

Economic commentary

Introduction

The outlook for world activity remains depressed and may, indeed, have worsened slightly in recent months with the further rises in oil prices. Payments imbalances have widened and are likely to persist for some time, so that recycling may be necessary on a scale comparable (in real terms) to 1974-75.

In the United Kingdom, the growth of consumer demand has slowed, reflecting the deceleration in real personal incomes which began in mid-1978. Other components of demand have also been subdued. With a strong exchange rate, and UK domestic costs moving further out of line with those of the other main industrial countries, the competitive position of industry has continued to deteriorate. This has been one factor behind the appreciable rise in import penetration, despite only modest expansion in domestic demand, and has also meant a loss of export market share. Output, in consequence, has been sluggish. GDP showed little or no growth during 1979, while the trend of manufacturing output alone, where competitive pressures are perhaps felt most keenly, may have turned downwards. (In the first quarter of this year, the steel strike will have reduced manufacturing output directly by around 2%, and overall by perhaps double this amount.) Profitability has also suffered, and the worsening financial position of companies may well accentuate the reduction in stocks which is already in prospect.

The deterioration in the current account last year mainly reflected adverse movements in the volume of trade. As well as the loss of competitiveness, various disruptions at home, and in the important export markets of Iran and Nigeria, also contributed. These disruptions eased somewhat in the later part of the year; but the weakening of visible trade, combined with a sharply reduced surplus on invisibles, led to a current account deficit for the year as a whole estimated at nearly £2½ billion.

The present pay round has been characterised by a wide spread in the level of awards. The average, so far, seems rather higher than last year, but the majority of employees have yet to settle. In a number of cases, there have been welcome signs of greater willingness to match pay to the financial and trading position of an industry, and some greater reluctance to resort to industrial action. Nevertheless, the continuing high rate of increase in earnings, coupled with the very large rise last year in raw material costs, has kept the underlying rate of inflation at around 15%; the rise in prices over the last year, including the effect of the indirect tax changes in the June Budget, has been about 18½%.

Meanwhile, monetary growth has been running somewhat above the top end of the target range. Over the seven months from June 1979 to January 1980, sterling M₃ increased by about 7%, or by just over 12% at an annual rate. The main expansionary factor continues to be bank lending, especially to the company sector. So far, lending has shown little clear

response to the increase in nominal interest rates, but some deceleration is likely as activity slackens.

Oil: more price increases . . .

By mid-February, official oil prices set by members of the Organisation of Petroleum Exporting Countries (OPEC) had risen, on average, to about \$29 a barrel, more than double the average at the beginning of 1979 (see chart).

At the OPEC meeting in Caracas last December there was no agreement on a common reference price; some producers settled at, or slightly above, the Saudi marker price of \$24, while others decided on much higher prices, with Libya charging \$34.50. At the end of January, a \$2 increase by Saudi Arabia was followed by a number of other producers at the lower end of the price range. But subsequent increases by Iran, Nigeria and Algeria widened differentials again, and took the increase in average price since the beginning of 1980 to 8%. Although further increases cannot be ruled out, there are grounds for expecting some stability, at least in the immediate future. After a mild winter, stocks in the consuming countries are at record levels, and consumption is easing as economic growth slows down. Developments in the spot market, where falling prices have narrowed the margin over official prices, lend some support to this view, although there are continuing uncertainties about supply, exemplified by the recent decision by Kuwait to cut output by 25%.

The sharp rise in prices during 1979 was accompanied by further changes in the structure of the oil market. Oil trade has traditionally been dominated by the major oil companies, which in recent years had direct access to about 60% of OPEC oil and passed on large amounts to independent oil companies, state-owned corporations and others, as well as supplying their own refineries. This trade was characterised by term contracts, giving security of supply to buyers of oil and a guaranteed market to sellers. The spot market, with limited access to crude oil, accounted for a very small proportion of total trade, but did act to smooth imbalances in the market for oil products. In early 1979, however, with the cutback in Iranian production and the sharp rise in spot market prices, some oil producers terminated or altered their arrangements with the major oil companies and diverted a growing proportion of their output to the spot market or into special bilateral deals at spot-related prices. As a result, the major oil companies have seen their share of OPEC production substantially reduced, and it seems unlikely, at least in the short term, that this position will be reversed.

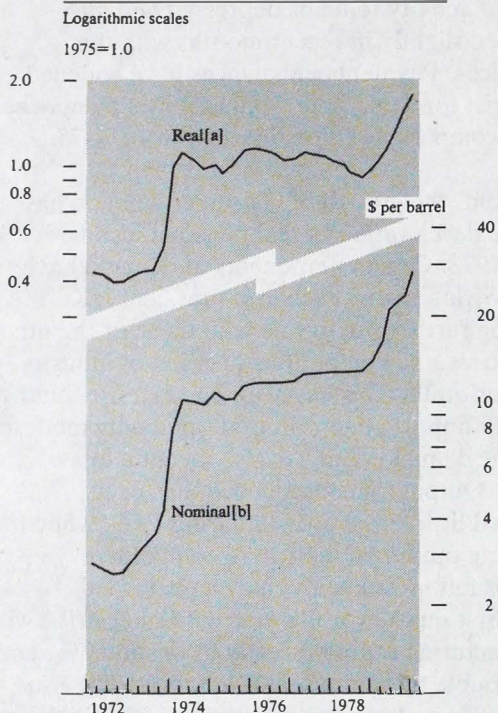
. . . and for other commodities too

The prices of most commodities, which began to increase around the middle of 1978, continued to rise steeply during 1979. The dollar price of metals was 40% higher in the fourth quarter of 1979 than in mid-1978, while that of agricultural products other than foods rose by 16%. During the same period, the dollar price of UK food imports also increased by around 16%. Prices were, however, somewhat lower in the middle of 1978 than historical relationships with the level of activity and world prices of manufactured goods would have suggested. In January this year prices again rose strongly, but since then they have eased a little.

One factor behind the increases was the acceleration in world industrial production, which increased by some 3½% between

Oil prices

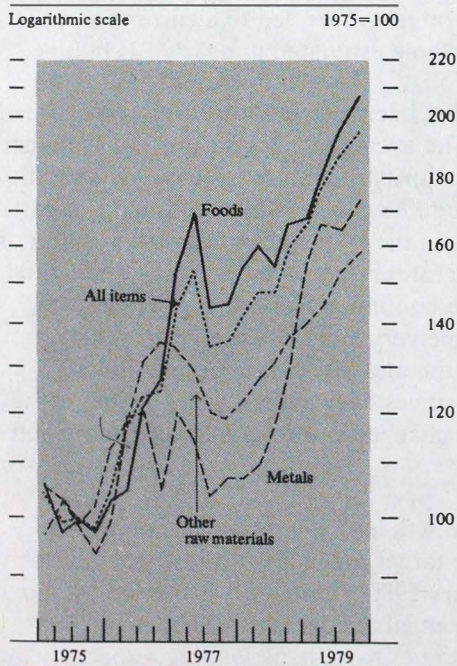
Oil prices doubled during 1979.



[a] The dollar price of crude oil divided by the dollar price of world exports of manufactures.
[b] Average contract price.

Economist dollar indices [a]

Prices of most commodities have risen sharply over the last two years.



[a] Used with permission.

the first and second halves of 1978—the sharpest rise for any half-year in the last five years. But if commodity prices rose solely for this reason, the response to *changes* in the level of activity has been much larger than in the past, suggesting that commodity supply problems could be a major constraint in any future phase of expansion.

Supply considerations are, however, difficult to gauge. Low real prices, which persisted for some years after the 1972–74 price boom, may have discouraged investment in minerals and may have been leading slowly towards capacity constraints. There is also extensive, albeit anecdotal, evidence for additional short-term supply problems: labour disputes in Canada have pushed up the price of nickel, and problems in southern Africa the prices of copper, chrome and cobalt; while, for other commodities, poor harvests in Russia have raised the price of wheat and grain, and frosts in Brazil the price of coffee.

