Economic Progress Report

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International debt

International debt has been much in the news and was one of the subjects discussed at the recent London Economic Summit (see pages 2-3). This article sets out the historical background.

During the 1960s, the economies of many developing countries grew relatively rapidly. Export markets in the industrialised countries expanded, and developing countries' productive capacity grew quickly. Direct investment by foreign companies (for example to finance purchases of factories and equipment) and official funds (such as government aid) accounted for most external development finance. Commercial bank lending was not very important. Official finance is generally on relatively easy terms, while returns on direct investment to the parent company are related to the investment's performance, and indeed are often reinvested. This meant that over this period debts owed abroad did not generally cause problems. Interest rates, too, tended to be low in both nominal and real terms.

Changes were, however, already occurring in the late 1960s and early 1970s. International banks were finding developing countries to be increasingly attractive customers. For their part, developing countries were attracted by the greater opportunity to decide how bank borrowing should be used than, for example, was available with direct investment. Long-term borrowing from financial institutions by the 25 major borrowers grew annually at an average rate of over 30 per cent between 1967 and 1973.

The first oil shock

The 1973 oil price rise greatly increased the import bills of those developing countries which did not produce oil themselves. This was followed by slower growth in their export markets, and a worsening in their terms of trade (the prices received for their exports compared with the prices paid for their imports). So their current account deficits widened, doubling as a percentage of exports.

Many developing countries attempted to maintain their growth rates by stepping up substantially their borrowing from commercial banks. They met with ready lenders, for several reasons. Banks were flush with funds because many oil producers put their export earnings into bank deposits. Many developing countries still appeared to have large potential for growth, while the recession in the industrialised countries limited the scope for profitable lending there.

Although nominal interest rates rose, real interest rates generally stayed low or even negative as world inflation continued high. Non-oil developing countries' debt service* payments as a percentage of exports rose only moderately, from about 15½ per cent in 1973 to about 18 per cent in 1979. But the pattern of financing had changed. In the years immediately after 1973 the share of bank finance doubled to around 60 per cent, while the shares of private direct investment and official finance declined.

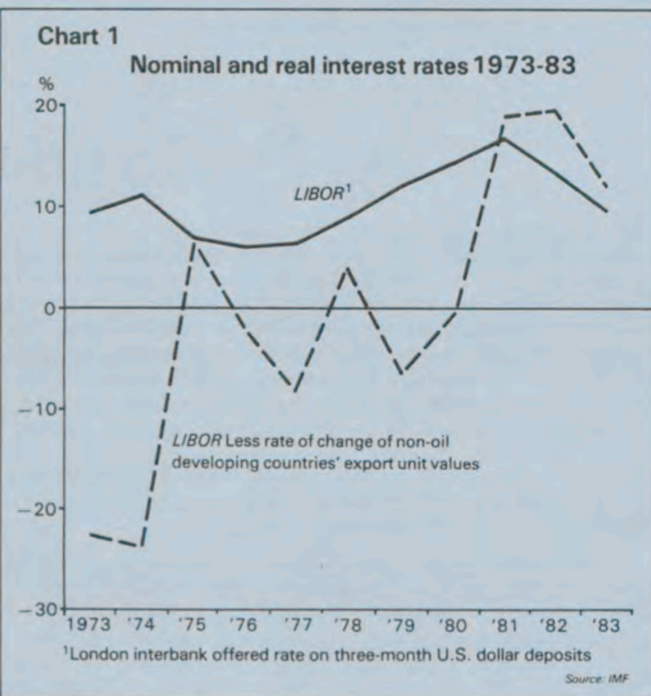
The second oil shock

Most developing countries failed to adjust their policies to the changed economic climate following the 1973 oil price rise. Their increased reliance on bank lending left them in difficulties, which were intensified by the second oil price rise in 1979-80 and its aftermath. Again oil import bills rose (although at first oil exporters like Mexico, Venezuela and Nigeria benefited from this). Again export markets contracted, and terms of trade deteriorated.

Much as after the first oil shock, developing countries stepped up their bank borrowing to finance their wider current account deficits, rather than adjusting economic policies to keep them to what could be prudently financed. The share of bank borrowing in total finance rose to over 70 per cent, and became increasingly short-term as banks became less willing to lend for long periods. This time, however, industrialised countries, in contrast to their reaction to the first oil shock, tightened economic policies in order not to accommodate the inflationary impact of higher oil prices. Real interest rates rose substantially (see chart 1). The exchange rate of the dollar, in which some four fifths of the debt of developing countries is denominated, rose sharply, increasing the share of export revenues needed to service their debts.

*Interest payments and repayments of principal.

Chart 1
Nominal and real interest rates 1973-83



¹London interbank offered rate on three-month U.S. dollar deposits

Source: IMF

The result was that the total external debt of non-oil developing countries from all sources, which had risen from below $200 billion in 1973 to $330 billion in 1978, rose sharply to $670 billion in 1983. Over $600 billion was concentrated in the 25 major debtors, of which the most important are listed in the table below. The five largest (Mexico, Brazil, Argentina, South Korea and Venezuela) account for almost half of the total. The increase in debt between 1973 and 1980 had been matched by generally buoyant export growth. But after 1980 the ratio of debt service payments to export earnings rose steeply, particularly because of general failure to predict the effect of the world recession on exports (see chart 2). For the major 25 borrowers, the peak in 1982 was over 32 per cent.

