Economic commentary

- *Growth in the major overseas economies is recovering after faltering in the first half of this year.*
- *With many commodity prices falling, and labour costs continuing to rise only slowly, inflation in the major overseas economies remains on a downward trend.*
- *The dollar's exchange rate has fallen further since agreement was reached among the authorities of five major industrial economies that it should better reflect fundamental economic conditions.*
- *At home there are some signs that the economy has been expanding more slowly. Consumption has continued to grow, but investment, after a temporary surge in the first quarter, was little changed in the third, and the real trade balance deteriorated.*
- *The growth of UK labour costs has accelerated, but import prices have fallen, and retail prices have risen more slowly. Company profitability improved in the first half of the year.*
- *Liquidity in the economy continues to grow more rapidly than nominal GDP.*

GNP growth in the major economies

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

	1983	1984			1985
		Year	H1	H2	H1(a)
Canada	3.3	5.0	4.1	4.9	4.0
France	0.7	1.6	1.9	1.7	−0.1
Germany	1.6	2.7	2.4	3.4	−0.2
Italy(b)	−0.4	2.6	2.8	2.2	1.9
Japan	3.4	5.7	6.1	5.6	4.8
United Kingdom(b)	3.2	2.6	2.1	2.9	4.1
United States	3.7	6.9	8.4	3.6	1.6
Total	**2.8**	**4.9**	**5.6**	**3.7**	**2.1**

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

Components of GNP(a) growth in the major economies

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

	United States, Canada and Japan			Europe(b)		
	1983	1984	1985 H1	1983	1984	1985 H1
Private consumption	4.4	4.6	4.4	1.3	1.1	2.2
Private fixed investment	5.4	13.3	5.9	0.5	2.5	−1.6
Public expenditure	0.2	2.7	0.3	1.9	1.3	−1.2
Stockbuilding(c)	0.4	1.4	−0.8	—	0.4	−0.2
Domestic demand	**4.1**	**7.1**	**3.1**	**1.2**	**2.0**	**0.5**
Net trade(c)	−0.5	−0.6	−0.5	0.2	0.4	0.6
GNP(a)	**3.6**	**6.4**	**2.6**	**1.4**	**2.4**	**1.1**

(a) Or GDP.
(b) France, Germany, Italy and the United Kingdom.
(c) Contribution to change in GNP (or GDP).

World recovery *suffers a temporary setback . . .*

The recovery in the world economy faltered in the first half of the year. Output in the United States grew more slowly, at an annual rate of only around 1½%, compared with 3½% in the second half of 1984, and activity in some European countries, most notably Germany and France, was very subdued in the first quarter. Only in Japan and Canada, among the major overseas countries, did growth hold up steadily in the first half of 1985.

Not all of the factors contributing to this slowdown have persisted. The European countries experienced exceptionally severe weather early in the year, which depressed construction activity in particular. Output has already recovered significantly and, with European inflation and interest rates generally falling, this improvement is expected to continue. In the United States, domestic demand, although slowing from the exceptional rates of increase earlier in the recovery, still grew at an annual rate of nearly 3% in the first half of 1985; worsening net trade, however, continued to depress output growth, reflecting the uncompetitive position of the US economy associated with the earlier strength of the dollar. This factor, however, should become less of a constraint on US growth as time goes on, now that the dollar has depreciated by some 19% in effective terms from its peak in late February. In addition, the easing in US monetary policy earlier in the year, itself associated with sluggish GNP outturns, should help to boost domestic demand. Most recently, US GNP is estimated to have risen at an annual rate of 4½% in the third quarter of the year, reflecting strong growth in personal consumption, as the savings ratio fell to a very low level by historical standards. Overall, output growth in the main industrial countries is expected to pick up to 3½% or more per annum in the second half of this year, and then to grow by

World economic prospects—latest Bank forecasts

Output in the seven major industrial countries is forecast to grow by close to 3% in 1985 and in each of the next two years. World trade may grow by just over 4% in 1985, rising to perhaps 4½% in 1986 and slowing somewhat thereafter. With monetary and fiscal policies generally remaining cautious, inflation in the major industrial countries in aggregate is forecast to fall further, from 4% in 1984 to around 3¼% in 1986, aided by subdued unit labour costs and weak world commodity prices.

Demand and output in the seven major economies[a]

Percentage changes

			Forecasts		
	1983	1984	1985	1986	1987
Domestic demand	**3.0**	**5.2**	**3.1**	**3.2**	**3.0**
of which:					
Private consumption	3.2	3.3	3.4	2.9	2.8
Private investment	3.4	9.1	5.0	5.8	5.2
Public expenditure	0.8	2.2	2.3	1.7	1.5
Stockbuilding(b)	0.2	1.0	-0.3	—	0.1
Net trade(b)	-0.2	-0.2	-0.1	-0.4	—
GNP(c)	**2.7**	**4.9**	**2.9**	**2.8**	**3.0**

(a) Canada, France, Germany, Italy, Japan, United Kingdom and United States.
(b) Percentage contribution to GNP or GDP.
(c) Or GDP.

The forecast suggests that the US economy is unlikely to grow much more rapidly than around 2½% per annum in 1985 or 1986; personal consumption is likely to be constrained by smaller rises in real disposable incomes and by some recovery in the savings ratio from its current exceptionally low level, while business investment has already slowed from the extremely rapid growth of 20% in 1984. However, the depreciation of the dollar since late February, together with lower interest rates and further improvements in profitability, should lead to faster growth in the US economy by early 1987, with output rising by perhaps 3½% in that year.

Elsewhere, activity is likely to benefit from further falls in interest rates and inflation; in particular, growth in the major continental European economies may rise from just under 2% in 1985 to 2¾% in 1986. Consumer spending is likely to pick up in both Germany and France, if falling import prices and domestic inflation rates boost real earnings and facilitate further interest rate reductions. German business investment is also likely to recover substantially from its setback early in the year, reflecting continuing improvements in unit profitability. This factor is also important in Japan, where a steady expansion of business investment and faster growth in consumption may contribute to continuing Japanese GDP growth of 4%–5% per annum between 1985 and 1987.