The prospective slackening in world industrial activity suggests that over the next two years the rise in non-oil commodity prices might be slightly lower than the general rate of inflation; but the position on oil prices is more difficult to predict.

Slower growth likely in the industrial countries . . .

Although the rise in oil prices over the last fifteen months has been proportionately smaller and less abrupt than in 1973–74, the absolute impact may be just as severe. Higher oil prices will add about \$160 billion to the combined OECD import bill this year, equivalent to about 2% of GNP. This represents the initial deflationary effect on the oil-importing countries; but in the longer run, unless offsetting policy measures are taken, activity may be further reduced by second round effects, although these in turn should be offset by higher exports to members of OPEC. At the same time, the rise in oil prices could add directly about 2% to domestic prices in the industrial countries in 1980; and the total inflationary impact could be very much greater, unless the need for relative price changes is accepted, in particular in pay bargaining. In addition, current account deficits will widen, with serious implications for financing and indebtedness. (These questions are discussed further in the assessment.)

Activity in the main overseas economies held up better in 1979 than had earlier seemed likely. This reflected two principal factors: stronger than expected fixed investment in several countries, and a fall in the personal saving ratio in the United States. Neither is likely to continue this year, and both could be reversed. Indeed, by the end of 1979, growth seems to have been slowing. Taking the six major overseas economies[1] together, domestic demand may fall in the first half of 1980 and remain flat in the second half, before beginning a modest recovery in 1981. It is still possible, however, that both the recession and the subsequent recovery may be delayed.

With domestic demand in the major industrial economies higher than expected in the second half of 1979, world trade was correspondingly more buoyant (see table). Increased imports by members of OPEC were also an important factor, and they should continue to rise in 1980; but imports by the rest of the world may be flat, or falling, in the first half of the year. Overall, world trade is likely to recover only slowly towards the

World trade and UK export markets

Percentage volume increase over previous period at an annual rate

	1979		1980[b]	
	1st half	2nd half[a]	1st half	2nd half
World trade	5	7½	0	2½
UK export markets	3½	7½	2	4

[a] Partly estimated.

[b] Forecast.

[1] United States, Canada, France, Italy, Japan, and Western Germany.

World current account: summary

\$ billions	1973	1974	1975
OECD	11	-27	2
Oil-exporting countries[a]	6	67	29
Non-oil developing countries	-7	-24	-33
	1978	1979[b]	1980[c]
OECD	12	-31	-70
Oil-exporting countries[a]	1	77	112
Non-oil developing countries	-25	-38	-50
	1978	1979[b]	1980[c]
Adjusted for inflation[d]			
OECD	8	-20	-39
Oil-exporting countries[a]	1	49	63
Non-oil developing countries	-18	-24	-28

[a] The thirteen members of OPEC plus Bahrain, Brunei, Oman and Trinidad and Tobago.

[b] Partly estimated.

[c] Forecast.

[d] Deflated to 1974 prices by an index of manufactured export prices.

Financial flows of oil-exporting countries[a]

\$ billions	1975	1976	1977	1978	1979[b]
Oil and gas revenues[c]	106	129	142	138	214
Merchandise exports	113	138	153	148	224
Merchandise imports	-59	-73	-89	-104	-102
Net invisibles, including official transfers	-25	-30	-37	-43	-45
Current balance	29	35	27	1	77
Net external borrowing etc.	4	2	8	13	..
Surplus available for investment	33	37	35	14	..
Identified surplus from deployment table	35	37	33	13	33[d]

.. not available.

[a] Estimates in this table are derived from various sources and are not necessarily consistent, partly because of rounding.

[b] Estimates for 1979 are provisional.

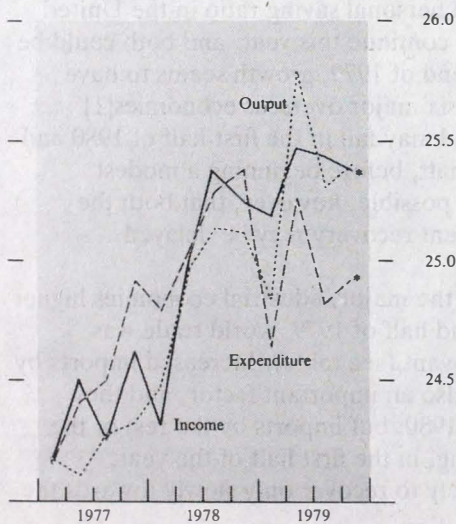
[c] Previously this series covered only oil revenues.

[d] Data for first nine months of 1979 only. See page 31.

Measures of GDP

The trend of GDP seems to have been flat during 1979.

Seasonally adjusted £ billions at 1975 prices



* Bank estimate for fourth quarter of 1979.

end of 1980 and rather moderate growth is then expected in 1981. The United Kingdom may escape the most serious effects of the check to world trade, partly because of this country's relatively large share of OPEC markets.

Consumer price inflation in the major overseas economies was running at an annual rate of just over 11% in mid-1979 and has eased back only slightly since then. As a result of the latest increases in oil prices and the continued strength of other commodity prices, a renewed acceleration is likely in the first half of 1980, although this may be followed by a more sustained slow-down. There is, as yet, no evidence of any significant worsening of domestically-generated inflation in the major overseas countries—apart from Italy, where wage indexation is widespread. In the United States, the growth of earnings slowed in the second half of 1979, despite accelerating price inflation; and the signs are still that forthcoming wage rounds in other countries may result in only moderate increases.

Large shifts in the terms of trade for the major economic groupings imply a significant redistribution of current account imbalances (see table). Latest estimates suggest that the oil exporters' surplus in 1979 was already bigger, in nominal terms, than in 1974. The counterparts were a sharp swing into deficit for the OECD as a whole, and a renewed deterioration in the position of the non-oil developing countries. In 1980, the OECD deficit may be more than double what it was in 1979, while the deficit of the developing countries could also widen further, even though policies to reduce the growth of imports are likely to be adopted. Within the OECD area, there could be a substantial rise in the deficits of the smaller countries, some of which are already heavily in debt.

The lower part of the first table gives some measure of these prospective imbalances by showing current account positions deflated by the rise in manufactured export prices since 1974. The expected oil exporters' surplus in 1980 is about as large in real terms as at its previous peak. On this occasion, however, a substantial surplus may persist for longer. Although the OPEC trade balance may worsen in volume terms, it is unlikely to deteriorate as quickly as in 1974-75; in any case, a deterioration in volume may be offset by some further improvement in the terms of trade, although the extent of this will depend on the strength of any recovery in OECD output in 1981.

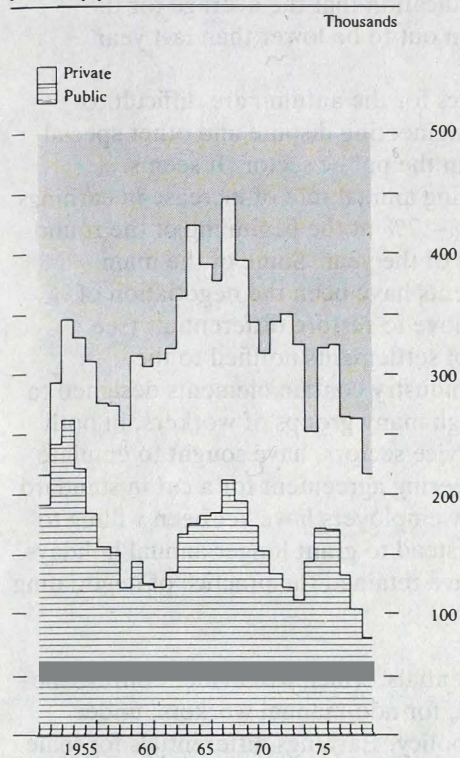
... and signs of recession become clearer in the United Kingdom ...

