General assessment

The pace of growth in several of the major industrial economies has increased and the recovery here seems set to continue at a moderate rate. Until recently, the main contributor to stronger UK demand has been higher consumer spending associated with lower saving, to which high consumer borrowing has contributed; that may now become less important and exports and investment more important as they respond to growth abroad and the effects of the Budget.

By no means all the borrowing by the personal sector has gone to finance consumer spending and house purchase; financial assets have been built up as well. Companies have behaved somewhat similarly.

The Budget contained a number of measures of importance to financial markets. They may be characterised as welcome steps in the direction of fiscal neutrality; whether between banks and building societies or between direct and institutionalised holdings of financial assets. These, as well as monetary aspects of the Budget, are also discussed.

Exports of goods in 1982 as a percentage of exporting area's GDP

	Exports to				
Exports from	OECD Europe(a)	*of which United Kingdom*	North America	Japan	Rest of world
OECD Europe(a)	15½	*1¾*	1¾	¼	6½
of which, United Kingdom	*11*	—	*3*	*¼*	*6¼*
North America	2	½	2½	¾	3¼
Japan	2	½	3¾	—	7¼

(a) Including United Kingdom.

Moderate growth continues in the world economy . . .

In the course of 1983, GNP in the seven largest industrial economies expanded by some 4% on average, though performance differed considerably between regions. GNP rose by over 6% in North America and 4% in Japan, but only 1½% in the major economies of Europe. Although some convergence of growth rates seems likely, much will depend on developments within Europe; the fast pace of recovery in North America cannot be relied upon to spread immediately or fully across the industrial world. Despite the rise of international trade in the post-war era, direct trade links between North America and Europe are surprisingly small. The North American and European economies, of roughly equal size, each exports to the other goods worth only about 2% of GDP (proportions not much different from ten years ago), whereas direct trade links within Europe have become much stronger in the past decade. Europe has thus become a major market for British goods and our exports would stand to benefit much more from further recovery there.

After falling in the course of 1982, world trade recovered last year, as did UK export markets, albeit at a slower rate. UK exports, apart from oil, followed a somewhat similar path, although their rise during 1983 was an erratic one, growth being heavily concentrated towards the end of the year. Our exports will still be benefiting, though diminishingly, from the recovery of competitiveness since 1981.

. . . and inflation remains subdued . . .

Inflation in the major overseas economies has not changed much over the past year. In the twelve months to January consumer prices rose on average by 4¾% (much the same as in this country). Oil prices fell in the early part of 1983 but later recovered somewhat; non-oil commodity prices followed a contrary path. Overall, import prices have changed very little for the major overseas countries taken together (although for individual countries exchange rate changes have made for very varied experience). The growth of earnings abroad may now no longer be slowing down, but productivity has increased rapidly with the recovery in activity, and profit margins have widened. With employment now also beginning to recover, productivity may rise more slowly, and recent very low increases in unit labour costs abroad may be hard to maintain.

The upturn in the world economy has contributed to a significant improvement in the external position of many developing countries. Export volumes grew more rapidly than expected last year, while stronger commodity prices brought to an end the decline in these countries' terms of trade. At the same time import volumes continued to be constrained, as countries with debt-servicing difficulties sought to bring their economies under better control. By the second half of last year the current account deficit of non-oil developing countries as a whole may have been as low as $40 billion at an annual rate, about half what it had been two years earlier. Several countries with debt-servicing problems have made considerable progress, and have begun to enjoy improved terms on the finance which the banks are still being asked to contribute; others, however, have only recently begun to negotiate with their creditors. For a number of countries it is likely to be some time before their external financial needs are reduced to a level at which they can be met through the normal operation of the market.

. . . but exchange rates shift and interest rates remain high.

In 1983 the US and Canadian dollars, together with the yen, rose nearly 20% against European currencies. The regional trading patterns mentioned earlier mean that in effective terms the movements were about half as large. In these terms sterling hardly changed. After the turn of the year the US dollar weakened temporarily by around 5% in effective terms; sterling has not moved with the European currencies, remaining reasonably steady but with a slight effective depreciation.

Uncertainty, springing from the likely scale of future fiscal deficits in the United States, has tended to hold up dollar interest rates and at times has undermined sentiment in the US capital market more generally. Some of these effects have inevitably spilled over into financial markets elsewhere, if only as background influences. In UK markets, long rates have continued to fall further below those in the United States; and more recently a gap has opened up in short rates as well.

Continued recovery at home . . .

While recovery in the major overseas economies has been under way for barely a year, and in some European countries has still to become clearly established, the upturn in the United Kingdom is now well into its third year. Although the statistics continue to be difficult to interpret, the economy has recovered in the $2\frac{1}{2}$ years since the low point of the recession, growing by 3% over the past year. Growth has been much slower than in the United States, but the pattern of demand is somewhat similar, particularly as regards the relative roles of consumption, stocks and net exports.

