Economic commentary

- *Recovery in the major industrial countries has slowed, with reduced output growth in the United States in the first half of 1985 and some slackening of activity in Europe and Japan at the beginning of the year.*

- *Inflation has remained subdued in most major countries, as commodity prices have fallen further while unit labour costs in manufacturing have generally shown little or no growth.*

- *In the United Kingdom, activity was buoyant in the first half of the year as the effects of the coal strike unwound. Consumer spending picked up in the second quarter but industrial fixed investment fell back after an exceptional first quarter surge.*

- *Unit labour costs have been rising strongly but manufacturers' material and fuel costs have started to fall as sterling has strengthened, bringing an improvement in manufacturers' and retailers' profit margins.*

- *Retail prices have started to rise more slowly again and further slowing seems likely during the rest of the year and into 1986.*

- *Bank lending to industrial and commercial companies and to the personal sector remained buoyant in the second quarter; but the average size of building society mortgage taken out by first-time house-buyers appears to have fallen in the face of higher mortgage interest rates.*

Slower output growth in the major industrial countries . . .

The growth of output in the United States, which had been slowing during the course of 1984, was only about $\frac{1}{4}$% at an annual rate in the first quarter of 1985. The latest estimate suggests somewhat faster but still modest US growth of 2% per annum in the second quarter; industrial production rose by only $\frac{3}{4}$% between March and July. If these provisional estimates are confirmed, GDP will have grown at an annual rate of only $1\frac{3}{4}$% in the first half of 1985, compared with $3\frac{1}{2}$% in the second half of 1984. Although some slowing of the US economy was expected after the exceptionally rapid growth early last year, the extent of the slowdown has surprised most analysts. Domestic demand appears to have remained quite strong, increasing by 3% at an annual rate in the first half of 1985, with personal consumption particularly buoyant; but a continuing deterioration in the net external trade position, in response to the cumulative loss of competitiveness induced by the dollar's appreciation, acted as a major constraint on output growth.

There does not appear to have been a compensating acceleration in output growth elsewhere. Although the growth of output in the major European countries increased from 2% per annum in the first half of 1984 to $2\frac{1}{2}$% in the second, it appears to have fallen again (to around $1\frac{3}{4}$%) in the first half of

GNP growth in the major economies

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

	1983	1984 Year	1984 H1	1984 H2	1985 H1(a)
Canada	3.3	5.0	4.2	4.9	3.6
France	0.7	1.3	1.1	1.8	—
Germany	1.3	2.6	2.4	3.4	1.5
Italy(b)	-0.4	2.6	2.8	2.2	1.5
Japan	3.4	5.7	6.1	5.6	4.2
United Kingdom(b)	3.1	2.4	1.7	2.5	4.6
United States	3.7	6.9	8.4	3.6	1.7
Total	**2.7**	**4.9**	**5.4**	**3.6**	**2.3**

(a) In most cases based on current best estimates/forecasts.
(b) GDP: figures for the United Kingdom relate to the average estimate.

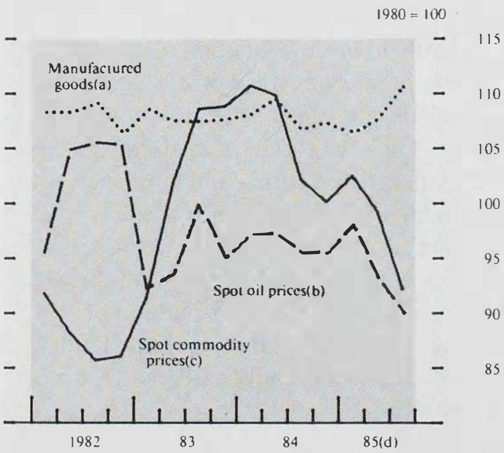
Contributions to GNP[a] growth in the major economies

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

	United States, Canada and Japan			Europe(b)		
	1983	1984	1985 H1	1983	1984	1985 H1
Private consumption	2.7	2.9	2.7	0.8	0.7	1.3
Private fixed investment	0.9	2.2	1.0	—	0.4	-0.1
Public expenditure	—	0.5	0.2	0.4	0.3	-0.1
Stockbuilding	0.4	1.4	-0.8	—	0.3	0.4
Domestic demand	**4.1**	**7.1**	**3.1**	**1.2**	**1.8**	**1.4**
Net trade	-0.5	-0.7	-0.7	—	0.4	0.3
GNP	**3.6**	**6.4**	**2.4**	**1.3**	**2.2**	**1.8**

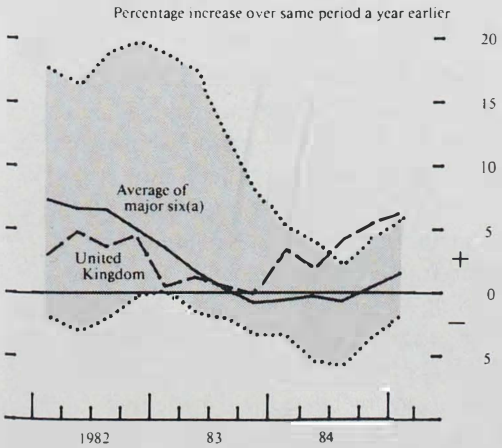
(a) Or GDP.
(b) France, Germany, Italy and the United Kingdom.

International commodity prices *fall, especially in real terms*



(a) World price of manufactured goods (in SDRs).
(b) North Sea marker spot price (in SDRs).
(c) Economist all-items commodity index (in SDRs).
(d) 1985 Q3 is partly estimated.

Manufacturers' unit labour costs *continue to rise faster in the United Kingdom than elsewhere*



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

1985. In Germany, output fell by over ¾% in the first quarter of the year, as construction activity was hit by exceptionally severe weather while consumer spending remained depressed. Output in France is now estimated to have been fairly stagnant around the turn of the year. Some special factors, such as the harsh winter, constrained activity in Europe and growth is expected to have resumed in the second quarter, especially in Germany; but the underlying recovery remains modest in comparison with previous upturns.

Output in Japan increased by about 6% per annum in both halves of 1984. In the first quarter of 1985, however, GDP appears to have grown at an annual rate of only ½%, with net trade strongly contractionary. Given the continuing competitive strength of the Japanese economy, this was probably erratic, and a return to stronger growth is generally expected in the rest of the year. However, without a marked increase in the rate of growth in Europe, the effects on the world economy of slower US output growth will not be fully offset, and activity in the major countries in aggregate in 1985 could well be less buoyant than had generally been expected earlier in the year.

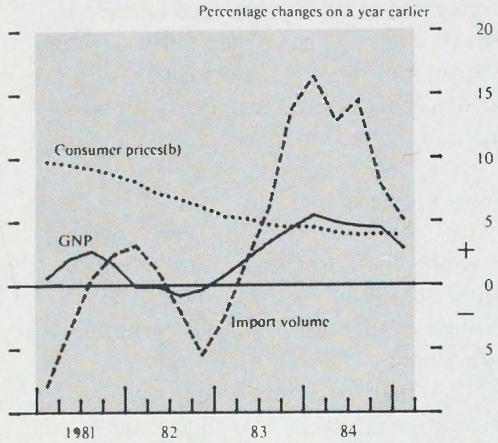
... has been accompanied by a slower rise in costs and prices

Inflation in most industrial economies has remained subdued or has continued to decline, helped by further falls in commodity prices in real terms (relative to world prices of manufactured goods) and by the continuing slow growth of unit labour costs. The effective nominal oil price, measured in SDR, has continued to fall: in the second quarter of this year it was about 1½% below its level of a year earlier and is estimated to have been lower still in the third quarter; since the turn of the year, oil prices also appear to have fallen in real terms. Non-oil industrial material prices, which had fallen in real terms by 2¾% in the second half of last year, seem to have fallen by more than 3% in the first half of 1985.

The rise in average earnings in manufacturing industry in the United Kingdom's major overseas competitors as a whole continued to slow during the course of 1984, from 5½% per annum in the first half of the year to 4% in the second; at the same time, although productivity growth economy-wide slowed down, manufacturing productivity continued to show buoyant growth. As a result, manufacturers' unit labour costs in these countries in aggregate fell at an annual rate of 1½% during the second half of 1984. Latest figures suggest that earnings, both in manufacturing and across the economy as a whole, have continued to grow fairly slowly in most major economies in the early part of 1985; but there are signs that a cyclical slowing of productivity growth in manufacturing may be under way in a number of them now.