Although the path of output during 1979 was erratic (see chart), partly because of industrial disputes, it now seems that the trend of GDP was almost flat and that, by the fourth quarter, the trend of manufacturing output may already have been turning down. Thus, after a rise of 3% in the first half of the year (mainly because of increased production from the North Sea), total output showed virtually no further increase in the second half, and manufacturing output fell by about 1½%.

The main factors underlying this weakening in activity were the further erosion of UK industrial competitiveness and the increasing sluggishness of domestic demand following the sharp, but temporary, increase in consumer spending before the rise in value added tax (VAT) in June. The manufacturing sector was the most seriously affected by the loss of competitiveness, but

Housing starts^[a]

In 1979, total starts were at their lowest for thirty years.



[a] Great Britain.

Recent movements in employment^[a]

Thousands

	Change (Sept.-Sept.)				Level (Sept. 1979)
	1975-1976	1976-1977	1977-1978	1978-1979	
Manufacturing	-122	+29	-55	-100	7,032
Transport, communication and distribution	-65	+22	+22	+57	4,231
Financial, professional and miscellaneous services	+120	+76	+103	+117	7,190
Public administration and defence	-17	-29	+7	-1	1,573
Other (including agriculture and mining)	-27	-33	+9	+29	2,341
All industries and services	-110	+67	+84	+102	22,367

[a] Great Britain.

most other components of output were also weak. Construction output, for example, was around 2% lower in 1979 than in 1978, with industrial investment in new building subdued, and housebuilding very depressed. Housing starts, almost 17% down from 1978, were the lowest for nearly thirty years (see chart).

The pattern of output and demand in 1979 is unusually uncertain because of a sudden shift in the residual error in the national accounts. For the five years 1974 to 1978, this error—the excess of the expenditure over the income measure of GDP—averaged about 1% of GDP. In the first quarter of 1979, however, the sign of the error reversed (that is, the income measure exceeded the expenditure measure) and for the first three quarters together this 'reversed' error averaged nearly 2% of GDP. The main reason is thought to be the under-recording of expenditure, perhaps in stockbuilding, but any such judgment is necessarily tentative. As well as obscuring developments during 1979, these uncertainties mean an insecure base for forecasting the course of the economy during 1980. It seems likely, however, that the principal factors depressing activity will continue, and may, indeed, intensify. With the prospect of a large fall in stocks, a decline in total output of 2% or more—and perhaps twice as much in manufacturing industry—now seems probable.

. . . especially in the labour market

After three years of sustained growth, total employment probably levelled off in the second half of 1979. The pattern of employment changes in different sectors is shown in the table. Manufacturing employment has continued to fall, but this has been more than matched by increases in the service sector, leaving total employment in September about 1½% higher than three years earlier.

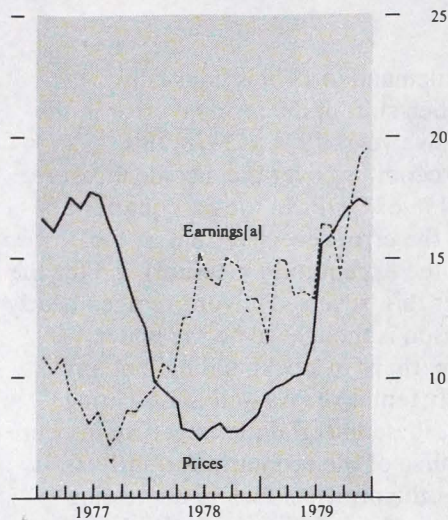
The recent behaviour of employment in the manufacturing sector has been difficult to assess, partly because of the short-term disruptions to activity caused by the road haulage dispute and, later, the engineering dispute. For 1979 as a whole manufacturing output was little higher than in 1978, but contraction of the manufacturing labour force meant a rise in productivity of about 2%—the average rate since 1975. Towards the end of the year manufacturing employment began to fall more quickly, with a drop of about 90,000 (more than 1½%) between August and December. Recruiting presumably slackened during the engineering dispute, but there is little evidence of any subsequent catching up. Changes in employment tend to reflect changes in output with some delay. It may be, however, that increasing financial pressures, coupled with widely-held expectations of a downturn in activity, persuaded some employers to cut their labour forces more promptly than usual. Part of the fall may also have resulted from a restructuring of the Government's employment support schemes.

The levelling off in employment led first to an end to the decline in unemployment, with a low point of 1,262,000 (5.2%) being reached in September, and subsequently to increases, which added 120,000 to the register by February (raising the rate to 5.7%). Vacancies have also indicated a marked slackening in the demand for labour; by January, they were about 25% lower than at the peak last June. These trends are likely to continue.

Earnings and prices

Earnings in the latter part of 1979 were rising somewhat faster than prices.

Percentage increase on a year earlier



[a] New series.

Pay differentials: male employees[a]

	Manual		Non-manual		
	As percentage of median		Mean earnings as percentage of manual mean earnings	As percentage of corresponding median	
	Upper quartile	Highest decile		Upper quartile	Highest decile
April 1972	121.4	144.0	155.3	136.4	184.2
1973	120.4	141.9	148.8	134.8	181.8
1974	119.5	140.5	147.5	133.6	179.1
1975	118.4	139.0	142.6	132.6	178.1
1976	118.1	138.0	146.3	135.0	181.8
1977	117.5	136.3	145.2	132.9	176.5
1978	118.1	138.3	146.5	131.8	174.0
1979	118.2	139.3	143.4	129.8	169.4

Source: *New Earnings Survey*, Department of Employment.

[a] Hourly earnings of full-time male employees (aged twenty-one and over), excluding employees whose pay was affected by absence. The highest decile refers to the point in the earnings distribution—in terms of numbers of employees—which is 10% below the top. Similarly, the upper quartile refers to earnings 25% below the top.

Pay settlements remain high . . .

There appear to have been wide variations in the level of pay awards agreed so far, and many important groups have yet to settle, but there is little indication that the average for the current pay round will turn out to be lower than last year.

Published earnings statistics for the autumn are difficult to interpret because of the engineering dispute and other special factors, such as back pay in the public sector. It seems, however, that the underlying annual rate of increase in earnings moved up from about 16%–17% at the beginning of the round to around 19% by the end of the year. Some of the main features of recent settlements have been the negotiation of productivity deals and a move to restore differentials (see below). About one third of settlements notified to the Confederation of British Industry contain elements designed to raise productivity. Although many groups of workers, in both the manufacturing and service sectors, have sought to emulate the provision in the engineering agreement for a cut in standard weekly working hours, few employers have yet been willing to concede this, preferring instead to grant longer annual holidays. Most pay deals seem to have retained the practice of negotiating for a twelve-month period.

The compression of differentials, which was evident during the early 1970s, has continued, for non-manual workers, under recent phases of incomes policy. Earnings differentials for male manual workers changed very little after 1975 (see table); indeed, there is some evidence that they widened slightly in the two years ending in April 1979. In contrast, not only has there been a further narrowing of differentials *within* the non-manual group, but the earnings of non-manual workers have continued to fall *relative* to those of manual workers. Similar patterns emerge for the earnings of manual and non-manual women, although women's earnings as a whole improved relative to those of men in the first half of the decade.

. . . and no indication of any easing in inflation

Retail prices rose by about 18½% between January 1979 and January 1980. About one fifth of this represented the effect of the indirect tax increases introduced in the June Budget: the underlying rate of price inflation was appreciably lower. Thus, during the six months to January, retail prices, excluding seasonal food, increased at an annual rate of around 14½%, similar to the rate in the previous six months.

One factor helping to moderate price increases has been the strength of sterling. During the second half of last year, the effective exchange rate was some 12% higher, on average, than a year before, and this restrained prices, both by curbing the increase in raw material costs and also by sharpening the competitive pressure from imports. Even so, manufacturers' buying prices rose by about 27% in the year to January 1980, some two thirds of which can be attributed to oil and oil products (which rose in price by more than 50%, in sterling terms, over the same period), although other commodity prices also rose steeply.