Although the world economic recovery is forecast to continue, unemployment levels are expected to remain high in most countries; a fall from current levels seems more likely in Germany than in the other major overseas economies. In such circumstances earnings are unlikely to accelerate; and although productivity growth has slowed with the cycle, unit labour costs in manufacturing are not expected to grow more rapidly than 2% per annum between 1985 and 1987 in the major overseas countries in aggregate. Weak oil and commodity prices are expected to sustain downward pressure on inflation rates, and consumer prices are forecast to rise by little more than 3¼%–3½% per annum on average in 1986–87, with further falls in inflation rates in Europe and Japan only partly offset by a small rise in inflation in the United States.

World trade growth is forecast to be considerably slower than in 1984, so that the external environment for the smaller industrial and developing countries is likely to be less favourable. Unless new initiatives bear rapid fruit, capital inflows to developing countries may continue to be subdued, and primary product prices are not expected to recover substantially. However, the external adjustment already undertaken by many developing countries should allow them to increase their import volumes at an overall rate of around 6% per annum over the next two years.

The smaller industrial countries may experience trade growth of only 3%–4% per annum, however, while the OPEC countries are likely to be adversely affected by weak oil demand and falling real oil prices; in consequence, OPEC may have to continue to cut back import volumes, perhaps by around 15% between 1984 and 1987. Given the importance of OPEC and the smaller industrial countries to UK trade, it seems likely that the United Kingdom's overseas markets will continue to grow more slowly than world trade in general. The gap between the two, however, may fall somewhat, especially in view of the slowdown in the United States in 1985–86 and the further recovery in growth in the larger European countries, which are more important to the United Kingdom as trading partners than is the United States.

World trade and UK markets

Percentage changes

				Forecasts		
	1982	1983	1984	1985	1986	1987
World trade	1.1	1.9	8.9	4.1	4.6	3.8
UK markets	-0.2	-0.8	6.8	2.7	3.4	3.1

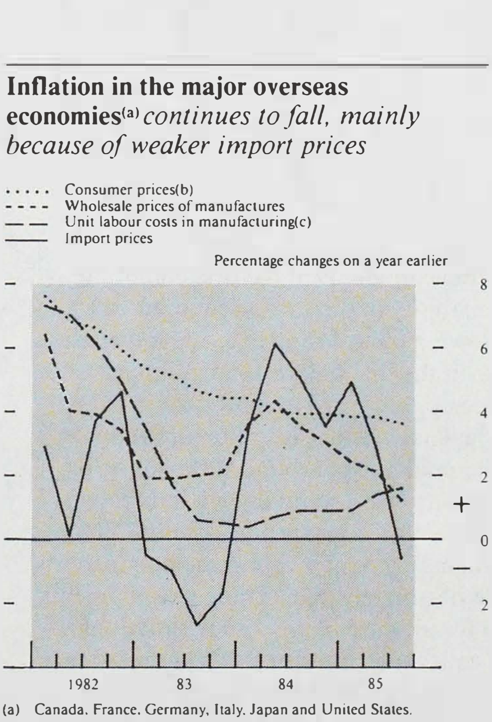
close to 3% per annum in 1986 and 1987. (The Bank's latest assessment of world economic prospects is summarised on page 506.)

. . . *while* **inflation** *continues to fall*

The anti-inflationary monetary and fiscal policies of industrial countries as a whole have continued to record successes. These policies have been reinforced by continued weakness in world commodity markets. With almost all foodstuffs in plentiful supply, food prices have been falling since late 1983, both in nominal terms and in real terms (ie relative to world manufactured export prices). The real price of industrial materials (as measured by the UN index) was some 12% lower in the third quarter of this year than a year earlier. Although oil prices were surprisingly firm earlier this year in nominal (dollar) terms, the depreciation of the dollar meant that, for example, average prices charged by OPEC fell in real terms by around 8% between the third quarters of 1984 and 1985.

These favourable influences on inflation rates have been reinforced, in Europe and Japan, by stronger exchange rates in more recent months, and import prices in local currencies have fallen in several countries; between the first and third quarters of the year, such prices fell some 6%–7% in France and Japan and by 2% in Germany. In the United States, exchange rate factors will have tended to have the opposite effect, but even there import prices have put no upward pressure on domestic inflation as yet, perhaps in part because exporters to the United States have accepted narrower profit margins.

Inflation in the major overseas economies[a] *continues to fall, mainly because of weaker import prices*



(a) Canada, France, Germany, Italy, Japan and United States.
(b) Consumer expenditure deflator.
(c) Adjusted for the state of the economic cycle.

A further element in the success of anti-inflation policies has been the very slow growth generally in unit labour costs in manufacturing. Adjusted for the state of the economic cycle, these costs rose by only around $\frac{3}{4}$% in the main overseas countries in aggregate last year, and are estimated to have increased at an annual rate of only $1\frac{3}{4}$% in the first half of this year. Earnings growth has remained fairly moderate, partly as a consequence of slack labour markets in Europe. However, even in the United States, where the unemployment rate has fallen from $10\frac{1}{2}$% in early 1983 to 7% at present, there has been little tendency for manufacturing earnings to rise more rapidly than 3%–4% per annum. These various influences have combined to produce some very low rates of increase for manufacturing wholesale prices recently; in the first half of this year, such prices were rising at year-on-year rates of only 2%–$2\frac{1}{2}$% in the major overseas countries in aggregate and this rate may have slowed to only $1\frac{1}{4}$% in the year to the third quarter. This pattern is also beginning to be reflected in consumer prices, which are now rising at an average rate of around $3\frac{1}{2}$%, compared with $3\frac{3}{4}$% in the first half of the year, and over 4% last year.

