expenditure, especially on plant and machinery, during the next twelve months although here, too, some slowing in the pace of investment next year was indicated.

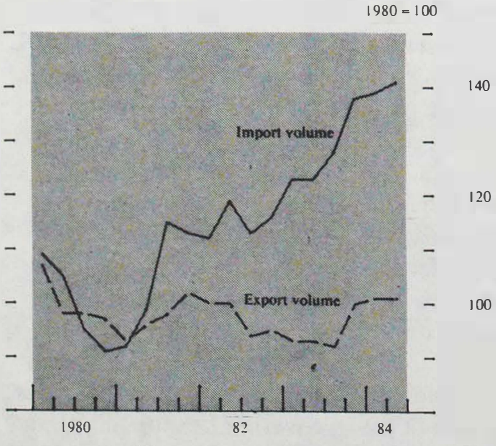
Stocks held by industry, after some rebuilding at the end of 1983, fell by almost 2% in the first half of this year. Manufacturers' stocks fell slightly in the first quarter but dropped more sharply in the second, perhaps reflecting the subdued level of output. There were substantial reductions in wholesalers' stocks in both quarters and stocks held in the energy and water supply industries were also lower. Retailers' stocks had been rising during the previous three quarters but fell in the second quarter as consumer demand recovered.

The oil surplus *is weakened by domestic energy requirements and the* **deficit on non-oil trade** *widens*

In the last quarter of 1983 and first quarter of 1984 a large surplus on the balance of trade in oil had broadly counterbalanced the rising deficit on non-oil trade, while in the second quarter of 1984 the oil surplus fell sharply, by about £800 million, and the deficit on non-oil trade continued to rise. In consequence, the visible trade balance—and even the current account balance—went sharply into deficit.

The fall in net oil exports was mainly a result of a major shift from coal to oil consumption by the electricity supply industry in reaction to the miners' strike. But it was also to some extent the result of a temporary fall in North Sea production and precautionary stockbuilding early in the quarter as tension rose in the Persian Gulf. The combined effects of these factors were most acute in April; since then there has been a steady improvement in the oil balance. By July total net oil exports had recovered to their first quarter average.

Trade in manufactures[(a)]—*UK performance deteriorates further*

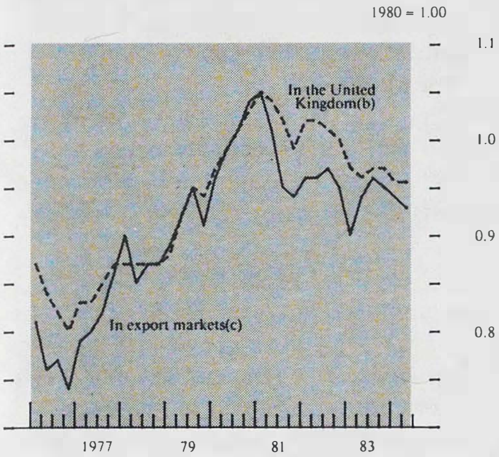


(a) Excluding erratic items.

After growing strongly towards the end of the year, the underlying rise in non-oil import volumes slackened in the first half of 1984 and little if any further growth was apparent in non-oil export volumes. In volume terms, and excluding erratic items, non-oil exports were 9% higher but non-oil imports were 12% higher than in the first half of 1983. Imports of manufactured goods have continued to rise: imports of raw materials (excluding oil), perhaps reflecting the decline in UK manufacturers' stocks so far this year, remained subdued. The non-oil trade statistics in July were considerably depressed by the short-lived dock strike, but the underlying volumes of non-oil imports and exports were probably much the same as in June.

The non-oil terms of trade deteriorated between the third quarter of 1983 and the second quarter of 1984 by $2\frac{1}{2}$% so that the growing gap between non-oil imports and exports by value was even more pronounced than by volume. Associated with this worsening of the terms of trade, however, was an

Past gains in **price competitiveness of UK output**[(a)] *are being held*



(a) A reduction represents an improvement in UK competitiveness.
(b) Manufacturers domestic selling prices in relation to import prices.
(c) Ratio of export prices of UK manufactured goods to foreign manufacturers' wholesale prices, expressed in a common currency.

improvement in UK manufacturers' price competitiveness as sterling depreciated.

