# Economic commentary

- *World trade and output have risen less rapidly since the middle of last year, as US growth has slowed. But world recovery continues, activity has quickened in most European countries and prices in domestic markets and in international trade remain subdued. Although differences in growth rates, inflation rates and real interest rates among the industrial countries have generally narrowed, the dollar continued to strengthen against most other major currencies until the end of February.*
- *In the United Kingdom, which will shortly complete its fourth year of recovery, output last year now appears to have been more buoyant than earlier statistics had suggested.*
- *Cost pressures, however, have been building up: with slower growth of productivity, the rise in unit labour costs accelerated sharply towards the end of 1984 and sterling's fall caused a rapid increase in the cost of imports even though world prices were weak.*
- *Depreciation of the exchange rate was until recently more than sufficient to maintain the competitiveness of UK manufacturers at home and abroad; but increases in costs have not so far been fully reflected in domestic selling prices.*
- *Bank lending to the private sector, especially to industrial and commercial companies, accelerated in the latter part of last year and personal sector debt and income gearing continued to rise.*
- *The March Budget provides for a £0.7 billion net fiscal stimulus in 1985/6 and target ranges for monetary growth lower than in 1984/5.*

Although activity in the major industrial countries in aggregate rose by less in the second half of last year than in the first half, this principally reflects the slowdown in US growth from the exceptional rates recorded early in the year. In most European countries growth quickened through the year, with a greater contribution from net trade and some revival in investment. At the same time, inflation in most countries has once again turned out better than expected: there is little sign of any upturn in North America or Japan, while inflation has continued to subside in those countries where it had been most rapid. The exchange rates of most major countries, however, continued to weaken in effective terms until the end of February as the US dollar went on rising; but in the first three weeks of March the dollar lost much of the ground it had gained in the previous month. Although the impressive performance of the labour market and further increases in business fixed investment in the United States still seem to suggest an underlying economic strength, the large US current account and budget deficits remain major causes for concern.

**GNP growth in the major economies**

Percentage changes at annual rates;
at constant prices: *seasonally adjusted*

| | 1982 | 1983 | 1984(a) | | |
|---|---|---|---|---|---|
| | | | Year | H1 | H2 |
| Canada | -4.4 | 3.3 | 4.8 | 3.7 | 4.6 |
| France | 2.0 | 0.9 | 2.1 | 2.8 | 1.6 |
| Germany | -1.1 | 1.4 | 2.6 | 1.8 | 3.9 |
| Italy(b) | -0.4 | -1.2 | 2.7 | 2.8 | 3.2 |
| Japan | 3.4 | 3.4 | 5.3 | 6.1 | 4.0 |
| United Kingdom(b) | 2.2 | 3.2 | 2.4 | 1.8 | 1.9 |
| United States | -2.1 | 3.7 | 6.8 | 8.3 | 3.6 |
| **Total** | **-0.3** | **2.7** | **4.8** | **5.5** | **3.4** |

(a) Figures include some estimates for Q3 and forecasts for Q4.
(b) GDP.

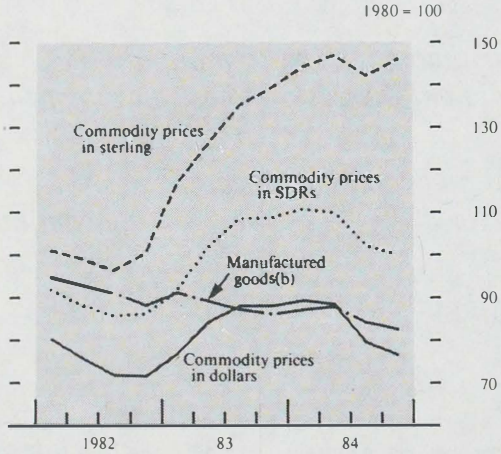
## *With complementary* monetary and fiscal policies *in most major countries . . .*

The reduction and containment of inflation has been encouraged by the monetary policies adopted in most of the major industrial countries. Monetary aggregates in 1984 were kept broadly in line with targets and inflation fell or remained subdued. In general, monetary policies have been complemented by fiscal restraint, although in the United States the main emphasis has so far been on tax cuts to improve incentives and the supply side of the economy. Current fiscal plans in all the major countries envisage reductions in budget deficits as a proportion of output—and, in most, in nominal terms—while monetary targets have been set lower or within narrower ranges for 1985. Overall, this would appear to imply neither a tightening nor a loosening of fiscal and monetary policy in the major countries as a whole, provided that inflation continues to subside. (Monetary and fiscal policies and recent budgets in the major overseas countries are discussed on page 11; the UK Budget is described on page 16.)

### . . . **inflation** *overall has slowed . . .*

Inflation in the major seven industrial countries has come down more quickly than had previously been expected as anti-inflationary policies have been assisted by weaker commodity prices; relative to prices of manufactured exports, industrial raw material prices fell by 5½% in the third quarter of 1984 and were little changed in the fourth. This may partly explain why the effective depreciation of most European currencies has had little effect on inflationary expectations. Perhaps more important, although all these factors interact, has been the continuing moderation of wages growth; this may be attributable in part to the still depressed state of labour markets in Europe, although wages have also grown more slowly than expected in the buoyant economies of North America. Average earnings in manufacturing in the major seven industrial countries are estimated to have grown at an annual rate of 5½% in the second half of 1984 and, with productivity continuing to improve, manufacturers' unit labour costs in aggregate actually fell slightly. Unit labour costs have shown little change over the first two years of the recovery—a marked contrast to the three previous cycles.

**International commodity prices**[a] *fell relative to* **manufactured export prices**




(a) The Economist all items commodity price index.
(b) World price of manufactured goods (in dollar terms).

### . . . *while* **growth rates** *have become less diverse*

Latest estimates suggest that output in the major seven industrial countries may have risen at an annual rate of around 3½% in the second half of 1984 compared with 5½% in the first half. This slowdown largely reflected the check to US growth in the third quarter, when real GNP rose by only 0.4%. Activity in the United States recovered appreciably in the fourth quarter, so that in 1984 as a whole output may have been almost 7%, higher than in 1983, its fastest annual growth rate for 30 years. In Europe, growth remained modest, GNP in the major continental countries increasing by perhaps 2½%, but there appears to have been some acceleration during the year: their net trade benefited from effective exchange rate depreciation and their relative cyclical position, while investment continued to show modest growth.

US and European growth rates seem likely to diverge less in 1985 and 1986 than in recent years. In the United States, GNP may grow by some 3%–4% in 1985 and by rather less in 1986, while output in the major continental European countries may continue to rise on average this year, and perhaps next, by

**Components of GNP**[a] **in the major economies**

Percentage changes at annual rates: at constant prices, *seasonally adjusted*

| | United States, Canada and Japan | | | Europe(b) | | |
|---|---|---|---|---|---|---|
| | 1983 | 1984(c) | | 1983 | 1984(c) | |
| | | Year | H2 | | Year | H2 |
| Private consumption | 4.4 | 4.5 | 2.7 | 1.5 | 1.1 | 0.5 |
| Private fixed investment | 5.4 | 13.3 | 9.6 | — | 2.1 | 1.7 |
| Public expenditure | 0.2 | 2.7 | 6.5 | 1.8 | 1.2 | 2.1 |
| Stockbuilding(d) | 0.4 | 1.4 | — | -0.1 | 0.5 | 0.1 |
| **Domestic demand** | **4.0** | **7.2** | **4.6** | **1.3** | **1.8** | **1.3** |
| Net trade(d) | -0.4 | - 1.0 | -0.7 | — | 0.5 | 1.5 |
| **GNP** | **3.6** | **6.3** | **3.8** | **1.3** | **2.4** | **2.7** |

(a) Or GDP.
(b) France, Germany, Italy and the United Kingdom.
(c) Figures include estimates for Q3 and forecasts for Q4.
(d) Contribution to change in GNP.

# Monetary and fiscal policy in major overseas countries

The major industrial countries continued, in 1984, to pursue policies designed to bring about further reductions in inflation and thus lay the basis for sustainable and broadly-based growth. In most countries monetary policy was again framed in terms of targets for the growth of various monetary aggregates and may be judged to have been generally successful: monetary aggregates grew broadly in line with targets, inflation fell and output recovered further. Real interest rates, however, although tending to converge, remained fairly high. In the United States, where attention is now focused on both the narrow and the broad measures of money, the narrower measures grew within target and the broader measures grew rather more rapidly. In Germany, growth in central bank money was in the lower half of the target range throughout the year, while in France growth in residents' M2 was approximately on target; emphasis in Italy was switched from total domestic credit expansion (which is dominated by movements in the central government deficit) to the monetary base and M2. Plans for 1985 are based on further lowering and/or narrowing of target ranges but this does not necessarily imply a tightening in the stance of monetary policy.