External debt

(Estimated totals outstanding end-1983, £ billion)

Mexico	95	Indonesia	25-30*
Brazil	90	Poland	28
Argentina	44	Philippines	25
South Korea	40	Yugoslavia	19
Venezuela	34	Chile	18
		Nigeria	15

*Precise figure uncertain — Source: Bank of England

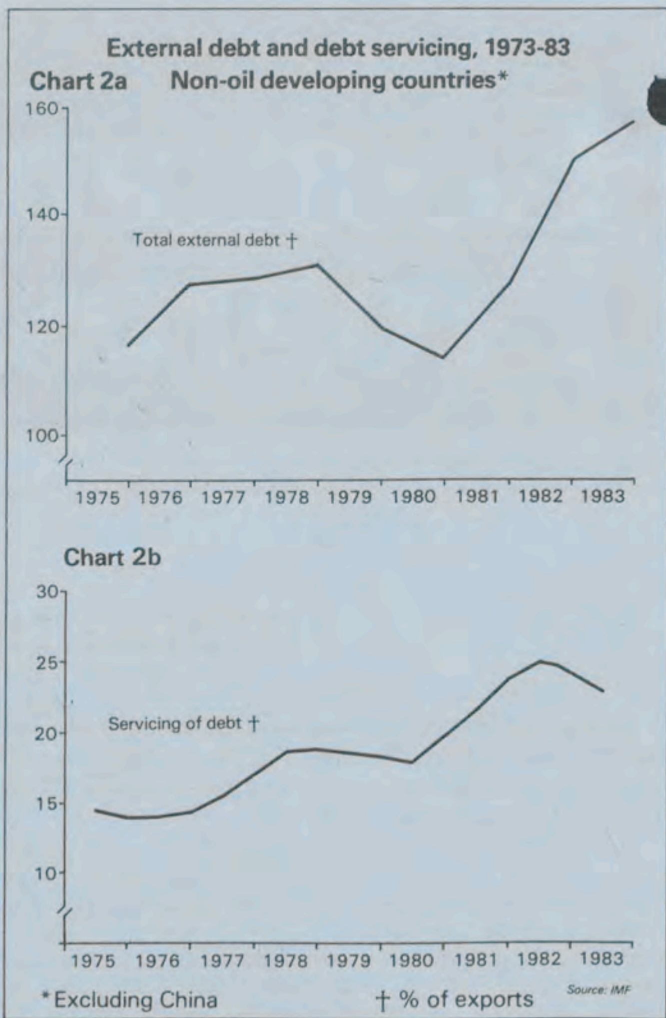
The 1980s

Difficulties had already started to appear in some Eastern bloc countries. But by 1982 it became clear that the process of continual increases in borrowing, to finance current account deficits perpetuated by overambitious aims for economic expansion, was leading to more general problems, particularly in Latin America. With over a third of total non-oil developing country debt now subject to variable interest rates, compared with less than one tenth in 1972, debtors were much more exposed to the effects of higher rates. As the share of short-term debt* in their total debt rose from one tenth in 1974 to one fifth in 1982, they were increasingly vulnerable to severe shortages of liquidity when creditors were reluctant to roll over their short-term commitments. And since 1982 new lending generally has slowed down markedly.

Many developing countries therefore took steps to adjust economic policies to improve their balance of payments and capacity to service their debt. Current account deficits fell on average by about a fifth in 1982 from their peak in 1981.

A growing number of debtors have sought longer periods to pay back their loans (rescheduling agreements). The average number of countries making such arrangements rose from less than four a year during 1974-78 to around nine a year during 1978-82. In 1983 alone some 30 countries, including almost half

*Debt with an original maturity of less than one year.



of the major 25 debtors made, or were engaged in making, rescheduling agreements.

A key role in such agreements has been played by the International Monetary Fund (IMF). Creditors have generally looked for an adjustment programme agreed with the IMF before debt renegotiations are completed.

As commercial lending to developing countries fell from two thirds of their external borrowing requirement in the late 1970s to two fifths by 1983, the IMF's lending rose, reaching a record $10 billion by 1983. The IMF has been making loans, to which it attaches conditions relating to economic policy, to about 40 countries for the last year or so.

Despite the efforts made by debtor countries and banks to deal with the problems, many remain. International debt is likely to stay in the news for some time to come.

The London Summit

The heads of government of the seven major industrialised countries and the president of the Commission of the European Communities met in London from 7-9 June 1984 for the tenth annual Economic Summit. The primary purpose of these summit meetings is to bring these people together to discuss economic problems, prospects and opportunities. The agreements reached on this occasion, in particular on the conduct of macro-economic policy, international debt and trade issues, were set out in an economic declaration, issued at the end of the meeting. This contained a ten-point action programme for the next twelve months.

The strategic thinking behind the action programme was contained in the opening section of the declaration, which traced global economic development since the 1983 Summit:

'At our last meeting, in Williamsburg in 1983, we were already able to detect clear signs of recovery from world recession. That recovery can now be seen to be established in our countries. It is more soundly based than previous recoveries in that it results from the firm efforts made in the Summit countries and elsewhere over recent years to reduce inflation.

'But its continuation requires unremitting efforts. We have to make the most of the opportunities with which we are now presented to reinforce the basis for enduring growth and the creation of new jobs. We need to spread the benefits of recovery widely, both within the industrialised countries and also to the developing countries, especially the poorer countries who stand to gain more than any from a sustainable growth of the world economy. High interest rates, and failure to reduce inflation further and damp down inflationary expectations, could put recovery at risk. Prudent monetary and budgetary policies of the kind that have brought us so far will have to be sustained and where necessary strengthened. We affirm the commitment of our Governments to those objectives and policies.'