World trade growth *slows . . .*

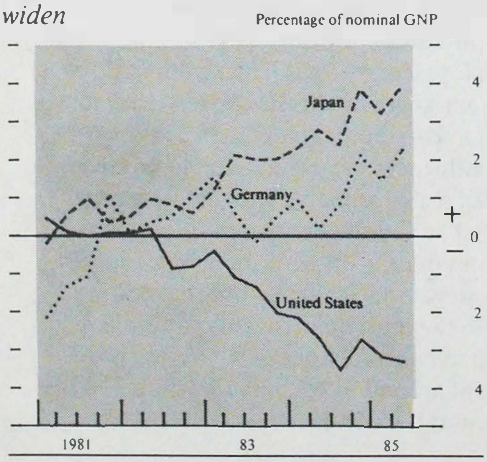
The temporary slowdown in demand in the major countries in the first half of the year will have adversely affected the rest of the world. World trade rose at an annual rate of just over 4% over this period, following the exceptional growth of 9% last year. With demand for oil weak and the real oil price falling in the second and third quarters of the year, the OPEC countries were particularly affected; their import volumes fell by a further

World trade and UK markets
Percentage changes at annual rates; at constant prices; *seasonally adjusted*

	1983	1984	1985 H1
Import volumes(a)			
Major seven(b)	4.8	12.9	6.3
of which:			
North America	11.0	23.0	11.6
Japan	0.7	11.0	-1.8
Europe	2.4	7.0	4.7
Other OECD	0.3	7.7	3.1
Oil exporting countries	-8.2	-10.1	-9.1
Other developing countries	-0.3	7.9	4.6
Total	**2.0**	**9.0**	**4.2**
UK markets	**-0.8**	**6.8**	**2.8**

(a) Imports of goods only.
(b) Canada, France, Germany, Italy, Japan, United Kingdom and United States.

Current account imbalances *continue to widen*



9% (at an annual rate) in the first half of 1985, following a decline at a similar rate between 1982 and 1984. The trade of the smaller industrial countries also appears to have slowed, rising at an annual rate of only 3% in the first half of the year, compared with nearly 8% last year. Because these two groups are particularly important markets for UK exports, UK markets, as conventionally measured, once again grew more slowly than world trade, increasing at an annual rate of only $2\frac{3}{4}$% in the first half of 1985.

. . . *posing* problems for the developing world

The performance of the non-oil developing countries so far this year has been mixed. The weakness of most primary product prices in real terms continues to have adverse implications for the terms of trade of many of them. Although their export volumes fell back around the turn of the year, there appears to have been a significant recovery in the second quarter. Indeed, even though import volumes expanded at an annual rate of $4\frac{1}{2}$% in the first half of the year, the group as a whole is still estimated to have remained in small surplus on trade account. The external adjustment which has already taken place has lowered the level of these countries' imports relative to their exports. This should give them scope to continue to increase their import volumes from a fairly low base despite a less buoyant outlook for non-oil exports, even if commodity prices remain depressed and, as seems likely, capital inflows into most developing countries remain subdued. It should be emphasised, however, that even though activity in the non-oil developing country bloc as a whole should continue to rise, prospects for a small number of larger, more heavily indebted, countries are subject to considerable uncertainty.

Imbalances in the world economy *bring some reassessment of policies . . .*

One risk, highlighted by developments in the first half of the year, relates to the sustainability of the world economic recovery. Evidence of growing internal and external imbalances continued to accumulate in the first half of 1985: although a number of plans have been put forward to limit the US federal budget deficit, it has so far shown little sign of falling and is currently running at an annual rate of around $200 billion or about 5% of GDP; the US current account deficit and the Japanese and German current account surpluses have increased further; and unemployment levels in most industrial countries have remained obstinately high. These developments have led, particularly in the absence of any rise in inflationary expectations, to further calls for significant shifts in the balance of monetary and fiscal policies between the larger industrial countries.

These questions were addressed at the meeting of Finance Ministers and central bank Governors of five major industrial countries (the G5) in New York in September. This meeting was marked by a recognition on the part of the participants that the dollar had been overvalued in the past in relation to fundamental economic conditions; it was therefore agreed that action to encourage a continuation of the dollar's previous gradual decline, if necessary by intervention in the foreign exchange markets, would be desirable. Furthermore, the

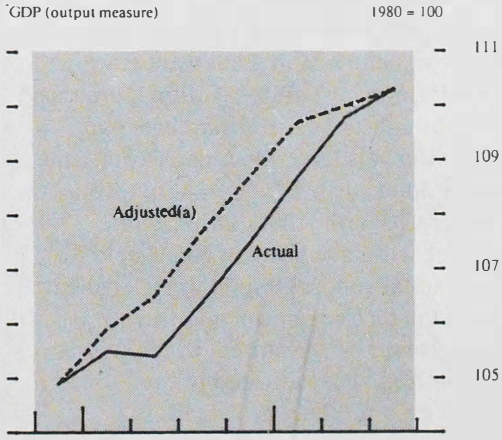
Effective exchange rates[a] and short-term interest rates[b]

Monthly averages

	1984	1985			
	July	Mar.	Sept.	Oct.(c)	Nov.(c)
Canada					
ERI	88.2	88.5	85.8	84.0	82.9
Interest rate	12.9	11.3	9.1	8.7	8.8
France					
ERI	65.7	63.2	67.2	67.9	68.8
Interest rate	11.8	10.7	9.6	9.3	9.1
Germany					
ERI	124.4	119.1	125.7	127.9	128.1
Interest rate	6.1	6.4	4.7	4.8	4.9
Italy					
ERI	48.3	45.0	44.2	44.6	44.7
Interest rate	16.8	16.1	14.4	14.3	14.6
Japan					
ERI	153.8	155.4	159.1	170.3	177.8
Interest rate	6.3	6.3	6.3	6.5	7.3
United Kingdom					
ERI	78.4	73.4	81.3	80.3	80.0
Interest rate	11.5	13.6	11.5	11.5	11.6
United States					
ERI	136.4	152.4	138.4	130.8	128.6
Interest rate	11.6	9.0	7.9	7.9	7.8

(a) Exchange rate index (ERI) 1975 = 100.
(b) Interest rates quoted are three-month market-determined interest rates.
(c) Interest rates for October and November include estimates.

Underlying growth in the UK economy *appears to have slowed*



(a) Adjusted for the direct effects of the miners' dispute.

participants acknowledged that current internal and external imbalances should be reduced by effective fiscal measures in the United States, by policies to stimulate domestic demand in Japan, and by continued efforts to reduce structural rigidities in the European economies. Such actions should be taken within the broad anti-inflationary framework of current macroeconomic policies, since the factor most likely to inhibit a continuation of the recovery was agreed to be any re-emergence of inflationary pressures.