Measures of the extent of recovery

Percentage changes; *seasonally adjusted*, at 1980 prices

	Measures of GDP			
	Expenditure	Income	Output	Average
1981 H1–1983 H2	5.8	8.0	5.1	6.2
1981 H1–1983 Q4	6.9	9.0	5.3	7.0

The recent recovery here is however proving unusual in several respects. The growth of output, despite the contribution from expanding North Sea production, has been slower than in previous cycles. The reason does not lie in the composition or the rate of growth of domestic demand, which has risen by over 9% since the first half of 1981, a rate comparable with that in recovery phases of earlier cycles. Rather, notwithstanding higher oil exports, the external trade balance has worsened, in sharp contrast to this stage in previous recoveries, by an amount equivalent to some 3% of GDP. This reflects, however, some adjustment from an initial position of large surplus, as well as the fact that the upturn began earlier here than in most other countries. As recovery abroad strengthens, exports may be expected to benefit. For that and other reasons the current recovery may prove more durable than its predecessors.

. . . has been aided by falling inflation.

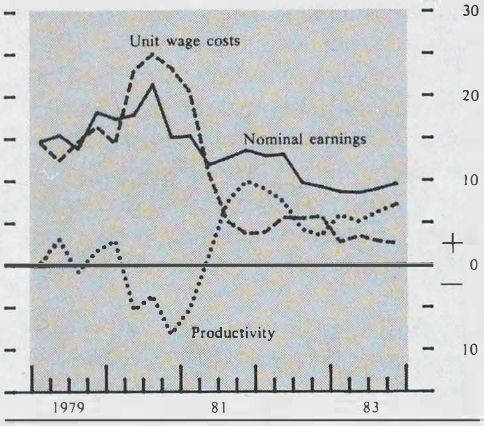
As in previous upswings, consumers' expenditure has played an important role in the recovery of domestic demand. Unlike previous occasions, however, growth in real personal disposable income as conventionally measured has been small (about 1%) while the saving ratio on the conventional basis has fallen substantially (by about 5 percentage points)—much more than in previous upswings. Much of this fall in the saving ratio is thought to be attributable to the large slowdown in inflation since 1980. Real personal disposable income adjusted by deducting inflation losses on net liquid assets has risen appreciably since mid-1981 (as the inflation deduction has declined). The recent path of consumption and saving is in large part explicable in terms of past statistical relationships using the adjusted income measure.

The decline in the conventional saving ratio has taken the form of heavy borrowing rather than a reduction in holdings of financial assets. Although money borrowed on mortgage is used in the first instance to buy houses, or pay for improvements, the sellers of houses (together with those borrowing in other ways) have used part of the proceeds for consumption and part for increased holdings of financial assets, principally bank and, especially, building society deposits. This last development would appear to reflect greater competition among financial institutions, with a consequent increase in the availability of personal credit and perhaps a narrowing of the costs of intermediation. The terms of the competition between banks and building societies, and their margins on consumer business, have been affected by the Budget and other recent changes. As far as profits on gilts and the tax treatment of deposit interest are concerned, both will in future be treated identically. Taken overall, the cost of intermediation is likely to rise.

UK inflation, measured by the twelve-month change in the retail price index, has fluctuated over the last year; but this was more a reflection of the inflation profile in 1982 than in 1983; the underlying picture remains one of inflation holding fairly steady at about 5% per annum. To some extent the improvement in industry's profit margins has been restrained by a somewhat faster increase in input prices, especially of imports. Although these prices were slow to respond to the sharp increase in dollar commodity prices from late 1982, and the decline in sterling against the dollar, they have recently picked up.

Since late 1980, productivity in manufacturing industry has grown at a rate of about 6% a year, much more quickly than before and faster than in most other industrial countries. This remains a crucial factor in containing unit costs and in improving

Unit wage costs in manufacturing *are rising at their slowest rate for some years.*



competitiveness. Much of this improvement has probably been achieved by closing high-cost plants, shedding labour and changing working practices, and some of it may be cyclical. Such productivity growth may not be sustainable indefinitely, although earlier fears that it might soon tail off have not been realised. Meanwhile, wage settlements no longer appear to be falling, and earnings growth in manufacturing industry is running at an annual rate as high as 9%–10% (though about 7¾% in the economy as a whole). Companies are therefore in no position to relax their efforts to moderate wage increases, or their quest for improvements in efficiency, if they are to continue to hold the rise in their unit labour costs to the rate to which they have slowed. The abolition of the national insurance surcharge in the Budget will, however, be a helpful factor, provided it is not passed on in wages.