Some of the acceleration in costs during 1979 has probably yet to feed through into selling and consumer prices, and some modest quickening of inflation may be in prospect over the next few months.

Real earnings and consumer spending level off . . .

The trend of consumers' expenditure seems to have flattened in the second half of last year, although changes in the timing of spending induced by the Budget meant that actual spending in the second half fell by 1½%. For the year as a whole, spending was nearly 4% higher than in 1978. Real personal disposable income (RPDI) rose only slowly until the fourth quarter, but then increased sharply with the receipt of income tax rebates. Overall in 1979, RPDI increased by slightly more than consumer spending.

More than £1 billion of income tax rebates, arising from the introduction in the June Budget of lower income tax rates and revised thresholds for the higher rates of tax, were received in the fourth quarter. Together with the increases in earnings, pensioners' Christmas bonuses and higher interest receipts, these probably raised RPDI by around 5%. Consumers' expenditure rose by rather less than 2%, so that the saving ratio probably increased to 20% or more. Besides the usual delay in responding to a temporary spurt in income, the uncertain outlook for employment and inflation and the prospect of an increased mortgage rate may also have encouraged saving, or at least discouraged borrowing.

Personal sector liquid asset holdings and borrowing

£ millions: not seasonally adjusted

	Increase in identified gross liquid asset holdings	Increase in personal sector bank borrowing	of which, consumer credit by banks to persons and households	Increase in other consumer credit outstanding	Increase in total consumer credit outstanding
1978 1st qtr	2,301	174	132	72	204
2nd ..	2,672	814	371	102	473
3rd ..	2,640	364	209	111	320
4th ..	2,649	515	211	221	432
1979 1st qtr	2,798	463	131	80	211
2nd ..	3,538	1,062	434	209	643
3rd ..	3,614	801	288	136	424
4th	846	184

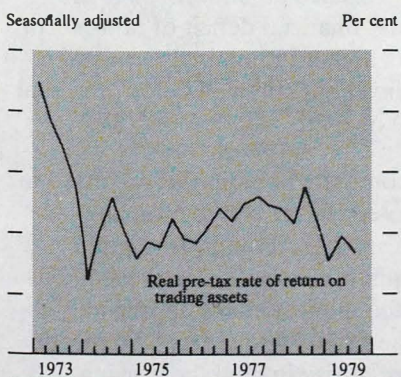
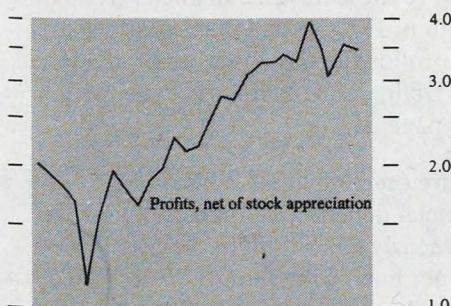
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The table illustrates the large increases around the middle of 1979 in both the gross liquid asset holdings of the personal sector and in consumer credit. The buoyancy of bank lending to the whole personal sector from the second quarter reflected increased borrowing by households to finance the sharp rise in spending before the Budget, and higher borrowing associated with house purchase, and by unincorporated businesses. In the fourth quarter, borrowing to finance consumption seems to have eased, partly because of the income tax rebates, but possibly also in response to the increases in bank lending rates in June and November.

Profitability of non-North Sea industrial and commercial companies

Profits weakened in 1979 and, with them, real profitability.

Seasonally adjusted £ billions
Logarithmic scale



. . . while company profits come under increasing pressure

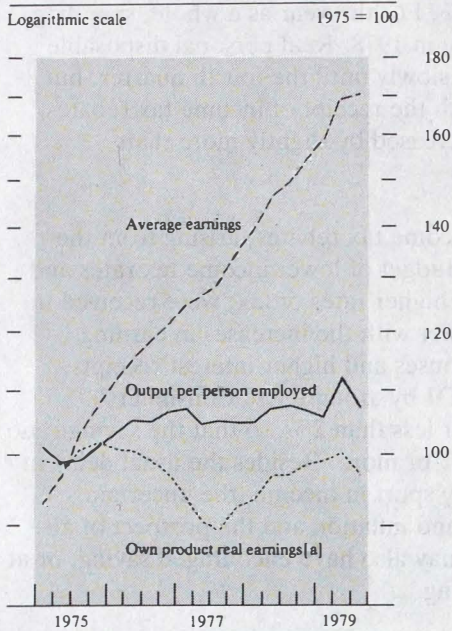
Industrial[1] profitability weakened sharply in 1979. In the first three quarters of the year, the real pre-tax rate of return on trading assets (after providing for stock appreciation and for capital consumption at current cost) was, on average, 3½%—lower than at any time since 1975 (see chart).

Industrial disruption during 1979—in particular the road haulage dispute in the first quarter and the engineering stoppage in the third—no doubt contributed to the decline in profits. Apart from these special factors, however, it seems clear that the trend of profitability has been weakening since late 1978. The main reason has been a loss of competitiveness as costs have moved out of line with those in the other main industrial countries, the divergence being accentuated by the appreciation of sterling. The extent to which 'real' labour costs have outstripped productivity increases and have contributed to the squeeze on profits is illustrated in the chart overleaf. Manufacturing productivity increased by about 4½% between mid-1977 and mid-1979, while real earnings in manufacturing increased by more than 9%. Substantial rises in raw material prices reinforced the pressure on profits in the latter part of 1978 and in 1979.

[1] Industrial and commercial companies, excluding North Sea activities.

Earnings and productivity in manufacturing industry

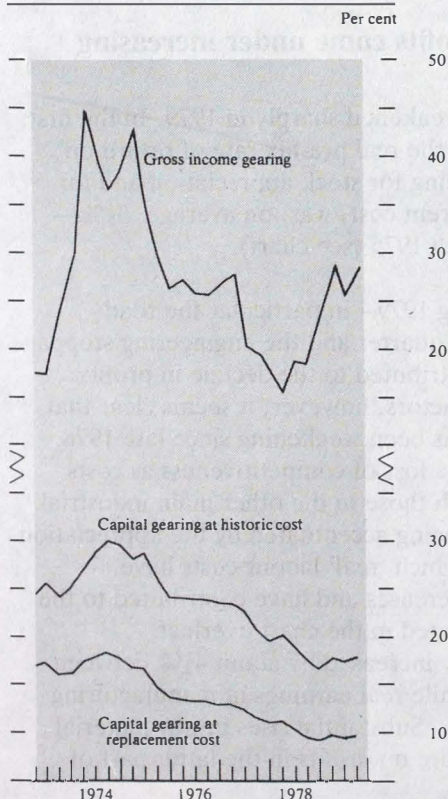
Over the last two years, real earnings have been rising faster than productivity.



[a] Average earnings deflated by wholesale selling prices of manufactures.

Income and capital gearing[a]

Income gearing has risen sharply, but capital gearing remains low.



[a] All industrial and commercial companies.

Profitability is likely to weaken again this year, with the real rate of return falling to perhaps 2%–2½%. Competitive pressures may intensify, and in addition profits will suffer as activity slackens.

Industrial investment reached a new peak (in real terms) in 1979, rising for the third year in succession and by 4½% over 1978. While the manufacturing component was virtually unchanged, some of the 8% increase in investment by the distribution and services sector probably represented continued growth of leasing to manufacturing industry. Even so, leasing seems to have expanded rather more slowly in 1979 than in previous years, perhaps partly because the favourable treatment of leased vehicles was eliminated by the 1979 Finance (No. 2) Act. The January survey of investment intentions by the Department of Industry (D.o.I.) suggested a fall of 6%–10% in manufacturing investment this year, but a further small rise in investment by the distribution and services sector. This represents a substantial downward revision of manufacturing investment plans since October, which may go further as the financial squeeze on companies comes to be felt more forcibly.