. . . *and* the dollar *continues to fall*

Even before the G5 meeting the dollar had fallen back from its spring peak, reflecting the easing of US monetary policy in the first half of the year. Against a background in which certain sectors of the US economy were being increasingly harmed by the high dollar, lower than expected inflation together with subdued growth provided some scope for this action. It was followed by further falls in interest rates in several European countries; these did not signify any shift in the overall stance of their monetary policy. By August, however, the dollar had steadied and it was only after the G5 meeting that its fall was resumed, influenced in part by actual or expected central bank intervention on the foreign exchanges and, more recently, by a tightening of monetary policy in Japan. All in all, the dollar had, by 10 December, depreciated by some 19% in effective terms from its February peak, while the Japanese yen and sterling had appreciated by some 13% and the deutschemark and French franc by over 10%. The downward trend in the dollar's exchange rate against the yen will help to make some inroads into the imbalances in the US and Japanese external accounts in the longer term.

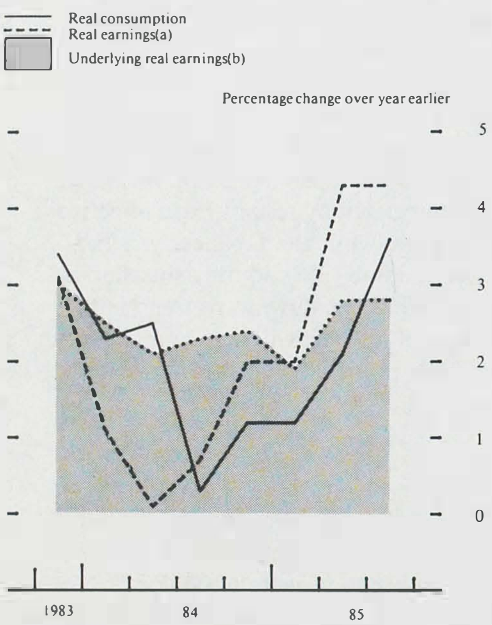
Growth at home *slows*

Now that the rebound from the mining dispute is virtually complete, there are some signs that the underlying growth in the economy has slowed. The output measure of GDP is provisionally estimated to have risen by about ½% in the third quarter of this year; of this, about ¼% was attributable to the continuing recovery in coal production and the other direct effects of the ending of the dispute. Excluding the direct effects of the dispute, GDP (O) had been rising at an annual rate of nearly 4% in the last quarter of last year and the first quarter of 1985. Since then the rate is provisionally estimated to have been about 1% per annum. This may have been raised by some indirect effects of the ending of the dispute, but on the other hand a number of unrelated factors appear to have depressed supply or demand temporarily in the middle part of the year.

The output of the energy industries has been subject to these disparate influences. With the ending of the dispute, coal production doubled in the second quarter and rose further in the third, while net output of the electricity industry also increased as more coal was burned in power stations in place of (more expensive) oil. Oil and natural gas production, however, had fallen meanwhile as an unusual amount of maintenance work was done on North Sea production rigs in the summer months. Altogether, energy production rose 5½% in the second quarter but hardly at all in the third. Manufacturing output was almost unaffected in any direct way by the miners' dispute, and grew steadily to the second quarter of this year. The preliminary official estimate is that manufacturing output fell slightly in the third quarter, although the results of surveys by the Confederation of British Industry are more compatible with continued growth, and official estimates of manufacturing output have a tendency to be revised upward. As has been found in all surveys in recent years, it is lack of demand which manufacturers quote as the most important factor constraining output, although shortages of skilled labour and of plant are said to be more significant than a year ago.

Outside the energy and manufacturing sectors information is more sparse. Although output of the service sectors grew more slowly in the first half of 1985 than in the second half of 1984, it picked up in the third quarter, particularly in the distribution sector.

Real consumption *has followed the path of real earnings*



(a) Average earnings in the whole economy deflated by the consumers' expenditure deflator.
(b) See footnote (1) on page 512.

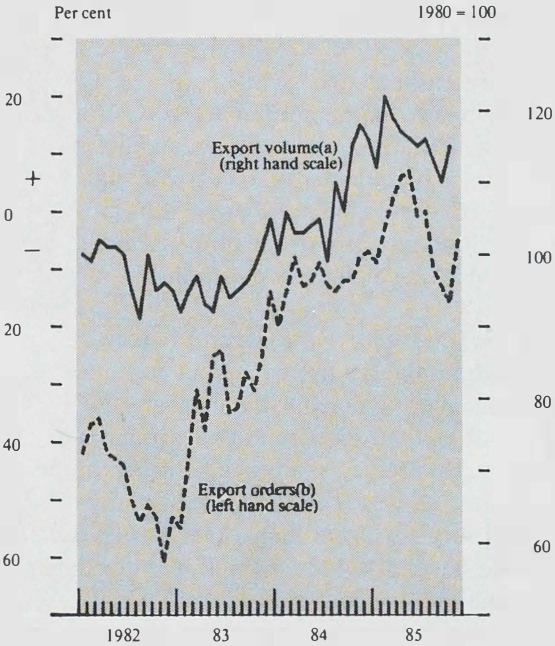
A major factor underpinning the economy in the course of this year has been the continued growth of personal consumption. The preliminary estimate is that it grew by ½% in real terms in the third quarter (and by over 3% from the third quarter of 1984). Retail sales grew by 1¼% in volume terms in the third quarter, but as explained in the September *Bulletin*, recorded retail sales may exaggerate the growth of the relevant items of consumers' expenditure. Very recently the volume of retail sales has faltered, falling by ¾% in the three months to November compared with the previous three months. This may, however, reflect no more than unusual weather patterns.

The strength of consumers' expenditure reflects that of real personal disposable income (up by 3¾% between the second quarters of 1984 and 1985, and probably as much between the third quarters). Incomes were depressed last year, primarily by the miners' dispute but also by delays in some public sector pay settlements. More recently, with the sharp rise in miners' earnings, and the payment of delayed pay increases, incomes have been growing above their underlying trend.