The action programme

The leaders set out the following heads of agreement:

(1) to continue with and where necessary strengthen policies to reduce inflation and interest rates, to control monetary growth and where necessary reduce budgetary deficits;

(2) to seek to reduce obstacles to the creation of new jobs:

— by encouraging the development of industries and services in response to demand and technological change, including in innovative small and medium-sized businesses;

— by encouraging the efficient working of the labour market;

— by encouraging the improvement and extension of job training;

— by encouraging flexibility in the patterns of working time;

— and by discouraging measures to preserve obsolescent production and technology;

(3) to support and strengthen work in the appropriate international organisations, notably the OECD, on increasing understanding of the sources and patterns of economic change, and on improving economic efficiency and promoting growth, in particular by encouraging innovation and working for a more widespread acceptance of technological change, harmonising standards and facilitating the mobility of labour and capital;

(4) to maintain and wherever possible increase flows of resources, including official development assistance and assistance through the international financial and development institutions, to the developing countries and particularly to the poorest countries; to work with the developing countries to encourage more openness towards private investment flows; and to encourage practical measures in those countries to conserve resources and enhance indigenous food and energy production. Some of us also wish to activate the Common Fund for Commodities;

(5) in a spirit of cooperation with the countries concerned, to confirm the strategy on debt and continue to implement and develop it flexibly case by case; we have reviewed progress and attach particular importance to:

— helping debtor countries to make necessary economic and financial policy changes, taking due account of political and social difficulties;

— encouraging the IMF in its central role in this process, which it has been carrying out skilfully;

— encouraging closer cooperation between the IMF and the International Bank for Reconstruction and Development (IBRD), and strengthening the role of the IBRD in fostering development over the medium- and long-term;

— in cases where debtor countries are themselves making successful efforts to improve their position, encouraging more extended multi-year rescheduling of commercial debts and standing ready where appropriate to negotiate similarly in respect of debts to governments and government agencies;

— encouraging the flow of long-term direct investment; just as there is need for industrial countries to make their markets more open for the exports of developing countries, so these countries can help themselves by encouraging investment from the industrial countries;

— encouraging the substitution of more stable long-term finance, both direct and portfolio, for short-term banking.

(6) to invite finance ministers to carry forward, in an urgent and thorough manner, their current work on ways to improve the operation of the international monetary system, including exchange rates, surveillance, the creation, control and distribution of international liquidity and the role of the IMF; and to complete the present phase of their work in the first half of 1985 with a view to discussion at an early meeting of the IMF Interim Committee. The question of a further allocation of Special Drawing Rights is to be reconsidered by the IMF Interim Committee in September 1984;

(7) to carry forward the procedures agreed at Versailles and at Williamsburg for multilateral monitoring and surveillance of convergence of economic performance toward lower inflation and higher growth;

(8) to seek to improve the operation and stability of the international financial system, by means of prudent policies among the major countries, by providing an adequate flow of funding to the international financial institutions, and by improving international access to capital markets in industrialised countries;

(9) to urge all trading countries, industrialised and developing alike, to resist continuing protectionist pressures, to reduce barriers to trade and to make renewed efforts to liberalise and expand international trade in manufactures, commodities and services;

(10) to accelerate the completion of current trade liberalisation programmes, particularly the 1982 GATT work programme, in cooperation with other trading partners; to press forward with the work on trade in services in the international organisations; to reaffirm the agreement reached at the OECD ministerial meeting in May 1984 on the important contribution which a new round of multilateral trade negotiations would make to strengthening the open multilaterial trading system for the mutual benefit of all economies, industrial and developing; and, building on the 1982 GATT work programme, to consult partners in the GATT with a view to decisions at an early date on the possible objectives, arrangements and timing for a new negotiating round.

Economic indicators[1]

(seasonally adjusted)

PUBLISHED MONTHLY	Unit	1981	1982	1983	1983 Q4	1984 Q1	1984 Mar	1984 Apr	1984 May	
1 Output of production industries	1980=100	96.3	98.0	100.9	103.0	103.1	101.9	101.7	—	1
2 Unemployment (excl. school-leavers)[2]	000s	2,413.1	2,793.2	2,970.2	2,946.1	3,011.6	3,011.6	3,010.9	3,028.6	2
3 " " " "	% of all employees	10.0	11.7	12.4	12.2	12.5	12.6	12.6	12.7	3
4 Retail sales (volume)	1980=100	100.4	102.5	107.8	110.3	108.5	108.3	112.2	110.3	4
5 Exports f.o.b.[4]	£m	50,977	55,565	60,658	16,225	16,853	5,691	5,370	5,635	5
6 Imports f.o.b.[4]	£m	47,969	53,181	61,158	16,220	16,912	5,918	6,207	5,953	6
7 Balance of payments current balance	£m	+6,574	+5,774	+2,924	+596	+838	+72	−588	−69	7
8 £'s effective exchange rate (average for month)	1975=100	95.0	90.5	83.2	—	—	81.0	79.9	80.0	8
9 Official reserves[5] (end of period)	$m	23,347	16,997	17,817	17,817	17,728	17,728	15,941	15,835	9
10 Retail prices[5]	Jan 1974=100	295.0	320.4	335.1	342.8	345.1	345.8	350.1	351.3	10
11 Tax and price index[5]	Jan 1978=100	152.5	167.4	178.0	178.0	179.4	179.4	178.8	179.6	11
12 Average earnings (whole economy)[3]	Jan 1980=100	125.8	137.6	149.2	152.5	154.9	154.4	155.5	—	12

13 Monetary growth to mid-May (per cent changes)	May banking month	3-month annual rate	6-month annual rate	last 12 months	13
M0	+0.5	+ 4.2	+3.9	+5.1	
£M3	+0.9	+10.5	+9.2	+8.6	

PUBLISHED QUARTERLY	Unit	1982	1982	1982 Q4	1983 Q1	1983 Q2	1983 Q3	1983 Q4	1984 Q1	
1 Output (gdp) at constant factor cost	1980=100	99.4	101.0	101.4	103.4	103.7	103.5	105.8	103.5	1
2 Manufacturing industry's fixed capital expenditure	£m 1980 prices	4,457	4,373	1,115	1,042	1,083	1,077	1,171	1,236	2
3 Consumers' expenditure	£m 1980 prices	139,390	144,812	35,573	35,505	36,095	36,527	36,685	—	3
4 Balance of payments, current balance	£m	+5,551	+2,924	+2,180	+1,589	−89	+828	+596	+838	4
5 Balance of payments on invisible account	£m	+3,167	+2,549	+1,066	+891	+423	+901	+334	+750	5

1. Many of the most recent figures are provisional and may be subject to revision. 2. Figures on the new claimant basis (see *Economic Progress Report*, December 1982). 3. Excluding Northern Ireland. 4. Visible trade (balance of payments basis). 5. Not seasonally adjusted.