Financial pressures, together with the general slowdown in the economy, are also likely to induce a reduction in stocks. The pattern of stockbuilding towards the end of last year, when much of the increase in retailers' stocks appears to have been involuntary, may give the first indication of a turn-round. For 1979 as a whole, however, stockbuilding apparently continued at much the same pace as in 1977 and 1978. This seems the more surprising because the recorded figures may well understate the actual rise in stocks, and make it difficult to predict with any certainty what will happen in 1980.

Company cash flow weakened appreciably during 1979, partly because of lower profits but also because of the increase in interest charges. The same factors led to an increase in income gearing to 33% for all companies, higher than at any time before 1973 but still well below the peak of 45% in 1974. At the same time, the marked improvement in capital gearing, at both historic and replacement cost, which had been sustained since 1974, came to an end in 1979. Even so, capital gearing remains low on both measures. Despite these adverse financial trends, dividend payments were high in 1979, with a particularly sharp increase in the third quarter following the abolition of dividend controls at the end of July. Dividend behaviour is examined in more detail in an article on page 33.

Evidence of financial pressure on companies is becoming increasingly clear. The financial deficit of all industrial and commercial companies was nearly £3¼ billion in the first three quarters of 1979, while the net borrowing requirement, which is a better indicator of cash needs, reached £5 billion. Over the same period the average quarterly financial deficit of non-North Sea companies (£1.3 billion) was higher in nominal terms than in the crisis year of 1974 (£1 billion) but still well below it in real terms. The position may worsen in 1980.

More recent figures show that company liquidity, as recorded in the D.o.I. survey, deteriorated very sharply in the fourth quarter of last year (following a smaller, though still significant, weakening in the third). Net liquidity, in real terms, reached its lowest point since mid-1975, although it remains appreciably stronger than at the height of the 1974–75 squeeze. The recent decline mainly reflects a substantial rise in bank borrowing,

accompanied, in the second half of 1979, by a large reduction in bank deposits.

The public sector

The public sector borrowing requirement (PSBR) for the financial year 1979/80 now seems likely to be around £9 billion, somewhat above the various estimates made in the course of 1979. The reasons include: higher than expected borrowing by local authorities and public corporations, the latter largely because of the industrial dispute in the Post Office and the consequent long delay in the payment of many telephone bills; an apparent lengthening of the lag in the payment by companies of VAT; and higher debt interest payments than originally forecast. Acting in the opposite direction, the advancing of petroleum revenue tax payments from May 1980 into the current financial year should reduce the PSBR by about £700 million.

In 1980/81, a number of influences will be operating to contain the PSBR, in particular the planned cuts in the volume of discretionary public spending, a full year's VAT revenue at the higher rate introduced in June 1979, receipts of the outstanding part of the telephone bills delayed from this year, and the reduction under negotiation in the United Kingdom's financial contribution to the EEC. There will, however, be powerful factors tending to swell the PSBR, most notably the effects of inflation on revenue and expenditure, a rise in debt interest charges, and the expected fall in activity and employment, with the resulting drop in tax receipts and increase in social security payments.

The table shows how the relative importance of social security payments, the main component of 'current grants to persons', has increased over recent years. To a considerable extent, however, the increase reflects the introduction of child benefits, which replaced family allowances in April 1977 and child tax allowances in stages between 1977 and 1979; but there have also been real improvements in long-term benefits and extensions of coverage. In contrast, the share of spending on goods and services showed a slight downward trend over the period 1975 to 1979, although, within the total, there was little net change in consumption, while capital formation fell sharply. For example, between 1974 and 1978 the volume of capital expenditure on roads and public lighting fell by over 30%, while in housing and education the cut was around 40%.^[1] Real expenditure on subsidies fell by around 30% over the same period. Subsidies on public sector housing, which account for just under half of total subsidies, actually grew over the period (by 25% in real terms) but other subsidy payments (to trading concerns) fell by a half.

The rise in current grants paid abroad reflects the growing net contribution to the EEC.

'Net lending etc.' is a heterogeneous and volatile category. The main movements since 1974 have largely reflected changes in general government net lending to public corporations and net cash expenditure on company securities. The latter involved expenditure of some £500 million in 1975, which included the

Shares in public expenditure^[a]

Percentages	1975	1976	1977	1978	1979 ^[b]
Final consumption	44.7	45.8	47.3	45.8	44.6
Gross domestic capital formation ^[c]	9.7	9.3	7.9	6.3	6.0
of which, dwellings	3.3	3.4	3.2	2.6	2.4
Total goods and services	54.4	55.1	55.2	52.1	50.6
Subsidies	7.2	5.9	5.4	5.1	4.9
Current grants to persons	19.9	21.9	24.5	25.0	25.0
Current grants paid abroad	0.7	1.3	1.8	2.4	2.3
Capital transfers	2.3	2.4	2.4	2.8	2.1
Debt interest	8.2	9.3	10.3	10.2	10.8
Net lending etc.	7.3	4.1	0.4	2.4	4.3
of which, net lending to public corporations	4.2	2.7	0.7	2.6	3.7
	100.0	100.0	100.0	100.0	100.0

[a] Calendar years.

[b] Bank estimates.

[c] Excluding stock appreciation.

[1] The categories in this sentence refer to the functional classification of general government expenditure in *National Income and Expenditure, 1979 Edition* (Table 9.4) and not the programmes of the public expenditure survey.

Balance of payments: current account

£ millions; seasonally adjusted

	1976	1977	1978	1979		
	Year	Year	Year	Year	1st half	2nd half
Visible balance	-3,911	-2,239	-1,493	-3,312	-2,074	-1,238
of which:						
Oil balance	-3,947	-2,771	-1,999	-780	-464	-316
SNAPS balance[a]	-207	-507	-66	-83	-101	+18
Underlying non-oil balance	+243	+1,039	+572	-2,449	-1,509	-940
Invisible balance	+2,709	+2,015	+2,425	+875	+549	+326
Current balance	-1,202	-224	+932	-2,437	-1,525	-912

[a] Ships, North Sea production installations, aircraft and precious stones.

Changes in trade volumes and prices[a]

Percentage change from previous year

	1976	1977	1978	1979
Export volumes	8.9	9.0	3.5	2.4
of which:				
Manufactures[b]	8.5	6.0	1.7	-0.3
Fuels	19.9	38.0	26.2	32.6
Other	8.2	13.3	3.5	1.3
Import volumes	6.4	2.3	7.3	9.9
of which:				
Manufactures[b]	10.2	8.2	13.6	17.7
Semi-manufactures	11.2	2.8	14.3	12.0
Finished manufactures	9.4	12.8	13.0	22.3
Fuels	0.2	-17.4	-3.1	-3.2
Other	4.6	3.5	2.2	2.4
Export prices	19.6	18.3	9.6	10.8
Import prices	22.1	15.8	4.0	10.4
Terms of trade	-2.0	2.1	5.4	0.4

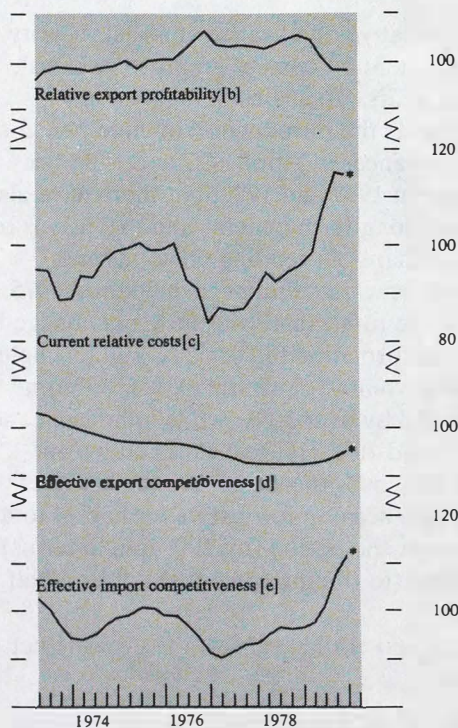
[a] Volumes: overseas trade statistics basis. Prices: balance of payments basis.