The surplus on services rose further in the second quarter as higher receipts brought the travel account back to balance and the surplus on interest, profits and dividends recovered from the low level now estimated for the first quarter, reflecting a recovery in UK banks' foreign currency earnings and a drop in foreign oil companies' profits. But the overall improvement of £400 million in invisible earnings was not sufficient to outweigh the £1,100 million rise in the trade deficit and the current balance was in deficit by £280 million. Among identified capital flows, outward portfolio investment fell back in the second quarter as UK banks reduced their net purchases of overseas securities (especially floating-rate notes) from the exceptionally high level in the first quarter and (on the basis of preliminary figures) other financial institutions were net sellers of overseas securities for the first time since the abolition of exchange controls in late 1979. There was a substantial net outflow of oil investment, dominated by the Shell Group's buy-out of minority shareholdings in its main US affiliate, Shell Oil. As the banks' purchases of overseas securities and the Shell transaction were financed in foreign currency, these outflows were largely matched by substantial net external foreign currency borrowing by the banks in both quarters.

Changes in employment in Great Britain
Thousands; *seasonally adjusted*

	Employees			Total employed labour force
	Male	Female		
		Full-time	Part-time	(a)
Level at June 1981	**12,274**	**5,286**	**3,799**	**23,751**
Change in 3 months to:				
1981 Sept.	− 112	− 26	+ 12	− 108
Dec.	− 97	− 55	+ 25	− 112
1982 Mar.	− 41	− 16	+ 28	+ 44
June	− 71	− 40	+ 7	− 150
Sept.	− 87	− 81	+ 20	− 131
Dec.	− 58	− 18	− 1	− 61
1983 Mar.	− 49	− 25	+ 22	− 34
June	− 30	− 32	+ 83	+ 39
Sept.	+ 8	− 10	+ 47	+ 65
Dec.	+ 24	+ 8	+ 62	+ 112
1984 Mar.	+ 4	+ 3	+ 21	+ 47

(a) Employees plus self-employed and HM forces.

Employment by sector in Great Britain
Thousands; *seasonally adjusted*

	Manufacturing industries	Service industries	All industries and services(a)
Level at March 1983	**5,589**	**13,092**	**20,697**
Change in 3 months to:			
1983 June	− 41	+ 85	+ 20
Sept.	− 32	+ 80	+ 45
Dec.	− 8	+ 105	+ 94
1984 Mar.	− 22	+ 65	+ 28

(a) Employees in manufacturing and services plus those in agriculture, construction, and energy and water supply.

Job patterns change as **employment and unemployment** *both rise*

The employed labour force in Great Britain is now estimated to have fallen between June 1981 and June 1983 by 513,000,[(1)] while total recorded unemployment rose by 571,000. Allowance for special factors[(2)] suggests that the working population (the total of those employed and unemployed) rose by some 250,000 over the two years, a rise which can be explained by demographic and cyclical factors. In the twelve months to March 1984, the employed labour force grew, by some 260,000; but although recorded unemployment fell slightly, there was an underlying increase in unemployment over the same period of about 200,000. With employment and unemployment both higher, the working population appears to have grown in the year to March by between 450,000 and 500,000—far more than can be attributed to population trends.

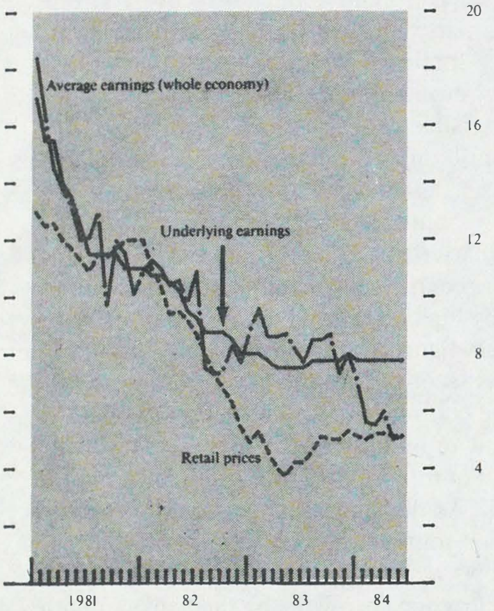
Part of the explanation lies in an increase in the number of women taking up part-time jobs—some perhaps in response to other members of the family becoming unemployed—without having previously been classified as unemployed. Although some rise was already discernible during the previous eighteen months, in the past year this trend has accelerated with 213,000 more women employed part-time in March 1984 than in March 1983. A related explanation is that the increase in employment has been in the service industries (up by 335,000) which may draw in marginal workers; job losses have been in manufacturing industry (down by 103,000 in the year to March 1984) and mainly among men who, claiming unemployment benefit,

