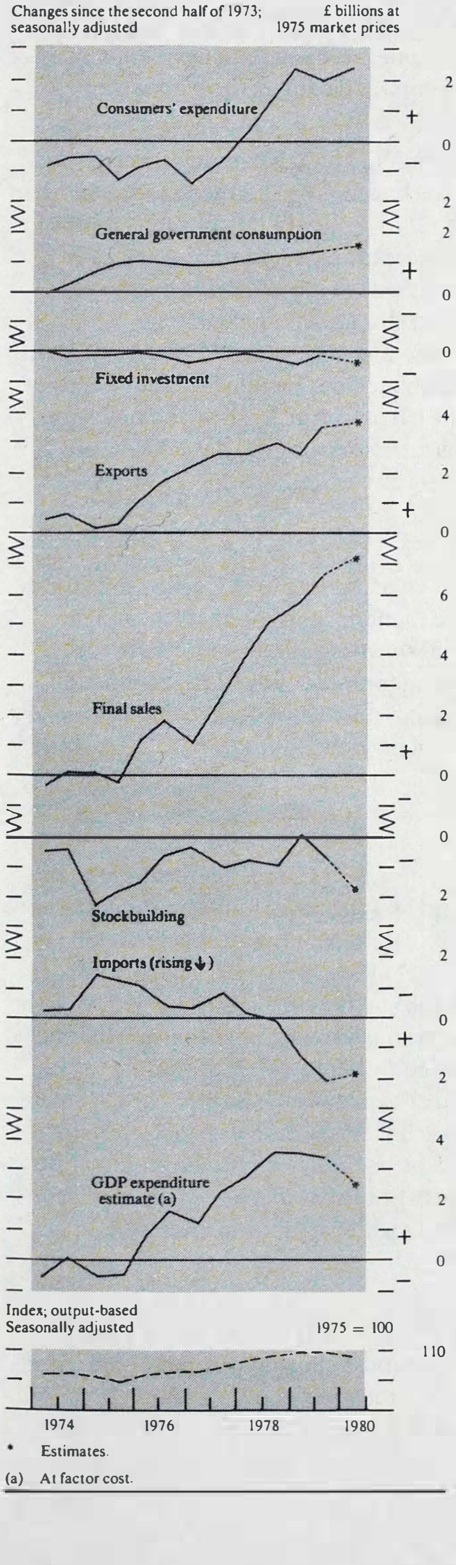
Economic commentary

GDP *has turned downwards.*



* Estimates.

(a) At factor cost.

Introduction

Output—especially in manufacturing industry—has been falling sharply in recent months as companies have sought to adjust their expenditure in the face of severe financial pressure. As expected, much of the adjustment has taken the form of a reduction in stocks. Employment, too, has been substantially reduced, perhaps by more than is usual at this stage of a recession, and unemployment has risen steeply to a level unknown since the war.

Though the recession is likely to be more severe in the United Kingdom than elsewhere, most other industrial countries have experienced—or are entering a period of—falling output and rising unemployment. In the United States, output and employment have dropped precipitously, and elsewhere signs of recession began to emerge about the middle of this year.

This reduction in activity is moderating price increases. At an international level, oil and other commodity prices have steadied in dollar terms, with the prices of some industrial materials showing falls. Together with the appreciation of sterling, this has already helped to restrain price increases in the United Kingdom: for some months, manufacturers' selling prices and retail prices have risen by 1% a month or less, a much slower rate of increase than earlier this year. Thus far, however, the growth of earnings has remained high. In the 1979/80 pay round, average earnings probably rose by some 22%; and, when allowance is made for increased short-time working and reduced overtime, as well as for the impact of comparability awards in the public sector, it is difficult to discern in the figures any clear deceleration in the pace of earnings growth. However, some recent settlements have been struck at lower rates.

Industrial and commercial companies have reacted to severe financial pressures very much as expected, but so far their efforts seem to have done little more than limit these pressures. Profitability in industry is lower than ever previously recorded. Shrinking markets, coupled with a continuing loss of competitiveness—the combined result of sharp cost increases and a strong exchange rate—have further eroded profit margins. According to a recent survey by the Confederation of British Industry (CBI), businessmen are almost as pessimistic as they were in early 1974.

In large part, these conditions stem from the slow adjustment, thus far, of expectations in the face of policies to moderate inflation. The public sector borrowing requirement (PSBR) in the first quarter of this financial year—nearly £4½ billion—is high against the projection of £8½ billion for the full year, but borrowing is expected to fall substantially. There is no sign yet that the recession is deeper than expected and that the PSBR is being enlarged on this account. The 5% growth of sterling M_3 in banking July, and the substantial, though smaller, increase in August, were heavily influenced by the end of the supplementary special deposits scheme (the 'corset').

The timing and depth of the recession in the United Kingdom have contributed to a marked improvement in the balance of payments. Helped by virtual self-sufficiency in oil, the current account has been in balance, or even surplus, in recent months. The exchange rate has continued to strengthen. But with activity in other industrialised countries now slowing down or falling, this 'cyclical' gain to the United Kingdom may well diminish at a time when past cost increases continue to affect the competitiveness of industry.

Monetary growth and the ending of the 'corset'

The 5% growth in sterling M_3 in the month to mid-July and an estimated further 3% in August carried the cumulative increase since mid-February (at an annual rate) well over the 7%–11% target range. The increase since mid-June has included a large amount of adjustment after two years of corset control on the banks.