Current fiscal plans in the developed countries mostly provide for reductions in government deficits as a proportion of output and also in nominal terms. The US government's current proposals envisage a Federal deficit of $180 billion (4.3% of GNP) in the fiscal year starting in October, following an expected deficit of $222 billion (5.7% of GNP) in the current fiscal year. Japan and Germany both have medium-term fiscal objectives. In Japan, the aim is to achieve balance on government current transactions by 1990, focusing on the expenditure side. In Germany the objective is to reduce the Federal deficit to around 1% of GNP; in the near term, the 1985 Budget provides for a reduction in the deficit from $1\frac{1}{2}$% of GNP in 1984 to $1\frac{1}{4}$% of GNP in 1985. Elsewhere, the pattern is broadly similar: the French CGBR is to be limited to 3% of GDP this year, following 3.3% in 1984, while in Italy (where last year's central government deficit, helped by a shift towards bank borrowing by local authorities, overshot its target by much less than in previous years) the deficit is to be held broadly constant this year. Most of the smaller industrial countries are also aiming to reduce their budget deficits, albeit from rather higher levels than the average for the larger countries.

### Changes in fiscal stance[a]

Percentages of GNP
More expansionary or less contractionary +.
More contractionary or less expansionary −.

| | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| United States | −0.8 | +1.6 | +0.9 | +0.6 |
| Canada | −0.9 | −0.2 | +1.7 | +0.8 |
| Japan | −0.8 | −0.2 | −0.3 | −0.5 |
| Germany | −0.7 | −2.2 | −0.8 | −0.5 |
| France | +0.6 | +0.2 | −0.3 | −1.0 |
| Italy | +1.1 | −0.7 | −2.5 | +2.6 |
| **Average** | **−0.6** | **+0.4** | **+0.2** | **+0.2** |

(a) Changes in fiscal balance, adjusted for the effects of inflation and variations in economic activity, as a percentage of GNP.

### Monetary and credit targets and projections

Percentage changes at an annual rate

| | 1984 Target | 1984 Outturn | 1985 Target |
|---|---|---|---|
| **United States** | | | |
| M1 | 4–8 | 5.2 | 4–7 |
| M2 | 6–9 | 7.7 | 6–9 |
| M3 | 6–9 | 10.5 | 6–9.5 |
| Domestic non-financial sector's debt | 8–11 | 13.4 | 9–12 |
| **Germany** | | | |
| Central bank money | 4–6 | 4.6 | 3–5 |
| **France** | | | |
| M2R | 5.5–6.5 | 5.7(a) | 4–6 |
| **Italy** | | | |
| Total domestic credit expansion | 19.3(b) | 19.3(c) | 16.2 |
| **Japan** | | | |
| M2 plus CDs(d) | 8 | 7.8 | 8 |

(a) Year to November.

(b) September 1984 forecast. The September 1983 forecast was 17.4%.

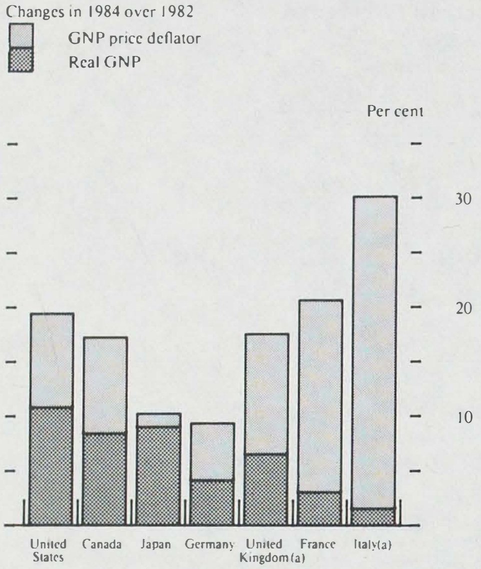
(c) Provisional.

(d) Projections are made for growth in average stock of M2 + CDs during the current quarter over corresponding quarter a year earlier. Column 1 shows the mid-point of the projection range in the last three quarters of 1984; column 3 the mid-point for 1985 Q1.

These fiscal comparisons do not take account of effects of the economic cycle on government finances. During an economic upturn budget deficits tend to decline, without any change in the stance of policy, as government receipts expand with activity and expenditure falls to the extent that unemployment is reduced. The table shows estimates of the change in fiscal stance after adjustment has been made for the cycle. The figures also include an inflation adjustment, the effect of which is to treat the notional gain to governments from the erosion of the real value of outstanding debt by inflation as a reduction in the fiscal deficit. The figures should be interpreted with caution, and are highly sensitive to assumptions about trend output growth and the responsiveness of expenditure and receipts to changes in activity. They suggest that there has been an increase in the structural fiscal deficit in the United States in recent years but in a number of other countries there has been a reduction. The net effect in the major overseas economies has been mildly expansionary during the past three years. Given the prospect of further recovery of output this year, the announced fiscal plans would seem consistent with the maintenance of a broadly neutral fiscal stance overall in 1985. Thereafter, the aggregate position will depend in large measure on the extent to which the US budget deficit is reduced.

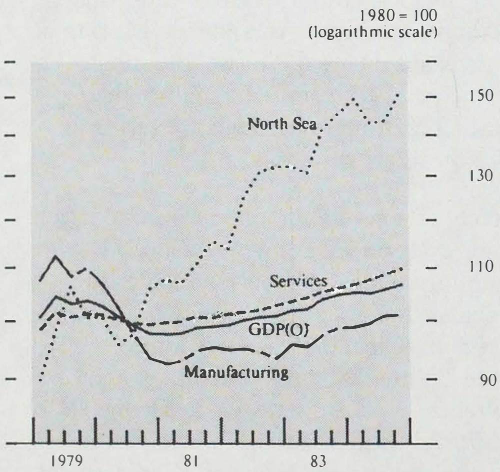
*Industrial countries have had mixed success in turning* **nominal** *into* **real GNP growth**

Changes in 1984 over 1982




(a) GDP.

*Each of the major sectors has contributed to the* **four-year recovery in output**




**Contributions to the change in GDP**

Change in components as percentage of GDP

| | 1982 | 1983 | 1984 Year | 1984 H1 | 1984 Q3 | 1984 Q4 |
|---|---|---|---|---|---|---|
| Consumer spending | 0.6 | 2.7 | 1.1 | 0.1 | −0.5 | 0.8 |
| Government consumption | 0.2 | 0.6 | 0.2 | — | 0.1 | 0.3 |
| Fixed investment | 1.3 | 0.8 | 1.5 | 1.6 | — | 0.2 |
| Stockbuilding | 0.8 | 0.8 | −0.4 | −1.1 | 0.3 | 1.0 |
| Exports | 0.3 | 0.3 | 2.0 | 1.1 | 0.2 | 2.3 |
| Total final expenditure | 3.2 | 5.3 | 4.4 | 1.7 | — | 4.6 |
| Imports | −1.1 | −1.6 | −2.6 | −1.1 | −0.5 | −1.5 |
| Factor cost adjustment | −0.6 | −0.5 | −0.3 | −0.2 | +0.2 | −0.2 |
| **GDP(E)** | **1.5** | **3.2** | **1.6** | **0.4** | **−0.3** | **2.9** |
| *Memo item:* | | | | | | |
| *GDP(O)* | *2.0* | *3.0* | *2.4* | *0.7* | *0.9* | *0.8* |

about $2\frac{1}{2}$%. A slowdown in the US economy may result from action on the fiscal deficit, its earlier loss of competitiveness, and a cyclical reduction in stockbuilding; business investment is also unlikely to maintain the very rapid pace seen in 1984.

Over the past two years of recovery, GNP in the major industrial countries rose by around 17% in nominal terms, of which rather less than half came from real output growth. Price and output experience, however, was very varied. Nominal GNP growth was broadly similar in the United States, Canada, the United Kingdom and France, but the degree of success in obtaining real growth rather than inflation differed markedly; and whereas most of Japan's nominal GNP growth was translated into higher output growth, in Italy most was taken up in higher prices. In the United Kingdom, nominal GNP grew slightly more than the seven-country average, but almost two thirds of this was accounted for by inflation.

By the second quarter of 1985, the UK economy will have completed its fourth year of recovery. More than half the growth in output since early 1981 has come from the service industries, which had also held up well during the recession, and a further fifth was contributed by North Sea oil; although manufacturing, being a larger sector, has contributed rather more to the recovery than has oil production, by the end of last year it was still 10% below its 1979 peak. Output increased in 1984 in spite of the coal strike and is now thought to have been more buoyant than earlier estimates had suggested; the interruption of growth in the second quarter (when the full impact of the coal strike was first felt) was short-lived. But for the coal strike, the increase in 1984 might have been around $3\frac{1}{2}$%, slightly faster than the $2\frac{1}{2}$% growth in 1983.