With cost pressures continuing to ease, price rises have generally been muted. Manufacturers' home selling prices have recently been falling in Japan and rising at an annual rate of only about 1% in the United States. In Canada and Germany in recent months they have been increasing at a twelve-month rate of some 2½%–3%; in France the rise has slowed from 8%

Output and prices *rise more slowly in the major industrial countries*[(a)]



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

(b) Consumer expenditure deflators.

World trade and UK markets

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

	1983	1984 Year	1984 H1	1984 H2	1985 H1(a)
Import volumes(b)					
Major seven(c)	4.7	12.8	16.1	6.2	4.5
of which:					
North America	11.0	23.0	31.2	5.3	11.2
Japan	0.7	11.0	13.1	2.1	−4.3
Europe	2.4	6.8	7.5	7.9	2.2
Other OECD	0.5	7.7	8.4	5.4	3.7
Oil exporting countries	−10.9	− 9.8	− 9.3	−8.2	−8.5
Other developing countries	− 0.3	7.9	8.6	4.2	7.8
Total	**1.7**	**9.0**	**11.0**	**4.8**	**3.8**
UK markets	**− 0.8**	**6.8**	**10.5**	**2.6**	**2.8**

(a) In most cases based on current best estimates/forecasts.

(b) Imports of goods only.

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

Effective exchange rates[(a)] **and short-term interest rates**[(b)]

Monthly averages

	1984 July	1985 Mar.	1985 July	1985 Aug.(c)
Canada				
ERI	88.2	88.5	87.3	86.2
Interest rate	12.9	11.3	9.3	9.1
France				
ERI	65.7	63.2	66.3	67.5
Interest rate	11.8	10.7	10.0	9.8
Germany				
ERI	124.4	119.1	123.7	126.4
Interest rate	6.1	6.4	5.3	4.8
Italy				
ERI	48.3	45.0	44.9	44.5
Interest rate	16.8	16.1	15.0	14.7
Japan				
ERI	153.8	155.4	156.9	157.2
Interest rate	6.3	6.3	6.3	6.3
United Kingdom				
ERI	78.4	73.4	83.3	81.7
Interest rate	11.5	13.7	12.1	11.5
United States				
ERI	136.4	152.4	139.7	136.9
Interest rate	11.6	9.0	7.6	7.8

(a) Exchange rate index (ERI) 1975 = 100.

(b) Interest rates quoted are 3-month market-determined interest rates.

(c) Interest rates for August 1985 include estimates.

per annum at the start of the year to an estimated 4½% in June. The twelve-month rate of increase in consumer prices has fluctuated during the first six months of the year within fairly narrow bands of some 1½%–2½% in Germany and Japan, 3½%–4% in North America, 6%–6½% in France and 8½%–9½% in Italy. In aggregate, consumer and wholesale prices in the major overseas economies are estimated to have risen at annual rates of around 3½% and 2¾% respectively in the first half of 1985, compared with average rates of 4% and 3½% during 1984.

Growth in the industrial countries, underpinned by low inflation, contributed to further and quite widespread recovery in the rest of the world during 1984. The volume of world trade increased by 9%, and this assisted many developing countries in their adjustment efforts. The non-oil developing countries in aggregate expanded the volume of their exports by 13½%; the OPEC countries, on the other hand, continued to suffer from sluggish growth in demand for their oil and a marked weakening of oil prices. (The economic prospects for developing countries are discussed on page 372.)

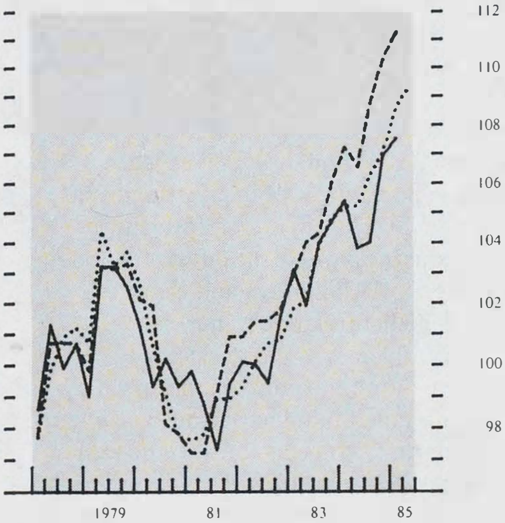
In 1985, the growth rates of domestic demand in the major industrial countries and of world trade seem quite likely to be halved. This possibility, together with the fact that inflation prospects continue to be favourable, has prompted suggestions that monetary and fiscal policies in some of the major countries other than the United States might be eased. Indeed, the effective depreciation of the US dollar since the spring and appreciation of other major currencies is likely to bring about a further reduction in inflation in many industrial countries. At present, however, it remains the view of governments in most of these countries that, outside the United States, a continuation of current monetary and fiscal policies offers the best hope for a further moderation of inflation and a broadly based and sustainable recovery in output.

During the second half of 1984 and the early part of 1985, the US dollar's effective exchange rate had continued to rise strongly, while short-term dollar interest rates moved downwards. Most other major currencies depreciated in effective terms, and in Canada, France and Italy short-term interest rates were reduced appreciably less than in the United States; in the United Kingdom they were raised sharply. In the spring, however, with US interest rates drifting down further, there appeared to be a shift in market sentiment away from the dollar; its effective exchange rate fell back on average by some 10% between March and August to a level which was much the same as a year earlier, although in early September it regained some ground. The combination of lower US interest rates and a somewhat weaker dollar eased the external pressures on most other major currencies, and domestic short-term interest rates fell in all the major countries except Japan. In the United Kingdom, the average level of short-term interest rates in August was 2% less than in March, while sterling's exchange rate index, having eased back a little since July, was 11% higher on average in August than in March and 14% higher than in February. Against other European currencies, sterling appreciated on average by 8½% between February and August. (Recent exchange and interest rate developments are discussed further on pages 377 and 365.)

Gross domestic product

- - - - Income measure
········ Output measure
——— Expenditure measure

Seasonally adjusted: at constant prices — 1980 = 100 (logarithmic scale)



Growth of GDP and industrial production

Percentage changes on previous quarter: *seasonally adjusted*

	1984				1985	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP (O):						
As recorded	0.4	—	1.0	0.7	1.5	0.6
Strike-adjusted(a)	0.9	0.8	1.0	0.7	1.3	-0.1
Industrial production:						
As recorded	0.5	-1.9	-0.1	1.1	2.0	2.2
Strike-adjusted(a)	2.0	0.1	-0.1	1.1	1.5	0.1
Manufacturing production(b)	1.1	0.6	0.9	-0.1	1.0	0.6

(a) Adjusted for official estimates of coal strike effects.
(b) The effect of the coal strike on the figures for manufacturing is estimated to be small.

In the United Kingdom, growth has continued *as the effects of the coal strike unwind . . .*

The UK economy continued to expand during the first half of 1985 and has now achieved four years of continuous growth. The underlying pace of growth, however, has been somewhat obscured so far by the recovery from the coal strike and by quite wide differences in growth rates indicated by initial estimates of the three conventional measures (the expenditure, income, and output measures) of GDP around the turn of the year.[1] Much of the growth during the first half of the year will have resulted from the gradual resumption of normal working in the coal industry and the unwinding of other effects attributable to the coal strike; it is estimated that the unwinding of the various direct effects will have been equivalent to a volume increase in GDP of $\frac{1}{4}$% in the first quarter and a further increase of around 1% in the second. Early estimates of the output measure, GDP(O), which has proved in the past to be more reliable than the other two measures as an indicator of short-term trends, point to growth at an annual rate of almost $4\frac{1}{2}$% between the second half of 1984 and the first half of 1985 but, if allowance is made for the ending of the coal strike, the underlying rate of growth may have been just over 3%.

In the second quarter, preliminary estimates of GDP(O) suggest that output of the economy as a whole rose by $\frac{3}{4}$% (compared with $1\frac{1}{2}$% in the first quarter) but that, if allowance is made for recovery from the coal strike, there was no underlying growth between the two quarters. Output of the production industries increased by 2% (an amount equivalent to $\frac{3}{4}$% of GDP), reflecting the post-strike recovery in net output of coal and electricity; manufacturing output also rose but this was offset by a fall in oil and gas production as a result of extensive North Sea maintenance work. The level of output in the construction and service industries taken together appears to have been unchanged between the first and second quarters. Earlier data had suggested that manufacturing production had shown little or no growth since the third quarter of 1984, in marked contrast to the buoyant picture of activity and prospects presented by the Confederation of British Industry's successive surveys of manufacturing industry. According to the latest official statistics, however, manufacturing output has been rising since last autumn; in the second quarter, it appears to have increased by just over $\frac{1}{4}$% to a level $2\frac{1}{4}$% higher than a year earlier; part of this increase will reflect the restoration of normal levels of value added in steel and aluminium production, which had been reduced by higher input costs during the coal strike. Industrial production is very provisionally estimated to have fallen by about 1% in July as an abrupt fall in manufacturing output was only partly offset by some recovery in oil and gas production.