Company sector finances in the recovery

Company profits and the overall financial position of the company sector have improved strongly over the last two years against a background of steady growth in the domestic economy, a recovery in overseas markets, and some easing of cost pressures. This article describes how industrial companies have rebuilt their profits and improved their financial situation since 1981 and how this improvement in liquidity is now being reflected in increased business investment. The box describes the main terms used in the article.

Profits and profitability

In manufacturing industry strong growth in productivity (around 6 per cent a year in both 1982 and 1983), a slowdown in wage inflation, and cuts in the national insurance surcharge have contributed to much slower growth in unit labour costs. With imported materials prices also rising much less rapidly, manufacturers have been able to rebuild profit margins (roughly speaking profit as a proportion of sales). Table 1 and chart 1 show that, although margins on export sales were squeezed more sharply than those on domestic sales, their recovery has recently been stronger, helped by the depreciation of sterling around the start of 1983.

Company sector finances — main terms

Industrial and commercial companies (ICCs)	Broadly, all UK corporate bodies other than public corporations, banks and other financial institutions.
Gross profits (net of stock appreciation)	Trading profits arising in the UK from UK companies, and UK branches and subsidiaries of overseas parent companies net of stock appreciation and gross of depreciation.
Saving (undistributed income)	Difference between ICCs' income (profits, rental and interest income) and allocations of income (tax, dividend, interest payments).
Financial surplus/ deficit	In broad terms, measures the extent to which ICCs' savings exceed or fall short of their domestic investment on fixed assets and stock.
Net borrowing requirement (NBR)	The financial surplus/deficit does not show the full picture of ICCs' actual cash position. NBR represents net cash borrowing and is analogous to the public sector borrowing requirement.
Net pre-tax real rate of return	Trading profits and rental income (net of stock appreciation and depreciation) as a ratio of net stock of fixed capital assets plus book value of UK stocks.

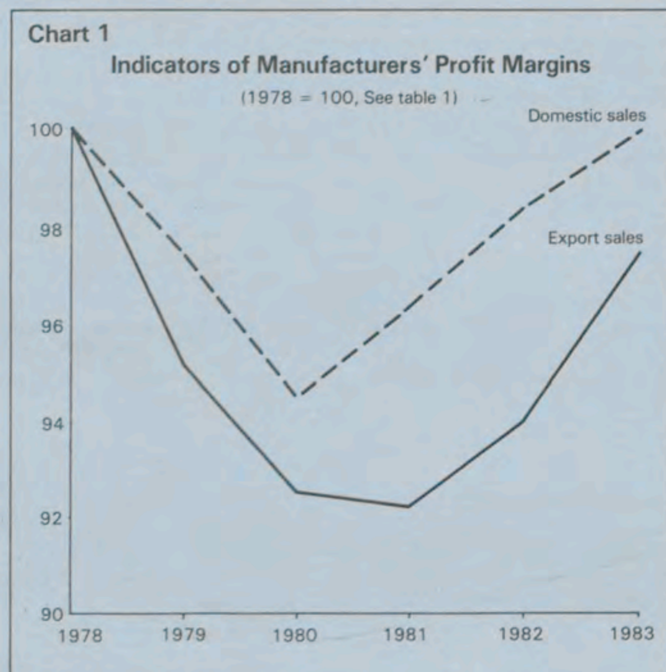


Table 1 Indicators of profit margins in manufacturing
(% changes)

	Costs			Prices		Ratio of selling prices to main unit costs *(1978 = 100)*	
	Unit labour costs	Imported input costs	Main unit costs[1]	Exports[2]	Sales[3]	Exports	Domestic sales
1978	15.0	0.9	10.3	10.5	9.9	100	100
1979	16.7	7.9	13.7	8.3	10.9	95.2	97.5
1980	21.2	10.8	17.7	14.3	14.0	92.5	94.5
1981	7.4	7.2	7.3	7.0	9.5	92.2	96.4
1982	4.1	8.4	5.5	7.5	7.8	94.0	98.4
1983	2.3[4]	7.2	3.9	7.8	5.4	97.5	99.9

1. Main unit costs defined here as weighted sum of unit labour costs (2/3) and imported input costs (1/3); taxes and administered prices are excluded.
2. Manufactures export unit value index. (Standard international trade categories 5 to 8, less erratic items.)
3. Producer output prices.
4. Unit wage and salary costs. 1983 figures for unit **labour** costs are not available until September 1984.

Table 2 ICCs' financial accounts
(£ billion, figures rounded to nearest £½ billion)

	Income[1] −	Allocation of income =	Saving[2] −	Expenditure =	Financial surplus +	Other financial transactions +	Balancing item	= Net borrowing requirement (borrowing positive)
1979	32	18	14	15½	−1½	−2½	−1½	5
1980	35	23	12½	12	½	−4½	−2	5½
1981	39½	25	15½	12	3½	−4½	−1½	3[3]
1982	44½	27½	18	13	4½	−5½	−4½	5½[3]
1983	53½	31	23½	15½	8	−4½	−2½	−1½

[1] Net of stock appreciation.
[2] Including capital transfers.
[3] The net borrowing requirement was distorted in these years by the civil service strike which, by delaying tax payments, reduced the NBR in 1981 and increased it in 1982.

However, as shown in chart 2, profitability has declined for much of the last twenty years. Even with recent improvements, rates of return - especially for non-North Sea companies - remain well below levels of the 1960s. Although it is difficult to make more than a rough allowance for the change in tax payments made by companies, a general easing in the burden of company taxation probably means that post-tax rates of return showed a less marked decline over the period as a whole.