[b] Excluding erratic items, i.e. ships, North Sea production installations, aircraft and precious stones.

Competitiveness[a]

Both import and export competitiveness deteriorated markedly in 1979.

1975=100



* Bank estimate for fourth quarter of 1979.

- [a] Except for relative export profitability, a downward movement in a series indicates an improvement in competitiveness.
- [b] Ratio of UK export prices of manufactures (excluding erratic items) to prices of manufacturing output.
- [c] Ratio of UK normalised unit labour costs to those of competitor countries: IMF series.
- [d] A weighted average of current and past relative costs, the weights being derived from coefficients in an equation explaining the volume of manufactured exports.
- [e] A weighted average of current and past relative costs and prices, the weights being derived from coefficients in an equation explaining the volume of imports of finished manufactures.

subscription to a rights issue by BL Ltd and the acquisition of Burmah Oil's stake in the British Petroleum Co. Ltd, (BP) and receipt of a similar amount in 1977 (from the sale of shares in BP).

The current account suffers from worsening competitiveness

Developments in 1979

The current account deficit in 1979 is provisionally put at £2.4 billion, a deterioration of more than £3 billion from 1978 and a reversal of the generally improving trend since 1976 (see table). Between 1976 and 1978 the current balance had strengthened broadly in line with the narrowing deficit on trade in oil. In 1979 the improvement on oil account continued, but the non-oil trade balance deteriorated sharply—largely because of an adverse shift in trade volumes in the early part of the year—while the surplus on invisibles was reduced by more than half.

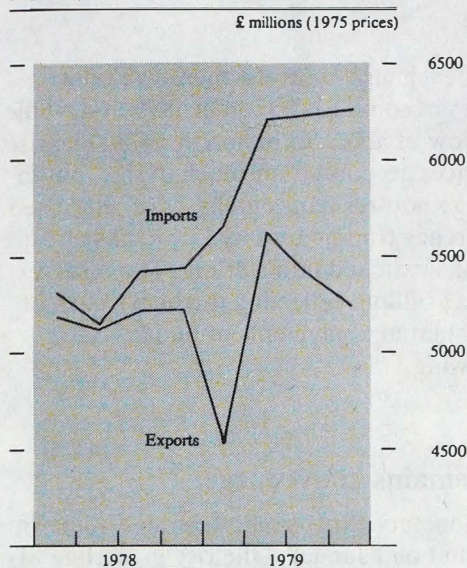
Some of the worsening in export performance reflected industrial disruption in the United Kingdom and difficulties in the important export markets of Iran and Nigeria. These special factors had less impact in the second half of 1979, and by the end of the year the volume of non-oil exports was about the same as at the end of 1978. UK manufactured exports in 1979—virtually unchanged in volume from 1978—do, however, appear to have fallen well behind the growth of world trade (see table). Some loss of market share has been normal in recent years, even when the competitive position of UK industry has remained unchanged. Between 1976 and 1978, with effective competitiveness improving, this long-term decline was largely offset (see chart). But in 1979 effective competitiveness began to deteriorate, and this, together with longer-term factors, probably accounted for about one third of the estimated half percentage point loss of world market share.

It is more difficult to ascribe the rise in imports to special factors. The volume of non-oil imports rose strongly at the beginning of 1979 and maintained this high level thereafter (see chart). A rise in imports of finished manufactures was principally responsible; this was not unexpected and can be largely explained by a significant loss of competitiveness, strong growth of consumer demand early in the year, and a seemingly long-term rise in import penetration. But imports of semi-manufactures also rose sharply, by 12% in volume (excluding precious stones), while imports of basic materials rose by almost 8%. These increases are difficult to explain at a time when domestic production of finished goods was weak, but as some of these imports have no doubt displaced domestic production of intermediate goods, it may again reflect loss of competitiveness.

Imports of chemicals have been an important element in the growth of imports of semi-manufactures. The relatively low level of US feedstock prices has been advanced as a possible reason. The proportion of UK chemical imports coming from the United States has, however, changed little in recent years. But the share of UK exports of organic chemicals going to the United States fell appreciably in 1978, and continued to do so in 1979, while in the United Kingdom there has been a sharp increase in the US share of the closely associated market in synthetic fibres.

Underlying non-oil export and import volumes

The volume of exports rebounded after the disruption in the first quarter of 1979 but the higher volume of imports has been sustained.



Components of the invisibles balance

£ millions; seasonally adjusted

	1978	1979	1979			
			1st qtr	2nd qtr	3rd qtr	4th qtr
Net services	+3,275	+3,070	+674	+732	+852	+812
of which:						
Private sector and public corporations	+3,974	+3,903	+882	+949	+1,046	+1,026
General government	-699	-833	-208	-217	-194	-214
Net interest, profits and dividends	+1,061	+207	+211	+17	+57	-78
of which:						
Private sector and public corporations	+1,560	+584	+319	+107	+128	+30
General government	-499	-377	-108	-90	-71	-108
Net transfers	-1,911	-2,402	-512	-573	-654	-663
of which:						
Private sector	-218	-374	-62	-51	-126	-135
General government	-1,693	-2,028	-450	-522	-528	-528
Net invisibles balance	+2,425	+875	+373	+176	+255	+71

Capital flows

£ millions; not seasonally adjusted

	1979			
	1st qtr	2nd qtr	3rd qtr	4th qtr
Current balance	-1,401	-471	-77	-488
Exchange reserves in sterling:				
Countries	+135	+160	+316	-104
International organisations	+6	-63	+99	+186
Private sterling balances:				
British government securities	+236	+67	+423	+274
Other banking and money-market liabilities	+462	+360	+448	+1,332
Net external foreign currency borrowing by UK banks	+941	+378	+626	-487
Other capital flows net (including balancing item)	+306	+327	-1,537	-743
Balance for official financing	+685	+758	+298	-30

Within the invisibles account, the most marked deterioration in 1979 was in interest, profits and dividends (IPD), where the surplus fell to under £¼ billion, from more than £1 billion in 1978 (see table). The growth in profits of foreign oil companies operating in the North Sea, was greater than that of UK oil companies overseas, while net earnings by UK banks on their euro-currency business declined sharply. The deficit on transfers widened by a further £½ billion, partly because of higher net contributions to the EEC and partly because of an increase in private transfers abroad following the easing, and subsequent removal, of exchange controls. In contrast, there was only a small fall in the surplus on services; within the total, the travel account worsened—there were slightly fewer visitors to the United Kingdom, and significantly more journeys abroad by UK residents—but the balance on 'other services' was substantially strengthened as earnings rose, and payments abroad for North Sea-related services declined.

The short-term outlook

Last year, there were wide fluctuations in the current account balance from one quarter to the next. While it is seldom possible to explain the changes fully, even after the event, it is nevertheless possible to identify some of the longer-term influences.

Looking ahead, two favourable factors this year will be the further rise in production of North Sea oil and gas, and the impact of the expected recession in moderating import growth. The trade deficit in petroleum and petroleum products should be eliminated this year, although the current account will bear the cost of rising oil IPD debits.

The major adverse factor will continue to be the loss of competitiveness. With a stable exchange rate, the present rate of increase in unit labour costs in the United Kingdom implies a further deterioration which is likely to lead to greater import penetration. Export performance, too, may increasingly come to reflect the erosion of competitiveness over the past two years, and on the basis of past relationships and the forecast growth of world trade, the volume of manufactured exports may show little or no increase in the near future. On the other hand, the tendency for the terms of trade to improve as competitiveness worsens should moderate the impact on the trade balance of a deterioration in trade volumes.