The diversity of experience within manufacturing industry continues to be marked, with output of the electrical engineering, metals, motor vehicles and chemicals sectors rising strongly in recent quarters, while output of food, drink and tobacco and of metal goods has been depressed. The years of recession, retrenchment and partial recovery of output appear to have

(1) The *Bulletin* went to press before revised quarterly national income data, consequent upon the publication of the 1985 Blue Book, were available.

Order books and capacity in manufacturing: responses to CBI surveys
Changes in percentage of responses(a): April surveys

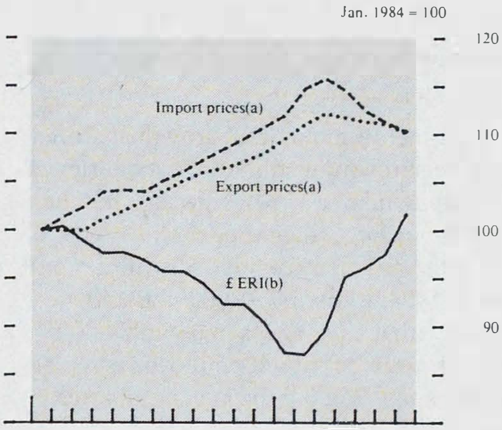
	Orders(b)			Excess capacity(c)		
	1979–1981	1981–1985	1979–1985	1979–1981	1981–1985	1979–1985
Food, drink and tobacco	−69	+59	−10	+37	−18	+19
Chemicals, man-made fibres	−77	+78	+ 1	+45	−42	+ 3
Metal manufacturing	−37	+37	—	+21	−20	+ 1
Engineering etc	−56	+71	+15	+18	−24	− 6
of which:						
Motor vehicles	−68	+76	+ 8	+19	−36	−17
Mechanical engineering	−58	+63	+ 5	+24	−27	− 3
Electrical engineering	−51	+69	+18	+10	−35	−25
Textiles	−85	+90	+ 5	+34	−44	−10
Other	−68	+65	− 3	+28	−34	− 6
Total	**−63**	**+68**	**+ 5**	**+27**	**−26**	**+ 1**

(a) Changes are expressed as the percentage response in the second period *less* the percentage response in the first period.
(b) Percentage of responses describing order books as above normal *less* percentage describing order books as below normal.
(c) Percentage of respondents answering 'yes' to the question, 'Is your present level of output below capacity?'

changed, in varying degree in different industries, manufacturers' perceptions of what constitutes a normal level of activity. Responses to the CBI's industrial trends surveys indicate that manufacturers overall consider order books and capacity utilisation, which had fallen sharply during the recession, to be as close to normal levels now as they were at the peak in 1979. With official statistics suggesting that manufacturing output in the second quarter of this year was still $8\frac{1}{2}$% less than in the second quarter of 1979, it seems likely that, in a number of industries, firms (individually and collectively) have modified their views about the amount of available capacity and the volume of orders and degree of capacity utilisation that is attainable, in the light of the restructuring that has taken place since 1979. Thus in the motor vehicle and textile and clothing industries, where output is still about 20% less than the levels seen in 1979, orders and capacity utilisation are both seen as higher (relative to normal or satisfactory levels) than in 1979, just as in the electrical engineering industry (where output, in contrast, has risen by 25%). In the food, drink and tobacco industry, however, even though output in recent quarters has been at much the same level as in 1979, order books and capacity utilisation are both perceived as at less satisfactory levels than in 1979.

Information so far available on the main components of demand suggests that output growth in the second quarter was sustained principally by a revival of consumer spending, together with a switch from substantial destocking to modest stockbuilding and a further improvement on net trade; fixed investment, on the other hand, fell back sharply after the exceptionally rapid surge in the first quarter. The volume of consumer spending, which had been virtually stagnant since the spring of 1984, is provisionally estimated to have risen by $1\frac{3}{4}$% (equivalent to 1% of GDP) in the second quarter of this year. The volume of fixed investment by manufacturing, construction, distribution and financial industries, which had risen by 15% (equivalent to about 1% of GDP) in the first quarter as companies brought capital expenditures forward before capital allowances and the corporation tax rate were reduced on 1 April, fell back by almost the same amount in the second quarter. The exceptional rise and fall was almost entirely the result of purchases of capital equipment financed by leasing companies; direct capital expenditure by industry outside the financial and business services sector increased by 1% in the first quarter and by a further $1\frac{1}{2}$% in the second quarter. Manufacturers' and distributors' stocks rose slightly in the second quarter, following substantial destocking in the first; an increase in manufacturers' stocks of finished goods and work in progress was only partly offset by further destocking in the energy and water supply industries and the wholesale and retail trades. While domestic demand in total appears to have grown fairly modestly despite the unwinding of much of the depressive effects of the coal strike, domestic output benefited in addition from a further volume improvement in the United Kingdom's net trade in goods and services. Data on the volume of trade in the second quarter show that non-oil exports of goods (including items which are normally erratic) rose while non-oil imports were virtually unchanged; oil imports fell back sharply in reaction to the ending of the coal strike and there was some further rise in the volume of net exports of services.

The **terms of trade** *in manufacturing improve as sterling appreciates, with* **import prices** *falling faster than* **export prices**



(a) Unit value indices.
(b) Sterling exchange rate index, monthly averages.

Changes in import volumes by commodity[a]

Percentage changes; *seasonally adjusted*

	1984			1985	
	Q2	Q3	Q4	Q1	Q2
Non-manufactured goods	– 0.7	–2.3	7.1	–3.6	– 2.2
Fuels	34.4	3.5	15.7	1.0	–18.3
Manufactured goods	2.1	4.2	1.3	0.7	0.7
of which:					
Consumer	*0.8*	*4.4*	*– 0.7*	*–1.9*	*3.9*
Intermediate	*1.5*	*4.6*	*2.3*	*–1.0*	*1.0*
Capital	*7.9*	*1.1*	*– 1.7*	*9.1*	*– 2.6*
Total visible imports	**5.0**	**2.8**	**3.3**	**–0.2**	**– 1.8**

(a) OTS basis, excluding normally erratic items.

Competitiveness of UK manufacturing industry

Percentage changes

	1984			1985	
	Q2	Q3	Q4	Q1	Q2(a)
Effective price competitiveness in export markets(b)(c)	–0.4	–0.3	0.4	–0.1	–0.2
Effective price competitiveness in the United Kingdom(b)(c)	–1.1	–1.1	–1.2	–2.0	–0.5
Relative unit labour costs in local currencies(b)	—	2.1	0.9	0.7	–0.2
Relative unit labour costs in a common currency(b)	–2.4	–0.3	–2.9	–3.7	9.0
Profit margins on UK exports	1.1	0.1	–0.1	0.5	3.1
Relative profitability of UK exports(d)	0.7	4.9	0.9	1.0	–1.2
Sterling exchange rate index	–2.3	–2.3	–3.7	–4.0	9.4

(a) Estimates.
(b) Improvement shown as negative.
(c) Changes in weighted averages of current and past levels of competitiveness. The weights are obtained from Bank estimates of the effects of changes in competitiveness on trade flows in manufactured goods. The time taken for the full effects to be felt differs for exports and imports: the mean lags are around six quarters and two quarters respectively.
(d) Relative to profitability of domestic sales.

. . . *and the* **trade deficit fell sharply**

Expressed in current prices, the visible trade deficit fell by more than £1 billion in the second quarter, to £222 million, the lowest quarterly figure for more than a year. A reduction of the non-oil deficit and a rise in the oil surplus contributed more or less equally to this fall, which reflected not only the further improvement, noted above, in the United Kingdom's net trade position in volume terms, but also a sharp improvement in the terms of trade (the ratio of export to import prices) as sterling's appreciation brought about a reduction in the price of imports in sterling terms. This terms of trade effect was of much greater significance than the volume improvement in reducing the non-oil trade deficit in the second quarter. Non-oil import prices in sterling terms had increased rapidly during 1984 and at the beginning of 1985 as the exchange rate fell: between the first quarters of 1984 and 1985 they had risen by 12%, matching the effective depreciation of sterling. With export prices growing rather less rapidly than this, the terms of trade deteriorated by about 2% over the period. Between the first and second quarters, however, as sterling strengthened, import prices fell by $1\frac{1}{2}$% whereas export prices in the second quarter were on average $\frac{1}{2}$% higher than in the first, and the terms of trade returned to where they had been in the first quarter of 1984.