Successive upward revisions to the official figures now suggest that manufacturing production recovered quite strongly in the spring and early summer—in line with CBI surveys. Although it seems to have levelled out since then, manufacturing production in the year as a whole apparently rose at much the same rate as output of the service industries, with particularly vigorous growth in chemicals and electronics. Industrial production in total revived in the latter part of last year, as North Sea oil production recovered from unusually heavy summer maintenance work and coal output picked up a little in the fourth quarter.

Consumer spending in the United Kingdom rebounded in the fourth quarter and stocks rose sharply. At the same time, fixed investment by the construction, distribution and financial industries rose further while manufacturing investment continued at a substantially higher level than in 1983. The foreign trade picture also appears more encouraging now contributing in real terms to GDP growth in the fourth quarter. Unemployment, however, has continued to rise at an underlying rate of some 10,000 to 15,000 a month as employment opportunities have failed to keep pace with the growth of the working population.

Recovery in the smaller industrial countries, led by strong export growth, accelerated in the course of last year, when GNP may have been some 3% higher than in 1983. In aggregate, non-oil developing countries too have benefited substantially from the upturn in world activity: with exports rising strongly and output recovering, a return to more normal rates of import growth (8% in 1984) has not prevented a further improvement in their trade and current account positions. Within this overall picture, countries' experiences have differed widely. A number of Asian countries have benefited considerably from the surge in US imports of manufactured goods. But several of the Latin American countries, despite buoyant exports, have been hampered by continuing debt service problems, while in most African countries economic activity remains subdued. The weakness in the world oil market has caused the OPEC countries to cut back their imports in volume terms by perhaps some 10% in both 1983 and 1984 and a further fall of much the same order seems possible this year. (World current accountdevelopments are discussed further on page 37.)

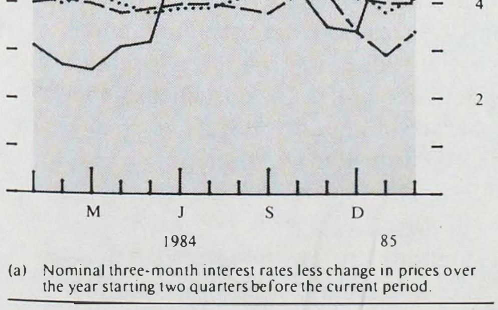
World trade in total last year was almost 9% higher than in 1983; with import volumes of the seven major industrial countries growing particularly rapidly, by over 12%, in response to GNP growth of 4¾%. Total imports in UK markets overseas have been growing more slowly than world trade in general and seem likely to continue to do so over the next two years—principally because of import retrenchment by the OPEC countries and because domestic demand in the smaller industrial countries has so far been held in check. Between 1983 and 1984 UK markets are estimated to have grown by just over 6% in volume terms; rather slower growth seems likely this year.

## **Interest rates** *fell more in the United States than elsewhere, as the dollar rose*

Short-term interest rates moved down fairly steadily in the United States, after the sharp rises seen in the summer, until early January when they started to harden once more. In a number of the other major industrial countries short-term rates moved more cautiously lower—the greatest reductions occurring in France and Italy, where the fall in inflation was most pronounced—before edging up in February as dollar rates firmed. Real short-term interest rates[1] tended to move closer together in the second half of 1984. Viewed against this background of convergence of real interest rates and of less disparate rates of economic growth and inflation, the rise in the US dollar relative to every other major currency was remarkable. Between the end of September and late February the exchange rate index of the US dollar rose by almost 11%, while the yen index was virtually unchanged and the deutschemark index fell by over 3%, even though the US current account and budget deficits continued to grow. By the end of the third week in March, however, the dollar had dropped back by 5% in effective terms from its peak.

Until mid-December, short-term interest rates in the United Kingdom also fell back from their summer peak. By late January, however, the three-month sterling interbank rate (and clearing bank base lending rates) had risen by over 4 percentage points,

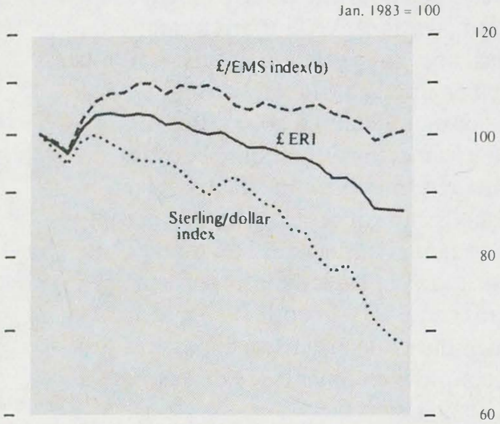
**Real interest rates**[a] *converged at the turn of the year*



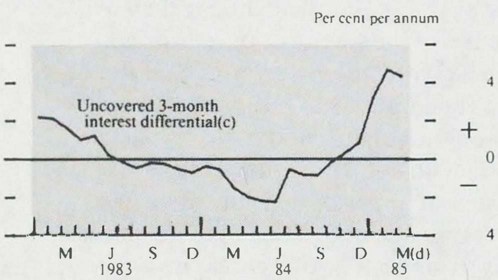

(a) Nominal three-month interest rates less change in prices over the year starting two quarters before the current period.

(1) The principles and problems of measuring real interest rates were described in the December 1983 *Bulletin*, pages 471–6.

**Sterling**[a] *fell more against the dollar than against EMS currencies . . .*




*. . . and the* **interest differential** *widened*




(a) Monthly averages of daily rates.

(b) Sterling exchange rate index against EMS currencies.

(c) 3-month £ interbank rate less eurodollar rate: average of daily rates.

(d) First half of March.

to 14%, where for the most part it remained in February and early March. And whereas sterling's exchange rate index fell by 3½% between end-September and mid-December while interest rates came down, it continued falling thereafter—by a further 5½%—until late February, despite the rise in interest rates (and a three-month interest rate differential above US rates at times as wide as 5%). Sterling's fall against most major currencies early this year was due in part to the weakness of oil prices and to periodic fears that the Government was weakening in its resolve and ability to maintain its firm domestic policies in the face of a continuing rise in unemployment. A clear demonstration in January of the Government's commitment to lower inflation, and a majority agreement on oil pricing policies among the OPEC countries helped stem the fall in sterling's exchange rate index, with sterling continuing for a time to weaken against the strong dollar but recovering against continental currencies. Further support was provided by the onset of cold weather and evidence of reduced OPEC supplies which contributed to a rise in spot oil prices of more than $2 a barrel from the January low (although market prices for forward oil deliveries continued to reflect expectations of a weakening market in the spring). During the first three weeks in March, sterling strengthened against most major currencies and its exchange rate index climbed back to its late November level. (Recent exchange and interest rate developments are discussed further on pages 29–31 and 41–4.)

## **Liquidity and credit** *growth in the United Kingdom strengthened towards the end of the year*

Growth of the broad money stock, £M3, was only slightly slower in 1984 than in 1983,[1] while nominal GDP growth, depressed by the coal strike, slowed more abruptly. £M3 rose by 9¾% and nominal GDP by about 6½% during the year. As economic activity regained in the second half of 1984 some of the momentum it had lost earlier in the year, when the impact of the coal strike was first felt, £M3 growth became particularly vigorous.

Industrial and commercial companies (ICCs), which had been major depositors in the third quarter, ran down their sterling deposits slightly in the fourth quarter, but personal sector and non-bank financial institutions' sterling deposits rose quite rapidly. The personal sector also continued to accumulate liquid claims on building societies on a substantial scale. Net holdings of term shares fell, as many with five-year terms (first issued on a large scale in 1979) reached maturity, but holdings of more liquid building society liabilities rose sharply, reflecting the very competitive rates then on offer. In consequence, the broader measure of private sector liquidity, PSL2 (which does not include such term shares), continued to rise faster than £M3. In the year as a whole, PSL2 rose by 14½%.

Within the counterparts to monetary growth during the quarter there was, as expected, a contraction in the PSBR as receipts came in from the sale of British Telecom and from accelerated VAT payments. There was also a marked increase in public

(1) Analysis of monetary developments in the light of what is known of activity in each of the main sectors of the economy is conducted here using calendar quarter money supply figures which are available to the end of 1984. The course of the monetary aggregates in recent banking months is discussed in detail on pages 25–7.