Further capital outflows following the removal of exchange controls

The balance for official financing in the fourth quarter of 1979 was almost nil. While there were very large inflows, as overseas residents increased their sterling bank deposits and made sizable purchases of gilt-edged stocks, these were offset by large capital outflows from the UK private sector on both current and capital account. These outflows had a strongly contractionary influence on the money supply, as in the previous quarter.

A comparison of transactions by the private sector in the fourth quarter with the experience of the last two years suggests, very tentatively, that the removal of exchange controls generated an outflow of perhaps £¾–1¼ billion. This is approximately the same as the estimate for the third quarter and similarly reflected large repayments of foreign currency borrowing. At the same time there was a sharp increase in private sector foreign currency

External and foreign currency finance

£ millions; not seasonally adjusted

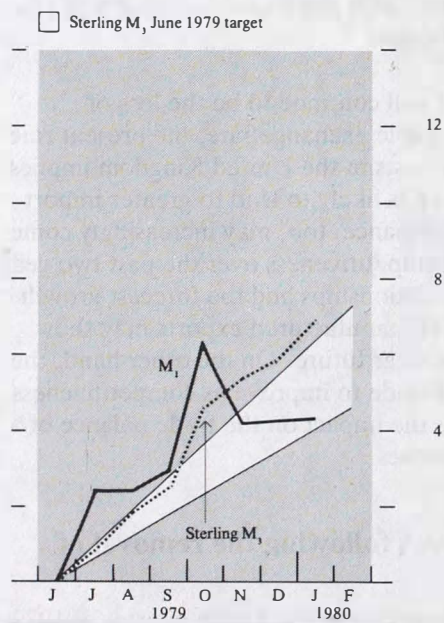
	1979			
	1st qtr	2nd qtr	3rd qtr	4th qtr
Current balance (surplus +)	-1,401	-471	- 77	- 488
Bank lending in sterling to overseas (increase-)	+ 80	+ 18	- 99	+ 15
Public sector foreign currency deposits (increase-)	- 10	- 5	- 1	- 28
Non-bank private sector capital and foreign currency transactions	+ 848	+317	-1,210	- 510
of which:				
Net foreign currency borrowing from UK banks (borrowing less deposits; increase+)	+ 440	-194	+ 311	- 407
Net borrowing from abroad[a] (residual; increase +)	+ 408	+511	-1,521	- 103
Total external and foreign currency finance (=effect on sterling M ₃)	- 483	-141	-1,387	-1,011

[a] Also includes public sector lending abroad (increase-) and certain foreign currency or external assets (increase +) held by UK banks.

Monetary objectives

The growth of sterling M₃ has continued to be above the top of the target range.

Seasonally adjusted Percentage change since mid-June 1979



deposits with UK banks. On the other hand, UK purchases of overseas securities were lower than in the previous quarter despite the abolition of the investment currency premium. By the end of the quarter, there were signs that the outflows had halted in the face of higher domestic interest-rates and a strengthening exchange rate.

Despite the removal of exchange controls, there were net identified capital inflows of some £3½ billion in 1979 as a whole, compared with an outflow of about £3 billion in 1978. The rise in private sterling balances accounted for much of this, but in addition there were large non-resident purchases of gilt-edged stocks. Net foreign currency transactions by UK banks also contributed, as the banks switched into sterling. The reserves, however, rose by only £1 billion, reflecting the heavy current account deficit and substantial repayments of public sector foreign currency borrowing.

Monetary growth remains above target

Although the rate of monetary expansion moderated somewhat between mid-October and mid-January, the rise in sterling M₃ since June (12¼% at an annual rate) remained above the target range of 7%–11% (see chart). Bank lending to the private sector continued to rise strongly, despite high nominal interest rates and relatively subdued output and consumer spending, and the central government borrowing requirement (CGBR) fell back rather less than expected. In consequence, very heavy sales of gilt-edged stocks were necessary to contain monetary growth, and these were facilitated by the climate in financial markets following the rise in minimum lending rate (MLR) in November. These sales, however, put a significant strain on the liquidity of the banking system, particularly with the onset of the main tax revenue season early in January. As a result, short-term rates remained high and markets generally became less sanguine about an early fall in MLR.

Underlying the present level of interest rates has been the objective of constraining monetary expansion to a target well below the present rate of growth of nominal incomes. But, as the course of bank lending in the three months to mid-January again demonstrated, even sharp increases in interest rates, such as occurred in November, may have little immediate impact on the demand for credit. On the partial information available, the demand for funds was well spread, but came most strongly from industry. Lending to persons (other than unincorporated businesses) eased somewhat towards the end of 1979 after rapid increases in the middle of the year.

Although the CGBR, reduced by the first receipts from asset sales and other measures in the 1979 Budget, was lower in the three months to mid-January than earlier in the financial year, the rest of the public sector borrowed fairly heavily from the banking system (see table). Overall, the PSBR for the whole financial year seems likely to be around £9 billion. Sales of central government debt in the three months to mid-January were on a scale previously exceeded only in the first half of 1979. More than £3½ billion (net) of gilt-edged stocks were bought by UK residents (other than banks), and receipts from national savings revived following the improvement in terms.

DCE and the money stock^[a]

£ millions; seasonally adjusted

Mid-month	Oct. 78– Jan. 79	Jan. 79– Apr. 79	Apr. 79– July 79	July 79– Oct. 79	Oct. 79– Jan. 80
Central government borrowing requirement	+2,239	+2,082	+2,889	+2,865	+2,355
Net purchases (-) of central government debt by non-bank private sector	-1,972	-3,589	-2,823	-1,165	-3,028
Other public sector ^[b]	+ 366	+ 766	+ 37	- 291	+ 347
Bank lending in sterling to:					
UK private sector ^[c]	+1,397	+2,397	+2,223	+2,073	+2,193
Overseas sector	+ 85	- 113	- 15	+ 54	+ 269
Domestic credit expansion	+2,115	+1,543	+2,311	+3,536	+2,136
External and foreign currency finance (increase -)	+ 52	- 485	- 141	-1,270	- 745
Other	- 154	- 274	- 414	- 291	- 151
Sterling M₃	+2,013	+ 784	+1,756	+1,975	+1,240
Percentage change in sterling M ₃	+ 4.2	+ 1.6	+ 3.4	+ 3.7	+ 2.3
M₁	+ 842	+1,015	+ 467	+1,038	- 547
Percentage change in M ₁	+ 3.4	+ 3.9	+ 1.7	+ 3.8	- 1.9

[a] Further details are shown in Table 11 in the statistical annex.

[b] Contribution to the public sector borrowing requirement by the rest of the public sector, less purchases of local authority and public corporation debt by the non-bank private sector.

[c] Including commercial bills held by the Issue Department of the Bank of England.

On the other hand nearly £½ billion of certificates of tax deposit (CTDs)^[1] were encashed to meet tax liabilities, but overall the public sector's financing needs were more than matched by net sales of debt outside the banking sector.

Thus, despite the continuing strength of bank lending (see table), domestic credit expanded more slowly between mid-October and mid-January than earlier in the financial year. External and foreign currency factors, however, were on balance a much less contractionary influence on money than in the previous three banking months. Indeed, there were net inflows in December and January.

Amongst the other monetary aggregates, both the total and the non-interest-bearing component of M₁ fell over the three banking months. In part this no doubt reflected the sharp rise in MLR in November, as well as the earlier increase in June; but the decline appears to have been a little greater than would have been suggested by econometric relationships. The recent fall has reduced the annual rate of growth in M₁ since mid-June from 20% last October to 7½% by mid-January. Total M₃ moved roughly in line with sterling M₃ in the three months to mid-January, despite the greater freedom now enjoyed by UK residents to acquire foreign currency; and the same pattern was repeated in the broad measures of private sector liquidity, although the overall increases during the three months were somewhat smaller (see Table 21 in the statistical annex). Within the widest measure, shares and deposits with building societies rose by 3.3% in the three calendar months November–January, somewhat faster than the growth of sterling M₃ over the three banking months to mid-January, but this was offset by the redemption of CTDs. The December rise in interest rates on building society shares brought some recovery in net receipts, while the accompanying rise in the recommended mortgage rate to 15% appears to have had some dampening effect both on the demand for mortgages and on house prices. Nevertheless societies have reported that the supply of funds is still failing to match demand.