The improvement in the non-oil trade position in volume terms was slight in comparison: the volume of imports showed little change and the volume of exports increased by less than 1% between the first and second quarters. This growth in exports was more than accounted for by erratic items; if these are excluded, non-oil exports fell in volume by over 1%, with falls in most categories of manufactured and non-manufactured goods. Erratic items had little influence on the volume of imports; lower imports of basic materials offset a further modest rise in imports of manufactures (which had been buoyed in the first quarter by a surge in imports of capital goods, perhaps to meet the abnormal level of investment expenditure). The sluggishness on both sides of the non-oil trade account in the second quarter is consistent with a picture of subdued growth in demand in the United Kingdom (excluding the effects of recovery from the coal strike) and in our overseas markets, and of little change in the effective price competitiveness of UK industry (determined to a large extent in earlier quarters, when current deliveries were being ordered) both at home and abroad.

In the growth of the oil surplus in the second quarter, volume movements were of much greater significance than the improvement in the terms of trade. Net exports of crude oil were lower in both volume and value: production was reduced while extensive North Sea maintenance work was undertaken, and the sterling price of oil was depressed by weak world oil prices and by the rising exchange rate. Trade in fuel products, however, which had shown a quarterly deficit of some £1 billion in recent quarters, moved into surplus in the second quarter as the coal strike ended, thus bringing about a £500 million rise in the overall surplus on oil account, despite the reduced surplus on trade in crude oil.

In July, the visible trade deficit fell further: the oil surplus was lower but, on the non-oil trade account, exports rose and imports fell in volume while the terms of trade continued to improve.

The non-oil trade position on average (and excluding erratic items) during the three months to July, however, was rather less encouraging: the volume of imports was 1% less than in the previous three months but the volume of exports was down by 2½%.

Employment and unemployment *appear to have been rising more slowly . . .*

Whereas the underlying momentum of output growth achieved last year appears to have been maintained in the first quarter of 1985, very preliminary employment estimates suggest that the growth of the employed labour force (including the self-employed), slowed in the early part of this year : after rapid growth towards the end of 1984, it rose by 31,000 in the first quarter of 1985 compared with an average increase of 84,000 a quarter last year. While the number of self-employed is assumed to have grown by about 30,000 (the average quarterly increase recorded between 1981 and 1984) the number of employees in employment remained broadly constant. The number of employees in the service industries rose by 46,000 in the first quarter (compared with an average quarterly increase of 60,000 in 1984) but there was an almost offsetting fall in employment in the production and construction industries, two thirds of which was in manufacturing. The increase in the number of employees last year was principally attributable to part-time working by women; if very approximate adjustment is made for the shorter hours they work, the full-time equivalent number of employees may have increased by only about 45,000 during 1984, only a third as much as the headcount total, and in the first quarter of 1985 it may even have fallen. The rate of increase in the seasonally adjusted level of unemployment (excluding school leavers) appears to have eased in recent months. So far this year there has been an average rise of about 9,500 per month compared with over 12,000 per month during 1984. This may in part reflect the increasing impact of special employment and training measures. The number of job vacancies, however, has also increased during the year and is now at around its highest since early 1980.

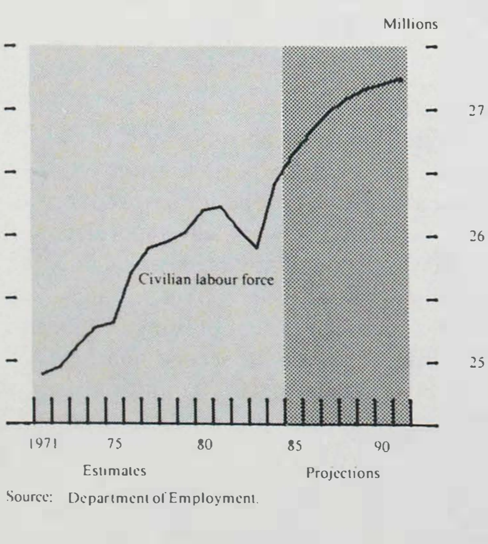
Changes in employment in Great Britain

Thousands: *seasonally adjusted*

	Employees in employment: Total	*of which:* Female part-time workers	Full-time equivalent(a)
Level at March 1983	20.547	3.864	18.615
Cumulative change since March 1983:			
1983 June	+ 13	+ 71	− 22
September	+ 58	+ 146	− 15
December	+ 126	+ 202	+ 25
1984 March	+ 135	+ 239	+ 16
June	+ 126	+ 276	− 12
September	+ 161	+ 319	+ 2
December	+ 261	+ 384	+ 69
1985 March	+ 265	+ 416	+ 57

(a) Assumes two part-time jobs to be equivalent to one full-time: adjustment has been made to female employment only (data for males are not available). The 1984 New Earnings Survey suggests average weekly hours worked by full-time employees is 40.3 and by part-timers is 19.6.

The **civilian labour force** *is projected to continue rising strongly during the next few years*



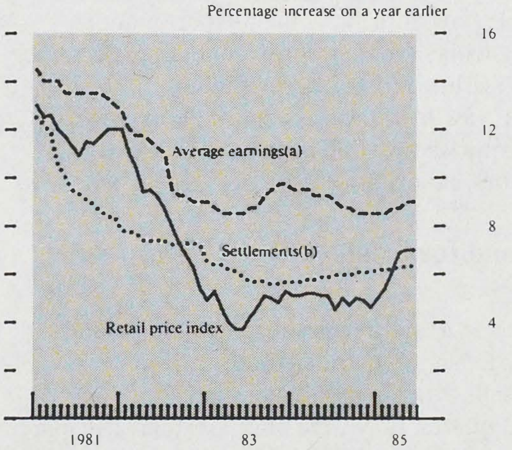
Source: Department of Employment.

The civilian labour force[1] in Great Britain is estimated to have numbered about 26½ million people in mid-1984, an increase of just over half a million since mid-1983. The male labour force rose by 130,000, with strong population growth but a small decline in activity rates (the proportions of the population in different age groups in work or actively seeking work). In contrast, there was an unprecedentedly sharp rise in female activity rates, as large numbers of (mainly married) women were attracted into the labour market; this contributed four fifths of the 380,000 increase in the female labour force over the same period, whereas population growth accounted for only one fifth. Changes in the size of the labour force during the second half of the 1970s and early 1980s were dominated by two opposing tendencies: rapid growth in the population of working age, and falling activity rates for men. Latest projections by the Department of Employment suggest that the latter effect has come to an end, with male activity rates

(1) All people over 16 with jobs, other than those in HM forces, together with those who were seeking work in a particular reference week.

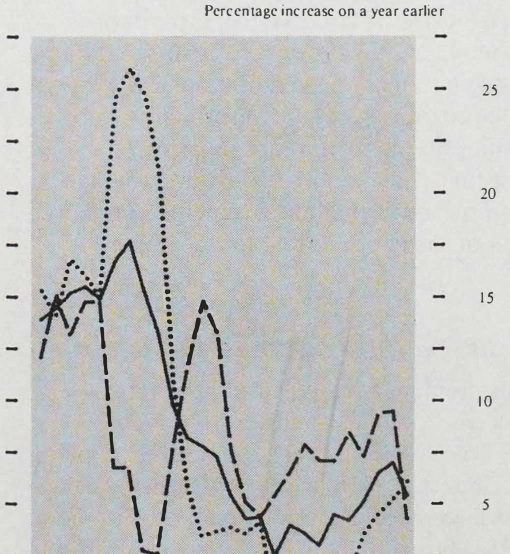
expected to remain broadly flat over the next five years; female activity rates are expected to continue rising (although at a slower rate than between 1983 and 1984). This, together with further growth of the population of working age, is expected to lead to a rise in the labour force of 150,000 per annum on average over the next five years. If the labour market were not to adjust to this fully, the impact of further employment growth and of special employment measures on the level of unemployment would be blunted.

Wage settlements and earnings growth *in manufacturing have edged upwards*



(a) Average earnings in manufacturing adjusted for arrears of pay, timing of settlements and industrial disputes.
(b) Average of rates of pay settlements recorded by the CBI during the latest twelve months.