Improved profit margins, and a recovery in sales volume have led to substantial growth in company profits since 1981. Gross trading profits of ICCs (net of stock appreciation) are estimated to have risen by a sixth in 1982 and by a quarter in 1983. Increases in non-North Sea and North Sea companies' profits were much the same in this period. Profits continued to improve strongly into the first quarter of 1984.

Company saving

Trading profits account, on, average for around three quarters of company income. Income from overseas activities (which rose only 7 per cent between 1981 and 1983, reflecting the weakness in overseas economies) and rental and interest income (which rose only 10 per cent over this period) account for the rest. Out of their income, UK companies pay tax, interest and dividends and allocate any profits due overseas to parent companies. Some of these payments are to a greater or lesser extent at companies' discretion. For example, dividend payments did not fall as sharply as company income in 1979 and 1980, and have not risen as quickly between 1981 and 1983. Lower levels of interest rates have helped keep interest payments down. In addition, tax payments are made in the year after profits are earned, so, for example, the tax liability incurred on the substantially higher profits in 1983-84 will not in general be paid until 1984-85. Also, for manufacturing companies at least, the increase in tax payments has been modest because losses incurred in earlier years have meant that offsets can be made against tax payments on profits.

The recovery in profits and other items of income, together with the more restrained increase in allocations out of income, have meant strong growth in company saving (see table 2).

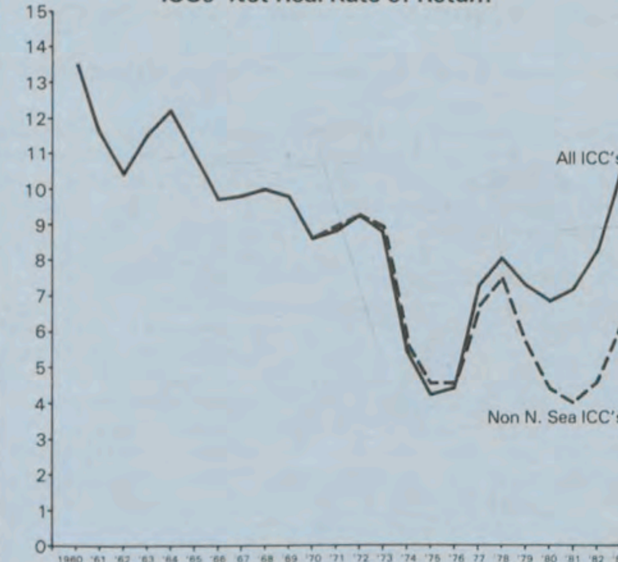
Financial surplus

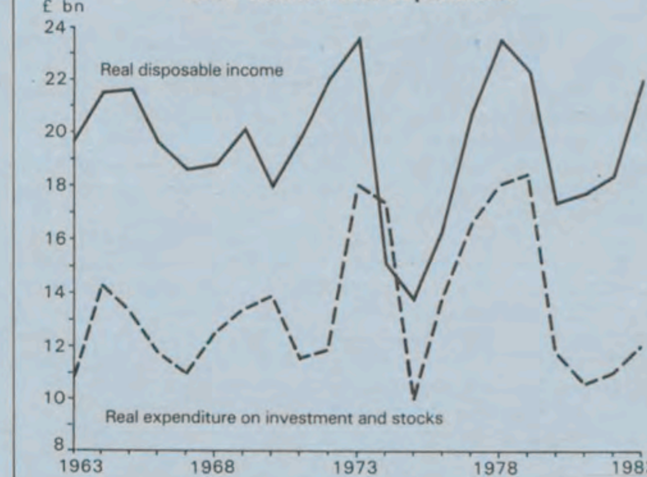
Increases in profits and incomes encourage higher company expenditure on fixed investment and stocks. There has been some tendency in the past for turning points in company spending to lag behind those in company incomes (see chart 3). This has also been the pattern of the current cycle; for example, manufacturing investment fell by around one third between 1979 and 1982 before picking up during 1983, and companies have been hesitant in rebuilding stock levels. Given this lag, companies have been running a large financial surplus, that is to say their saving has exceeded their expenditure on capital and stocks through the recovery.

More recently, business investment has begun to grow quite strongly, with an increase of 8 per cent in the six months to March 1984 compared with the preceding six months. The May Department of Trade and Industry intentions survey pointed to increases of 12 per cent in manufacturing investment between 1983 and 1984 as a whole, with an 8 per cent rise in services investment. It is the normal cyclical pattern for spending to increase faster than income at this stage and for the financial surplus to tend to diminish.

Company borrowing

Information on the financial surplus is built up from identified company income and expenditure (using national accounts data). It does not measure what companies actually raise in cash to meet their overall borrowing needs. The 'net borrowing requirement' provides such a measure of companies' net cash borrowing. It comprises borrowing from banks, borrowing from other sources (for instance from overseas and by issuing shares) and possibly from running down financial assets (a build-up being counted as negative borrowing). In theory, the net bor-