Industrial investment changed little in the third quarter. It had surged in the first quarter as firms brought forward expenditures into the 1984/85 fiscal year, before capital allowances were reduced as part of the reform of corporate taxation announced in the 1984 Budget. The amount of expenditure brought forward into the first quarter was larger than had at one time been expected. Although domestic production of investment goods temporarily accelerated in the first quarter, some increased capital spending will have been on goods held in stock and on imported capital goods. Despite the fall back in industrial investment in the second quarter and little movement in the third, growth in investment in the year as a whole may be around the 7% to 8% indicated in the Industry Act forecast, with further growth likely next year.

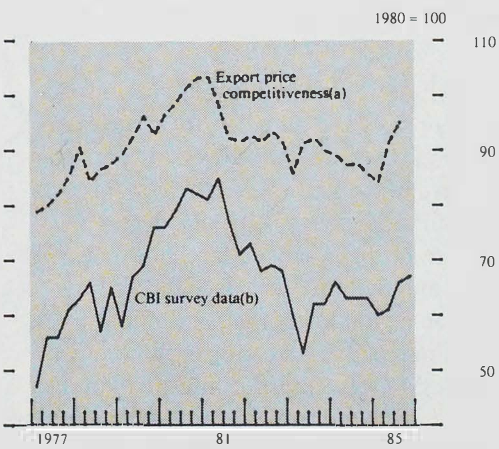
After some small destocking by private industry in 1984, the rundown was maintained in the first quarter of this year (with particularly heavy destocking by manufacturers), but was partly reversed in the second quarter. In the third quarter wholesalers' stocks fell, although there were some rises in retailers' and manufacturers' stocks. Improved stock control methods seem to be providing the room for the continuing decline in the ratio of stocks to turnover; this has probably been encouraged by the final abolition of stock relief in the 1984 budget.

Manufactured exports *are below the peak reached earlier in the year*



(a) Excluding the more erratic items.
(b) Balance of CBI respondents reporting export orders above normal.

Manufacturing price competitiveness *has worsened*



(a) UK manufactured export prices relative to wholesale prices of manufactures abroad (in a common currency).
(b) Percentage of respondents citing prices (relative to competitors') as a factor likely to limit export orders.

Changes in employment in Great Britain

Thousands: *seasonally adjusted*

	Employees in employment: Total	Employees in employment: *of which:* Female part-time workers	Full-time equivalent(a)
Level at March 1983	20,547	3,864	18,615
Change on three months earlier:			
1983 June	+ 9	+ 67	− 25
Sept.	+ 49	+ 73	+ 13
Dec.	+ 68	+ 61	+ 38
1984 Mar.	+ 9	+ 39	− 11
June	− 9	+ 31	− 25
Sept.	+ 36	+ 40	+ 16
Dec.	+ 98	+ 74	+ 61
1985 Mar.	—	+ 33	− 17
June	− 8	+ 35	− 26

(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.

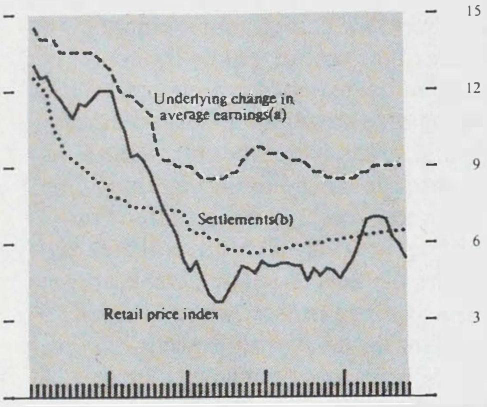
Trade volumes *weaken*

The real balance of trade in goods and services, which had been improving in late 1984 and the early part of 1985, deteriorated somewhat in the third quarter. The earlier improvement reflected in part the ending of the coal strike and the consequent improvement in oil trade; but there had also been tentative signs of unexpectedly favourable growth in the net volume of manufactured trade. A surge of exports at the end of 1984 appeared to have been consolidated and imports seemed surprisingly subdued. The more recent downward trend in export volume has been disappointing in that it has come at a time when major overseas markets for manufactures appear to have continued to expand, albeit modestly, and UK competitiveness, allowing for the delay with which it is estimated to affect trade volumes, has been largely unchanged. It may be that new seasonal patterns, not yet reflected in the official seasonal adjustments, have distorted recent figures. (Exports were also unexpectedly weak in the middle quarters of 1983 and of 1984.) But it is also possible that the sharp fall apparent in OPEC imports is having a disproportionately large impact on UK trade, which may also have been affected by temporarily weak demand in Europe. The replies to recent CBI surveys of manufacturers' opinions also point to a sharp slowing in the rate of export deliveries and to steep declines in optimism about export prospects and in export order books, although this last was partly reversed in November's monthly survey. The proportion of manufacturers quoting price competitiveness as a factor limiting export orders has risen sharply, and is now higher than at any time since January 1982. The domestic market for manufactures is likely to have grown in the course of 1985, but imports have been roughly unchanged after a sharp increase towards the end of last year. Imports of finished manufactures actually fell in the latest quarter, although the pattern through the year will have been affected first by the bunching of capital goods imports in the first quarter and then by earlier-than-usual arrivals of passenger cars ahead of the new registration year. Movements in trade prices have tended to offset changes in trade volumes recently. The volume of oil trade has improved as production has picked up after the summer, but sterling oil prices have fallen. On the other hand a marked improvement in the non-oil terms of trade has meant there has been little change in the value of the non-oil trade balance, despite adverse volume movements. Indeed with the invisibles balance holding up well the current balance remained in comfortable surplus in the third quarter and, on first estimates, in October.