Manufacturers' total costs *increase more slowly as slower growth of material and fuel costs outweighs the faster rise in unit labour costs*



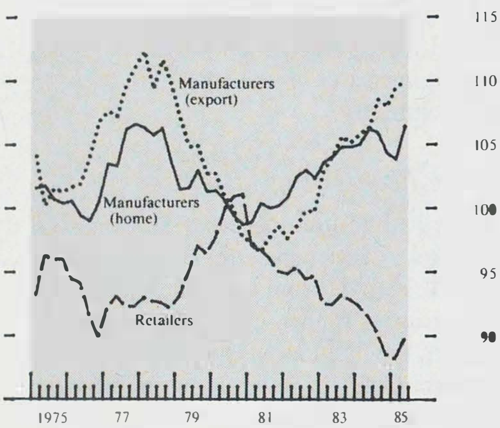
Unit labour costs *have been rising faster . . .*

The rate of productivity growth (output per head) in the economy as a whole appears to have picked up in the first quarter of 1985, as output started to recover from the coal strike and with slower employment growth. It now seems, according to latest estimates of output in the first half of the 1985, that productivity growth in manufacturing industry has remained close to 3% at an annual rate since the latter part of 1984, although this still represents a sharp slowdown from the exceptional (9¼%) increase recorded between the first quarters of 1982 and 1983. Wage settlements, however, have edged upwards. According to the latest estimates by the CBI, the average percentage increase reached in manufacturing settlements over the twelve months to July is around 6.4% compared with 6.0% at the same point a year earlier. With additional contributions from overtime working and bonus payments, average earnings (adjusted for delayed settlements and back pay) rose by 9% in manufacturing in the year to June, whereas between October 1984 and February this year the twelve-month rate of increase had remained steady at 8½%. As productivity growth has apparently remained much more sluggish than in 1983, underlying unit wage costs in manufacturing have been rising increasingly rapidly, from ½% in the year to the fourth quarter of 1983 to 1½% in mid-1984 and almost 6% by mid-1985—a much faster rise than in most other major industrial countries.

Labour costs per unit of output in the economy as a whole are estimated to have risen much less than in manufacturing industry and to have shown less acceleration. Average earnings (adjusted for delayed settlements and for back pay) have continued to grow at an annual rate of 7½% since July 1984 and, with somewhat faster productivity growth at the beginning of this year, unit labour costs are estimated to have risen by 3¼% between the first quarters of 1984 and 1985—almost twice the rate of increase recorded a year earlier.

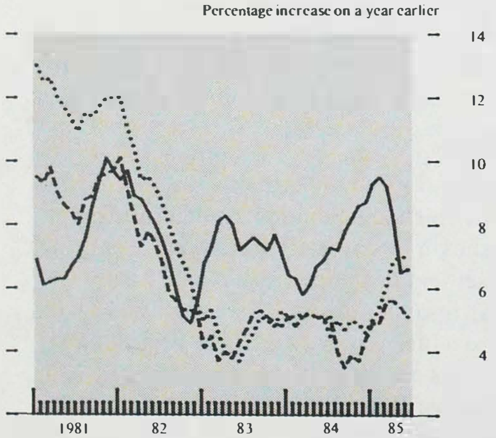
For most of the period between 1981 and 1984, despite some periods of rapid increase in materials and fuel costs, the rise in manufacturers' total unit costs had been restrained by the subdued growth of unit labour costs. This was in contrast to the pattern of 1979–81, when rapid increases in total costs were mainly the result of unit labour cost increases while the rise in material and fuel costs remained modest as sterling appreciated. During the course of 1984, however, and in the first few months of this year, manufacturers were faced with both a rapid rise in material and fuel costs as sterling depreciated and a sharp acceleration in the growth of unit labour costs. In the first quarter of 1985, raw material and fuel prices were on average 9½% higher and unit labour costs were 5¼% higher than

Manufacturers' and retailers' profit margins *have widened recently*



(a) Ratio of selling prices to unit costs. Indicates the direction, but not necessarily the scale, of changes in profit margins.

There has been a more pronounced slowing in **retailers' costs** *than in their* **selling prices** *than in recent months*



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

a year earlier; in the first quarter of 1984 the comparable figures had been 7% and 2½%. In consequence, the rise in manufacturers' total costs per unit of output is estimated to have increased from perhaps 4½% per annum to some 7%. As a result, the ratio of manufacturers' home market prices (which continued to rise at around 6% per annum) to their costs fell quite rapidly between the beginning of 1984 and the first quarter of 1985. In accepting this squeeze on profit margins, UK manufacturers improved their competitive position in the home market at a time when import prices of manufactured goods were rising by more than 12% per annum, roughly twice as fast as domestic output prices. Manufacturers showed a greater willingness to raise their export prices to cover costs: the ratio of manufactured export prices to costs continued to rise during 1984 and in the first quarter of 1985. While thus improving their export margins they were still able to achieve some improvement in export price competitiveness—in sterling terms, prices of UK manufactured exports rose by rather less than 11% in the year to the first quarter, compared with an average increase of 17% in overseas competitors' export prices.

. . . *but* **material and fuel costs** *have fallen in recent months*

Since February, however, as sterling has regained the ground it had lost over the previous year, manufacturers' raw material and fuel prices have fallen for six months in succession; on average in the second quarter they were only 3½% higher than a year earlier and by August they were fractionally lower than in August 1984. Despite the further acceleration in unit labour costs, therefore, total costs per unit of output in manufacturing rose by perhaps 5% between the second quarters of 1984 and 1985—much more slowly than at the beginning of the year. Although there was also some slowing in the rate of incease of manufacturers' domestic output prices, from an annual rate of around 6% at the beginning of the year to about 5½% in the second quarter, the ratio of home market prices to costs is estimated to have rebounded quite sharply.

The recent fall in import prices is also likely to have improved retailers' profit margins. The ratio of prices to costs in retailing is estimated to have fallen more or less continuously between the end of 1980 and the beginning of 1985. Profitability of large retailing companies (in terms of return on capital employed) does not seem to have declined, however, perhaps because of increases in turnover and improvements in retailing technology which cannot easily be allowed for in simple estimates of costs.

. . . *and* **inflation** *has recently begun to fall again*

In the past few months, retailers' margins will have reflected not only lower import prices but also a faster rise in retail selling prices. Much of the rise in the twelve-month increase in the official (all-items) index of retail prices (RPI) since the end of 1984, from 4.6% in December to around 7% in each of the four months to July, was brought about by changes in mortgage interest rates. Nevertheless, there was also a noticeable acceleration in other components of the index which together rose by 5¾% in the year to July compared with 4% in the year to December. As a result of sterling's appreciation, lower import prices of retail goods and possibly some further slowing of the rise in UK manufacturers' domestic output prices, there should recently have been a significant reduction in the pressures on retailers' costs, although this may not be reflected immediately or fully in their selling prices. The CBI monthly trends survey for August suggests that inflationary pressures may have moderated sharply. The balance of manufacturing firms expecting to raise their output prices over the following four months has fallen abruptly to almost the lowest point since the monthly survey started in 1979. The twelve-month increase in the RPI fell back in August, as a consequence of the large rises in mortgage rates a year earlier, to 6¼%. The lower prices of imports since the spring, however, together with the reductions in mortgage rates which took place at the beginning of September, point to a substantial fall in the twelve-month increase in the all-items index during the rest of 1985 and into 1986.

Domestic cost inflation across the economy as a whole, as measured by the GDP deflator, had also started to accelerate by the early part of this year, from a rise of 4½% over the year to the fourth quarter of 1984 to 5¼% in the year to the first quarter of 1985. Until last year, low increases in unit labour costs (reflecting the strong improvement in productivity and, for much of the time, slowing earnings growth) allowed profits per unit of output to revive considerably during the upswing since 1981 while keeping cost inflation down. During the course of the past fifteen years, unit labour costs have always risen more slowly than the GDP deflator when output was in a recovery phase, and faster than the deflator during recession. The converse has been true of profits, except during the period 1971–73 when rents and other income (including income from self-employment) grew particularly fast and, for part of the time, price controls were in operation. The share of employment income in GDP shows a correspondingly cyclical pattern. It also exhibits a downward trend since the mid-1970s but this is due to the rapidly rising share of North Sea profits in GDP: the North Sea sector is both very capital intensive and highly profitable, so that most of the value added accrues in the first instance to (pre-tax) profits rather than to labour. If this sector is excluded, the share of employment income in GDP, and its relative contribution to domestic costs, has so far been no less during the present cycle than in the previous one.