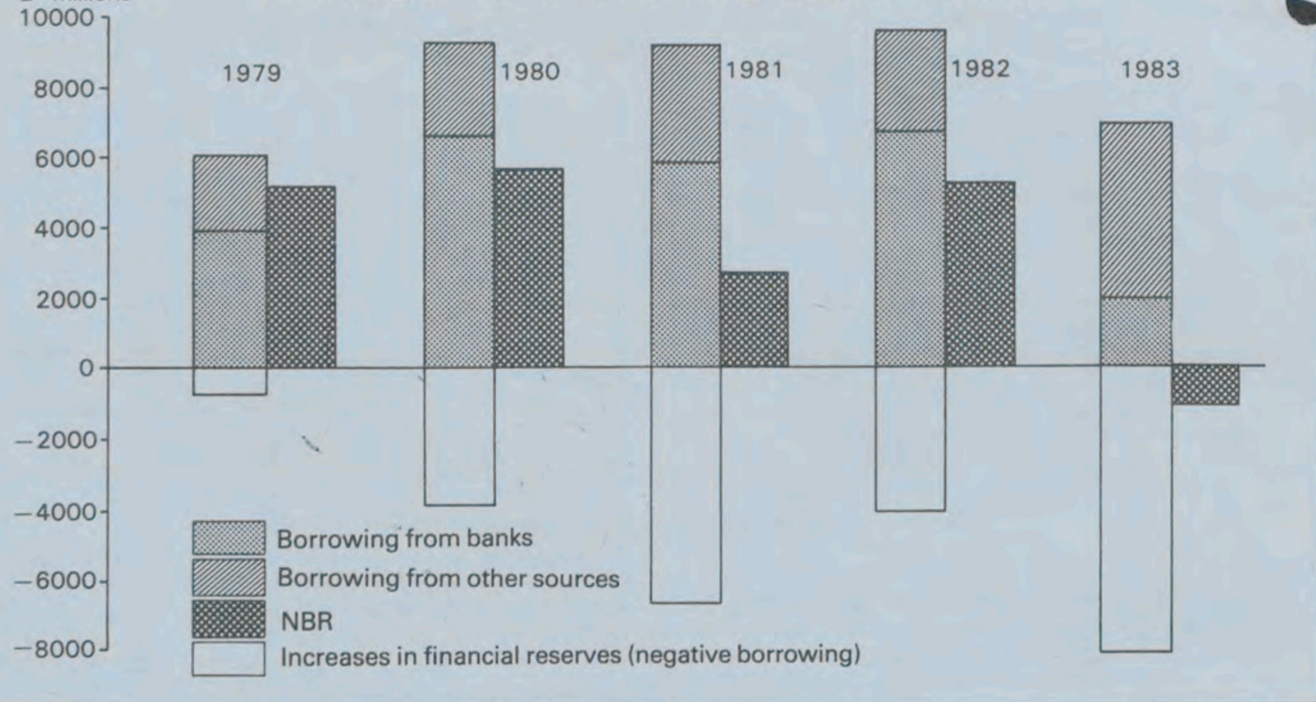


Chart 4
Financing of ICCs' net borrowing requirement (NBR)

rowing requirement should also be equal to the financial surplus adjusted for companies investment overseas and other miscellaneous financial transactions. In practice, these estimates differ. The discrepancy is the 'balancing item' shown in table 2. This represents either overrecording of receipts, or an underrecording of payments made, or errors in the measurement of financial transactions. The balancing item is volatile and can be substantial. This sometimes makes it difficult to interpret movements in companies financial surplus and borrowing.

Financing company borrowing

Chart 4 shows how companies have financed their borrowing requirement since 1979. There was a sharp build-up in bank borrowing between 1979 and 1980, which remained high through to 1982 as companies attempted to restore depleted reserves. Within an overall fall in borrowing in 1983, companies restructured the pattern of their financing away from bank borrowing and towards other sources of borrowing; in particular, companies were able to increase their share issues substantially as trading prospects improved and inflation and interest rates fell. There was also a sharp build-up of liquid assets by companies 1983.

Monthly economic assessment

Based on information† available up to 5 July.

- **Retail price inflation remains steady; survey evidence shows fewer manufacturers expect to increase selling prices.**
- **GDP growth is continuing at an underlying rate of around 3 per cent a year.**
- **Company profits continue to grow strongly and this is now being reflected in sizeable increases in business investment.**
- **There has been continued nervousness in financial markets particularly concerning the course of US interest rates.**

Financial developments

The **public sector borrowing requirement** was estimated at around £3½ billion in the first two months of the 1984-85 financial year, including borrowing of around £1¼ billion in May. Almost all of the PSBR for 1984-85, forecast at £7¼ billion at Budget time, is expected to occur in the first half of the financial year (April to September). This is partly because some of the Budget measures, in particular changed arrangements for payment of VAT on imports, will boost tax receipts considerably in the second half-year.

Monetary growth and public borrowing were lower in May than markets expected, allaying some fears about the domestic situation and helping to take some of the upward pressure from interest rates. However, markets became more nervous late in June with the release of second quarter US gross national product figures, which showed continued rapid growth. This raised fears of further increases in US interest rates. Lloyds and the National Westminster raised their base rates by ¼ per cent to 9¼ per cent at the end of June, bringing them into line with the rate charged by the other major clearing banks since early May.

US interest rates have been a major factor in the strength of the **dollar** against most other currencies, including sterling, in recent weeks. **Sterling** has been very steady against European currencies, however, and in effective terms has remained within a band 1 per cent either side of 79½ in the last three months.

Costs and prices

The year-on-year rate of **retail price*** inflation has been little changed over the last six months, at around 5 per cent. The rate in May stood at 5.1 per cent. Year-on-year increases in **producer output prices*** have also been fairly stable. Increases of about 6½ per cent over the year to April and May were slightly above the twelve-monthly increases recorded in the first quarter of 1984, but this was partly attributable to excise duty increases in the Budget. Both the May and June CBI industrial trends enquiries showed reductions in the number of firms expecting to raise selling prices in the next few months. **Import prices** are rising somewhat faster than domestic costs. In the three months to May finished manufactures import prices were around 5 per cent above their level a year earlier, with increases of 7 and 13 per cent in semi-manufactures and basic materials prices over the same period.

†Figures seasonally adjusted unless marked *.

