Economic commentary

- *After an exceptionally rapid increase, the growth of output in the United States slowed during the winter; activity in the major European countries quickened slightly in the second half of 1984.*
- *Lower commodity prices and modest earnings growth have helped contain inflation in most major countries.*
- *The expansion of world trade and of UK markets overseas, this year and next, is expected to be more modest than in 1984.*
- *In the United Kingdom, recovery from the coal strike, although not yet complete, has helped to sustain output growth since the winter. Even allowing for the changing impact of the strike, GDP appears to have risen by almost 3% in the year to the first quarter of 1985, with fixed investment particularly buoyant and a marked improvement since last autumn in net external trade.*
- *Unit wage costs have been rising more rapidly and, until recently, sterling's depreciation contributed to faster growth of materials and fuel costs. Import costs are now subsiding but a number of other factors have contributed to a rapid acceleration of retail prices, to 7% in the twelve months to May.*
- *Broad money has been rising appreciably faster than nominal income. Bank lending to the private sector, and to companies in particular, has continued to grow strongly in spite of still buoyant earnings and a continuing accumulation of liquid assets by the company sector as a whole.*
- *In the personal sector, consumption and investment have been subdued in recent quarters; borrowing has increased quite slowly and holdings of bank and building society deposits have grown strongly. Competition for the personal sector's savings has intensified.*

Contributions to GNP[a] growth in the major economies

Changes in components (annual rates) as a percentage of GNP: at constant prices; *seasonally adjusted*

	United States, Canada and Japan			Europe(b)		
	1983	1984 H1	1984 H2	1983	1984 H1	1984 H2
Private consumption	2.7	3.2	1.6	0.9	0.7	0.2
Private fixed investment	0.9	2.5	1.7	-0.1	0.2	0.2
Public expenditure	—	0.4	1.2	0.4	0.1	0.3
Stockbuilding	0.3	2.1	—	-0.1	0.7	0.4
Domestic demand	**3.8**	**8.3**	**4.4**	**1.2**	**1.8**	**1.2**
Net trade	-0.2	-0.9	-0.2	—	—	1.7
GNP	**3.6**	**7.4**	**4.2**	**1.2**	**1.8**	**2.8**

(a) Or GDP.
(b) France, Germany, Italy and the United Kingdom.

Domestic demand in the major industrial countries expanded much more rapidly in 1984 than in 1983, mainly because of faster growth in the United States where domestic demand increased by $8\frac{3}{4}$% last year compared with 5% a year earlier. In the other major industrial countries domestic demand in aggregate also expanded more rapidly, rising by $2\frac{3}{4}$% in 1984—almost twice as fast as in 1983. Consumer spending was a less dominant feature but fixed capital expenditure grew faster (especially in the United States, Japan and the United Kingdom) and stockbuilding was resumed on a significant scale in most of the major countries.

With net trade flows partly compensating for differences in domestic demand, however, the disparity between the United States and the other major countries was rather less marked in terms of output growth. US competitiveness continued to deteriorate as the dollar strengthened further and, although output growth accelerated quite sharply in the United States, it failed to match the growth in demand and net imports rose strongly. In contrast, in all the other major countries except the United Kingdom (where the coal strike adversely affected

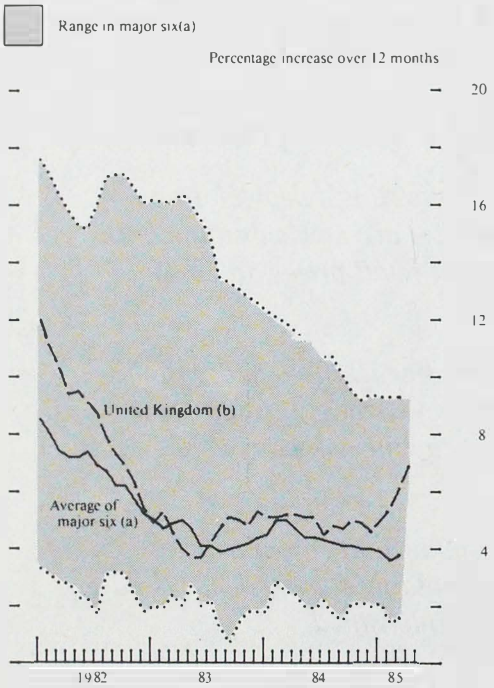
GNP growth in the major economies

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

	1982	1983	1984 Year	H1	H2
Canada	-4.4	3.3	4.7	3.5	4.6
France	2.0	0.9	1.6	1.6	1.7
Germany	-1.0	1.3	2.6	1.6	4.2
Italy(a)	-0.4	-1.2	2.6	2.8	3.0
Japan	3.4	3.4	5.7	6.1	5.5
United Kingdom(a)	2.2	3.1	2.4	1.7	2.5
United States	-2.1	3.7	6.8	8.3	3.6
Total	**-0.3**	**2.7**	**4.9**	**5.3**	**3.7**

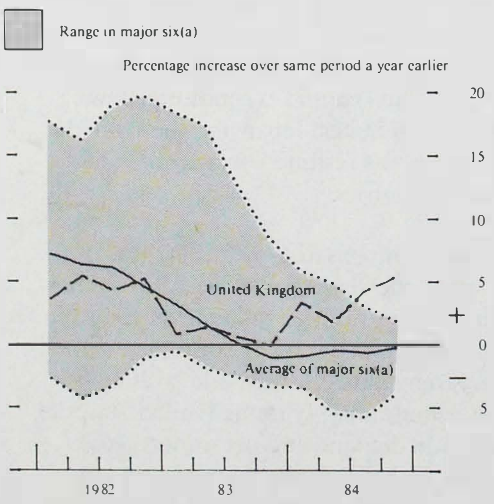
(a) GDP; figures for the United Kingdom relate to the average estimate.

Consumer price inflation *remains subdued in most major economies except the United Kingdom*



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

Manufacturers' labour costs *rise faster in the United Kingdom but are little changed elsewhere*



(a) Canada, France, Germany, Italy, Japan and United States.

the balance on energy **trade) net exports made a positive** contribution to **output growth. Thus, while GNP rose by $6\frac{3}{4}$%** in the United **States in 1984, in the other six major countries as** a whole it rose **by $3\frac{1}{2}$%.**

Output in North America *has grown more slowly during the past winter . . .*

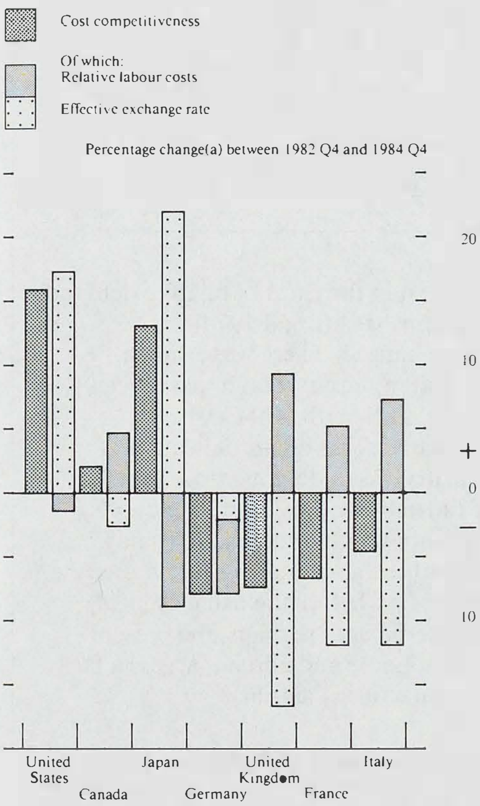
The growth of output in the major countries taken together was considerably more rapid (at $5\frac{1}{4}$% per annum) in the first half of 1984 than in the second half, when it dropped back to $3\frac{3}{4}$% as a slowdown in the United States more than outweighed a modest underlying acceleration in Europe. In the first quarter of 1985, US output is provisionally estimated to have grown at an annual rate of only $\frac{3}{4}$% compared with $4\frac{1}{4}$% in the previous quarter. This further reduction largely reflected a very sharp rise in imports, and appears to confirm earlier indications that the US economy had moved to a slower underlying rate of output growth during the second half of last year, although the very low figure recorded in the first quarter may have been exceptional. The disparity in growth rates between North America and Japan on the one hand and Europe on the other has thus diminished and it could well be further reduced during the next two years. (The Bank's spring forecast of world economic prospects is summarised on page 198.)