Changes in income components of GDP

Average percentage changes(a); at annual rates

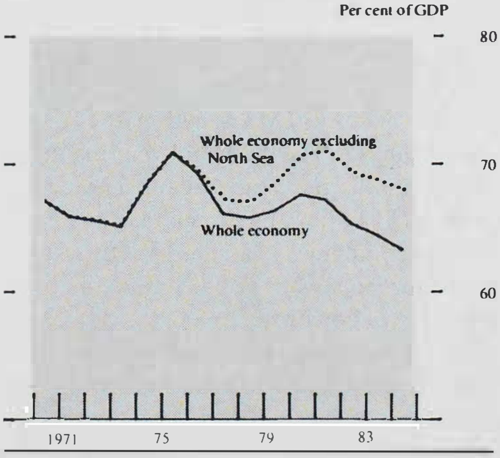
	1970–73	1973–75	1975–79	1979–80	1980–84
Income from employment(b)	9.7	26.2	11.4	20.9	4.0
Profits(b)	7.6	12.7	21.0	6.4	14.2
Other income(b)(c)	15.5	19.2	11.3	21.4	4.9
GDP deflator	10.4	23.0	12.7	18.7	5.8
GDP (I) at constant prices	3.4	– 0.9	2.8	– 5.3	3.0

(a) Between fourth quarters of years shown

(b) Per unit of GDP.

(c) Rent, self-employment income, imputed capital consumption.

Income from employment—share of GDP



Broad money *grew rather less rapidly in the second quarter*

With output growth reflecting the ending of the coal strike and with the inflation rate rising, nominal GDP is likely to have grown quite rapidly in the second quarter. At the same time the rate of growth of the money stock broadly defined, £M3, slowed quite sharply from 4½% in the first quarter to 2½% in the second. Taking the first two quarters of the year together, however, the downward trend in £M3 velocity that has been evident since 1980 appears to have continued.[1] The broader aggregate, PSL2, rose almost 4% faster than £M3 during the course of 1984 but subsequently this disparity was reduced as the banks gained share in the retail savings market. The building societies managed nevertheless to maintain and even

(1) The behaviour of £M3 velocity during recent years was discussed in the June *Bulletin*, pages 166–7.

to increase their rate of mortgage lending in the second quarter, despite losing retail deposits to the banks, by increasing their use of wholesale funds and running down their liquidity.

Growth of bank deposits and lending

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

	1983	1984			1985	
		Year	Q3	Q4	Q1	Q2
Domestic deposits						
Personal sector	0.8	0.8	0.3	1.4	1.3	1.7
Companies	1.2	0.2	1.8	1.2	1.8	0.2
Other financial institutions	0.7	1.5	0.4	2.2	0.4	2.5
Public sector	—	0.2	0.1	0.6	0.1	-0.1
Total deposits	**2.7**	**2.7**	**2.6**	**5.4**	**3.6**	**4.3**
	2.2	*2.5*	*3.2*	*3.0*	*4.2*	*2.6*
Domestic lending						
Personal sector	2.1	1.6	1.6	1.8	2.5	2.2
Companies(a)	0.4	2.0	1.3	3.4	3.9	2.3
Other financial institutions	1.1	1.7	1.8	1.9	3.8	1.4
Public sector	-0.5	0.2	1.6	0.5	-3.7	-0.8
Total lending	**3.1**	**5.5**	**6.3**	**7.6**	**6.5**	**5.1**
	2.7	*4.3*	*5.1*	*5.5*	*3.3*	*3.7*
Overseas sector: deposits net of lending						
Sterling	0.3	-0.1	0.3	-0.7	1.1	0.1
Foreign currency	-0.3	0.7	0.4	-0.5	-0.3	-1.7

(a) Including Issue Department transactions in commercial bills.

The growth of £M3 in the second quarter stemmed almost entirely from an increase in interest-bearing sight deposits, reflecting in part the continued attractiveness of the banks' new high interest accounts. After the end of the quarter, with two ½% base rate cuts in July, their attractiveness is likely to have diminished a little, in absolute terms and relative to competing building society accounts as well as to other interest-bearing bank accounts. The high level of such sight accounts at end-June may also have reflected a preference on the part of unsuccessful subscribers to the sale of shares in Abbey Life Group p.l.c. to retain their deposits in liquid form while reconsidering the disposition of their portfolios. The rise in interest-bearing sight deposits held by the personal sector seems to have been especially pronounced and was only partly offset by a rundown in their holdings of time deposits. Sterling deposits held by other (non-bank) financial institutions (OFIs) rose strongly, for the third successive quarter, in total by 7½%; their holdings of time deposits increased particularly sharply, on this occasion the building societies being major depositors. The slowdown in £M3 growth thus largely reflected the behaviour of the company sector, which reduced its sterling deposits (but added substantially to its foreign currency deposits) during the second quarter.

Counterparts to changes in money stock

	1983	1984			1985	
	Year	Year	Q3	Q4	Q1	Q2
	£ billions, quarterly averages seasonally adjusted					
PSBR	2.9	2.6	2.8	2.1	2.3	1.7
of which, CGBR (own account)	*2.3*	*1.7*	*2.2*	*0.4*	*1.5*	*1.3*
Public sector debt sales to UK non-bank private sector	-2.7	-2.8	-2.9	-2.9	-4.5	-1.4
Sterling lending to private sector	3.2	4.1	3.6	5.2	7.0	4.5
External and foreign currency counterparts(a)	-0.6	-0.9	-0.5	-0.6	0.8	-0.9
Net non-deposit liabilities in sterling(a)	-0.5	-0.5	—	-1.2	-1.2	-1.3
£M3	**2.4**	**2.5**	**3.0**	**2.6**	**4.4**	**2.6**
PSL2	4.6	6.2	5.9	6.2	8.9	2.6
	Percentage changes(b)					
£M3	10.4	9.7	11.7	9.8	16.8	9.2
PSL2	12.3	14.6	13.7	14.0	19.7	5.3

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

. . . and bank lending *to the private sector slowed but was still buoyant*

The main counterpart to the decline in £M3 growth in the second quarter was a slowing in the growth of bank lending in sterling to the private sector. In the first quarter, bank lending had been inflated (by perhaps £1 billion) by the surge in borrowing by finance leasing companies (classified as OFIs) to finance investment expenditure in advance of the reduction in capital allowances at end-March; borrowing to finance capital expenditure is likely to have been abnormally depressed in the second quarter, thus helping to hold down the end-June total. The surge in capital issues by industrial and commercial companies since the turn of the year may also have helped to cover their immediate financing needs. New lending in sterling to industrial and commercial companies was almost £2 billion less than in the first quarter and lending to OFIs was down by £½ billion. Sterling lending nevertheless remained fairly high when compared with much of 1984 and lending to the personal sector was almost as buoyant as in the previous quarter, with lending for house purchase and to unincorporated business growing strongly. With public sector asset sales of as much as £1.3 billion during the second quarter, the PSBR fell further, to £1.7 billion—about half as much as at its peak in the second quarter of 1984. Although official gilt sales were markedly less than the exceptional level achieved in the first quarter, the PSBR was more than fully funded by central government debt sales. A large part (some £1.3 billion) of the gilts sold, however, was taken up by the overseas sector. (Monetary developments in recent months are discussed in greater detail on pages 361–4.)

The overseas sector also invested heavily in the UK private sector. However, a large part of this investment was in UK bank securities, including perpetual floating-rate notes, and may represent a movement by the banks away from deposit liabilities as a source of funds for their international operations. Total investment and capital transactions with the overseas sector showed a small inflow following the large net outflow in the first quarter. This change largely reflected a drop in outward portfolio investment by the non-bank private sector which, although still high in relation to other recent quarters, was little more than half that of the first quarter. As the current account moved by almost £2 billion (before adjustment for seasonal factors) from deficit to surplus between the first and second quarters, while net official financing transactions switched by £$\frac{3}{4}$ billion from inflow to outflow, there would appear to have been a £3$\frac{1}{2}$ billion change in unidentified transactions from inflow to outflow.