### **Growth of bank deposits and lending**

£ billions; *figures for sterling only in italics*

| | 1981 | 1982 | 1983 | 1984 Year | 1984 H1(a) | 1984 H2(a) |
|---|---|---|---|---|---|---|
| **Domestic deposits** | | | | | | |
| Persons | 4.0 | 3.8 | 2.9 | 3.3 | 3.3 | 3.4 |
| Companies | 4.9 | 1.9 | 5.2 | 0.8 | − 4.1 | 5.7 |
| Other financial institutions | 2.0 | 2.8 | 2.8 | 6.0 | 6.6 | 5.5 |
| Public | 0.1 | 0.5 | 0.1 | 0.7 | — | 1.4 |
| **Total deposits** | **11.0** | **9.0** | **11.1** | **10.9** | **5.8** | **16.0** |
| | *8.8* | *7.9* | *8.9* | *9.7* | *7.4* | *12.1* |
| **Domestic lending** | | | | | | |
| Persons | 6.3 | 10.1 | 8.5 | 6.6 | 6.2 | 6.9 |
| Companies(b) | 5.7 | 6.8 | 1.5 | 7.3 | 7.1 | 7.6 |
| Other financial institutions | 2.1 | 2.7 | 4.1 | 7.2 | 5.9 | 8.6 |
| Public | − 0.3 | − 2.3 | − 1.9 | 0.8 | − 2.6 | 4.2 |
| **Total lending** | **13.7** | **17.3** | **12.3** | **21.9** | **16.6** | **27.3** |
| | *11.7* | *15.6* | *10.8* | *16.9* | *12.9* | *21.0* |
| **Overseas sector: deposits net of lending** | | | | | | |
| Sterling | − 0.6 | 0.4 | 1.3 | − 0.3 | 0.1 | − 0.4 |
| Foreign currency | − 1.0 | 1.1 | − 2.9 | 1.7 | 4.6 | − 1.2 |

(a) Seasonally adjusted, at an annual rate.

(b) Including Issue Department transactions in commercial bills.

### Counterparts to changes in money stock

£ billions, unless otherwise stated

| | 1982 | 1983 | 1984 Year | 1984 H1(a) | 1984 Q3(a) | 1984 Q4(a) |
|---|---|---|---|---|---|---|
| PSBR | 4.9 | 11.6 | 10.1 | 10.7 | 11.1 | 8.0 |
| *of which. CGBR (own account)* | *4.1* | *9.2* | *6.9* | *8.7* | *8.8* | *1.2* |
| Public sector debt sales to UK non-bank private sector | 11.0 | 11.3 | 11.3 | 9.9 | 11.2 | 14.3 |
| *of which:* | | | | | | |
| *Gilt-edged* | *5.2* | *8.3* | *7.5* | *6.3* | *8.2* | *9.3* |
| *National savings* | *3.6* | *3.0* | *3.4* | *2.9* | *4.5* | *3.1* |
| *Other, including CTDs* | *1.1* | *0.1* | *0.5* | *0.3* | *– 1.2* | *2.6* |
| Sterling lending to private sector | 17.8 | 12.8 | 16.4 | 15.5 | 14.0 | 20.7 |
| External and foreign currency counterparts | – 2.2 | – 0.6 | 1.0 | – 1.4 | 3.1 | 3.6 |
| Net non-deposit liabilities | – 2.2 | – 3.6 | – 6.6 | – 5.5 | – 4.5 | –10.8 |
| £M3 | 7.8 | 9.5 | 9.8 | 8.6 | 11.9 | 10.0 |
| PSL2 | 12.0 | 18.4 | 24.5 | 24.9 | 23.6 | 24.7 |
| **Percentage changes from end of previous period** | | | | | | |
| £M3 | 9.3 | 10.3 | 9.7 | 8.5 | 11.3 | 9.2 |
| PSL2 | 8.8 | 12.3 | 14.6 | 14.9 | 13.1 | 13.3 |

(a) Seasonally adjusted at an annual rate.

sector debt sales to the non-bank private sector. The PSBR in consequence was overfunded by £¾ billion during the quarter, with a contractionary impact on £M3 which substantially outweighed the expansionary contribution from external and foreign currency counterparts (reflecting in part a strengthening on the current account of the balance of payments). Sterling lending to the non-bank private sector, however, having grown rather slowly around the middle of the year, accelerated sharply. At the same time, banks increased their net non-deposit liabilities (including capital issues and retained profits) rapidly, strengthening their capital base and also reducing the volume of additional deposits needed to finance the current growth in their assets. Sterling lending to industrial and commercial companies (ICCs) rose particularly strongly in the fourth quarter and, despite substantial additions to their foreign currency deposits, ICCs reverted to being net borrowers (in sterling and foreign currencies together) from the banking system as a whole. The personal sector in the fourth quarter was a net taker of bank funds on a much smaller scale than in the third, increasing borrowing at a slightly faster rate but adding considerably to deposits.

Within the fourth quarter figure for bank lending to the personal sector there was a marked recovery in loans for house purchase. Although building society lending fell, mortgage lending by banks and building societies together was only slightly less buoyant than earlier in the year. During 1984 as a whole, such lending amounted to more than £16 billion, some £3½ billion higher than in 1983. The contribution of borrowing on mortgage to the financial position of the personal sector is considered below; the wider economic implications of its growth in recent years are discussed in an article on page 80.

## **Public sector spending** *exceeded targets in 1984/5, in large part because of the coal strike*

In the first eleven months of the 1984/5 financial year, the PSBR totalled £7.6 billion (not seasonally adjusted), compared with £7.5 billion at the same stage in 1983/4. The financial position of central government has been helped by the special sales of assets which have raised just over £2 billion during 1984/5, largely from the British Telecom flotation. The PSBR for 1984/5 is now expected to be £10½ billion, though this is still subject to a wide margin of error, compared with a projection of £7.2 billion at the time of the March 1984 Budget and £8.5 billion in the Autumn Statement. General government receipts are expected to be £1 billion higher than thought at the time of the 1984 Budget, with North Sea oil revenues £2 billion higher than expected, because of higher production and (as a result of the strength of the dollar) higher sterling oil prices. Increases in a number of expenditure items, however, have more than offset these gains. Local authorities have overspent on capital account by around £¾ billion and by a larger amount on current items, including education, transport and debt interest payments. Central government spending on health, social security and net contributions to the European Community has also exceeded original targets. So have the external financing requirements of the nationalised industries in total (by £2¼ billion), mainly as a result of the coal dispute and its knock-on effects on the steel, rail and electricity

# The Budget

The Budget proposals provide for a 'fiscal adjustment'—the reduction in government revenue, net of expenditure changes, resulting from the proposed measures—of £$\frac{3}{4}$ billion, when measured against a fully indexed tax base. Over a full year, when all the measures have worked through, the net cost is £1$\frac{1}{4}$ billion. The PSBR is forecast to fall from an estimated £10$\frac{1}{2}$ billion (3$\frac{1}{4}$% of GDP) in 1984/5 to £7.1 billion (2% of GDP) in 1985/6.

### The main proposals

Most *personal tax* thresholds are increased by rather more than the rate of inflation; the single and married persons' allowances increase by more than twice the rate of inflation. In addition, the *national insurance contributions* of lower paid employees and their employers are being reduced from 6 October 1985. These changes are only partly financed by the abolition of the upper limit on employers' contributions, so that, together with reductions in self-employed and voluntary contributions, the net cost of these measures is £450 million in a full year.

*Excise duties* are increased by varying amounts, but the net effect is to increase revenue in a full year by £240 million more than that from indexation. The base of *value added tax* is widened to include press advertisements. The direct effect of the changes in taxes on spending is estimated to raise retail prices by $\frac{1}{2}$% (0.1% more than indexation).

The Chancellor also announced extensions of the Community Programme and the Youth Training Scheme to be phased in over the next three years. These will eventually cost £400 million.

### Targets for monetary growth

Percentage change over target period at an annual rate

| | 1985–86 | 1986–87 | 1987–88 | 1988–89 |
|---|---|---|---|---|
| Narrow money, M0 | 3–7 | 2–6 | 1–5 | 0–4 |
| Broad money, £M3 | 5–9 | 4–8 | 3–7 | 2–6 |

### The medium-term financial strategy

The Government has retained the 1985/6 targets for M0, as a measure of narrow money, and £M3, as a measure of broad money, set out in last year's MTFS which gave illustrative target ranges moving downwards by one percentage point each year. No special role is assigned to PSL2 or M2. The performance of M0 and £M3 will continue to be interpreted in the light of other indicators of monetary conditions. Significant changes in the exchange rate are also important.

The PSBR is projected to be £7–7$\frac{1}{2}$ billion in nominal terms in each of the next four years, falling from an estimated 3$\frac{1}{4}$% of GDP in 1984/5 to 2% of GDP this year and to 1$\frac{3}{4}$% by 1987/8. The public expenditure planning total, as set out in the *Public Expenditure White Paper* (Cmnd 9428), has been revised upwards to allow for the addition of £2 billion to the reserve for each of the next three years. Expenditure is projected to remain roughly flat in real terms at about the level of 1984/5 (excluding the costs of the coal strike) and to fall as a percentage of GDP. The upward revision to spending plans and higher debt interest payments are only partially offset by higher projections for tax receipts. On the assumptions set out in the MTFS this will allow room for fiscal adjustments (for example by way of tax cuts) in future years, although the sums available are smaller than previously envisaged.