. . . while weak commodity prices *and modest* earnings growth *in most major countries have helped to contain* inflation

With most major industrial countries continuing to pursue anti-inflationary monetary and fiscal policies and with activity slowing in the United States and accelerating only a little in Europe, inflation is subdued and seems likely to remain so. A major contributory factor has been the recent weakness of world oil and commodity markets. Oil prices have fallen in dollar terms by more than 5% over the past twelve months as the dollar appreciated and the real price of oil (relative to world prices of manufactured exports), although a little higher on average in 1984 than in 1983, has since fallen back. The size of the fall in non-oil commodity prices during 1984 surprised most analysts; industrial raw material prices dropped by $3\frac{1}{2}$% in real terms and by 10% in nominal dollar terms between the second and fourth quarters. Partly as a result of these developments, consumer prices in the major countries as a whole increased by about 4%, and manufacturers' output prices by only $1\frac{1}{2}$%, at an annual rate during the second half of 1984.

The inflationary pressure from wages has also proved to be very modest in most of the major countries. With productivity rising overall by 3% during 1984, unit labour costs generally showed little growth. Actual unit labour costs in manufacturing were lower at the end of 1984 than a year earlier in Japan, Canada and Germany, and increased during the year by 2% or less in most other major countries. Japan, Germany and the United States have experienced lower growth in unit labour costs (adjusted for cyclical effects of productivity growth) over the past two years than the other major countries, but exchange rate movements have more than offset the effects of

Competitiveness *has been affected more by* **exchange rates** *than by* **labour costs** *in most major countries*



(a) An increase represents a loss in competitiveness.

International trade and market growth: 1982–84

Percentage changes between 1982 and 1984

	Export markets	Export volume	Final expenditure	Import volume
Major OECD countries:				
Canada	24.7	32.6	13.1	37.6
France	7.4	9.4	2.2	0.2
Germany	7.1	9.6	5.0	9.6
Italy	6.5	11.8	2.7	8.0
Japan	10.4	24.8	9.5	11.8
United Kingdom	6.6	8.8	6.8	18.0
United States	8.6	0.1	12.9	36.2
Smaller OECD countries	9.5	14.6		6.9
Non-oil developing countries	13.0	21.1	..	7.6
Oil exporting countries	9.8	2.9	..	−19.5
Centrally planned economies	6.7	5.7	..	8.3
Total	**10.4**	**10.4**(a)	..	**10.4**

.. not available.
(a) Total export volume constrained to equal total import volume.

such changes on relative competitiveness in all except Germany and Canada.

Changes in **competitiveness** *affect market shares*

Movements in competitiveness appear to have influenced the extent to which countries have gained or lost export market shares during the world recovery. The United States, Japan and Canada have all lost competitiveness over the past two years. The United States has experienced a considerable reduction in its share of export markets. On the other hand, both Canada and, more especially, Japan have expanded exports by considerably more between 1982 and 1984 than the growth of their markets would have suggested; in view of the magnitude of the yen's appreciation, Japan's performance has been especially noteworthy. The major European countries' export markets have so far grown more slowly but increased competitiveness has enabled several of them to expand their exports over the past two years faster than their markets have been growing. The response of import volumes to economic activity (measured by total final expenditure) and to changes in competitiveness in the major countries during the past two years has been less clear cut. This may in part reflect the influence of cyclical factors on countries at different stages of recovery. Imports have risen most rapidly, in relation to final expenditure, in Italy, Canada and the United States, despite rather different movements in their relative competitiveness. In Japan, import growth was much lower in relation to final expenditure despite a substantial loss of competitiveness. Changes in competitiveness, however, appear to affect trade volumes with rather different time lags in different countries.

Competitive positions are likely to have been less affected by exchange rate movements so far this year as the dollar has recently lost much of the ground it had gained at the beginning of 1985. The dollar's effective exchange rate, which was 6% higher on average in March than in December, had dropped back by almost 5% by the first half of June. US short-term interest rates fell by $1\frac{1}{2}$% between the end of March and the middle of June as the markets came to expect that the US authorities would respond to the low growth of output in the first quarter by easing monetary policy and, in the latter part of May, the Federal Reserve cut its discount rate by $\frac{1}{2}$%. Although other major countries have accepted a modest reduction in domestic interest rates, they have (with the exception of Canada) allowed the limited reversal of pressure from the US dollar to be taken principally on their exchange rates. In the first half of June, the deutschemark and French franc were on average some 2%-3% higher in effective terms than in March while the lira and the yen also rose a little. Over the same period, sterling rose by about 8% in effective terms (and by 13% against the US dollar) while the three-month sterling interbank rate eased from 14% in early March to just under $12\frac{1}{2}$% in the first half of June. (Recent exchange and interest rate developments are discussed further on pages 203 and 188.)

Growth of **UK export markets** *slows . . .*

Many of the non-oil developing countries have gained from the recovery in the volume of imports of the major industrial countries. Although output in the smaller industrial countries

The composition of recovery

Between 1979 and the first half of 1981, output in the United Kingdom fell by more than 5%; by the middle of 1983, this loss had been made good and by the second half of 1984, despite the coal strike, GDP was 3½% higher than in 1979. If adjustment is made for output lost as a result of the coal strike, GDP in the second half of 1984 was more than 10% above the 1981 trough. The recovery has been widely spread. Output of the services sector, which fell only slightly during the most severe period of the recession, is now about 9% above its 1979 peak. Manufacturing output has shown strong growth since the trough but it had fallen by over 15% in the early stages of the recession and by the second half of 1984 it was still more than 9% less than in 1979 (and 11½% less than in 1973). North Sea oil and agriculture, forestry and fishing, although initially forming only a very small part of GDP, have together contributed almost a quarter of the increase in total output since the trough.

Output and employment by industry

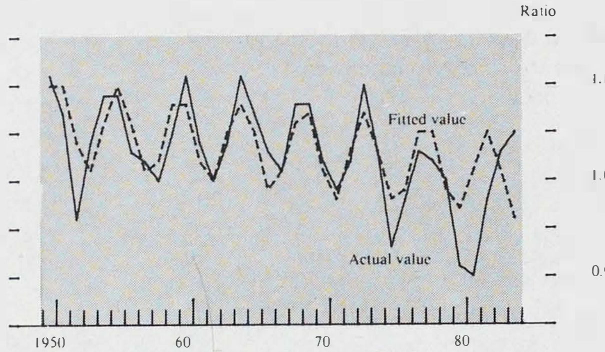
Percentage changes *(except figures in italics)*

	1980 output weight	1981 H1–1984 H2 Output	1981 H1–1984 H2 Employment	1983 Q4–1984 Q4 Output	1983 Q4–1984 Q4 Employment
Agriculture, forestry, fishing	*22*	13.3	1.4	5.5	0.9
North Sea oil and gas	*44*	38.1	40.8	4.9	9.7
Other energy and water	*51*	−26.8	−23.4	−23.4	−3.8
Manufacturing	*266*	9.1	−11.8	2.2	−0.5
Construction	*63*	8.8	−14.4	0.6	−2.5
Retailing, distribution etc	*128*	10.2	6.4	3.8	2.8
Transport and communication	*72*	10.2	− 9.1	3.8	−0.9
Other services	*354*	9.4	2.8	3.7	1.0
Total	*1,000*	**9.0**	**− 3.4**	**1.9**	**0.6**

Employment in the economy as a whole has been rising since early 1983 but in the second half of 1984 was still 215,000 less than in early 1981 and over a million less than in early 1979. Employment growth has been concentrated more narrowly than output growth—primarily in the service industries (which together have provided about 350,000 additional jobs since early 1981). In the manufacturing and construction industries, employment has continued to fall and was almost 925,000 less in the second half of 1984 than in 1981. In the energy and water sector employment has been falling steadily over the past 3½ years; although North Sea oil exploitation may have directly created 10,000 jobs, employment in the sector as a whole fell by 86,000 during this period.