Company profits and borrowing *were still rising strongly at the beginning of the year . . .*

Profits of industrial and commercial companies (ICCs) rose to £15$\frac{3}{4}$ billion in the first quarter of 1985,[1] some 20% higher than the quarterly average for 1984. If North Sea activities are excluded, recorded profits showed an even faster rate of growth. Income from abroad rose only a little, despite the further fall in the exchange rate during the first two months of the year, but higher interest rates contributed to a £200 million increase in non-trading income. Total income of all ICCs is thus estimated to have been £1$\frac{3}{4}$ billion higher than in the fourth quarter and £4 billion higher than in the first quarter of 1984.

Appropriations out of income also increased, with interest payments rising particularly sharply as a result of higher gross debt and increased interest rates. Dividend payments, although much lower than in the fourth quarter, were still substantial; in the year to the first quarter of 1985 a total of £5.9 billion was paid out in dividends on ordinary shares, some 28% more than the average of the previous four quarters. Tax payments increased, but less than in proportion to the rise in profits. The changing structure of corporate tax rates and allowances has yet to have an impact on payments, as opposed to accruals, of company taxes; later this financial year, the combination of increased profits, reduced investment allowances and the withdrawal of stock relief is likely to result in higher tax payments, even though the rate of corporation tax has been reduced. Despite the increase in appropriations, undistributed income (net of stock appreciation) rose by £1.6 billion (about 27%) in the first quarter. Although the volume of fixed investment increased sharply in the first quarter, this was largely financed by leasing companies; capital spending (including stockbuilding) by ICCs themselves in the first quarter was much the same as in the previous quarter—some 12% higher than in the first quarter of 1984.

With capital spending virtually unchanged while undistributed income continued to rise, there was a large increase in the recorded financial surplus of ICCs, which rose to £4 billion.

Industrial and commercial companies' income, spending and financial transactions

£ billions at a quarterly rate, seasonally adjusted; *figures in italics at 1980 prices*
Inflow of funds +, outflow −

	1982	1983	1984			1985
	Year	Year	H1	Q3	Q4	Q1
Gross trading profits(a)	8.7	10.5	12.2	13.6	14.1	15.7
of which:						
Non North Sea	5.6	6.6	7.8	8.9	8.6	10.1
Total income(b)	**11.0**	**13.1**	**15.0**	**16.8**	**17.3**	**19.2**
	9.3	*10.5*	*11.6*	*12.8*	*13.1*	*14.1*
Allocation of income						
Dividends, interest, profits due abroad	−4.1	−4.4	−4.8	−5.2	−6.0	−6.0
UK taxes	−2.6	−3.1	−3.6	−3.9	−3.9	−4.2
Undistributed income	4.2	5.6	6.6	7.6	7.4	9.0
	3.6	*4.5*	*5.1*	*5.8*	*5.5*	*6.6*
Spending on fixed assets and stocks	−3.3	−3.8	−4.2	−4.3	−5.2	−4.9
Financial balance	**1.0**	**1.7**	**2.5**	**3.3**	**2.2**	**4.0**
	0.8	*1.4*	*1.9*	*2.5*	*1.7*	*3.0*
Balancing item	−0.9	−0.3	−2.0	−2.7	−3.8	. .
Financial transactions	**−0.1**	**−1.4**	**−0.5**	**−0.6**	**1.6**	. .
of which:						
UK company securities	−0.4	−0.3	−1.1	−0.5	−1.3	−1.2
Investment abroad	−0.7	−0.8	−1.4	−0.5	−0.8	−2.0
Liquid assets	−0.7	−1.5	−0.5	−1.3	−1.5	−2.3
Other financial assets	−0.3	−0.4	0.2	−0.8	0.1	
Trade credit, etc(c)	−0.4	−0.1	0.5	0.2	−1.5	0.3
Bank borrowing(d)	1.6	0.4	1.7	1.2	3.4	4.5
Equity issues	0.3	0.5	0.3	0.3	0.2	0.9
Other borrowing etc	0.6	0.8	0.5	0.9	2.8	1.6

. . not available.

(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.

(1) The recorded growth in profits in the first quarter was due in part to the inclusion of an estimate of the profits earned by the newly privatised British Telecom (perhaps some £300 million) for the first time; other parts of the company sector accounts will also be affected by the privatisation.

Even so, ICCs as a whole sought considerable amounts of external funds. Equity issues of almost £1 billion, bank borrowing of £4½ billion and other borrowing of £1¾ billion, together with their estimated financial surplus of £4 billion, provided ICCs with a possible addition to their funds of £11 billion in the first quarter. Financial transactions identified so far, however, account for only £5.2 billion of this so that the discrepancy (the 'balancing item') between preliminary estimates of the financial surplus of the ICCs and their identified financial transactions would seem to be of the order of £5 billion—equivalent to a quarter of total company income. Although this balancing item is shown by convention as if it were used to acquire (unidentified) financial assets, the errors and omissions which it represents may reflect income, expenditure and appropriations as much as underrecording of financial transactions.

A number of factors may have contributed to the apparently high level of bank borrowing in the first quarter,[1] although none seems to amount to a sufficient explanation on its own. Some borrowing may have been brought forward in anticipation of the tax changes after the end of the 1984/85 financial year, especially by companies with taxable profits, but (as noted above) most of the surge in expenditure on capital equipment was financed by leasing. Recorded investment in UK acquisitions remained at a high level—almost as much in the first quarter as in the whole of 1983. Investment overseas was also substantial— £2 billion compared with a quarterly average of £1 billion in 1984—although a considerable part of this is thought to be accounted for by ICI's acquisition of Beatrice Chemicals. There was also a considerable increase in the acquisition of liquid assets by ICCs in the first quarter, but this does not appear to have resulted from arbitrage activity.[2]

. . . *and* **companies** *sought* **external finance** *again on a substantial scale in the second quarter*

External finance appears to have been obtained by companies on a substantial scale again in the second quarter. The continued strengthening of the stock market no doubt encouraged the increase in equity issues, some of which may earlier have been held back while the market adjusted to the large British Telecom issue in the latter part of 1984. Bank borrowing in sterling and foreign currencies was £1¼ billion less in the second quarter than in the first but was still higher than the quarterly average in any previous year. At the same time, companies virtually ceased adding to their bank deposits, so that they remained net takers of funds from the banking system on as large a scale as in the previous two quarters.

The growth in bank borrowing and capital issues by ICCs over the past year has been widely, although not altogether uniformly, spread across industrial sectors. Within manufacturing, although greater variation is apparent, borrowing also appears to have been widely spread despite marked differences in levels of activity. The Department of Trade and Industry's quarterly

Output and external financing of industrial and commercial companies: industrial analysis

February 1984 to May 1985

	Bank borrowing		Net capital issues		Output
	£ billions	As per cent of stock	£ billions	As per cent of stock of bank borrowing	Percentage change in volume
Manufacturing	3.8	16.3	1.7	7.4	1.7
of which:					
Minerals and metal manufacturing	—	− 1.5	0.1	4.8	− 0.8
Chemicals etc	0.5	28.5	0.3	14.2	3.4
Metal goods, mechanical engineering and vehicles	0.2	3.5	0.2	3.3	0.1
Electrical/ electronic engineering	0.7	28.9	0.4	16.2	12.1
Food, drink and tobacco	1.0	27.0	0.3	6.6	− 1.0
Other	1.4	22.8	0.5	7.8	− 1.2
Construction	0.6	14.3	0.1	1.3	4.3(a)
Distribution, hotels, etc	3.1	17.5	0.5	2.6	3.8(a)
Property companies(b)	1.2	24.9	0.4	8.4	
Services, agriculture, forestry and fishing(b)	5.3	37.8	0.5	3.4	
Total	**14.0**	**21.9**	**3.1**	**4.8**	2.7(a)(c)

(a) Change over the period 1984 Q1 to 1985 Q1.

(b) Output data not available for these categories.

(c) Excluding property companies and services etc.

(1) Bank borrowing was equivalent to 29% of ICCs' profits in the first quarter. This is much higher than in any other recent quarter and compares with an average of almost 25% in 1980, a year of considerable financial pressure. In 1974, however, the proportion was as high as 53%.

(2) Companies with good credit ratings may at times find it profitable to borrow money from one source and redeposit it elsewhere, inflating both borrowing and deposits figures. The principle of arbitrage was discussed, and claims that it may have taken place were examined, in the June *Bulletin*, page 189.