(1) Figures, revised in the light of the Labour Force Survey for June 1983, show a fall of 642,000 in the number of employees partly offset by a rise in self-employment.

(2) Measures in the 1983 Budget are estimated to have removed 162,000 men aged over 60 from the register during the five months to August 1983. Special employment and training measures are estimated to have reduced recorded unemployment by about 80,000 though some of these may also have been recorded as in employment.

Underlying **average earnings** *are still growing, even in real terms*

Percentage increase over a year earlier



Pay, productivity and labour costs in manufacturing industry

Percentage change from a year earlier(a)

	1980	1981	1982	1983	1984
Settlements(b)	+16	+ 9	+7¼	+6	+6
Average earnings	+21½	+12¼	+9¾	+9	+8¼
Output per head	− 4	+ 6½	+4	+7	+4¼
Unit wage costs(c)	+25¾	+ 5½	+5½	+1¾	+3¾
Unit labour costs	+21¾	+ 6	+3¾	+1	+3½
Background factors					
Output	*− 9¾*	*− 3*	*−1*	*+3*	*+3*
Employment	*− 6¼*	*− 9*	*−5*	*−3¾*	*−1¼*
Average weekly hours worked per operative	*− 3½*	*+ ½*	*+ ¾*	*+1¼*	*+1½*

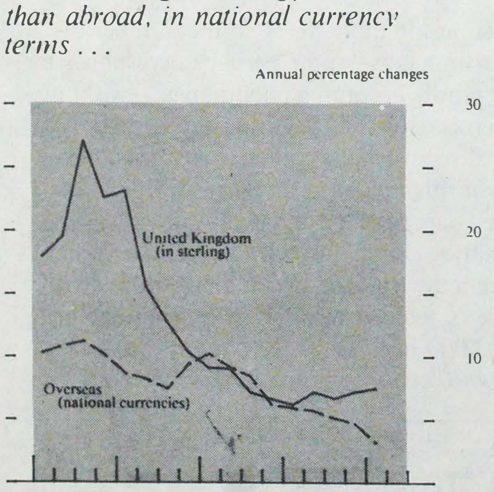
(a) Third quarter on third quarter—approximately the timing of the pay round—except for 1984 where the figures relate to change in the year to the second quarter.

(b) As monitored by the CBI.

(c) Average earnings less productivity

Employment costs per man-hour in manufacturing *are rising faster here than abroad, in national currency terms . . .*

Annual percentage changes



remain part of the measured labour force. Although such changes in the structure of employment are unlikely to be sustained on this recent scale, they may well continue for some time to raise the rate of output and employment growth at which unemployment might start to fall. Over the past year unemployment has been growing at an underlying rate of 10–15,000 a month with no sign of any slowing down so far. The number of vacancies fell during the winter but has recovered since February. This suggests that conditions in the job market may be improving slightly.