Continuous, if modest, output growth for a period as long as four years has been unusual in the post-war UK economy. From the beginning of the 1950s to the early 1970s periods of growth lasting two to three years were followed by periods of stagnation. This regular (4½ year)

UK manufacturing output relative to trend



cycle can be clearly seen in the chart of relative demand pressures in manufacturing. Around 1974–75, however, the pattern changed. There was a much greater downward shift in output than in past cycles and, from about 1979, the length of the cycle appears to have increased. This could indicate that manufacturing industry has undergone structural changes that have radically improved efficiency so that growth can be more steadily sustained. It may, however, reflect in part the greater scope for recovery after such a deep recession before the usual cyclical restraints are encountered and, perhaps, the present strength of demand, at home and abroad, across a fairly narrow range of manufacturing activity.

Manufacturing output growth is still heavily concentrated in a few sub-sectors—principally electrical and instrument engineering, chemicals and, to a lesser extent, textiles and clothing. The only sizable increases in employment in the past year have been in the mechanical and electrical engineering industries; most others have continued to shed labour. Export demand has been more widely spread, although, in those industries where exports recently have been most buoyant, imports have also increased strongly.

Manufacturing output, trade and employment: year to 1985 Q1

Percentage changes *(except figures in italics)*

	1980 output weights	Output	Exports	Imports	Employment
Metals and minerals	*90*	1.8	15.5	− 1.2	− 1.9
Chemicals and man-made fibres	*92*	5.5	13.2	5.0	0.3
Mechanical engineering	*144*	0.2	11.1	10.8	0.8
Electrical engineering	*129*	11.6	26.6	17.0	1.0
Other engineering(a)	*170*	− 1.2	10.6	2.6	− 2.7
Food, drink and tobacco	*135*	1.6	4.3	0.9	− 2.1
Textiles and clothing(b)	*71*	4.0	6.1	2.2	−12.1
Other	*171*	2.5	..		− 0.4
Total	*1,000*	**2.8**	**10.1**	**7.9**	**− 0.7**

.. not available.

(a) Motor vehicles and other transport equipment, other engineering and metal goods not elsewhere specified.

(b) Includes also footwear and leather.

has also benefited, their import demand has generally remained subdued, while the oil exporting countries have been constrained by weak demand for their oil and have had to cut imports severely over the past two years. As these two groups of countries represent over 30% of the United Kingdom's overseas markets their import restraint has contributed to the slow growth of UK markets overall, which recovered rather less quickly than world trade during 1983 and 1984. Growth of UK markets in 1985 and 1986 is expected to be more subdued than last year. (World current account developments are discussed on page 197.)

. . . but, as the coal strike ends, **recovery continues in the United Kingdom . . .**

The UK economy, now entering its fifth year of recovery, seems to have remained quite buoyant in the early months of 1985. Preliminary estimates of the output measure, GDP(O), indicate growth at an annual rate of perhaps 3% in the first quarter this year, only slightly less than the previous quarter. Some of this recent growth (perhaps a third) is attributable to the ending of the coal strike; if allowance is made for changes in the strike's impact on the economy (which will not yet have been fully unwound), output appears to have grown at an underlying rate of some $2\frac{3}{4}$% between the first quarters of 1984 and 1985. Manufacturing production, which was little affected by the coal strike, seemed to falter in the latter part of 1984 but now appears to have regained some of its earlier bouyancy; in the three months to April it was 1% higher than in the previous three months and $2\frac{1}{2}$% higher than a year earlier. (The sectoral composition of output growth over the past year and since the cyclical trough of 1981 is discussed on page 172.)

. . . stimulated by **capital spending** *and improved performance in* **net trade**

The principal expenditure components of UK growth in the first quarter appear, from the limited information available so far, to have been fixed investment and net overseas trade. Investment by manufacturing, construction, distribution and the financial industries surged by 18% as companies took the opportunity to utilise, especially through leasing, existing levels of capital allowances against corporation tax before both allowances and the tax rate were reduced (in accordance with the 1984 Budget) on 1 April. The net external trade position also appears to have improved further in the first quarter, perhaps reflecting in part the 16% effective depreciation of sterling between June 1983 and February 1985; visible exports rose by 1% and imports fell by $\frac{1}{2}$% in volume terms. On the other hand, the volume of consumers' expenditure (which accounts for over 60% of GDP) is provisionally estimated to have been virtually flat in the first quarter to a level little more than 2% higher than at a year earlier; this contrasts with the apparent buoyancy of retail sales which, in volume terms, are estimated to have been $4\frac{1}{2}$% higher in the first quarter of 1985 than a year earlier, and to have shown further growth in April and May. Private industry as a whole (and most notably manufacturing) ran down its stocks on a substantial scale in the first quarter. Indeed, whereas the rise in industrial fixed investment during the quarter was equivalent in size to an increase of $1\frac{1}{2}$% in GDP, destocking in manufacturing, wholesaling and retailing together was

Contributions to change in GDP in the United Kingdom

Change in components as percentage of GDP; at 1980 prices

	1979	1980	1981	1982	1983	1984
Consumer spending	3.0	−0.2	−0.2	0.6	2.7	1.1
Government consumption	0.5	0.3	0.0	0.2	0.6	0.2
Public investment	−0.2	−0.5	−1.0	0.0	0.6	0.2
Private investment	0.6	−0.6	−0.8	1.3	0.1	1.4
Stockbuilding	0.2	−2.7	0.1	0.8	0.8	−0.4
Net trade	−1.7	1.1	0.4	−0.8	−1.2	−0.6
Factor cost adjustment	−0.6	0.6	0.3	−0.6	−0.5	−0.3
GDP (E) at factor cost	**1.9**	**−1.9**	**−1.2**	**1.5**	**3.2**	**1.6**
Memo item:						
GDP (O)	*3.1*	*−3.0*	*−1.7*	*1.8*	*3.1*	*2.5*

Changes in export volume by commodity[a]

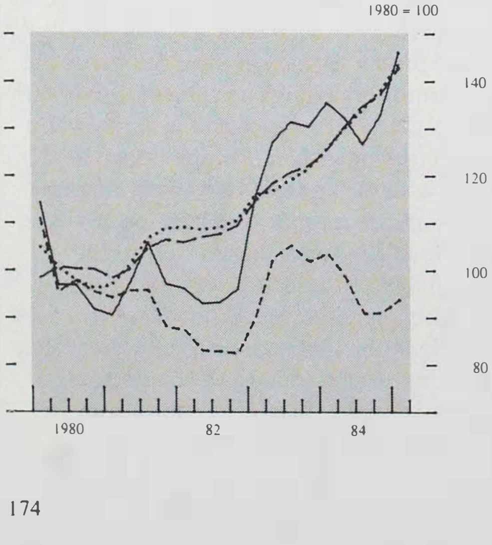
Percentage changes; *seasonally adjusted*

	1984 Q1	1984 Q2	1984 Q3	1984 Q4	1985 Q1
Total visible exports	1.0	−0.1	1.1	9.0	3.1
Non-manufactured goods	0.1	2.7	−2.6	7.2	0.1
Fuels	0.6	−9.1	5.4	5.7	10.2
Manufactured goods	4.1	—	1.0	10.8	1.8
of which:					
Consumer	*−1.0*	*−2.0*	*−1.0*	*17.2*	*−4.3*
Intermediate	*1.0*	*1.0*	*1.0*	*11.4*	*1.7*
Capital	*4.6*	*4.4*	*2.1*	*3.1*	*4.0*

(a) Excluding normally erratic items.