### Direct effects of Budget measures on public sector transactions—changes from indexed base

£ millions at current prices; a decrease in revenue or increase in expenditure –.

| | Effect in 1985/6 | Effect in a full year |
|---|---|---|
| **Revenue changes** | | |
| Income tax allowances and thresholds | –730 | – 910 |
| National insurance contributions | –160 | – 450 |
| VAT and Excise duties | +295 | + 430 |
| Other | – 60 | + 20 |
| Total | –655 | – 910 |
| **Expenditure measures** | | |
| Employment and training | – 75 | – 400 |
| **Total direct effects** | **–730** | **–1,310** |

### Economic prospects

The rate of inflation is forecast to rise to 6% in the second quarter of 1985, but to fall back to around 5% by the end of the year and to decline slowly thereafter. GDP is forecast to grow by 3$\frac{1}{2}$% this year; without the temporary boost to output growth attributable to the ending of the coal strike, the figure would be 2$\frac{1}{2}$%. The rise in fixed investment is expected to slow but growth of consumer spending gradually accelerates. The sterling exchange rate is assumed not to change much from its average level in January and February. The current account forecast shows a return to substantial surplus in 1985 after the end of the coal strike; the rapid rise in exports in the fourth quarter of 1984 is projected to continue in the first half of 1985 but subsequent increases are offset by renewed import growth.

### Projected contributions to the change in GDP

Percentages of GDP at annual rates

| | 1984 H2–1985 H1 | 1985 H1–1985 H2 | 1985 H2–1986 H1 |
|---|---|---|---|
| Consumer spending | +2 | +2$\frac{1}{2}$ | +2$\frac{3}{4}$ |
| Government consumption | +1 | – $\frac{1}{4}$ | – $\frac{1}{4}$ |
| Fixed investment | +1$\frac{1}{4}$ | + $\frac{1}{4}$ | + $\frac{1}{4}$ |
| Stockbuilding | – $\frac{1}{2}$ | + $\frac{1}{4}$ | + $\frac{1}{2}$ |
| Exports | +2$\frac{1}{2}$ | +1 | +1 |
| Imports | + $\frac{1}{4}$ | –1 | –1$\frac{1}{4}$ |
| **GDP** (a) | **+4$\frac{1}{4}$** | **+2$\frac{3}{4}$** | **+2$\frac{1}{2}$** |

**Source:** *Financial Statement and Budget Report 1985–6.*

(a) Average measure at 1980 factor cost. Adjustments needed to derive this measure from the expenditure figures are omitted from the table.

industries. Overall the dispute is estimated to have added £2½ billion to spending in 1984/5 and (including lost tax revenue) £2¾ billion to the PSBR. Spending on programmes in 1984/5 is thus expected to turn out about £6¼ billion higher than original programme plans compared with a reserve of £2¾ billion, giving a net overspend on the planning total of nearly £3½ billion. In addition, gross debt interest payments are some £1 billion more than forecast because debt sales and interest rates were both higher than expected. (The Budget proposals and projections for 1985/6 are set out on page 16.)

## **Profits** *continued to grow but* **company borrowing** *rose strongly*

In sharp contrast to 1983, companies in 1984 were net takers of funds from the banking system. In spite of a further apparently strong rise in profits, their borrowing was about £1 billion higher than in 1983, while their deposits were little changed. In 1983, industrial and commercial companies (ICCs) had been substantial net lenders to the UK banking system, their borrowing rising by £1½ billion while their deposits climbed by a substantial £5¼ billion. The 1983 picture was unusual but appeared to be consistent with a strong growth of profits and still flat or falling real capital expenditure. The swing from net lending to net borrowing in 1984 was distorted by the Shell Group's takeover of its US affiliate, an important counterpart of which was a buildup of ICCs' bank deposits during 1983 and their subsequent rundown in the second quarter of 1984. This nonetheless leaves a sharp rise in ICCs' borrowing, particularly in the latter part of 1984, to be explained.

Lending to companies in the property, hire, business and other services category, and in the construction industry, appears to have been particularly strong. Lending to manufacturing industry also grew faster than the average, especially in the three months to mid-November. Within manufacturing, lending to the food, drink and tobacco (£1.2 billion) and electrical and electronic engineering (£0.8 billion) industries both grew by 35% over the year to mid-November; the value of their output rose by 9% and 16% respectively.

It is difficult to reconcile the available information on ICCs' income, appropriations and expenditure used in the national accounts with their identified financial transactions, so an explanation of company sector borrowing is unavoidably tentative. In the first three quarters of 1984 (the latest period for which full figures are available), the company sector balancing item was pointing to an unidentified net acquisition of real or financial assets or an overstatement of income receipts equivalent, at an annual rate, to £8 billion. Companies' internally generated funds apparently remained buoyant in the first three quarters of 1984. Profits arising in the United Kingdom continued to advance, the real pre-tax rate of return on non-North Sea companies' activities reaching 7½%—higher even than in 1978—while other forms of company income (including income from abroad) also continued to rise. Dividends, interest payments and other appropriations (except tax payments) rose more slowly than income so that undistributed income appears to have made a major contribution to ICCs' financing requirements. Expenditure on

### Bank lending to businesses: industrial analysis

£ billions: *not seasonally adjusted*

| Banking months | Dec. 83–Feb. 84 | Mar. 84–May 84 | June 84–Aug. 84 | Sept. 84–Nov. 84 | Percentage change(a) mid-Nov. 83–mid-Nov. 84 |
|---|---|---|---|---|---|
| Total lending to businesses (b) | 1.9 | 1.6 | 1.1 | 3.0 | +12 |
| *of which:* | | | | | |
| Oil, extraction of gas | 0.2 | −0.3 | −0.1 | 0.1 | − 1 |
| Manufacturing | 0.6 | 0.4 | 0.5 | 1.6 | +14 |
| Construction | 0.3 | 0.1 | — | 0.2 | +16 |
| Garages, distribution, hotels, etc. | 0.3 | 0.5 | 0.3 | 0.4 | + 9 |
| Transport | — | 0.1 | −0.3 | 0.1 | − 4 |
| Property, hire firms, business services | 0.6 | 0.9 | 0.6 | 0.6 | +21 |

(a) Excluding valuation changes.

(b) In sterling and foreign currencies. Excludes, where possible, figures for the public, personal and financial sectors; unincorporated businesses are included but cannot be separately identified.

### Industrial and commercial companies' income, spending and financial transactions

£ billions at a quarterly rate, seasonally adjusted; *figures in italics are at 1980 prices*

Inflows of funds +, outflows −

| | 1982 | 1983 | | 1984 | | |
|---|---|---|---|---|---|---|
| | Year | H1 | H2 | Q1 | Q2 | Q3 |
| Gross trading profits(a) | 8.9 | 10.0 | 11.3 | 12.4 | 11.9 | 13.2 |
| *of which:* | | | | | | |
| Non-North Sea | 5.7 | 6.4 | 7.1 | 8.1 | 7.5 | 8.5 |
| **Total income**(b) | **11.1** | **12.2** | **13.8** | **15.0** | **14.4** | **16.1** |
| | *9.4* | *10.0* | *11.0* | *11.8* | *11.2* | *12.4* |
| **Allocation of income** | | | | | | |
| Dividends, interest, profits due abroad | −4.1 | −4.3 | −4.6 | −4.5 | −4.8 | −5.1 |
| UK taxes | −2.6 | −3.0 | −3.2 | −3.5 | −3.6 | −3.9 |
| Undistributed income | 4.3 | 4.9 | 6.1 | 7.0 | 6.0 | 7.0 |
| | *3.7* | *4.0* | *4.9* | *5.5* | *4.7* | *5.4* |
| Spending on fixed assets and stocks | −3.3 | −3.4 | −4.1 | −4.4 | −3.9 | −4.2 |
| **Financial balance** | **1.1** | **1.5** | **1.9** | **2.6** | **2.1** | **2.8** |
| | *0.9* | *1.2* | *1.5* | *2.0* | *1.6* | *2.2* |
| Balancing item | −1.0 | −0.5 | −0.4 | −3.2 | −0.6 | −2.2 |
| **Financial transactions** | **−0.1** | **−1.0** | **−1.5** | **0.6** | **−1.5** | **−0.6** |
| *of which:* | | | | | | |
| UK company securities | −0.3 | −0.4 | −0.3 | −1.0 | −0.5 | −0.1 |
| Investment abroad | −0.7 | −0.6 | −0.7 | −1.2 | −2.0 | −0.6 |
| Liquid assets | −0.7 | −0.9 | −2.2 | −1.1 | 2.2 | −1.6 |
| Other financial assets | −0.4 | −0.4 | −0.5 | 0.3 | −0.7 | −0.2 |
| Trade credit etc(c) | −0.4 | 0.4 | −0.1 | 1.2 | −0.1 | −0.2 |
| Bank borrowing(d) | 1.6 | −0.1 | 0.9 | 2.5 | 1.0 | 1.1 |
| Equity issues | 0.2 | 0.4 | 0.5 | 0.1 | 0.4 | 0.3 |
| Other borrowing etc | 0.5 | 0.5 | 0.9 | −0.2 | −1.8 | 0.7 |

(a) Net of stock appreciation.