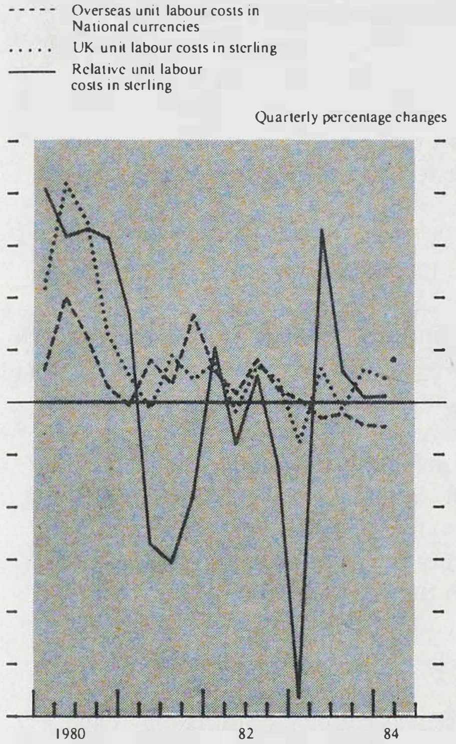
The fall in manufacturing employment appears to have been checked in recent months. This may also be an encouraging sign, although employers have generally been reluctant so far to take on new labour in the face of uncertainty about longer-term prospects. In manufacturing, particularly, overtime has tended to rise instead, especially during the second half of last year. Partly as a result, average earnings in manufacturing have grown very rapidly, at an underlying rate of 9% in the year to July. Settlements may have edged up slightly in the wage round just ending, but the increase in overtime working has become less rapid. Earnings in the economy as a whole have been rising at an underlying annual rate of 7½%–8%, compared with an annual rise in retail prices of around 5%. This suggests that the underlying upward trend in real earnings of those in work is still quite strong, although some settlement delays and industrial disputes have depressed actual earnings in recent months.

After a year of slow growth, **unit labour costs** *may have risen rather faster this year*

Productivity growth in manufacturing was particularly rapid in 1983, with hourly output per head 6% higher than in 1982. This enabled the rise of wage and salary costs per unit of output in manufacturing to be contained at around 2%. Productivity growth on data so far available appears to have slowed sharply, to about 1% at an annual rate, between the second half of 1983 and the first half of 1984, so that the growth of unit wage and salary costs may have quickened, to an annual rate of over 6%, in the first half of 1984. In the economy as a whole, productivity increased by about 3% in 1983 and, helped also by cuts in the national insurance surcharge, unit labour costs rose by only 3%; it is likely that these will have risen faster in the first part of 1984.

The underlying rate of productivity growth in UK manufacturing industry during the present recovery compares very favourably with past experience and has generally more than matched the performance of other industrial countries. Nevertheless, growth in employment costs here has picked up slightly since the beginning of 1983, whereas in other industrial countries it has continued to slow and unit labour costs have actually fallen. In consequence, UK manufacturing industry would have steadily lost cost competitiveness over the past year had it not been for the decline in sterling's effective rate which, between the second quarters of 1983 and 1984, almost checked the rise in UK unit labour costs relative to other countries in common currency terms. By mid-September, sterling's effective rate had fallen a further 3%.

... *though in sterling terms* **relative unit labour costs in manufacturing** *are steady*



Industrial and commercial companies' income, spending and financial transactions

£ billions at quarterly rate; seasonally adjusted
Figures in italics are at 1980 prices

	1981	1982	1983			1984
			Year	Q3	Q4	Q1
Income						
Gross trading profits(a):						
North Sea operations	2.7	3.2	3.9	4.0	4.3	4.4
Other	4.8	5.7	6.9	7.4	7.2	8.4
Total income(b)	9.7	11.1	13.2	14.1	13.9	15.5
	8.8	*9.5*	*10.7*	*11.2*	*11.0*	*12.2*
Allocation of income (payments−)						
Dividends, interest, profits due abroad	−3.8	−4.1	−4.4	−4.4	−5.0	−4.9
UK taxes	−2.2	−2.6	−3.1	−3.2	−3.2	−3.5
Undistributed income	3.7	4.4	5.7	6.5	5.7	7.1
	3.4	*3.7*	*4.7*	*5.2*	*4.5*	*5.6*
Spending (−) on fixed assets and stocks	−2.9	−3.3	−3.9	−4.1	−4.4	−4.0
	−2.6	*−2.8*	*−3.1*	*−3.2*	*−3.5*	*−3.1*
Financial surplus (+)/deficit (−)	0.8	1.1	2.0	2.5	1.4	3.1
	0.7	*0.9*	*1.5*	*2.0*	*1.0*	*2.5*
Financial transactions(c)						
Miscellaneous investments(d)	−1.0	−0.7	−0.4	−0.4	−0.3	−2.5
Liquid assets	−1.2	−0.7	−1.6	−1.4	−3.8	−0.7
Other financial assets	−0.4	−0.4	−0.4	−0.3	−1.0	0.3
Trade credit etc(e)	0.1	−0.4	−0.1	−0.8	−0.5	1.7
Capital issues	0.4	0.3	0.5	0.8	0.3	0.2
Bank borrowing(f)	1.4	1.7	0.5	1.6	0.9	2.3
Other loans, mortgages	0.1	0.2	0.2	0.2	0.3	0.1
Total	−0.4	—	−1.3	−0.4	−4.0	1.2
Balancing item	−0.4	−1.1	−0.6	−2.1	2.7	−4.4