Import prices *rose strongly in sterling terms while the exchange rate was falling*

——— Economist index of industrial material prices (£)
- - - - - Economist index of industrial material prices (SDR)
.... UK manufacturers input prices (£)
— — — UK import prices (£)



equivalent to a ¾% fall. Comparable data for public sector investment in the first quarter are not yet available; it had picked up a little in 1983 and 1984 following sharp falls in the previous two years. Total current and capital expenditure by the public sector even so represented real GDP growth of only ½% last year, compared with 1¼% in 1983.

The strength and timing of the recent improvement in the United Kingdom's net trade position is somewhat surprising. In the three months to April, non-oil export volume (excluding the normally erratic items) rose 3%, to a level 12% higher than a year earlier. Most of this increase has occurred since the third quarter of 1984, despite the slower growth of UK markets abroad, which increased by only 3% between the first quarters of 1984 and 1985. Furthermore, although current competitiveness improved as the exchange rate declined over most of that period, if allowance is made for the usual lag in the response of export volumes to changes in relative prices and exchange rates it appears that there was little improvement in effective export price competitiveness last year. Nor does there seem to be an explanation in a changing commodity composition of exports: most broad categories of exports have grown in much the same way, apart from fuels (which have been distorted by the effects of the coal strike) and basic materials.

Non-oil imports also pose something of a puzzle. Import volume grew throughout 1984 but in the three months to April this year the total volume of non-oil imports was some 2% less than in the previous three months and 6½% greater than a year earlier. But there has been no sign of any abrupt slowing of aggregate demand or of particularly strong domestic non-oil output growth so far this year; and effective competitiveness in the domestic market improved only modestly if at all during the past year. Trade statistics, however, are typically so volatile that it would be premature to conclude that the earlier tendency for import volume to rise strongly has come to an end.

The coal strike continued to affect the oil surplus—March in particular showing exceptionally large oil imports—but there was an overall strengthening in the first quarter. This improvement in part reflects higher North Sea output (with a record production rate in January) and in part the strengthening of sterling oil prices (despite weaker dollar prices) while sterling was weakening. The price of crude oil in sterling terms rose by 15% between the first half of 1983 and the second half of 1984 and by a further 5% on average in the first quarter of 1985.

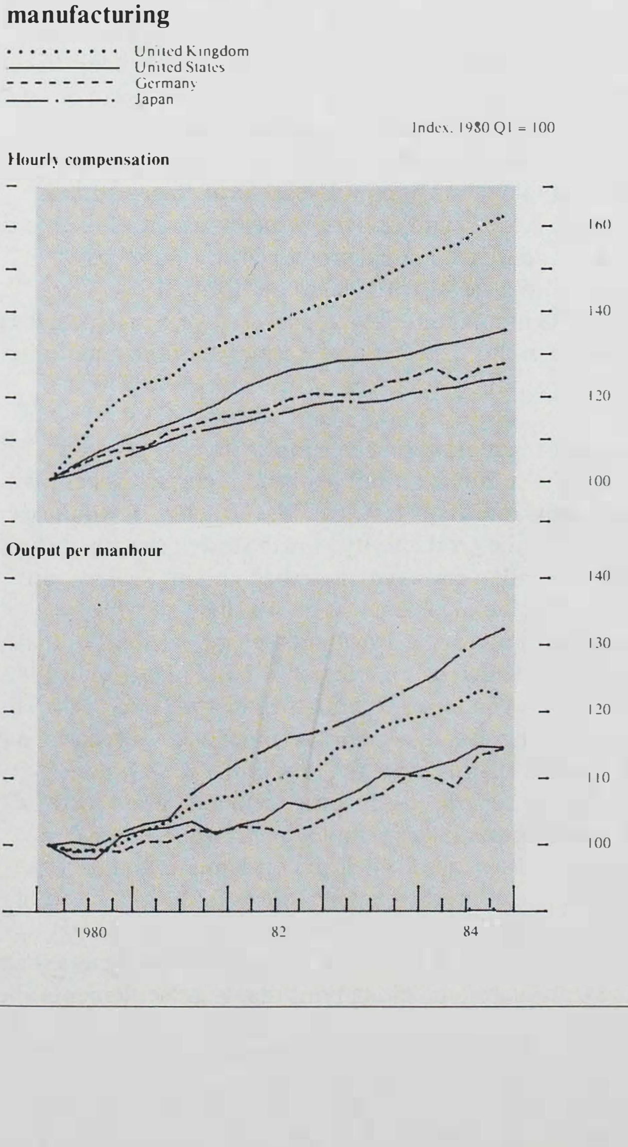
The fall in sterling until late February also affected UK non-oil import prices which rose by 4% in the first quarter to a level almost 13% higher than a year earlier. Non-oil industrial material prices on world markets, however, were weak in real terms through much of 1984 and have since recovered only slightly. UK import prices have tended to respond smoothly, with a lag, to changes in world commodity prices in terms of a common currency, but the lag appears to have become more pronounced recently—import prices rose more slowly than commodity prices during 1983 but continued to rise after

Competitiveness of UK manufacturing industry

Price competitiveness in export markets (as measured by the ratio of UK export prices of manufactures to overseas prices in sterling terms) tended to improve since the beginning of 1981 and in the first quarter of 1985 was some 4½% better than in the corresponding period last year and 15% better than in the same period in 1981. UK manufacturers also became more price competitive in their home market. But these improvements were more than accounted for by the fall in sterling (of some 50% against the dollar and 30% in effective terms) over the period. Leaving aside the benefit from exchange rate movements, the underlying competitive position of UK manufacturers, as determined by changes in costs and productivity at home and overseas, has deteriorated.

Although UK productivity growth has generally compared favourably, average earnings have been growing more rapidly in the United Kingdom than among our overseas competitors. In 1982, the rise in employees' pay was slightly lower in the United Kingdom than the overseas average, though notably

Remuneration and productivity trends in manufacturing



Measures of UK competitiveness

Percentage changes, Q4 on Q4

	1981	1982	1983	1984
Price competitiveness in export markets(a)	− 9.9	0.6	0.1	−3.5
Price competitiveness in the United Kingdom	− 3.0	0.9	−3.1	−4.9
Relative unit labour costs(a)	−13.2	−2.3	−6.7	−5.6
Profit margins on UK exports	2.7	2.0	4.7	0.9
Relative profitability of UK exports(b)	2.2	−0.2	3.2	3.4
Sterling exchange rate index	−10.5	−0.7	−6.6	−9.7

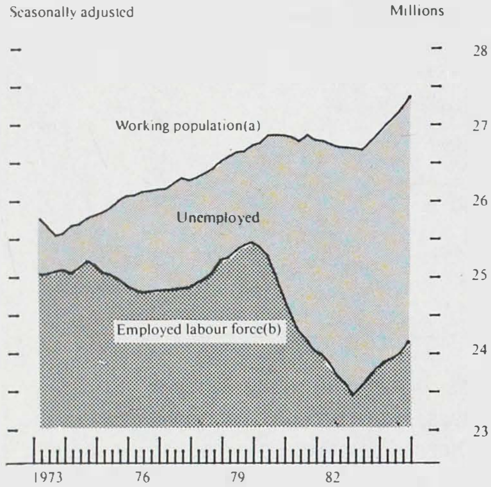
(a) Improvement shown as negative.
(b) Relative to profitability of domestic sales.

higher than it was in some larger economies. In the following two years, UK average earnings showed steady growth whereas in other countries the rise in earnings slowed progressively. In 1983, this disparity was largely offset by stronger UK productivity growth. With unit labour costs showing little change in the United Kingdom and falling by 1% (in local currencies) abroad, the decline in sterling in 1983 led to a sharp improvement in UK manufacturers' *relative unit labour costs* in common currency terms. In 1984, however, it took a much larger fall in sterling's effective rate to produce a smaller improvement in relative unit labour costs, as slower productivity growth caused UK unit labour costs to rise while those abroad (in local currencies) fell for the second year running. Although UK productivity growth may have revived a little recently, some further loss of cost competitiveness is likely to have occurred since the turn of the year as the rise in average earnings has not slowed but sterling has appreciated sharply.