(b) Including interest, other property income and income from abroad.

(c) Accruals adjustment, net unremitted profits and net trade credit.

(d) Including Issue Department holdings of commercial bills.

fixed investment and stocks has risen since 1983 but stock levels in particular remain low in relation to output when compared with previous cycles. Overall, this would not seem to call for heavier bank borrowing.

It cannot be ruled out that companies' income may have been somewhat overestimated: whereas ICCs' profits (excluding stock appreciation) rose by over 17% between the third quarters of 1983 and 1984, the volume of private sector output may well have grown by only about 3%. A rise in output which brings with it a spreading of overhead costs, however, will readily yield a substantial increase in profits, the more so in view of the low level of real profits experienced during the recession. Moreover, the depreciation of sterling has permitted an increase in profit margins on export sales.

Part of the explanation of the growth of bank borrowing may lie in the diversity of experience within the company sector, with small firms in particular more dependent on bank finance than large ones. Small firms' financing needs may also be greater if, as CBI surveys imply, they are expanding faster. Differences in the financial position of large and small companies in recent years are also suggested by a comparison of the DTI's liquidity surveys with the aggregate sector data, which shows that the liquidity of the 264 large companies in the DTI survey sample has improved substantially more (and their borrowing by less) than that of ICCs as a whole since the first quarter of 1983. In the fourth quarter of 1984, the net liquidity of surveyed companies dropped quite sharply, but mainly because of an unusually large fall in their liquid assets held abroad.

Other more specific factors may have affected ICCs' bank borrowing and net liquidity in the fourth quarter of 1984. Capital issues by ICCs were low, perhaps reflecting a reluctance to go to the market ahead of the British Telecom floatation (whereas so far in 1985 there has been a surge of new issues), and trade credit may have been squeezed by the public corporations. Bank borrowing is also likely to have been boosted by the accelerated payment of VAT on imports, by the (possibly related) surge in imports and stocks and by payments of corporation tax which were unusually high (£2.1 billion, not seasonally adjusted) in the fourth quarter.

### **Productivity growth** *has slowed and* **cost pressures** *have increased, but so far* **domestic price inflation** *has been contained*

The measurement of productivity was complicated last year by the impact of the coal strike on output and by the wide divergence between the three conventional measures of GDP. Taking GDP(O) as the most reliable guide to short-term output changes, productivity (output per head) in the economy as a whole rose by about $\frac{1}{2}$% in the year to the third quarter of 1984, compared with 4% over the previous year. Even making allowance for output losses associated with the strike, it is estimated that productivity was growing rather more slowly than the previous year, at an underlying rate of perhaps 2%. Average earnings rose by less than 6% over the same period, the rise being affected by the coal strike and other temporary factors: the underlying rise was close to $7\frac{1}{2}$%. Unit wage costs in the

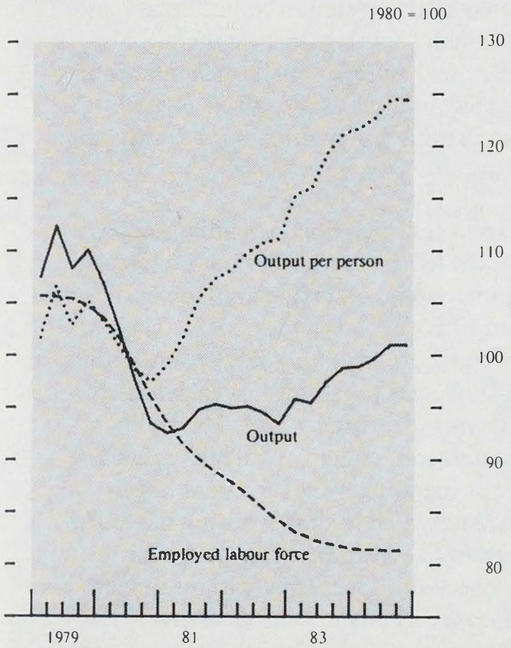
**UK output and industrial production adjusted for the coal strike**

Index 1980 = 100, seasonally adjusted; *percentage change on previous period in italics*

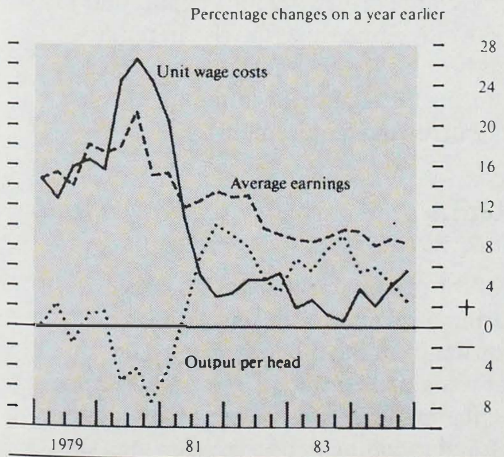
| | 1984 Year | Q1 | Q2 | Q3 | Q4 |
|---|---|---|---|---|---|
| **GDP(O):** | | | | | |
| As recorded | 105.8 | 105.3 | 105.1 | 106.0 | 106.9 |
| | *+2.4* | *+0.4* | *−0.2* | *+0.8* | *+0.8* |
| Strike-adjusted(a) | 106.9 | 105.8 | 106.4 | 107.3 | 108.2 |
| | *+3.6* | *+0.9* | *+0.6* | *+0.8* | *+0.8* |
| **Industrial production:** | | | | | |
| As recorded | 102.8 | 104.0 | 101.8 | 102.1 | 103.3 |
| | *+0.9* | *+0.1* | *−2.1* | *+0.3* | *+1.2* |
| Strike-adjusted(a) | 105.8 | 105.2 | 105.2 | 105.9 | 107.1 |
| | *+3.7* | *+1.0* | — | *+0.7* | *+1.2* |

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

*The fall in* **manufacturing employment** *has levelled out and* **productivity** *growth has slowed . . .*




*. . . and as* **average earnings** *remain buoyant,* **unit wage costs** *have picked up*




economy as a whole would therefore seem to have risen at an underlying rate of perhaps 5% between the third quarters of 1983 and 1984, somewhat faster than in the previous year.

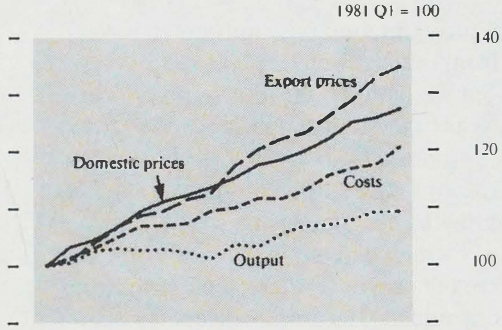
The growth of manufacturing productivity appears to have slowed down sharply from the very rapid rise in 1983: whereas it had increased by about 9% between the fourth quarters of 1982 and 1983, in the year to the fourth quarter of 1984 manufacturing productivity rose by $2\frac{1}{2}$%. This recent slowing, however, has not been accompanied by a commensurate reduction in earnings growth. Average earnings in manufacturing industry increased at a rate of $8\frac{1}{2}$% during 1984, about 1% less than the previous year when overtime working was rising more quickly. In consequence, the rise in unit wage costs has shown a marked acceleration, from less than 1% during 1983 to over 5% during 1984; if allowance is made for the removal of the national insurance surcharge and for other non-wage costs of employment, manufacturers' unit labour costs probably rose by 4%.

Other costs in manufacturing have risen much faster than unit labour costs. In SDR terms, world prices of industrial materials (measured by the Economist index) fell almost 11% in the year to the fourth quarter of 1984 but the 14% fall in sterling against the SDR more than offset this. The mix of basic material imports and the contractual terms on which they are actually imported to the United Kingdom are such that their sterling cost rose by 12% over the year as a whole. Much of the input of materials to UK manufacturing industry, however, consists of imported manufactures—particularly chemicals, paper and textile-related products. Average world prices in sterling of manufactured exports were probably about 16% higher in the fourth quarter than a year earlier but the price of manufactured goods imported into the United Kingdom rose by about 11%.