In the money markets,^[2] a combination of the substantial gilt-edged sales and high bank lending exacerbated the usual seasonal pressure on bank liquidity that followed the start of the main tax revenue season early in January. The pressure on reserve assets was sometimes intense and, although the authorities released all special deposits on 16th January, short-term interest rates remained high during the month and considerable official assistance was given in the money markets. These conditions continued into February and prompted the facility for the sale and repurchase of gilt-edged stocks which was made available to the London and Scottish clearing banks from 15th February. Because of the pressure, banks also switched part of their non-reserve asset lending to the discount market (which is treated as an offset in the calculation of eligible liabilities) on to a reserve asset basis (which is not an offset), and this, together with the need to finance the expansion of bank lending, contributed to a sharp rise in the interest-bearing eligible liabilities of the banks. Indeed, a number of banks began to incur significant penalties under the

[1] Hitherto transactions in CTDs have not been seasonally adjusted. But there is some evidence of a seasonal pattern to surrenders of CTDs, and there may now be a sufficiently long run of data to allow it to be estimated. This will be considered in the annual update of the seasonal factors affecting the money stock.

[2] See also financial review page 19.

supplementary special deposits scheme; by mid-February twenty-two banks were paying more than £100 million in total, with seven of these in the third penalty tranche, where the rate of (non-interest-bearing) deposit is 50% of excess interest-bearing eligible liabilities. Pressure on the banks' liquidity may ease as the period of heaviest tax payments passes; but the difficulties are likely to recur until the growth of bank lending is substantially reduced.

Assessment

This assessment discusses, in turn, the international banking scene, and the domestic monetary situation.

The international banking scene

The world is now absorbing last year's rise in oil prices, the impact of which will be as serious as the rise in 1973-74. In addition to its effect on prices and the level of demand, it also entails a major shift in the pattern of payments imbalances, with greater deficits (or, in a few cases, smaller surpluses) for almost all consuming countries, both developed and less developed; and an OPEC surplus as large in real terms as in 1974.

The international financial system will thus again be called on to recycle funds on a very substantial scale. In some respects, the international markets are better equipped to respond than in 1974. They have grown fourfold since the end of 1973; their sources of funds are much more widely spread; and more banks, of various nationalities, are involved in international lending and are available to share the risks. There has also been a strengthening of prudential controls in individual banks, and the supervision by regulatory authorities in all the major financial centres has been improved and extended.

There are, however, several factors which may constrain the ability of the banks to recycle funds. The first is the uncertain outlook for market conditions. Until recently, very active competition amongst the banks, in a market with ample liquidity, created a climate favourable to borrowers; and loans were extended on increasingly fine terms, and in amounts that in general satisfied the financing requirements of the growing number of countries that had access to them.

In the later part of 1979, market conditions started to change. While OPEC deposits continued to increase as a result of higher surpluses, conditions in domestic financial markets have been tightening, most particularly in the United States but also in many of the other industrialised countries. More importantly, perhaps, there was a growing realisation that the lower margins on which loans to many countries were being extended did not adequately reflect the risks. The accumulated volume of debt outstanding—particularly among the non-oil developing countries—is now much larger than in 1974. Their debt servicing obligations are rising sharply, reflecting both a bunching of capital repayments from earlier lending and the current high level of interest rates. The re-emergence of very substantial requirements for additional financing thus comes at a time when the amount of maturing debt to be refinanced is larger than ever; and there is a consciousness of the banks' growing exposure to country risk. In the last three months maturities have been shortening; and, although the evidence is still rather limited, margins on loans to less than prime

borrowers appear to have started to rise. At the same time, the uncertainties arising from the legal complications of the Iranian crisis have contributed to a reduction in the volume of lending and a reluctance on the part of some banks to join large syndicates.

The implications of these changes for the recycling problem are still not clear. There could be some fragmentation in the market, with a tendency towards smaller loans, arranged among a narrower circle of banks. The prospect of some discriminating increase in spreads is, in itself, welcome. With returns more commensurate with the risks assumed, banks which may be holding back from the international lending market may return.

It would be wrong to conclude that the banks will find beyond their powers problems which, as in 1974, look formidable beforehand. Nevertheless, the problems which the banks face are complex, and some are unfamiliar. It will be important that the banks, and the supervisory authorities, pay particular attention to the prudential aspects of the international banking framework, in order to maintain a system which is sound and which commands confidence.

Although the banking system will undoubtedly play a major part in the recycling process, it seems clear that international banking flows will need to be complemented and supported by other private flows, and by flows through official channels. It is likely that OPEC surpluses will be more persistent than they proved to be after 1974; and it is possible that the counterpart deficits will come to be more concentrated in those countries which have the greatest difficulties in adjusting to the new situation. Official institutions may for these reasons have a greater rôle to play in 1981 and subsequent years. The dual function of the International Monetary Fund (IMF) in providing finance, and in fostering necessary adjustments, could be particularly helpful. In the near term, thought may need to focus on ways of encouraging a fuller use of IMF resources; over a longer period, the traditional means of providing such resources may need to be supplemented.

The domestic monetary situation

In recent months monetary policy has been operating against strong continuing inflationary tensions. The target for sterling M_3 (7%–11% at an annual rate) is currently for a period which extends from last June to next October. The annualized rate of growth so far has been above the target range; in recent months, however, its rate of growth has moderated. The size of the PSBR for the first three quarters of the financial year 1979/80 was higher than originally expected, while throughout the period the underlying rate of bank lending has continued high. In the final months of the financial year, the combination of high bank lending with high debt sales and a greatly reduced scale of government borrowing has depleted the liquidity of the banks. That in turn has led to upward pressure on short-term interest rates, which the Bank has countered by the temporary release of special deposits and by other assistance.

Other monetary aggregates (as noted earlier in this commentary) have shown less fast growth than sterling M_3 . In recent months M_1 has actually fallen, while, on a wider measure, private sector liquidity has also recently risen rather

less rapidly than sterling M_3 . One of the main ways in which monetary policy affects the economy is via the exchange rate. It is thus also relevant that the exchange rate, even though not solely as a result of domestic monetary policy, has been consistently strong. There is little reason to doubt that, taken as a whole, monetary conditions have recently been restrictive.

The effects of restrictive monetary policy inevitably interact with many other forces bearing on the economy. Given that monetary growth in recent months has in large part reflected continuing high bank lending to the private sector, it is an important question how long companies will want to borrow, or banks to lend, on the recent scale. The reason for high bank lending has been the large cash flow pressure on industry, which has been even greater than expected. Stocks, and labour costs, have been two elements of particular importance.

Stocks have for some time appeared to be high, and, with commodity prices rising strongly in the last eighteen months, they have had to be replaced at steadily increasing cost. It seems probable, as argued in the December 1979 *Bulletin*, that stocks will be substantially reduced in the period ahead; indeed this decline may be an important element in the recession which Bank forecasts continue to suggest is likely. For this reason among others, bank lending could later fall away.

Another major source of financial pressure on firms has been rising labour costs. In some cases there have been signs of greater realism in wage settlements—evidenced by greater willingness to take account of what firms can afford to pay, or by the inclusion of significant productivity elements. But the outcome of this wage round may not, overall, show settlements lower than in the last round, which would be a disappointing result. Inflationary attitudes, once deeply entrenched, take time to change. Nevertheless, there remain good grounds for expecting progress in reducing inflation, given both the stance of monetary policy and probable demand conditions. There will be need for monetary policy to maintain a consistent restrictive pressure, so that inflation is brought down, and the basis thus laid for economic expansion in later years.