UK manufacturers were able to increase their *profit margins* on exports in 1983 while still improving their competitive position, as total unit (labour, material and fuel) costs were unchanged and the exchange rate declined. In 1984, exporters appear to have widened their margins a little further as sterling fell but to have placed more emphasis on price competitiveness in export markets, exercising greater restraint in raising their foreign currency prices. The rise in import prices as sterling weakened also allowed UK manufacturers to increase their domestic margins until the latter part of 1984 but by less than their export margins (so that the *relative profitability of exports* as against home sales rose further).

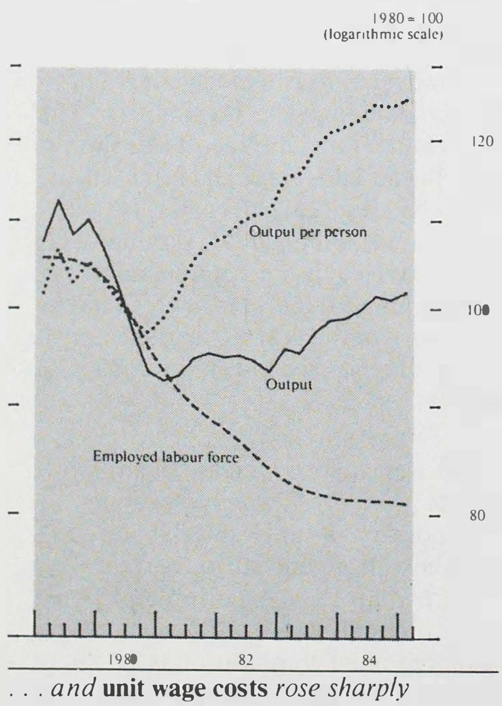
Since the early part of 1985, although the pressure from raw material and fuel costs may have eased, UK manufacturers are likely to have been facing greater competitive pressure on their margins at home and abroad as sterling has strengthened.

Employment and unemployment *continue to rise*

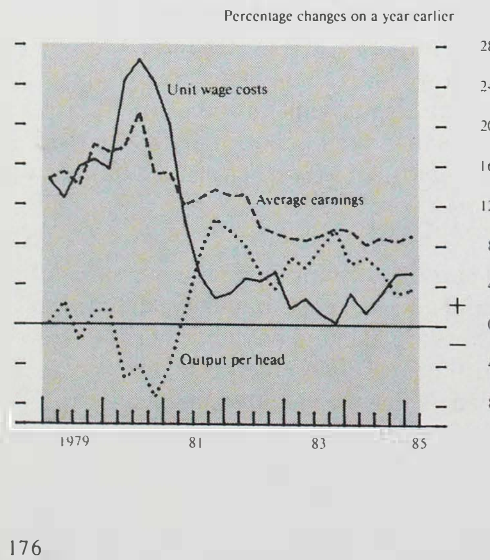


(a) Unemployed plus employed labour force.
(b) Employees in employment, HM Forces and self-employed.

Productivity *in manufacturing grew more slowly during 1984 . . .*



. . . and **unit wage costs** *rose sharply*



commodity prices fell sharply in the spring and summer of last year. It may therefore be that the United Kingdom still stands to benefit to some extent from the weaker trend in commodity prices during 1984 and, with sterling now having strengthened and world commodity prices likely to remain subdued, cost pressures from this source may subside quite rapidly this year.

Employment and unemployment *are both still rising*

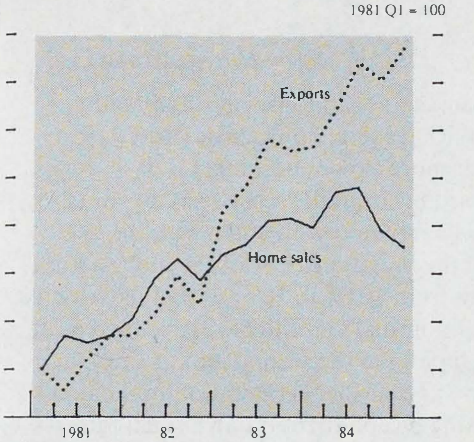
With output in the economy as a whole in 1984 about $3\frac{1}{2}$% higher (after adjustment for the impact of the coal strike) than in 1983 and $3\frac{3}{4}$% above its 1979 peak, it is estimated that 340,000 new jobs were created during the year; but the working population is estimated to have increased by 480,000 and unemployment rose on average by almost 12,000 a month. Of the 200,000 rise in female employees, 190,000 were part-time workers. Male employment continued its downward path, falling by 60,000, but the number of self-employed is projected to have risen by 200,000. Employment in manufacturing, which appeared to stabilise during 1984, has fallen further since the turn of the year (by some 27,000) and unemployment has continued to rise. Although monthly movements have varied, unemployment (seasonally adjusted and excluding school leavers) in the first five months of 1985 has increased on average by almost 15,000 a month.

Labour and other input costs *increased rapidly last year . . .*

The marked upturn in employment while output growth has remained fairly steady (if allowance is made for the coal strike) indicates a commensurate slowing of the rate of growth of productivity. Output per person employed in the economy as a whole is estimated to have increased during 1984 at only about half the rate of the previous year. As average earnings (adjusted for back pay and delayed settlements) continued to rise strongly, the underlying annual growth of unit wage costs accelerated from $4\frac{3}{4}$% during 1983 to 6% during 1984. The underlying rise in total unit labour costs last year will have been slightly less than this, because of the removal of the remaining 1% national insurance surcharge.

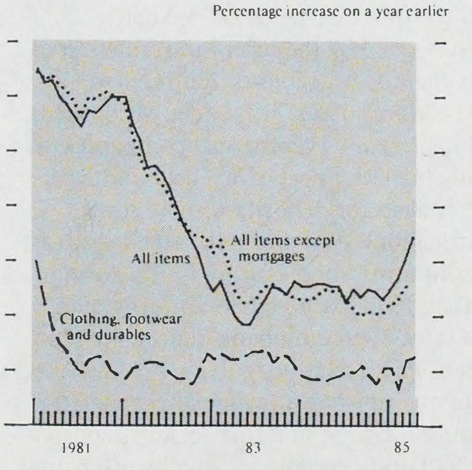
In manufacturing industry, where employment continued falling until the summer, output per head increased faster than in the economy as a whole last year. Nevertheless, it would seem that manufacturing productivity growth slowed sharply during the year as the fall in employment halted and, in the autumn, output growth faltered. There was only a slight slowing, however, in the underlying growth of average earnings so that unit wage costs, which had increased by barely 1% during 1983, rose by $5\frac{1}{4}$% between the fourth quarters of 1983 and 1984. The quarterly path suggests that manufacturers' unit wage costs may have moderated slightly since the turn of the year: productivity growth seems to have revived a little, with a renewed increase in output and further falls in employment; while average earnings (after allowance for delayed settlements and back pay) continued to rise at much the same rate as in the latter part of 1984. Nevertheless, with unit wage costs still rising strongly, their growth over the past year has been the fastest recorded since 1981; there are also some indications that wage settlements and

Manufacturers' profit margins[a] *are cut on home sales but rise in export markets*



(a) Manufacturers' price/cost ratios, which indicate the direction but not necessarily the scale of changes in, or the level of, profit margins.