(a) Net of stock appreciation.
(b) Including interest, other property income and income from abroad.
(c) Inflow of funds (+)/outflow(−).
(d) Investment in UK company securities, net investment abroad.
(e) Including accruals adjustment, net unremitted profits.
(f) Including Issue Department holdings of commercial bills.

With UK unit labour costs at first subdued, the rate of increase in total domestic costs per unit of output (measured by the GDP deflator) has slowed since the middle of 1983, showing a rise of about 4½% between the second quarters of 1983 and 1984. Import prices, the other major component of manufacturers' and distributors' total input costs, have been rising more rapidly than domestic costs since 1982. After some acceleration in early 1983 as the exchange rate fell, the rise in import prices settled back to an annual rate of about 7% in the middle of the year. The renewed decline in sterling's effective exchange rate since mid-1983 appears to have caused a fresh acceleration of import prices: from the third quarter of 1983 to the second quarter of 1984, import prices rose at an annual rate of 10%. The cost of UK manufacturers' inputs of materials and fuel in the second quarter was 8½% higher than a year earlier.

UK manufacturers' total costs, including both labour costs and materials and fuel costs, rose by perhaps 6% between the second quarters of 1983 and 1984. The margin between manufacturers' domestic output prices and their total costs had been widening since 1981 (see the article on page 352) until around the turn of the year, when substantial rises in import prices, and slackening productivity growth, contributed to a fall in domestic profit margins in two successive quarters. In the second quarter of 1984, manufacturers' output prices rose by more than 2%, and margins probably deteriorated no further. Distributors' and retailers' gross margins may have continued to narrow, contributing to the stability of the rate of retail price inflation which, over the year to June, had been close to 5%. The consumers' expenditure deflator, a broader and differently constituted index of prices facing consumers, rose similarly between the second quarters of 1983 and 1984.

The company sector's financial surplus *remains strong* [1]

Although profit margins were under some pressure around the turn of the year, continuing growth in activity was sufficient to sustain a considerable rise in the gross trading profits[2] of non-North Sea industrial and commercial companies in the first quarter of 1984, when they were more than 25% higher than a year earlier. Trading profits from North Sea activities also rose further in the quarter, as sterling oil revenues benefited from higher production and the strengthening of the US dollar. With taxes only slightly higher than in the final quarter of last year and payments of dividends and interest virtually unchanged, undistributed income rose by 25% (almost £1½ billion) in the first quarter alone. At the same time, industrial and commercial companies' total capital expenditure fell so that the recorded financial surplus of the sector rose in the first quarter to a substantial £3 billion. This followed a surplus of about £8 billion in 1983 as a whole.

These estimates of the financial position of industrial and commercial companies should be viewed with caution. They have proved exceptionally difficult to reconcile, especially quarter-by-quarter, with the recorded financial transactions undertaken by companies. Thus the statistics suggest a large

(1) A more detailed and longer-run analysis of the financial position of industrial and commercial companies is given in the article on page 352.
(2) Excluding stock appreciation.

financial *surplus* of £3 billion in the first quarter of 1984 but at the same time a net *inflow* of funds amounting to £1½ billion; in consequence, the balancing item swung round sharply. The sources of such discrepancies have proved difficult to identify although it is of some comfort, perhaps, that so far the discrepancies in annual figures have been proportionately much smaller. This suggests that part of the problem may lie in timing differences in the accounting for business transactions and financial flows.