Table 1

GDP and expenditure components

% change in half-year to March compared with a year earlier to nearest ½ %

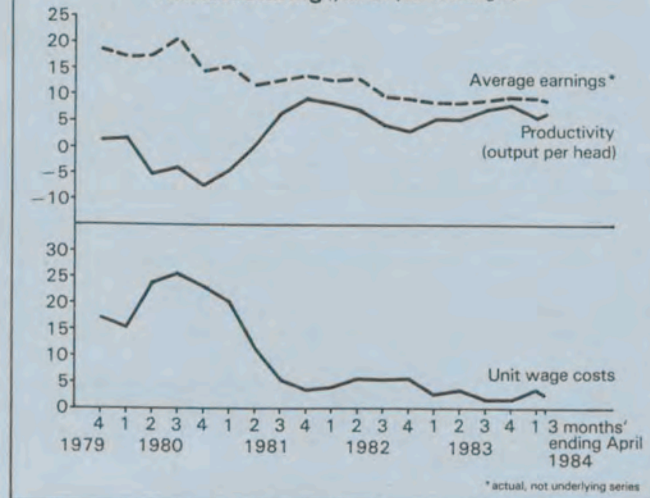
	Consumers' expenditure	General govt. expenditure	Total fixed investment	Stock building	Exports of goods & services	Imports of goods & services	GDP (expenditure measure at market prices)	GDP (average measure factor cost)
(1983 level £ billion, 1980 prices)	145	50	40	½	63	60½	238	—
% change over year to six months ending:								
1982 Q1	0	−½	½	2*	3	10½	½	2
1983Q1	3½	4	6½	0*	0	1½	4	2½
1984Q1	2½	½	8½	0*	4½	9½	2	3

*contribution to growth

Year-on-year increases in **underlying whole economy** and **manufacturing earnings** were 7¾ and 9½ per cent respectively in April, little different from twelve-monthly increases recorded during the last eighteen months or so. **Wage settlements** in manufacturing are running at around 6 per cent according to the CBI pay databank, probably somewhat higher than in the economy as a whole. Perhaps 1 per cent of the difference between settlements and earnings in manufacturing is attributable to payments for increased hours worked — continued growth in economic activity increasing overtime and reducing short-time working. Increased productivity and bonus payments contribute to the remaining gap between settlements and earnings.

A gradual deceleration in the growth of average earnings, coupled with significant improvements in **productivity**, have helped reduce the year-on-year increase in **manufacturers' unit wage and salary costs** from a peak of over 25 per cent in 1980 to around 2½-3 per cent during the last year (see chart 1).

Chart 1
Earnings, productivity and unit wage costs; manufacturing (year-on-year % changes)



Gross domestic product

Provisional estimates for **gross domestic product** (GDP) in the first quarter of 1984 confirm that activity continued to grow at an underlying annual rate of about 3 per cent. Movements in the output, expenditure and income measures of GDP continue to diverge somewhat, though their broad trends are similar (see chart 2). All three measures of GDP in the first quarter were depressed somewhat by reduced coal output resulting from the miners' dispute.

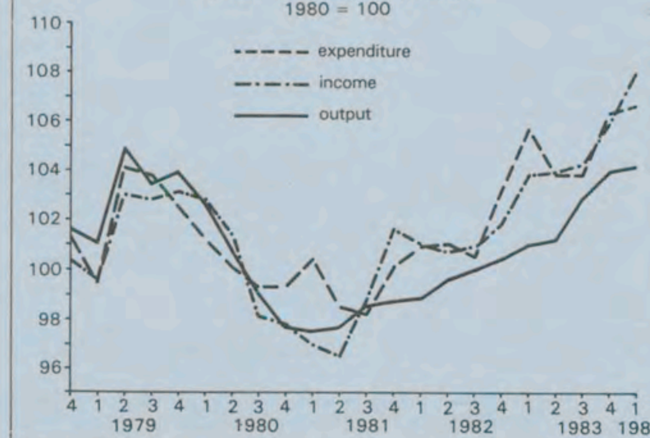
The **expenditure measure** of GDP has moved unevenly in recent quarters. It is clear, however, that **investment** and **exports** are playing a more important role, and consumer spending a less important role than hitherto in overall expenditure growth.

Within total fixed investment, capital spending by **manufacturing industry** — which fell by around a third between 1979 and 1982 — picked up particularly strongly in the course of 1983 and into 1984 with an 11 per cent increase now estimated in the six months to the first quarter of 1984 compared with the previous six months.

The **income measure** of GDP has also moved unevenly recently though strong growth in company profits, up by almost a quarter between he first quarter of 1983 and the first quarter of 1984, has been a consistent feature for the last two years.

The **output measure** of GDP, usually considered the best indicator of quarter-to-quarter movements, was little changed between the fourth quarter of 1983 and the first quarter of 1984, but was 3 per cent above its level a year earlier. The level of total output in the first quarter was affected by the reduction in coal output resulting from the miners' dispute. **Output of production industries** (energy and manufacturing industries, together accounting for around a third of total output) was little different in the first quarter of 1984 from its level in the fourth quarter of 1983; reduced coal output offset increases elsewhere. There were small falls in distribution activity, partly because consumer spending eased, but output of other services continued to grow. In the three months to April the output of production industries other than coal and coke industries was about 5 per cent up on the same period in 1983.

Chart 2
Gross Domestic Product
1980 = 100



Current account

The **current account** moved into a small deficit over the three months to May reflecting some deterioration in both oil and non-oil visible balances.

Total export volumes (excluding erratic items — ships, North Sea installations, aircraft, precious stones and silver) fell 2 per cent in the latest three months compared with the previous three months, but were 9 per cent up on the same period last year. The underlying trend of non-oil exports has levelled out in recent months after rising rapidly in the second half of 1983.

Total import volumes (excluding erratic items) rose 4½ per cent in the latest three months, mainly due to an increase of around two fifths in fuel imports (reflecting a rebuilding of oil stocks by oil companies and also higher oil imports resulting from the miners' dispute). Growth in non-oil imports has eased recently.