Mortgage rates contribute to a sharp rise in **retail prices**



Components of inflation

Percentage changes; fourth quarter on a year earlier

	1979	1980	1981	1982	1983	1984
Domestic factor costs:						
Profits(a)	14.6	6.4	20.9	15.9	10.2	4.1
Income from employment(b)	16.4	20.9	4.4	4.2	4.0	4.2
Total domestic costs (GDP deflator)	15.6	18.7	6.9	6.9	4.8	4.2
Other costs:						
Taxes on spending less subsidies	34.2	16.1	21.6	3.7	2.8	5.0
Imports	10.7	5.4	13.8	3.7	7.9	12.0
Total final expenditure	**16.5**	**15.6**	**9.8**	**5.9**	**5.2**	**6.0**
Deflators for domestic expenditure						
Consumer spending	16.9	13.8	11.2	6.7	4.7	5.3
Fixed investment	18.6	17.8	4.3	3.2	4.2	5.0

(a) Gross trading profits (public and private), less stock appreciation.
(b) Per unit of GDP (income measure).

Shares of gross domestic income

Per cent of GDP

	1979	1980	1981	1982	1983	1984
Income from employment	67.6	69.0	68.5	66.6	65.7	64.9
Income from self-employment	9.6	8.5	8.7	8.9	8.7	8.9
Gross trading profits(a)	15.2	14.7	14.9	16.5	17.9	18.6
Other income(b)	7.7	7.8	8.2	8.1	7.8	7.6

(a) After allowing for stock appreciation.
(b) Rent income and imputed charge for consumption of non-trading capital.

average earnings in manufacturing may now be rising at a slightly faster pace than at the turn of the year.

Until very recently, other input costs were also rising strongly. Although world commodity prices have tended to fall since early 1984, UK manufacturers' material and fuel costs in sterling terms increased rapidly as the pound weakened. The rate of increase over the previous year accelerated from 7% in the first quarter of 1984 to $9\frac{1}{2}$% in the first quarter of 1985. With unit wage costs in manufacturing still rising faster than a year earlier, the increase in manufacturers' total costs between the first quarters of 1984 and 1985 may have been of the order of $6\frac{1}{2}$%–7%, almost half as fast again as in the previous year. More recently, however, sterling's appreciation since February and lower prices of foodstuffs have contributed to a sharp reduction in manufacturers' material and fuel costs which in May were little more than $3\frac{1}{2}$% higher than a year ago.

. . . *but the recent acceleration of* **retail prices** *should prove temporary*

The buildup of cost pressures does not appear to have led UK manufacturers in general to raise their domestic selling prices any faster over the past twelve months. They appeared instead to accept an erosion of margins on domestic sales while taking advantage of sterling's depreciation to safeguard their overall profitability by raising their export margins. The rate of increase in the retail price index (RPI), however, has accelerated markedly, from 4.6% over the year to December to 7% in May. A number of factors have contributed to this upsurge: sterling's sharp depreciation between November and February continued to affect prices of imported consumer goods, and mortgage interest rates, television licence fees and Budget increases in excise duties also added upward pressure. Most of these special factors could prove to be transitory and some may be reversed.

The RPI is very sensitive to changes in mortgage interest rates, despite the low weight that is given in the index to their level, since short-term changes in interest rates tend to be quite large in proportion to their previous levels. With a current weight in the RPI of some $4\frac{1}{2}$%, an increase in mortgage rates from 10% to 12% (ie 20 per cent) would raise the index by almost 1%. Through most of 1983, the movement of mortgage rates offset some of the increase in other items of the RPI but, since the early part of 1984, it has had the opposite effect. The prices of clothing, footwear and durable goods, however, have risen consistently slowly, reflecting competitive pressures and technical progress (especially in electronic goods).

The interaction of costs and prices across the economy as a whole in recent years can be seen in the national income data presented in the table. Although these are subject to revisions that typically may be quite substantial, they show clearly the squeeze on profit margins during 1984 which was brought about by the faster rise of unit labour costs and the impact of higher import prices on other input costs. In the year as a whole, however, the share of profits in GDP was again higher, and the share of income from employment lower, than the previous year. As the more rapid rise of import costs was partly absorbed in profit margins, the index of total home costs (the GDP deflator) rose rather less last year than during 1983. Even so, prices in all the main expenditure categories rose at a rather faster rate in 1984.

Broad money *has been rising faster than output . . .*

With output in the economy as a whole growing less rapidly, as a result of the coal strike, and total home costs (the GDP deflator) also rising rather more slowly, nominal GDP is estimated to have increased by around 7% between the fourth quarters of 1983 and 1984 compared with about $8\frac{1}{2}$% the previous year. Growth of the broad measure of the money stock, £M3, slowed only slightly, from $10\frac{1}{2}$% to 10%, so that its velocity of circulation (the ratio of nominal GDP to £M3) declined quite sharply. £M3 grew more rapidly in the second half of 1984 than in the first half and there was a further acceleration in the first quarter of 1985 when, rising by about 16% at an annual rate, it exceeded any likely growth of nominal GDP by a large margin. (Influences on the velocity of circulation are discussed on page 166.)

Nearly half the increase in £M3 in 1984 was in interest-bearing sight deposits, which also accounted for about half of the £$4\frac{1}{2}$ billion rise in £M3 in the first quarter of 1985. Such deposits, which have been buoyed by the recent introduction of a number of high-interest chequable accounts, represented almost 16% of total £M3 in March 1985. Total deposits of the personal sector and of industrial and commercial companies (ICCs) rose strongly during the latter part of last year and in the first quarter of 1985. Personal sector deposits with building societies grew steadily throughout 1984 and PSL2, the broader measure of private sector liquidity, increased by 14.6% during the year, some 5% more than £M3. Although an improvement in the competitiveness of rates offered on bank deposits tended to slow the rate of growth of PSL2 relative to that of £M3, the continuing movement out of term shares (which are excluded from PSL2) into more liquid forms of building society deposits (which are included) has had, until recently, a broadly offsetting effect.

. . . and **bank lending to the private sector** *has been very buoyant*

Among the counterparts to monetary growth, the PSBR was slightly less in the first quarter of 1985 than in the latter part of 1984 while government debt sales, especially of gilts, were substantial; but the contractionary influence of this on the money supply in the first quarter was outweighed by a sharp acceleration in bank lending to the private sector. Lending in sterling to (non-bank) financial institutions, having increased markedly in the second half of 1984, rose by as much as £1.7 billion in the first quarter of 1985; lending to leasing companies increased especially sharply as lessors brought forward investment ahead of the reduction in allowances against corporation tax (and in the rate of tax) on 1 April. Lending in sterling to industrial and commercial companies also rose strongly in the first quarter, to £3.2 billion, and lending to unincorporated businesses (classified as part of the personal sector) increased. Lending to persons for house purchase, which had revived in the fourth quarter of 1984, was sustained at much the same rate in the first quarter of 1985 but bank lending for other purposes to the personal sector (excluding

Growth of bank deposits and lending

£ billions; seasonally adjusted at a quarterly rate;
figures for sterling only in italics

	1983	1984				1985
	Year	Year	H1	Q3	Q4	Q1
Domestic deposits						
Personal sector	0.8	0.8	0.8	0.3	1.4	1.3
Companies	1.2	0.2	-1.0	1.8	1.2	1.7
Other financial institutions	0.7	1.5	1.7	0.4	2.2	0.6
Public sector	—	0.3	—	0.1	0.6	0.1
Total deposits	**2.7**	**2.8**	**1.5**	**2.6**	**5.4**	**3.7**
	2.2	*2.5*	*1.8*	*3.2*	*3.0*	*4.2*
Domestic lending						
Personal sector	2.1	1.6	1.5	1.6	1.8	2.3
Companies(a)	0.4	2.0	1.7	1.3	3.4	4.4
Other financial institutions	1.1	1.7	1.6	1.7	1.8	3.8
Public sector	-0.5	0.2	-0.7	1.6	0.5	-3.7
Total lending	**3.1**	**5.5**	**4.1**	**6.2**	**7.5**	**6.8**
	2.9	*3.5*	*3.1*	*3.0*	*4.8*	*6.1*
Overseas sector: deposits net of lending						
Sterling	0.3	-0.1	0.1	0.3	-0.7	3.4
Foreign currency	-0.7	0.4	1.2	0.1	-0.6	-0.2

(a) Including Issue Department transactions in commercial bills.