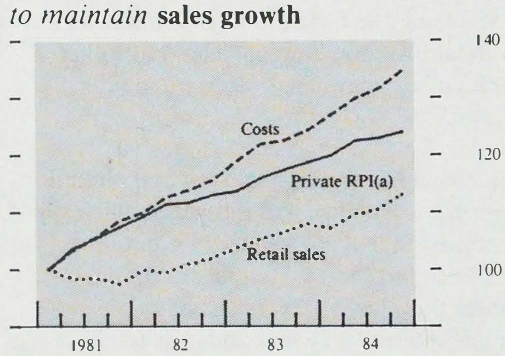
The cost of materials and fuel bought by manufacturing firms rose more or less in line with import prices. Excluding the food, drink and tobacco industries, the rise between the fourth quarters of 1983 and 1984 was over 12% and there has been some further acceleration since the turn of the year; but smaller increases (partly reflecting good harvests) in the prices of materials for the food, drink and tobacco industries kept the overall increase during 1984 to around 9%. With labour costs rising by about 4%, manufacturers' total direct (labour and material) costs are estimated to have increased by rather more than 6% during 1984. UK manufacturers responded to these cost pressures in different ways in their home and overseas markets. In export markets, depreciation of the exchange rate has allowed manufacturers to raise their sterling prices fairly rapidly, by 9% in the year to the fourth quarter of 1984, while still improving slightly their competitive position. In the home market, UK producers raised their prices less rapidly than this: with import prices rising about 11%, the increase of only 6% in domestic output prices improved the price competitiveness of UK manufacturers quite considerably.

Inflationary pressures have so far been well contained, with retailers and distributors absorbing some of the rise in UK manufacturers' output prices and much of the rise in import prices, apparently preferring to maintain growth in sales

**Manufacturers** *responded to cost pressures differently in* **home and export markets** . . .




. . . *while* **retailers** *trimmed profit margins to maintain* **sales growth**




(a) Retail price index excluding mortgages and nationalised industry prices.

**Price changes in expenditure components of GDP**

Percentage change in price deflators in year to fourth quarter

| | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| Private consumption | 13.7 | 10.9 | 6.7 | 4.7 | 5.3 |
| Government current expenditure | 24.3 | 9.3 | 6.1 | 6.0 | 7.4 |
| Investment | 17.8 | 4.2 | 3.2 | 4.3 | 4.7 |
| Exports | 10.6 | 11.7 | 5.2 | 7.2 | 8.5 |
| **Total final expenditure** | **15.5** | **9.8** | **5.9** | **5.2** | **6.0** |
| Imports | 5.1 | 13.8 | 3.7 | 7.9 | 12.0 |
| GDP (factor cost) | **18.5** | **6.9** | **6.9** | **4.9** | **4.1** |

volume at the expense of profit margins. The annual rate of increase in retail prices remained in the region of 5% throughout 1984 and, although it edged up from 4.6% in December to 5.4% in February 1985, this was largely because of the higher mortgage interest rates announced in January and the effects of the exceptionally cold weather on the price of fresh food. Some further quickening of retail price inflation may be seen in the next few months as the effects of sterling's depreciation and the acceleration in manufacturers' unit labour costs feed through.

An indication of the extent to which domestic inflation has so far been sheltered from the full impact of sterling's depreciation is given by comparing total home costs (the GDP deflator) with the price deflator for imports of goods and services. The rise in total home costs has become progressively slower, amounting to only 4% during 1984, whereas the import price deflator, which had started to accelerate in 1983, rose by 12%. The rise in consumer prices has remained moderate, while the faster rise in the deflator for current spending by government largely reflects the release of accumulated back pay during the fourth quarter. The overall cost of fixed capital expenditure has in large part been held in check until recently by lower tender prices in the construction industry since the recession. In contrast, export prices have accelerated, rising by 8½% during 1984—nearly one and a half times as fast as total (domestic and import) costs. Thus sterling's depreciation appears, at least for a time, to have been associated with some cross-subsidisation between the private sector's export and domestic selling prices. At the same time, the rise in public sector output prices has been held down in spite of the greater use of imported fuels during the coal strike (although this has raised the public sector borrowing requirement).

## *Real* **personal sector** *income growth has slowed and strong borrowing has raised income gearing*

The financial surplus of the personal sector has remained broadly unchanged during the course of the last two years. In part this reflects the constancy of the inflation rate and of the saving ratio (which has remained between 10% and 11% since the end of 1982), while the modest rise in house prices relative to earnings has kept capital spending in line with saving. The statistical counterpart to the high growth of personal sector borrowing has been a rapid accumulation of liquid assets. This is not an unusual occurrence and reflects financial intermediation (largely by building societies) between borrowers and lenders within the sector. The detailed picture in recent quarters has been obscured to some extent by a much enlarged balancing item in the personal sector accounts, indicating unidentified net inflows which might be a counterpart to some of the unidentified net outflow of the company sector (possibly in the form of trade credit to consumers or to unincorporated businesses).

Building societies continue to attract the bulk of the personal sector's liquid savings but purchases of British Telecom shares may have had some depressing effect on inflows to the societies in the fourth quarter of 1984 and more recently their interest rates were less competitive than on other forms of savings.

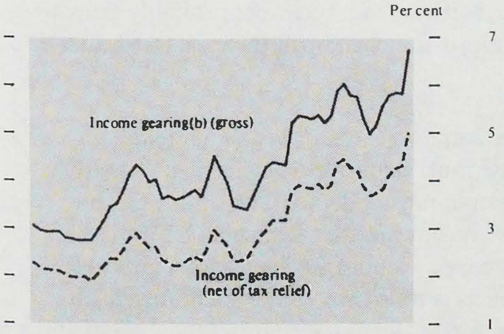
### Personal sector income, expenditure and financial transactions

£ billions: inflow of funds +, outflow −

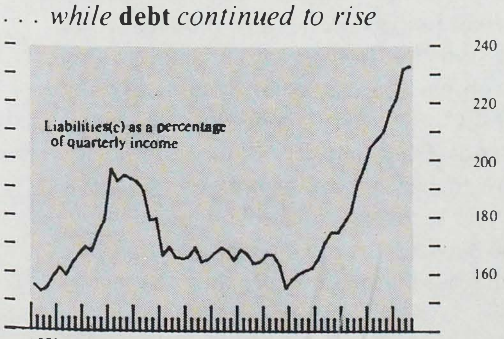
| | 1982 Year | 1983 Year | 1984 H1(a) | 1984 Q3(a) | 1984 Q4(a) |
|---|---|---|---|---|---|
| Personal disposable income | +191.3 | +204.7 | +214.8 | +217.4 | |
| Consumers' expenditure | −166.5 | −182.4 | −192.1 | −194.8 | −199.6 |
| Saving | + 24.8 | + 22.3 | + 22.7 | + 22.6 | |
| Capital expenditure | − 12.5 | − 14.3 | − 15.5 | − 14.9 | |
| **Financial surplus (+)/deficit (−)** | **+ 12.3** | **+ 8.0** | **+ 7.2** | **+ 7.7** | |
| **Acquisition of financial assets** | | | | | |
| Bank deposits | − 3.8 | − 2.9 | − 3.3 | − 1.3 | − 5.4 |
| Building society deposits | − 10.3 | − 10.3 | − 14.0 | − 11.0 | − 13.6 |
| National savings | − 3.5 | − 2.9 | − 2.8 | − 5.0 | − 2.7 |
| Life assurance and pension funds | − 14.1 | − 15.0 | − 17.2 | − 16.6 | |
| Other | + 0.3 | − 0.5 | + 0.7 | − 3.4 | |
| Total | − 31.4 | − 31.6 | − 36.6 | − 37.3 | |
| **Borrowing** | | | | | |
| For house purchase: | + 14.1 | + 14.4 | + 16.3 | + 17.0 | + 16.7 |
| *From banks* | + *5.1* | + *10.9* | + *14.0* | + *15.5* | + *13.6* |
| *From building societies* | + *8.1* | + *3.7* | + *2.3* | + *1.5* | + *3.1* |
| *Other mortgages* | + *0.9* | − *0.2* | — | — | |
| Other bank borrowing: | + 5.0 | + 4.9 | + 3.9 | + 5.0 | + 4.3 |
| *For consumption* | + *2.3* | + *2.6* | + *2.2* | + *2.3* | + *3.7* |
| *By unincorporated businesses etc* | + *2.7* | + *2.3* | + *1.7* | + *2.7* | + *0.6* |
| Other non-bank borrowing | + 0.4 | + 1.0 | + 0.8 | − 0.3 | |
| Total | + 19.5 | + 20.3 | + 21.0 | + 21.7 | |
| **Net identified financial transactions** | **− 11.9** | **− 11.3** | **− 15.6** | **− 15.6** | |
| Balancing item | − 0.3 | + 3.3 | + 8.4 | + 7.9 | |

(a) Seasonally adjusted at an annual rate.

### Household sector[a] income gearing *reached new heights . . .*




*. . . while* **debt** *continued to rise*




(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.