Companies are husbanding their finances

The recovery in company profits continued, it seems, in the second half of last year. By the third quarter, the real rate of return (in non-North Sea operations) had risen to nearly 7%, more than double the low level of early 1981. Companies have, however, been cautious in their appropriations and capital spending. Dividends, which rose sharply about the time they were freed from control in 1979, and were maintained during the depth of the recession, have not kept pace with profit growth over the past year. Company spending on fixed capital and stocks has remained subdued until quite recently: in the first three quarters of 1983, fixed investment was scarcely higher, even in nominal terms, than in 1980, while stocks were still being run down. Preliminary information for the fourth quarter, however, suggests that a sharp increase in capital spending took place then.

Better profitability, and caution over spending, have brought a transformation of the company sector's financial position from a deficit of £1½ billion in 1979, and surpluses of £2½ billion in 1981 and 1982, to a surplus of over £6 billion (annual rate) in the first three quarters of last year. The financial counterparts to these surpluses are as yet exceptionally difficult to identify, perhaps to a degree that throws some doubt on the published company sector statistics. Nevertheless, the balance of the evidence (including a major buildup in company bank deposits) points to a substantial improvement in corporate liquidity in recent years. Companies' bank borrowing did, however, pick up in the second half of last year.

In relation to the improvement in company profits and finances, pre-Budget projections of company fixed investment in 1984 and beyond remained decidedly modest, implying that companies expect for a while to maintain a more substantial cushion of liquidity than has been customary in the past. It may be that these plans will be revised somewhat in response to the Budget incentive to advance investment in order to take advantage of the transitional levels of the first year allowances and (mainstream) corporation tax, including through leasing. In the longer run the effects on investment are hard to gauge; though leasing will become less attractive, companies overall will gain substantially.

Monetary trends

Much of the consumer borrowing mentioned above has taken the form of mortgage debt. The lending was facilitated by very high inflows to building societies which contributed to a continuing growth of over 12% per annum in the widest target aggregate (PSL_2). Earlier in the target period the rate of growth of sterling M_3 first rose and then fell as the balance between the public sector position and net sales of gilts shifted, but sterling M_3 is now well within the 11% limit of the target range. Although public sector borrowing exceeded original expectations, additional gilt sales were made before the end of the year on a similar scale. The major counterpart to the growth of money has been bank lending to the private sector, both households and companies. Companies, like households, have in aggregate acquired financial assets on a scale which is large in relation to their borrowing.

Over both the most recent three months, and the target period since February last year, M_1 has grown somewhat faster than sterling M_3. This would seem to reflect some aspects of recent institutional changes, which have raised the proportion of M_1 that bears interest. It has thus become a less reliable measure of retail deposits. M_2, which was designed as a measure of transactions balances, is only available for a very short period and has recently been affected by changes in the terms of some building society deposits. For these reasons the broad monetary base MO has been adopted as the narrow target aggregate complementing the broad target sterling M_3.

In interpreting these target aggregates, account will be taken of other monetary indicators and, in particular, of M_2 and PSL_2; these latter include building society liabilities which have risen relatively fast since the realignment of their interest rates last summer. MO grew by 6%–7% in the first twelve months of the 1983–4 target period and, like M_1, its growth has been somewhat lower in the latest quarter. Since 1980 MO has, on average, grown about 5% per annum less than sterling M_3, though the gap has narrowed slightly more recently. It is thus appropriate that a lower target range of 4%–8% has been set for 1984–5 while the range for sterling M_3 is 6%–10% as envisaged a year ago. Assessment of monetary conditions will give equal weight to broad and narrow money as well as taking account of other available evidence, including the exchange rate.

Since February 1983 the growth of all three aggregates then targeted has been fairly close to that of total spending. Thus velocity has not changed significantly. With the relative stability of the exchange rate in effective terms, and the modest decline of both nominal and real interest rates, this suggests that the stance of monetary policy remained, as intended, moderately restrictive.

Financial consequences of the Budget

The Budget provides for a PSBR in 1984/5 of £$7\frac{1}{4}$ billion or $2\frac{1}{4}$% of GDP. Part of the reduction reflects plans to realise more from the sale of public sector assets, but it still represents a marked fall from the estimated outturn for 1983/4 (£10 billion, or $3\frac{1}{4}$%). This should provide a background helpful to the conduct of monetary policy which will also be assisted by the Budget's implications for the primary and secondary market in company debt and equity. The corporate bond package should make it more attractive to companies to fund their overdrafts while the company tax package, including abolition of the national insurance surcharge, may, by raising share prices and reducing the tax rates against which debt interest is deductible, encourage equity issues. This last effect will be reinforced if the stamp duty reduction is capitalised into share prices.

The major benefits of lower stamp duty are, however, in reducing the cost of transacting in the London market. This not only makes for a more efficient market but should help London to increase its share of trading in both foreign and UK securities. The same is true of recent institutional changes in the City from which groupings are emerging which should be able to hold their own against international competition. This combination of institutional and fiscal change is particularly welcome.