Counterparts to changes in money stock

	1983	1984				1985
	Year	Year	H1	Q3	Q4	Q1
	£ billions, quarterly averages seasonally adjusted					
PSBR	2.9	2.6	2.7	2.8	2.1	2.1
of which, CGBR (own account)	*2.3*	*1.7*	*2.1*	*2.2*	*0.3*	*1.4*
Public sector debt sales to UK non-bank private sector	-2.7	-2.8	-2.7	-2.9	-2.9	-4.3
Sterling lending to private sector	3.2	4.1	3.9	3.6	5.2	7.2
External and foreign currency counterparts(a)	-0.8	-0.9	-1.2	-0.5	-0.6	0.8
Net non-deposit liabilities(a)	-0.2	-0.5	-0.5	—	-1.2	-1.3
£M3	**2.4**	**2.5**	**2.2**	**3.0**	**2.6**	**4.5**
PSL2	4.6	6.2	6.2	5.9	6.3	8.8
	Percentage changes(b)					
£M3	10.0	9.4	8.4	11.2	9.6	16.0
PSL2	12.3	14.6	15.4	13.7	14.1	19.5

(a) On new definitions, see page 185.
(b) From end of previous period, at an annual rate.

unincorporated businesses) fell back. (The course of the monetary aggregates in recent banking months is discussed further on pages 183–6.)

Overseas residents' sterling deposits rose at an unprecedented rate and, despite a large increase in sterling lending to overseas residents, the overseas sector was a net supplier of £3.4 billion in sterling to the UK monetary sector in the first quarter of 1985. Identified net external capital flows overall, however, showed an outflow of £1 billion, somewhat greater than in the third and fourth quarters of 1984 (although it appears to have been broadly matched by unidentified net inflows). Several of the identified components exhibited large, and possibly erratic, movements, some of which may have been related to the sharp fall and subsequent revival of sterling during the quarter. Non-oil direct investment flows, both inward and outward, reflected major acquisitions by companies while, on the basis of early figures, net portfolio investment abroad by financial institutions was greater than in other recent quarters.

Companies *in aggregate have raised substantial amounts of* **external finance . . .**

It is difficult to find a fully convincing explanation of the strong growth of bank lending to industrial and commercial companies throughout last year and in the first few months of 1985, particularly as companies' profits in aggregate have been very buoyant since the early part of 1984 and they have steadily built up their bank deposits. In the fourth quarter of 1984, however, profits (net of stock appreciation) rose less rapidly than earlier in the year: profits from North Sea activities rose by 17% in the quarter, reflecting increased sales volume and higher sterling oil prices, but profits of other industrial and commercial companies fell by $6\frac{1}{2}$% (perhaps reflecting cost pressures on domestic profit margins) and their real rate of return fell back a little to 7%. Income from abroad, which had surged by 34% in the third quarter, remained at much the same level in the fourth. Dividend payments nevertheless increased sharply, by 29%, while tax and interest payments continued at a high level, so that companies' undistributed income (net of stock appreciation), which in the year as a whole was 27% higher than in 1983, fell slightly in the fourth quarter of 1984.

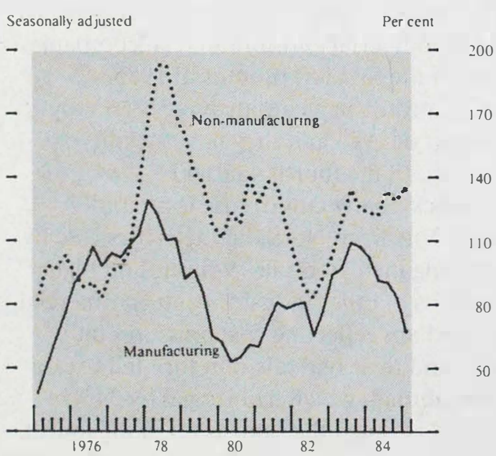
Although internal funds were thus somewhat constrained in the fourth quarter, the company sector as a whole increased its expenditure on fixed capital and resumed stockbuilding. At the same time, companies appeared reluctant to raise external funds through capital issues while the new issues market was digesting the British Telecom offer. This, together with the need of some companies to finance accelerated VAT payments, may partly explain the sharp rise in bank borrowing—to almost £$3\frac{1}{2}$ billion in sterling and foreign currencies—during the quarter.[1]

Information so far available suggests that industrial and commercial companies have raised considerable amounts of external finance in the first few months of 1985: they borrowed

(1) A more detailed analysis of the financial position of industrial and commercial companies last year is given in the article on page 224.

over £3 billion in sterling and over £1 billion in foreign currency from UK banks during the first quarter and raised £2$\frac{3}{4}$ billion (net) through capital issues in the first five months of the year—almost as much as in the whole of 1984. Some of these funds may have been used to acquire physical capital. The volume of fixed capital expenditure by the manufacturing, construction, distribution and financial industries increased by 18% in the first quarter of 1985. Most of this increase, however, was accounted for by the acquisition of fixed capital by finance leasing companies (which are classified not as ICCs but as other financial institutions); the volume of fixed investment undertaken directly by manufacturing, construction and distribution companies rose by only 1$\frac{1}{2}$%. A temporary surge in spending on fixed capital had been expected in advance of the reduction in capital allowances (especially by leasing companies which were able to offer exceptionally fine rates) but the scale on which this appears to have taken place, and the extent to which it has been concentrated among leasing companies, is somewhat surprising.

The **liquidity ratio**[(a)] *of large companies has fallen in manufacturing but not in other industries*



Source: Department of Trade and Industry.

(a) Ratio of total current assets to total current liabilities: all large companies.

. . . *but experience has been diverse*

With substantial destocking taking place during the first quarter, especially in manufacturing industry, and direct investment expenditure by industrial and commercial companies apparently modest (and likely to remain so in the coming months) the amount of external finance raised by ICCs since the turn of the year is particularly puzzling. Part appears to have been associated with take-over activity and part may have been attributable to the financing of accelerated VAT payments which built up further in January. Some of the explanation, however, seems likely to lie in the widely differing economic circumstances of individual sectors of industry and of individual firms. The Department of Trade and Industry's quarterly survey of company liquidity suggests that the net liquidity of industrial and commercial companies in aggregate has deteriorated gradually since the middle of 1983 but that, within this overall picture, the liquidity ratio of manufacturing companies has fallen back very sharply (from 109% to 67%) whereas that of other companies collectively has remained fairly steady above 120%.

Bank lending and output: industrial analysis

	Bank lending(a): year to mid-Feb. 1985			Output: year to 1985 Q1
	£ billions	As per cent of stock		Percentage change
Oil, extraction of gas	0.1	+ 2		+3
Manufacturing	3.6	+16		+2
of which:				
Metals, other minerals and mineral products	0.2	+ 8		−2
Chemicals	0.6	+34		+6
Electrical and instrumental engineering, and metal goods	0.9	+20		+8
Food, drink and tobacco	0.9	+23		+1
Construction	0.6	+13		+4
Distribution, hotels etc.	2.4	+14	*+10*	+4(b)
Transport	−0.1	− 3	*− 3*	+4(b)
Business services, etc.	4.5	+33	*+26*	+8(b)
Total of above	**11.2**	**+19**	*+19*	**+4**(c)

(a) Flow of bank lending in sterling and foreign currencies (excluding valuation changes). Excludes, where possible, figures for the public, personal and financial sectors; unincorporated businesses are included but cannot be separately identified. Figures in *italics* show changes between *mid-November 1983 and mid-November 1984.*

(b) Change in output in the year to 1984 Q4: later output data are not available for these industries.