A deterioration in the **terms of trade*** also contributed to the deficit on the visibles balance. Import prices rose 1 per cent faster than export prices in the three months to May compared with the previous three months.

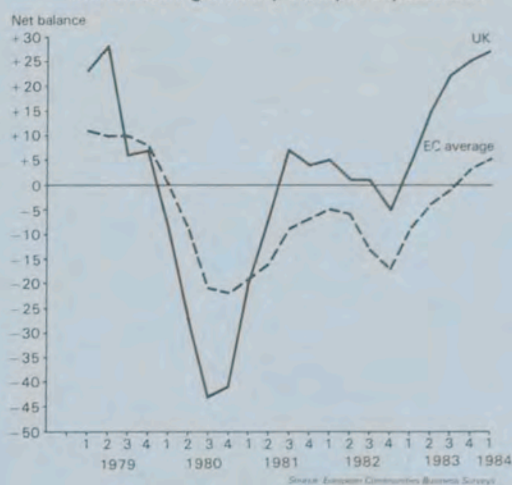
Table 2

Current account

£ billion, rounded

	Visible trade non-oil balance	Oil balance	Invisible trade balance	Current account
3 months to Feb	−2	2½	1	1½
3 months to May	−3	1½	¾*	−½

*Invisible balance is a projection, subject to substantial revision.



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Labour market

Adult unemployment (seasonally adjusted, excluding school-leavers) rose by 8,000 in June to 3,036,000 (12.6 per cent of all employees). The rise in the second quarter of 1984 averaged 8,000 a month. This compared with a rise averaging 22,000 a month in the first quarter, which included erratically large increases (of about 30,000) in January and February. The stock of **unfilled vacancies** rose by 3,000 to 159,000 in June. Vacancies have recovered since falling back somewhat at the turn of the year, but remain below the average levels for the second half of last year.

Forward indicators

The **June CBI industrial trends enquiry** points to further increases in manufacturing output with, if anything, an easing of pressure for increases in selling prices. Chart 3 shows output expectations of manufacturing industry in the UK and in the EC as a whole. UK output expectations weakened in mid-1979, somewhat ahead of the EC average, but picked up in late 1980, before the rest of the Community. Both UK and EC expectations weakened again during 1982 before making a firmer recovery through last year and into 1984.

There have been falls recently in the CSO's **shorter and longer leading indicators** of activity, but more complete data are required to determine whether these are more than temporary effects. The overall assessment of movements in the indicators is that recovery will continue into 1985.

Future financing of the European Community

The Stuttgart European Council in June 1983 agreed that action should be taken to relaunch the European Community and that major negotiations should tackle the most pressing problems. These included additional finance or 'own resources',† the need for a fairer sharing of financing of the Community Budget, Budget discipline, the accession of Spain and Portugal, and the development of new Community policies.

The Fontainebleau agreement

The negotiations were successfully concluded at the Fontainebleau European Council on 26-27 June 1984. The main elements of the agreement are:

- The UK will get a final *ad hoc* refund of £590 million for 1984, to be paid in 1985. With effect from 1986 the UK will get a refund each year of 66 per cent of the difference in the previous year between its share in the Community's VAT own resources and its share in expenditures from the 'allocated'* Community Budget. The system of budgetary refunds will be legally binding and incorporated in the new decision on own resources (see below) which cannot be changed without the UK's agreement. This ensures that the refunds will continue as long as the 1.4 per cent VAT ceiling lasts.
- These refunds will be effected by an abatement of UK VAT payments to the Budget. They will be paid automatically. This will avoid the annual haggle with other member states and the European Parliament which has occurred in the past.
- Measures to guarantee effective budgetary discipline will be introduced. The aim will be to reduce the share of agricultural expenditure in the budget and to set strict limits on the growth of both agricultural and other expenditure.
- Subject to the agreement of Parliament and the legislatures of the other member states the ceiling on the Community's VAT revenues will be increased from 1 per cent to 1.4 per cent.
- The agreement refers to a possible further increase in the VAT ceiling to 1.6 per cent. This could only take place with the agreement of the UK Government and the approval of the House of Commons.
- France and Italy have withdrawn their objections to payment of the UK's outstanding rebate of £440 million in respect of 1983.

Financially this agreement is better than the arrangement on offer at the March European Council and far better than the alternative of having no agreement at all. Failing an agreement the refunds due to the UK this year would have been lost. Moreover there would have been no agreement on refunds for any future years.

Without any increase in the 1 per cent VAT ceiling, the UK's net contribution would have been around twice as much as under the new system now negotiated.

The agreement has the following further important features:—

- The UK's effective VAT rate under the system now agreed upon will remain less than 1 per cent for the foreseeable future, while all other member states will pay more than 1 per cent.
- The UK's net contribution to *new* Community expenditure will not exceed about *7 per cent* in contrast to the current maximum marginal net contribution of about 21 per cent.
- The new 1.4 per cent VAT figure is a maximum; it will not all be used up immediately. The purpose of the new arrangements on budgetary discipline is to see that the Community lives within the new limit for as long as possible.
- Germany will remain, and France will become, substantial net contributors, so they too will have a strong interest in effective budgetary discipline.

The European Council also confirmed that the negotiations for the accession of Spain and Portugal should be completed by 30 September 1984. It stressed the importance of early completion of the negotiations on the renewal of the Lomé agreement. There was also some discussion of the future development of the Community, during which the British Prime Minister particularly emphasised the importance of achieving a genuine common market in goods and services, which would create new jobs throughout the Community.

†'Own resources' consist of agricultural levies, customs duties on imports from outside the EC, and the proceeds of a flat rate on transactions in the VAT harmonised base (which consists of a standardised range of goods and services related to spending on consumption).

*Over 90 per cent of Community expenditure is assigned ('allocated') to recipients in particular member states. 'Unallocated' expenditure is mainly overseas aid.

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