Labour costs *accelerate, despite a weak labour market*

Employment growth has slowed this year. The number of self-employed is assumed to have continued to increase. Among employees, the number of part-time female employees has also increased, maintaining recent trends, but the number of male employees has declined. The number of full-time equivalent employees is estimated to have fallen. Manufacturing employment has continued to fall but at much slower rates than those witnessed earlier in the decade. Despite the slowdown in employment growth so far this year, unemployment appears to have stabilised, in contrast to the

Pay settlements and earnings in manufacturing *have edged upwards*



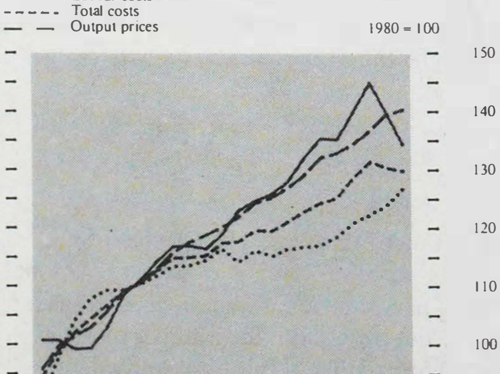
(a) Change in average earnings in manufacturing adjusted for arrears of pay, timing of settlements and industrial disputes.
(b) Average of rates of pay settlements recorded by the CBI during the last twelve months.

Output and productivity in manufacturing

Percentage changes on a year earlier

		Output	Employment	Output per person	Average earnings	Unit wage costs
1983	Q1	1.1	-5.4	6.8	8.7	1.8
	Q2	0.6	-5.1	6.0	8.5	2.4
	Q3	3.6	-4.1	8.0	9.0	0.9
	Q4	6.0	-3.0	9.3	9.7	0.4
1984	Q1	4.1	-2.2	6.4	9.5	2.9
	Q2	4.9	-1.2	6.2	8.1	1.8
	Q3	4.0	-0.9	4.9	8.8	3.7
	Q4	2.6	-0.5	3.1	8.4	5.1
1985	Q1	3.0	-0.4	3.4	9.0	5.4
	Q2	3.3	-0.6	3.9	10.0	5.9
	Q3	1.7	-0.5	2.2	9.2	6.9

Profit margins in manufacturing *have widened as material and fuel costs have fallen*



upward trend of 10–15,000 over the past two years. This improvement in trend is due in part to the increasing impact of special employment and training measures.

Wage settlements have continued to edge higher in manufacturing, averaging $6\frac{3}{4}$% in the third quarter. According to firms surveyed by the CBI, the cost of living remains the dominant factor pushing pay settlements higher, with high profits an important secondary influence. Fewer firms are reporting the risk of redundancy as a strong influence on bargaining (despite continuing high unemployment).

For the economy as a whole, 'underlying' earnings[1] grew at $7\frac{1}{2}$% per annum throughout the last pay round but edged up to $7\frac{3}{4}$% in the year to September. Coupled with faltering productivity growth, the gradual acceleration of earnings has led to increased labour cost pressures in manufacturing. In the third quarter, manufacturers' wage costs per unit of output were estimated to be nearly 7% higher than a year earlier, the highest rate of increase since early 1981. Even if manufacturing production and productivity turn out to be higher than at present estimated, it is clear that manufacturing wage costs are rising faster in the United Kingdom than in any of the other major industrial countries.

. . . *but lower* import costs *make for wider* profit margins

Total costs have risen much more slowly thanks to the impact of lower world commodity prices and a higher exchange rate. Indeed, manufacturers' total costs may have been lower in the third quarter than they were in the first. Nevertheless, the annual rate of increase of manufacturers' output prices remained fairly steady at around $5\frac{1}{2}$% since March, having been around 6% in the second half of 1984. Recent monthly increases have been at a somewhat lower rate, with the twelve-month increase falling to 5.1% in October and likely to fall further in the new year. Manufacturers' domestic margins are therefore likely to have increased rapidly since the beginning of the year. It is difficult to foresee how much further margins may grow, however. They appear to be now very much higher than at the turn of the year, higher than the peak reached at the turn of 1983/84, but still somewhat lower than the previous peak of 1978.

The annual rate of retail price inflation (5.4% in October) has been declining since July and is likely to fall further in the new year. However, the deceleration so far has been mostly accounted for by mortgage rate effects; excluding the mortgage element, the twelve-month rate peaked at $5\frac{1}{2}$% in September and fell to just over 5% in October. The signs are that it is set to fall further as reduced import costs feed through to both producers' and retail prices.

Nationalised industries' prices included in the retail price index have accelerated; the annual rate was $4\frac{1}{2}$% in the first quarter of 1985 but stood at 6% in October. This reflects in part increased

(1) The term underlying earnings is used by the Department of Employment to mean actual weekly earnings adjusted for temporary factors such as timing of settlements, back-pay and strikes. It includes overtime earnings.

water rates; a number of other nationalised industries are planning price increases above the general rate of inflation.

Company profits *and saving improve*

Divergent movements in costs and prices have been reflected in increasing company profits. In the first half of 1985, the gross profits of non North Sea companies net of stock appreciation were about 25% higher than a year previously.[1] In the second quarter, the real pre-tax rate of return reached nearly 8% compared with about 6% in 1984 and just over 3% at the depth of the recession in 1981. The wider profit margins of manufacturing companies since February may, however, simply reflect the usual delays in adjusting output prices to input costs and may therefore prove temporary. Moreover the profitability of companies facing strong international competition has reportedly come under increased pressure more recently, as adverse trends in relative labour costs have reasserted themselves.

While company income rose by a quarter between the first halves of 1984 and 1985, appropriations rose by a third, and undistributed income by about a fifth. Although fixed investment by non-financial companies surged in the first half of the year (particularly, as noted above, in the first quarter), the bulk of this was not financed by the companies themselves, but rather took the form of assets leased to them by specialist leasing companies included in the financial sector of the economy. Despite the bunching of investment, the recorded financial surplus of non-financial companies improved in the first half of the year.

Companies issue more equity *and their liquidity improves*

With the stock market buoyant, companies have issued a considerable amount of equity this year; in the first ten months, non-financial companies raised £3½ billion net, more than twice as much as in the whole of 1984. The changes in corporation tax announced in the 1984 Budget are making equity finance progressively more attractive than it used to be compared with debt. Until the 1984 Budget, with the imputed basic income tax rate at 30% and the corporation tax rate at 52%, the relative tax advantages of debt financing were considerable. From next April onwards, the corporation tax rate will be down to 35% and the relative advantage of debt finance will be correspondingly reduced.