(c) Weighted average of constituents.

The quarterly analysis of bank lending and a broadly equivalent analysis of industrial output also point to a diversity of experience over the past year. Some categories of industry have increased their output and borrowed rapidly (notably the chemicals and electrical engineering industries and a number of service industries); other categories (such as the metal manufacturing and food, drink, and tobacco industries) experienced falling output or very little growth but increased their bank borrowing; the transport industry expanded output but repaid bank loans. This analysis illustrates not only differences in their economic circumstances but also the diverse reasons firms may have for borrowing from banks: some companies regard bank borrowing as a convenient source of funds to finance rapid growth, or as a temporary substitute for equity finance; other, less buoyant, companies may rely on banks for a more permanent source of funds or to tide them over a difficult period.

Real personal disposable income (RPDI), household income, consumption and saving ratio

	1981	1982	1983	1984 Year	Q3(a)	Q4(a)
	Growth rates, per cent					
RPDI	−2.2	0.2	1.6	2.2	1.7	2.9
Contribution of:(b)						
Real earnings per head	0.4	0.8	2.2	0.6	0.3	1.1
Employment	−3.1	−1.8	−1.0	0.3	0.3	0.4
Current grants	1.5	1.4	0.6	0.5	0.2	0.6
Other income (c)	−0.7	0.3	0.3	1.2	0.8	1.2
Tax and national insurance payments	−0.4	−0.5	−0.7	−0.5	−0.1	−0.5
Real household income (inflation adjusted)	−2.2	2.6	3.2	2.8	1.2	3.9
Consumers' expenditure	−0.2	0.8	3.9	1.5	0.2	1.0
Memo items:	*Per cent of RPDI*					
Personal saving ratio (conventionally measured)	13.5	12.9	10.9	11.4	11.6	12.9
Household saving ratio (inflation adjusted)	−1.6	0.1	−0.7	0.5	1.2	2.2

(a) Seasonally adjusted; income and expenditure data expressed at an annual rate.

(b) Change in components deflated by consumers' expenditure deflator, as a percentage of RPDI.

(c) Includes income from self-employment, employers' national insurance contributions and rent, dividends and interest receipts.

Personal sector financial transactions

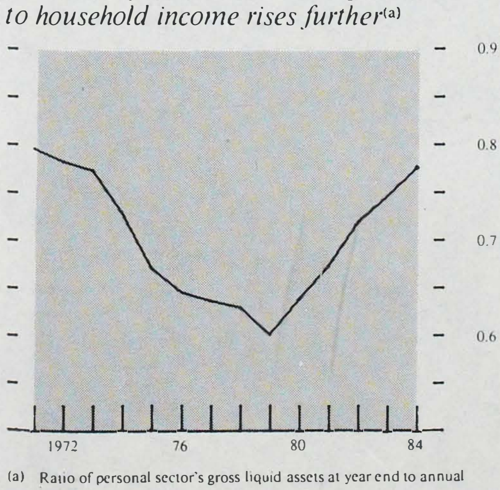
£ billions: seasonally adjusted at an annual rate

	1982	1983	1984 Year	1984 Q3	1984 Q4	1985(a) Q1
Borrowing						
For house purchase	14.1	14.4	16.5	16.9	16.5	16.3
of which:						
From banks	5.1	3.7	2.3	1.5	3.1	2.9
From building societies	8.1	10.9	14.3	15.5	13.6	13.3
Bank borrowing for consumption	2.3	2.6	2.6	2.3	3.7	2.1
Other bank borrowing	2.6	2.3	1.7	2.3	0.1	4.1
Other borrowing	−0.1	0.7	0.1	−0.4	0.7	..
Total	18.9	20.0	20.9	21.1	21.0	..
Acquisition of financial assets						
Building society shares and deposits	10.3	10.3	13.2	11.4	13.8	12.1
Bank deposits	3.8	2.9	3.3	1.3	5.4	5.4
National savings	3.5	2.9	3.3	4.5	3.3	2.0
Life assurance and pension funds	14.0	15.3	17.3	16.4	18.2	..
Other	−0.5	0.5	1.1	3.4	1.1	..
Total	31.1	31.9	38.2	37.0	41.8	..
Net acquisition of financial assets	**12.2**	**11.9**	**17.3**	**15.9**	**20.8**	..

.. not available.

(a) Partly estimated.

The ratio of personal sector liquid assets *to household income rises further*[(a)]



(a) Ratio of personal sector's gross liquid assets at year end to annual income.

With slower growth of consumer spending, personal saving *rose as a proportion of* household incomes . . .

The underlying increase in economic activity and the overall buoyancy of company sector profits contributed to a faster rise in real personal disposable income (RPDI) last year than in any other year since 1979; but if adjustment is made to exclude net contributions to life assurance and pension funds and to allow for the erosion by inflation of the value of net liquid asset holdings, the increase in real household income was rather less rapid than in 1983. Although average earnings in the economy as a whole were reduced by the coal strike, employment rose and the contribution of total wage and salary earnings to the growth of RPDI was only a little less in 1984 than in 1983. 'Other income' increased in importance; this was assisted in the second half of the year by an exceptionally strong rise in dividend receipts but, acting in the opposite direction, there was an increase in the spread between borrowing and lending rates as interest rates rose in the latter part of 1984. The personal sector, although a net lender, saw its interest payments rise faster than its interest receipts and net receipts may have fallen quite sharply. Consumers' expenditure was very subdued, as reduced spending on durables partly offset the modest rise in expenditure on non-durables. In consequence the saving ratio, both as conventionally measured and after the adjustments to RPDI described above, rose quite sharply during 1984.

Net capital expenditure also showed only modest growth. Private residential investment was subdued: investment in new dwellings was fairly constant in 1984 while expenditure on improvements in existing dwellings fell back in the course of the year as local authority grants were reduced and zero-rating for VAT came to an end. In the latter part of 1984 and at the beginning of this year, housebuilding activity also fell back: private sector housing starts (seasonally adjusted) in the two winter quarters were 4% less than in the two previous quarters. While the unusual severity of the weather appears to have contributed to this, rising costs of building may also have been a factor: construction material prices and average earnings in the construction industry were both $6\frac{1}{2}$% higher than a year earlier and the rise in interest rates will also have added to builders' costs.

With a sharply rising savings ratio and only modest capital expenditure, the personal sector increased its borrowing slowly and accumulated bank and building society deposits on a considerable scale. The high rate of borrowing over the last few years and the rise in interest rates since the middle of 1984 pushed income gearing (net of tax relief) of the household sector to well over 5% and this, together with uncertainty about future movements of interest rates, may have reinforced the decline in the rate of personal sector borrowing.

. . . *and competition for the* personal sector's savings *intensified*

The personal sector's growing awareness of the increased competition for its savings was highlighted in the third quarter of last year, when deposits were switched into the 28th issue of national savings certificates. The building societies have not so far succeeded in recapturing the share of the personal sector's liquid assets which they held in the first half of 1984, in spite of the continuing erosion of the building society cartel's ability to fix interest rates, which has increasingly allowed individual societies greater freedom to set competitive rates. The introduction of a composite rate of tax for banks in April this year has made bank deposit rates more directly comparable with those offered by building societies and competition has become even more intense as a result. Increased competition, together with the very high real rates of interest available on deposits, appears to have contributed to the recovery in the personal sector's ratio of liquid assets to income, from 66% in 1979 to 78% by the end of last year.