Most of the increase in borrowing by the personal sector during the last few years has taken the form of mortgage finance, the availability of which has been stimulated by deregulation in financial markets and competitive innovation by banks and building societies (see article on page 80). Total mortgage borrowing, although slightly lower in the fourth quarter of 1984 than in the third, remained strong. The building societies, perhaps having lowered their lending objectives in the light of their low net inflows the previous quarter, extended less finance in the fourth quarter, but bank lending for house purchase recovered strongly.

Bank borrowing by the personal sector other than for house purchase fell by nearly 20% in 1984 to just under £4 billion. Within this total, a distinction can be made between lending to the 'household' sector[1] for consumption and lending to the 'non-household' sector.[2] The growth of lending to the 'household' sector for consumption during 1984 was marginally higher than in the previous year, the pattern through the year matching that of consumer spending, with some recovery in the fourth quarter. Bank lending to the 'non-household' part fell in 1984 to £1.5 billion compared with a peak of £2.6 billion in 1982 which may have been associated with a greater number of small business startups.

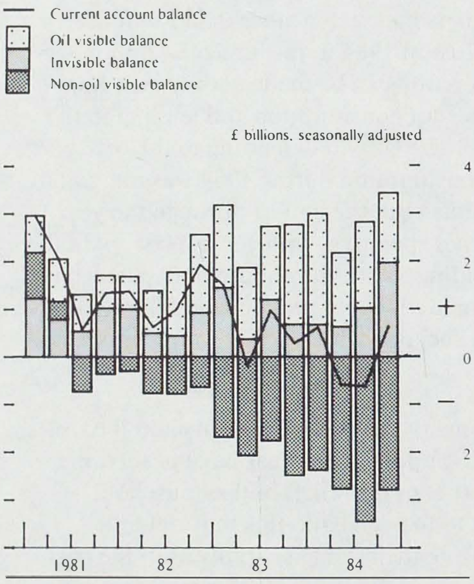
The high rate of borrowing over the last few years and the rise in interest rates since the middle of last year have pushed the level of income gearing (net of tax relief) of the household sector to well over 5%. On the one hand this may deter households from increasing their debt as rapidly as in the past, especially if uncertainty about future levels of interest rates has increased; on the other hand, the supply of credit remains plentiful. Should net borrowers' spending be more sensitive to changes in income than that of net savers, the higher debt service burden (if maintained) might eventually cause consumer spending to rise more slowly than otherwise. The personal sector as a whole holds more assets than liabilities and its income normally gains overall from higher interest rates. If, however, the spread between deposit and lending rates widens (as was the case with building society rates last summer and again more recently) personal sector net income could be reduced even though interest rates have risen. Dividend income, however, seems likely to have remained a source of strength.

Of the main components of personal sector income, total wages and salaries grew by just under 1% in real terms in the third quarter, mainly reflecting the continuing rise in employment. Average earnings in the economy as a whole remained depressed by the coal strike and in the third quarter were less than 6% higher than a year earlier, while consumer prices increased by rather less than 5%. The underlying trend in real earnings, after allowing for the effects of the coal strike, was probably close to 2% per annum. Overall in the first three quarters of 1984, the personal sector's real disposable income rose by only 1%; as the inflation rate remained steady, the rise in inflation-adjusted income was also sluggish. With income growth slowing, total consumers' expenditure grew more slowly too, by just over $1\frac{1}{2}$%

(1) See T Jones, 'The Household Sector', *Economic Trends*, September 1981.
(2) The 'non-household' part of the personal sector comprises unincorporated businesses, private non-profit-making bodies, and private trusts.

in 1984 compared with 3% in the previous year. Car sales in particular were down but retail sales remained quite buoyant. In the fourth quarter, spending on all categories of retail and other durable goods grew strongly, repeating the pattern of recent years.

*The* **current account** *has moved back into surplus*




## *Long-term* **capital outflows** *shrank in 1984 as the* **current account** *surplus fell away*

The UK surplus on current account (which corresponds to the overseas sector's deficit) fell virtually to zero in 1984. The oil and non-oil trade balances were both adversely affected by the coal strike which brought about a reduction in net oil exports and higher net coal imports. After being in deficit in both the second and third quarters, the UK current balance showed a surplus of some £0.6 billion in the fourth quarter of 1984: as North Sea oil output recovered, the deficit on non-oil trade diminished and the surplus on invisibles (notably from net overseas investment income) continued to grow. But for the effect of the coal strike on the energy balance, the current account might have shown a surplus of about £2¾ billion for the year as a whole, slightly more than in 1983.

The reduction in the non-oil visible deficit in the fourth quarter, from its extremely high level in the third, largely reflected an improvement in trade in manufactures. Non-oil export volume had shown only a modest rise during the first three quarters of the year despite export market growth and a steady improvement in UK manufacturers' cost and price competitiveness as the effective exchange rate fell. In the final quarter the volume of non-oil exports (excluding erratic items) rose by 9%, even though export markets were probably growing more slowly as US imports fell back from the high third quarter level.

The volume of non-oil imports (excluding erratic items) increased by 2½% in the fourth quarter. Some growth was to be expected at a time when domestic demand was buoyant, but the underlying trend in recent months is particularly uncertain. The change in the system of accounting for VAT on imports from November onwards is thought to have encouraged some traders, fearing congestion at the ports, to bring their goods in early; and the dock strikes in the summer also induced wide swings in the monthly statistics. In these circumstances any short-term statistical comparison may be misleading. Average figures for the six months to February may be broadly indicative of recent trends. Over that period, the volume of non-oil imports was 6% higher than in the previous six months and 9% higher than a year earlier; comparable figures for exports show a 9% rise between the most recent six-month periods and an 11% increase on the same period a year ago.

As the current account shrank, long-term capital outflows became much smaller than in recent years. Provisional estimates suggest that outward portfolio investment, other than by the monetary sector, was quite modest in the fourth quarter. For the year as a whole, outward investment by non-bank financial institutions amounted to £1.5 billion, much less than the average annual outflow recorded since the abolition of exchange controls in late 1979. At the end of 1983 these

### UK balance of payments: capital account

£ billions: *not seasonally adjusted*
Inflow +, outflow −

| | 1981 | 1982 | 1983 | 1984 Year | 1984 H1 | 1984 H2 |
|---|---|---|---|---|---|---|
| **Current balance** | **6.9** | **4.9** | **2.5** | **0.1** | **−0.8** | **0.9** |
| Portfolio investment: | | | | | | |
| Outward (excluding UK banks) | −3.1 | −4.4 | −3.6 | −1.5 | −0.7 | −0.8 |
| Inward | 0.5 | 0.5 | 1.6 | 1.1 | — | 1.1 |
| Direct investment (non oil): | | | | | | |
| Outward | −5.1 | −2.5 | −2.5 | −3.2 | −1.6 | −1.5 |
| Inward | 1.0 | 1.1 | 2.4 | 2.5 | 1.1 | 1.3 |
| Net oil investment(a) | 0.5 | −0.1 | −0.5 | −3.6 | −3.8 | −0.2 |
| UK banks' external transactions: | | | | | | |
| Outward portfolio investment | −1.0 | −1.8 | −2.5 | −7.0 | −2.8 | −4.3 |
| Net foreign currency borrowing(b) | 1.5 | 4.1 | 1.4 | 8.7 | 5.3 | 3.4 |
| Net sterling borrowing | −0.6 | 1.3 | 2.6 | −0.8 | −0.6 | −0.2 |
| Other flows | −1.0 | −1.7 | −2.2 | −0.1 | 1.0 | −1.1 |
| **Total identified capital flows** | **−7.4** | **−3.4** | **−3.2** | **−3.9** | **−2.1** | **−1.8** |
| Official financing | 0.7 | 1.3 | 0.8 | 1.3 | 0.9 | 0.5 |
| Balancing item | −0.4 | −2.8 | −0.1 | 2.5 | 2.0 | 0.5 |

(a) Includes miscellaneous investment.
(b) Excluding export credit.

institutions' holdings of overseas securities represented about 16% of their total assets. Valuation gains, arising partly from the appreciation of the dollar and other currencies against sterling and partly from increases in foreign stock market prices, seem likely to have sustained the investment institutions' share of overseas assets in their portfolios despite a much reduced net outward investment flow.

Purchases of overseas securities by UK banks rose sharply in 1984, as they increasingly substituted floating-rate notes and other marketable instruments for conventional loans in their foreign currency portfolios. Unlike investment abroad by non-bank financial institutions, which is predominantly funded in sterling, the banks' acquisitions of notes (like their conventional overseas loans) were predominantly financed by foreign currency borrowing from abroad which consequently rose sharply in 1984.[1] Their external sterling borrowing and lending also grew rapidly.

(1) Direct investment figures for 1984 are dominated by transactions related to the Royal Dutch/Shell Group's acquisition of its US affiliate Shell Oil. A major part of this was financed out of foreign currency deposits built up in 1983 and withdrawn in the first half of 1984.