Net borrowing by companies from the banks has fallen from the very high rates seen in the first quarter. Indeed in the third quarter, companies' deposits rose by more than their borrowing. Companies are estimated to have invested £3.3 billion overseas in the first half of the year—10% more than in the corresponding period of 1984. The recent spate of mergers is partly reflected in the estimated £2.3 billion invested by companies in UK company securities: this represents only purchases of shares from persons and financial institutions, and excludes purchases from other non-financial companies.

The DTI survey of the liquidity of large companies shows a slight recovery in the second and third quarters of 1985. Within

(1) After (approximate) adjustment for the inclusion of British Telecom following privatisation.

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 –

	1983	1984			1985	
	Year	Year	H1	H2	Q1	Q2
Gross trading profits(a)	10.2	12.5	11.7	13.3	15.0	15.0
of which:						
Non North Sea	3.9	4.8	4.5	5.1	5.6	4.8
Total income(b)	**12.8**	**15.7**	**14.7**	**16.7**	**18.6**	**18.4**
	10.2	*12.0*	*11.3*	*12.6*	*13.7*	*13.4*
Allocation of income						
Dividends, interest, profits due abroad	–4.5	–5.4	–4.9	–5.9	–6.5	–6.3
UK taxes	–3.1	–3.8	–3.4	–4.1	–4.7	–4.5
Undistributed income	5.1	6.5	6.3	6.6	7.4	7.7
	4.1	*5.0*	*4.9*	*5.0*	*5.5*	*5.6*
Spending on fixed assets and stocks	–3.9	–4.7	–4.4	–4.9	–5.1	–5.8
Financial balance	**1.3**	**1.8**	**1.9**	**1.7**	**2.3**	**1.9**
	1.0	*1.4*	*1.5*	*1.3*	*1.7*	*1.4*
Balancing item	0.5	–1.6	–1.2	–2.1	–2.1	..
Financial transactions	**–1.6**	**–0.2**	**–0.7**	**0.4**	**–0.2**	..
of which:						
UK company securities	–0.3	–1.0	–1.1	–0.9	–1.2	–1.4
Investment abroad	–0.8	–1.2	–1.5	–0.8	–2.2	–1.1
Liquid assets	–1.5	–0.6	0.5	–1.4	–2.4	–0.4
Other financial assets	–0.4	—	0.2	–0.4	–0.2	
Trade credit, etc(c)	–0.2	—	0.2	–0.3	–0.1	–0.9
Bank borrowing(d)	0.3	2.0	1.7	2.3	4.1	2.3
Equity issues	0.5	0.3	0.3	0.3	0.9	1.1
Other borrowing etc	0.8	0.3	–1.0	1.6	0.9	0.4

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.

this picture the net liquidity of large manufacturing companies continued to decline. A more widely based survey by the CBI, however, suggests that manufacturers' net liquidity improved in the twelve months to October.

In the economy at large **liquidity** *continues to expand rapidly*

Broad measures of money and of private sector liquidity have continued to expand faster than nominal GDP. Competition between the institutions whose liabilities are included in the various measures affects their relative growth rates. In the third quarter the banks' domestic sterling business expanded particulary fast and £M3 growth accelerated to an annual rate of 20% from one of 8% in the second quarter. The trend decline in £M3's velocity of circulation will therefore have quickened. PSL2, a wider aggregate that includes some building society deposits, had grown faster than £M3 in 1984–85, largely in consequence of the buoyant mortgage lending associated with a move away from mortgage rationing by the building societies. Since then the societies' business has grown more slowly. Even though their gross advances were, just, a record in the third quarter, they received unusually large repayments of principal, and their net lending was the least since early 1984. PSL2 grew much more slowly than £M3 in the third quarter.

Counterparts to changes in money stock

	1983 Year	1984 Year	1985 Q1	Q2	Q3
	£ billions, quarterly averages seasonally adjusted				
PSBR	2.9	2.5	2.2	1.4	2.9
Public sector debt sales to UK non-bank private sector	-2.7	-2.8	-4.5	-1.5	-0.8
External and foreign currency finance of the public sector	-0.4	-0.4	-1.1	-0.9	-0.4
Public sector contribution to £M3	-0.2	-0.6	-3.4	-1.0	1.6
Sterling lending to private sector	3.2	4.1	6.7	4.7	4.4
External and foreign currency finance of the monetary sector(a)	-0.2	-0.5	-1.8	-0.2	0.1
Net non-deposit liabilities in sterling(a)	-0.5	-0.5	-1.0	-1.4	-0.6
£M3	**2.4**	**2.5**	**4.2**	**2.1**	**5.6**
PSL2	4.6	6.2	9.0	1.8	7.7
	Percentage changes(b)				
£M3	10.4	9.7	15.8	7.6	20.1
PSL2	12.3	14.7	20.0	3.6	15.8

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

Competition and innovation have also affected the form taken by the growth of liquidity. Funds have been drawn into high-interest accounts with the banks. An increase in interest-bearing sight deposits accounted for the bulk of the rise in £M3 in the second quarter, and a little under half that of the following quarter. Deposits in such accounts rose by as much as £9 billion at an annual rate in the first nine months of 1985, following increases of £1¾ billion and £4½ billion in 1983 and 1984 respectively. The rest of the rise in £M3 in the third quarter came from time deposits, which had slumped in the second quarter. Growth in wholesale deposits was especially buoyant in the third quarter.

In contrast to the previous quarter, the rise in £M3 in the third quarter was broadly spread among sectors. Personal sector holdings of sterling deposits grew by £1.1 billion, a little below the average of recent quarters and representing a slower percentage rate of growth than that of £M3 as a whole. Industrial and commercial companies' sterling bank deposits rose sharply, by £2.5 billion, following a quarter in which they actually fell; uneven growth in this component is not unusual. Sterling bank deposits held by other (non-bank) financial institutions rose by £2.0 billion, above the already high average of recent quarters. Acquisition of bank deposits by building societies, which have moved out of gilt-edged securities in some recent months, made a significant contribution. The tendency for the share of non-bank institutions' deposits with banks to rise as a proportion of £M3 is well established—their holdings now account for some 18% of £M3, compared with 10% at the end of 1980.