Personal sector income, expenditure and financial transactions
£ billions

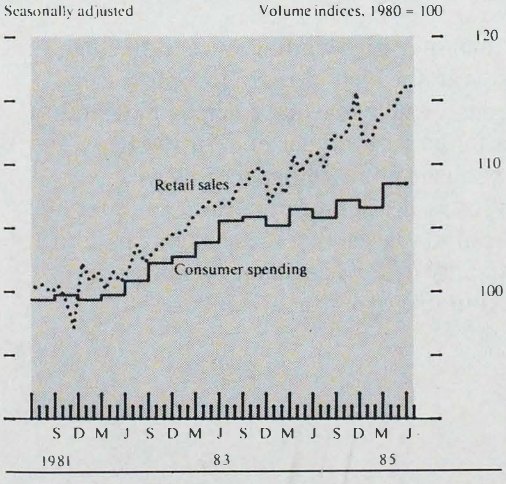
	1983	1984 Year	1984 Q4(a)	1985 Q1(a)	1985 Q2(a)(b)
Personal disposable income	204.8	219.9	229.1	229.2	..
Less consumers' expenditure	182.4	194.6	199.6	202.9	209.2
Saving	24.6	22.4	25.3	29.5	26.3
Less capital expenditure	14.0	14.9	15.2	17.4	..
Financial surplus	**8.4**	**10.4**	**14.3**	**8.9**	..
Acquisition of financial assets					
Building society shares and deposits	10.3	13.2	13.8	11.9	13.5
Bank deposits	3.2	3.3	5.4	5.3	6.9
National savings	2.9	3.3	3.3	2.1	3.1
Life assurance and pension funds	15.2	17.0	17.3	16.6	..
Other	0.3	− 0.6	− 1.3	15.5	..
Total	32.1	36.2	38.5	51.4	..
Borrowing					
For house purchase	14.4	16.5	16.6	16.0	17.2
of which:					
From banks	3.6	2.3	3.2	2.9	2.9
From building societies	10.9	14.2	13.6	13.3	14.3
Bank borrowing for consumption	2.6	2.6	3.7	2.1	2.3
Other bank borrowing	2.3	1.6	0.1	3.6	3.1
Other borrowing	1.0	0.8	1.8	1.9	..
Total	20.3	21.5	22.2	23.6	..
Net acquisition of financial assets	**11.8**	**14.7**	**16.3**	**27.8**	..
Balancing item	3.4	4.3	2.0	18.9	..

.. not available.

(a) Seasonally adjusted at an annual rate.

(b) Partly estimated.

Total **consumer spending** *has generally been less buoyant than the* **retail sales** *index.*



survey of the liquidity of large companies showed a further fall in the liquidity ratio of manufacturing companies in the second quarter (as their current liabilities rose faster than their current assets) to its lowest level for almost three years; but this was outweighed by a very large rise in the liquidity of oil companies and a modest rise in the liquidity of other non-manufacturing companies.

Consumer spending *has picked up . . .*

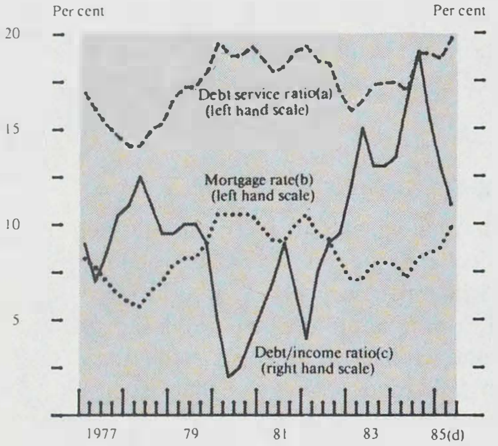
The erratic pattern of dividend payments by ICCs around the turn of the year was reflected in the receipts of unearned income by the personal sector, which rose by nearly £1 billion (equivalent to almost 1½% of total pre-tax income) in the fourth quarter of 1984 and fell back by as much in the first quarter of this year. The fall broadly offset a further rise in income from employment, and total personal disposable income in the first quarter remained at the same level as in the previous six months. Taking the two quarters together, however, real personal disposable income was some 2% higher than in the previous two quarters. Although consumer spending in the first quarter fell in volume, it increased by about 1½% in value terms, and the personal sector's saving ratio fell back a little; taking together the fourth quarter of 1984 and the first quarter of 1985, however, the saving ratio, at 12¼%, was on average 1¼% higher than in the middle two quarters of 1984.

In the second quarter the volume of consumer spending rose quite sharply but, as it had been virtually unchanged during the previous three quarters, it was still only 1¾% higher than a year earlier, in marked contrast to retail sales which were 4½% higher than in the second quarter of 1984. Only two fifths of consumers' expenditure represents retail purchases and some of these items (notably sales by food retailers) have consistently shown more buoyant growth in the retail sales data than those measured in the consumers' expenditure statistics. The retail sales survey measures sales by type of retailer rather than product, and gives considerable weight to the larger (and faster growing) stores which sell other goods, including non-food items, in addition to their primary lines. If the growth of retail food sales were the same as the growth in the food component of consumers' expenditure, the retail sales index would show much the same sluggish rate of growth (until the second quarter) as the retail element of the consumers' expenditure series. Some commentators have suggested that expenditure on retail goods and services in the United Kingdom by foreign tourists, which is included in the retail sales figures but not in the consumers' expenditure data, has contributed to the divergence between the two series, but this does not seem to have been a significant factor.

. . . as has housebuilding *activity, although* investment in new dwellings *has been falling*

Personal sector capital expenditure (at current prices) rose quite strongly in the first quarter of 1985, largely as a result of a recovery in investment in existing dwellings; in 1984, expenditure on improvements had apparently been brought forward from the second half of the year to the first in anticipation of the ending of the zero-rating of VAT on building work and the reduction in local authority grants. Housebuilding

First-time borrowers have taken smaller **mortgages** *relative to income as their* **debt service** *burden has risen*



(a) Annual interest and capital repayment (net of tax relief) on average mortgage advance to first-time borrowers, as a percentage of their gross income.
(b) Representative base annuity mortgage rate net of tax relief.
(c) Average mortgage advance to first-time borrowers, as a proportion of their gross income.
(d) 1985 Q2 is partly estimated.

House prices[a]

Percentage changes from a year earlier

		Department of the Environment index(b)		Halifax Building Society index(c)		Nationwide Building Society index(c)	
		New	All	New	All	New	All
1984	Q1	10.9	9.5	7.4	7.3	12.8	13.0
	Q2	5.7	10.2	6.4	6.6	13.3	14.4
	Q3	10.4	9.4	7.0	6.8	9.3	11.4
	Q4	6.8	9.6	6.7	8.4	10.6	14.3
1985	Q1	8.8	8.6	6.9	9.0	13.3	14.1
	Q2	7.8	8.8	6.5	8.9	10.6	11.0

(a) Mix-adjusted prices of new and all dwellings in the United Kingdom.
(b) Based on the mortgage completion stage.
(c) Based on the mortgage approval stage.

activity, which had been affected by exceptionally adverse weather, recovered in the second quarter. Both starts and completions rose strongly, possibly reflecting renewed vigour after a protracted period in which the industry has suffered from marketing problems with smaller starter homes and timber-framed houses. A new programme aimed at the second-time buyer has been undertaken, but builders still seem to be experiencing difficulty in selling the smaller starter homes which they have already completed. Investment in new dwellings, which is measured when they are sold, has now fallen for three consecutive quarters; this may also indicate a greater reluctance among first-time buyers to undertake increased mortgage debt servicing commitments at a time when interest rates were high and rising.

Whereas the household sector as a whole has been willing to accumulate debt relative to income, in spite of record levels of income gearing (net of mortgage interest relief), first-time buyers have on average reduced the size of mortgage advance they have taken up in relation to their income. This may be attributable to rises in the mortgage rate since the middle of last year: the average proportion of income required to service newly acquired debt has now risen above the levels reached in early 1980, when mortgage rates rose rapidly to 15%. On that occasion, too, mortgage borrowers experienced difficulty servicing their debt and a similar fall in the average ratio of advances to income among first-time buyers resulted (although from a lower base). The availability of mortgage finance has eased since 1980, allowing first-time buyers to take up larger advances in relation to their income should they wish. Societies have recently responded to the fall in demand from first-time buyers by lowering their rates to this group.

. . . *and* **prices of new houses** *have recently been rising more slowly*

Despite a recovery in total mortgage lending since its decline from the middle of last year, the high levels of income gearing in the household sector as a whole may have helped to restrain the rise in house prices in the second quarter of this year. Although the various published house price indices are constituted in different ways and show rather different rates of increase, recent data seem to suggest that the changing pattern of demand and the difficulty in servicing large advances have been particularly unfavourable to new house prices.