Companies increased their rate of investment in UK company securities in the first quarter, while their direct and other investment abroad (net of inward investment) rose sharply. At the same time they borrowed heavily from the banking system but added much less to their liquid assets than in the, exceptional, second half of 1983. Whereas companies were net suppliers of funds to the banking system (a flow of nearly £3 billion) in the second half of 1983, they were net takers of banking funds (some £1½ billion) in the first quarter of 1984. For the second successive quarter, company issues of ordinary shares were rather low: £190 million in the fourth quarter of 1983 and £120 million in the first quarter of 1984. Over the preceding year, such issues had averaged £450 million a quarter.

Preliminary figures suggest that company profits may have fallen back a little in the second quarter. At the same time there was a sharp fall—to just over £1 billion—in the rate of company borrowing in sterling and foreign currencies from the banks. Companies' deposits in sterling and foreign currency fell by £2 billion in the quarter, but much of this will have been associated with the Shell Group's take-over of Shell Oil in the United States. Ordinary share issues revived in the second quarter, to £400 million.

Personal consumption, and housing investment *continue to be financed in part by mortgage lending*

Total personal disposable incomes rose more slowly than consumer prices in the first quarter of 1984 and real personal disposable income (RPDI) fell. In part this reflected the impact of industrial disputes and less back-pay on total wage and salary earnings. The fall in RPDI broadly matched the temporary fall in the volume of consumers' expenditure so the saving ratio, which had risen a little at the end of 1983, remained virtually unchanged in the first quarter. Personal sector capital expenditure, responding to the imminent withdrawal of local authority improvement grants, increased sharply, leaving a smaller financial surplus. During the second quarter, the revival in spending on consumer goods, especially on clothing and footwear, may have outpaced growth in real disposable incomes.

Equity withdrawal from the housing market,[1] averaging a little over 40% of total net advances for house purchase, probably helped last year to sustain the growth of consumers' expenditure, much of which was on durable goods. In the first quarter of this year, despite the rise in investment expenditure, total personal sector borrowing fell back: but in the second

(1) See the September 1983 *Bulletin*, page 333.

Personal income, consumer spending, and saving

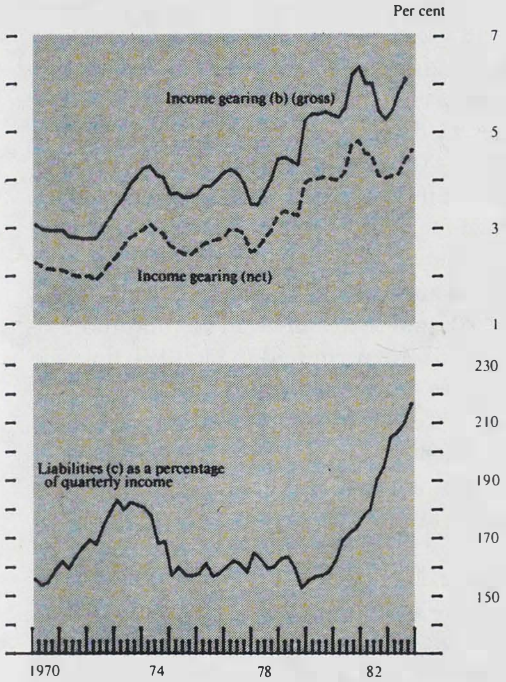
1980 = 100; *percentages in italics*

	Real personal disposable income: As conventionally measured	Real personal disposable income: Adjusted for inflation losses(a)	Consumer spending	Saving ratio
1979	99.0	101.0	100.3	*14.1*
1980	100.0	100.0	100.0	*15.2*
1981	98.0	100.0	99.9	*13.5*
1982	98.3	100.4	101.0	*12.9*
1983 H1	99.0	102.0	104.0	*10.9*
Q3	100.6	104.4	106.4	*10.3*
Q4	!02.0	106.5	106.8	*11.3*
1984 Q1	101.4	105.8	106.2	*11.1*
Q2	..	..	106.9	

.. not available.

(a) The adjustment is for the effect of inflation on the real value of net assets fixed in nominal terms (see the June *Bulletin*, page 231).

Household sector[(a)] debt *reaches new heights in relation to income*



(a) Personal sector, excluding net contributions to life and pension funds.

(b) Household sector interest payments as a percentage of household income.