Growth of bank deposits and lending

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

	1983	1984	1985 Q1	Q2	Q3
Domestic deposits					
Personal sector	0.8	0.8	1.3	1.8	1.2
Companies	1.2	0.2	1.8	—	2.8
Other financial institutions	0.7	1.5	0.6	2.4	2.5
Public sector	—	0.2	0.2	-0.2	0.3
Total deposits	**2.8**	**2.7**	**3.9**	**4.1**	**6.7**
	2.2	*2.5*	*4.1*	*2.1*	*5.9*
Domestic lending					
Personal sector	2.1	1.6	2.5	2.3	3.4
Companies(a)	0.4	2.0	4.0	2.6	1.2
Other financial institutions	1.1	1.7	3.5	1.2	-1.0
Public sector	-0.5	0.2	-3.6	-1.2	-2.4
Total lending	**3.1**	**5.6**	**6.3**	**4.9**	**6.0**
	2.7	*4.3*	*3.0*	*3.5*	*6.8*
Overseas sector: deposits net of lending					
Sterling	0.3	-0.1	3.4	—	1.2
Foreign currency	-0.3	0.6	-0.3	-1.3	-3.3

(a) Including Issue Department transactions in commercial bills.

Among the counterparts to £M3 in the third quarter, public sector transactions were expansionary, in contrast to the previous quarter. The central government's deficit on own account was larger, as was net borrowing by local authorities and public corporations. At £1.4 billion (about half in the form of gilt-edged securities), sales of central government debt to the non-bank private sector were rather lower than in the second quarter and well below the rate of most recent quarters. A feature of the third quarter, however, and of earlier quarters this year, was the flow of external and foreign currency finance to the public sector. On a wide definition of funding which includes such flows (and which now provides the basis for funding policy), public sector transactions in the third quarter were expansionary by £1.6 billion, whereas they were contractionary by £1.0 billion in the second quarter (and so were expansionary by £0.7 billion in the first half of the financial year).

Bank lending *slows*

Bank lending in the third quarter (sterling lending to the non-bank private sector) was the lowest for a year, and showed a marked change in composition from the second quarter. Industrial and commercial companies (£0.3 billion)[1] and financial institutions (£0.7 billion) borrowed modestly by recent standards—the concentration of fixed investment, and particularly leasing activity, in the first quarter was probably a factor here. The personal sector, by contrast, borrowed a record £3.3 billion. Some £0.9 billion (an unusually large amount) went to unincorporated businesses: the remainder was lending for house purchase (at £1.5 billion, back to the rate of 1982 when the banks made large inroads into the mortgage market) and lending for consumption which, at £0.9 billion, was considerably higher than the rate in the first half of the year.

Against a background of a strengthening exchange rate and favourable sterling interest rates, the banks took sizable sterling funds from abroad in the third quarter. Overseas residents' holdings of sterling bank deposits rose by more than £$\frac{3}{4}$ billion in the third quarter and, as in the second quarter, net repayments of £400 million of sterling borrowing were made. Banks themselves continued to be large investors in securities issued by non-residents while running down their other net external foreign currency liabilities. (Very provisional estimates suggest that UK residents other than banks reduced their purchases of overseas securities from the high levels recorded in the first half of the year.)

With regard to the banks' foreign currency business at home, industrial companies and non-bank financial institutions showed contrasting behaviour. Industrial and commercial companies (ICCs) borrowed £0.9 billion (in transactions terms) in the third quarter and added £0.3 billion to deposits. Non-bank financial institutions (OFIs), on the other hand, repaid £1.7 billion of foreign currency debt, partly because of a reorganisation of business by one financial group; there may also have been some repayment of earlier overseas borrowing undertaken for hedging purposes. While repaying debt, OFIs added £0.5 billion (after allowance for valuation changes) to their foreign currency deposits in the third quarter—close to the recent average of an erratic series. As often happens, changes in the personal sector's foreign currency deposits and borrowing were small.

(1) Including Issue Department transactions in commercial bills and shipbuilding paper.

Altogether, therefore, the personal sector borrowed a net £2.2 billion from the banks in the third quarter. At the same time, the personal sector borrowed some £3.3 billion from the building societies, depositing a similar amount with the societies, and also borrowed from non-bank consumer credit sources (eg retailers and specialist consumer credit grantors outside the monetary sector). ICCs, on the other hand, were net lenders to the banks (by £1.6 billion, a sharp reversal from the previous quarter, possibly reflecting buoyant profits). Their stock market issues (£0.4 billion) were lower than in the second quarter but high by recent standards.

The public finances *remain broadly on target*

The Chancellor in his Autumn Statement indicated that the estimated outturn for the PSBR in 1985/86 was now £8 billion compared with the £7 billion announced in the March Budget. This increase reflects lower than expected North Sea oil revenues due to the lower sterling oil price. The expected outturn for the planning total of public spending is unchanged; but to meet spending in excess of plans on a number of individual programmes the contingency reserve is expected to be fully spent. Spending on social security is expected to exceed plans by £1,200 million, on defence by £200 million, and on agricultural subsidies by £450 million. Spending in excess of targets, mainly by local authorities, is also expected on education and science (£800 million) on housing (£400 million) and on environmental services (£500 million). The total external financing requirement of the nationalised industries is £900 million higher than planned, the continuing costs of the coal strike being a major influence.

Although the public expenditure planning totals for 1986/87 and 1987/88 in the Autumn Statement were unchanged from their previously announced levels, they do include larger than previously planned special sales of assets (including British Gas), which are counted as negative expenditure matched by increases in departmental programmes. Excluding the privatisation proceeds, the planning total is planned to rise 0.7% in real terms in 1986/87 after a fall in 1985/86, and to remain broadly flat in 1987/88 and 1988/89. Total general government expenditure on this basis is, therefore, expected to decline as a percentage of GDP from 45% in 1985/86 (and a peak of 47% in 1982/83) to 42% by 1988/89.