(c) Stock of mortgages, bank borrowing and retail trade credit outstanding with the household sector.

House prices[(a)]

Percentage changes on a year ago

	Department of the Environment index(b)	Nationwide Building Society index(c)	Halifax Building Society index(c)	*Consumer price index*
1983 Q3	11.3	13.2	..	*+4.9*
Q4	10.9	12.2	..	*+4.6*
1984 Q1	9.4	13.0	7.3	*+4.4*
Q2	10.1	14.4	6.6	*+5.2*

.. not available.

(a) Mix-adjusted prices of all houses in the United Kingdom.

(b) Based on the 5% sample survey of building society mortgages completed.

(c) Based on the mortgage approval stage. The Halifax index begins in 1983 Q1 so changes on a year ago are not available before 1984.

quarter most forms of personal borrowing rose strongly. Mortgage borrowing was particularly vigorous as building society lending reached record heights. This may have contributed to the strength of consumers' expenditure, although spending on cars motorcycles and other durable goods was still appreciably less than in the latter part of 1983. The $2\frac{1}{2}\%$-$2\frac{3}{4}\%$ rise in building society mortgage rates, which came into effect at the beginning of August, is likely to act as a restraint on consumers' expenditure in the second half of this year. A greater proportion of household income will be pre-empted by higher mortgage interest payments and, to the extent that there may be lower demand for mortgages, there could well be less equity withdrawal. On the other hand, since the personal sector as a whole is a net saver, its disposable income will benefit from higher interest accruals. It is likely that consumption by net borrowers will be more responsive to higher interest charges than net savers' consumption will be to higher interest receipts.

By the end of 1983, the income gearing of households[(1)] had risen close to the peak of 1982 and well above that in 1973. Total personal sector debt, although tailing-off slightly around the turn of the year, was still historically high in real terms. At the same time, the personal sector as a whole, like the corporate sector, has accumulated financial assets on a considerable scale—in the form of building society deposits and, after a lull in the second half of 1983, through bank deposits. In the second quarter of 1984, the increase in personal sector bank deposits was particularly strong, outstripping the rise in the sector's borrowing from banks.

Personal sector investment, particularly in housing, reached record levels in 1983 and rose further in the first quarter of 1984. In part it was sustained by the prospective cut in the rate of local authority grants (previously announced to take place at the end of March). Because the qualifying date for the higher rate of grant was the date on which the local authority received the application, the second quarter figures may also be affected in this way. Although the amount of new private sector housebuilding that was started in the first seven months of 1984 was rather less than in the same period last year, the number of houses under construction by the private sector is now higher than at any time since 1976. Further growth in personal sector housing investment might therefore be expected later this year despite the rise in mortgage rates. House prices continue to rise appreciably faster than consumer prices but there are no clear signs of acceleration.

The pattern of **financial intermediation** *continues to change*

The personal sector (like the company sector) is in financial surplus but continues to increase its borrowing from the banking system while adding to its holdings of bank deposits. Historically, the personal sector has generally been a net lender of funds to the banking system—in 1980 to the extent of some £3 billion. But since then, as its financial surplus has declined, its borrowing from banks has grown more rapidly than its acquisition of bank deposits. By 1983 the personal sector had become a net borrower (a flow of £$5\frac{1}{2}$ billion) from the banking

(1) Personal sector interest payments as a percentage of household income, excluding net contributions to life and pension funds.

system—a £8½ billion change since 1980 which closely matches the reduction in its financial surplus over the three years. Taking the two quarters together, the personal sector was also a net borrower from the banking system in the first half of 1984.

Building societies have traditionally been the main source of mortgage finance for the personal sector. And for a decade or so the personal sector has held more deposits with building societies than with banks. Almost all of the building societies' finance has been obtained from the personal sector and most (apart from that retained for liquidity purposes) has been lent back to the personal sector, which has thus tended to be a net supplier of funds to the societies. In 1983, however, the building societies ran down their liquid assets in order to fund more mortgage lending and they were permitted to tap the wholesale money markets on a large scale for the first time. In consequence the personal sector borrowed from the societies £0.5 billion more than it lent to them. This appears to have continued in the first half of 1984, despite the high rate of depositing in the first quarter.

In July, the government outlined, in a Green Paper(1), proposals for a comprehensive review of building society legislation. New legislation would ensure that the building societies continue primarily in their traditional roles while loosening some legal restraints under which they have operated for a century or more, so that they can develop in other fields. It is proposed, for example, that building societies should be able to offer a fuller range of personal banking and money transmission services to their members. These could include issuing cheque guarantee cards, guaranteeing third-party payments in electronic money transmission systems and providing encashment and paying services more widely through reciprocal arrangements with other financial institutions. It is also proposed that the societies be allowed to undertake limited amounts of unsecured personal lending and second mortgage business (at present they can only lend on the security of a first mortgage). The effect of these and other proposed changes would be to enhance competition and consumer choice within financial services generally.

With a strongly rising financial surplus, industrial and commercial companies borrowed much less from the banking system in 1983 than in 1982. They continued to acquire liquid assets (especially bank deposits) on a considerable scale. Around the turn of the year, however, there was a sharp revival in the amount of bank borrowing by companies (notably in the first quarter of 1984 when the company sector was in even stronger surplus). Bank deposits held by companies have clearly been distorted latterly by transactions relating to the take-over activities of the Shell Group mentioned earlier, but altogether over the year to mid-1984 industrial and commercial companies deposited with banks only half as much as they borrowed from them.

The public sector as a whole has been a net lender to the banks, principally through the take-up of bills by the Issue Department of the Bank of England to ease cash shortages in the banking

(1) Cmnd. 9316 *Building Societies: A New Framework.*

Borrowing by domestic sectors[a]

£ billions

	1981	1982	1983		1984
			Year	H2(b)	Q1(b)
Personal sector					
Financial surplus +/deficit –	13.4	9.8	6.2	7.0	6.2
Total borrowing	14.6	19.2	20.4	19.6	20.3
of which:					
From banks	*6.3*	*10.1*	*8.5*	*8.4*	*5.7*
From building societies	*6.3*	*8.1*	*11.0*	*10.6*	*12.4*
Industrial and commercial companies					
Financial surplus +/deficit –	3.3	4.6	7.8	9.6	14.5
Total borrowing	8.9	9.7	6.9	10.3	8.4
of which, from banks(c)	*5.6*	*6.8*	*1.7*	*4.5*	*9.1*
Public sector					
Financial surplus +/deficit –	– 8.6	– 7.2	–10.4	–11.5	–10.7
Total borrowing	10.6	4.9	11.6	10.8	9.9
of which, from banks	*– 0.4*	*– 2.7*	*– 2.0*	*– 1.4*	*5.9*
Memo item					
Total bank lending to UK domestic sectors(c)	*13.5*	*16.8*	*10.8*	*14.0*	*27.4*

(a) New borrowing net of repayments in sterling and foreign currencies.
(b) Seasonally adjusted, at an annual rate.
(c) Includes Issue Department transactions in commercial bills.

Bank's domestic lending and deposits

£ billions, 1980 prices(a); *seasonally adjusted*

	1981	1982	1983	1984
			Year	H1(b)
Bank lending in sterling				
To the private sector	10.2	14.7	10.2	11.5
of which:				
Personal sector	*5.6*	*8.3*	*6.8*	*4.9*
Industrial and commercial companies(c)	*2.7*	*5.0*	*1.0*	*5.3*
Non-bank financial institutions	*1.9*	*1.4*	*2.4*	*1.3*
To the public sector	0.2	– 1.9	– 1.6	– 1.1
Sterling bank deposits				
Personal sector	3.3	3.0	2.4	3.2
Industrial and commercial companies	2.6	0.7	2.8	0.2

(a) Nominal figures divided by the GDP deflator, 1980=100.
(b) At an annual rate.
(c) Includes Issue Department transactions in commercial bills.

system. Short-term fluctuations in the borrowing requirement and in funding operations can lead to changes in the direction of financial flows between the public sector and the banks. Thus underfunding of the PSBR and easier money-market conditions in the second quarter of 1984 were accompanied by a substantial reduction in the Issue Department's holdings of bills which had been built up by purchases from the banking system during the previous three quarters.