Over a longer period—which should give a better guide to the underlying rate of growth—sterling M_3 has still increased faster than the present or previous (8%–12%) target. In the thirteen months to mid-July, it grew at an annual rate of 16%; and since April 1978 it has grown at an annual rate of about 13½%.[1] On the narrower definition (M_1), the money stock has grown much more slowly—since June 1979 by 6½% and since April 1978 by 9¼%, both at an annual rate; but M_3 (which includes foreign currency deposits held by UK residents) and the narrower measure of private sector liquidity have grown about as fast as sterling M_3 in each of these periods, although the wider measure of liquidity has grown rather more slowly.

Money and liquidity

Percentage change at annual rates; *seasonally adjusted*

	M_1	Sterling M_3	M_3	PSL1(a)	PSL2(a)
Feb. 1980–July 1980	+9.0	+23.3	+23.7	+21.2	+17.6
Oct. 1979–July 1980	+0.5	+16.2	+16.5	+13.2	+12.4
June 1979–July 1980	+6.4	+15.9	+15.4	+15.0	+12.9
Apr. 1978–July 1980	+9.3	+13.6	+13.2	+14.7	+13.0

(a) For details of the composition of these aggregates, see the additional notes to Table 12 in the statistical annex.

Although the underlying growth of sterling M_3 exceeded the targets, there can be no doubt that the economy and the financial system came under pressure. Nominal short-term interest rates rose to record levels; sterling was strong for most of the time; economic activity levelled off last year and is now falling; and by mid-summer price inflation seemed to be slowing down.

Counterparts of the money supply(a)

£ millions; *seasonally adjusted*

Mid-month	July 79–Oct. 79	Oct. 79–Jan. 80	Jan. 80–Apr. 80	Apr. 80–July 80
Central government borrowing requirement	+2,805	+2,342	+ 213	+3,286
Net purchases (-) of central government debt by UK non-bank private sector	−1,017	−3,085	−1,479	−1,915
Other public sector(b)	− 312	+ 271	+ 62	+ 680
Sterling lending(c) to:				
UK private sector	+2,339	+2,246	+2,481	+3,186
Overseas sector	+ 50	+ 271	+ 411	+ 761
Domestic credit expansion	**+3,865**	**+2,045**	**+1,688**	**+5,998**
External and foreign currency finance (increase −)	−1,419	− 722	− 630	− 810
Net non-deposit liabilities (increase −)	− 328	− 249	− 210	− 538
Sterling M_3	**+2,118**	**+1,074**	**+ 848**	**+4,650**
Percentage change in sterling M_3	*+ 4.0*	*+ 1.9*	*+ 1.5*	*+ 8.2*
M_1	**+1,127**	**− 468**	**− 212**	**+ 794**
Percentage change in M_1	*+ 4.2*	*− 1.7*	*− 0.8*	*+ 2.9*

(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 UK non-bank private sector.

(c) For details, see footnotes (c) and (d) to Table 11.3 in the statistical annex.

Recent developments

During the spring and early summer, the target aggregate, sterling M_3, grew only moderately, and by June, after four months of the new target period, the recorded annual rate of growth appeared to be only fractionally above the target of 7%–11%. Because of the constraints imposed on the banks by the corset, this was known to be an understatement of the underlying growth; over the same period there was an increase roughly equivalent to 2½% of sterling M_3 (at an annual rate) in the take-up of bank bills by the non-bank sector (the so-called 'bill leak'). Nevertheless, with signs of a deepening recession, the authorities felt able to reduce minimum lending rate (MLR) from 17% to 16% early in July, and at that stage financial markets were expecting further significant falls in interest rates before long.

The recorded growth of 5% in sterling M_3 in banking July was affected by major upward distortions following the end of the corset. The best documented was the rundown of about £1 billion in the bill leak, which added an equivalent amount to recorded bank lending

(1) In this paragraph, monetary growth is measured from various dates which have been the base for a target for sterling M_3.

and also significantly boosted sterling M_3.[1] Other forms of adjustment to the ending of the corset also occurred but their effects on sterling M_3 are less easily quantified. In particular, the banks acquired large amounts of gilt-edged stocks and other public sector debt, both short-term and long-term, probably much of it in response to the end of the corset. There seems also to have been a very sharp rise in UK banks' lending abroad in sterling; much of this was to overseas offices and banks abroad and probably included euro-sterling business that UK banks had previously been constrained by the corset from undertaking. It appears, too, that UK residents switched out of foreign currency into sterling deposits, which may again have been related to the ending of the corset; UK residents may also have switched from sterling deposits held abroad into sterling deposits with UK banks.

Of the other aggregates, M_3, which has been subject to most of the same distortions, grew roughly in line with sterling M_3 between February and July; while the measures of private sector liquidity[2] showed less rapid, but still substantial, growth in the same period. M_1, by contrast, has continued to grow only modestly, by 4.6% in the twelve months to July, although the sudden rise in interest-bearing sight deposits in July provides further evidence of the size of possible post-corset adjustments; indeed, non-interest-bearing M_1 rose at an annual rate of only 1% between February and July, and by only 2.7% in the twelve months to July. If account is taken of the rate of inflation, the behaviour of M_1 may be seen to be comparable with the rate of growth of similar aggregates in a number of major countries, some of which set a target for M_1.

Growth of M_1 in selected countries
Percentage change in year to July 1980

	M_1	Retail prices	Real M_1
United Kingdom	4.6	16.9	−10.5
United States	3.2(a)	13.2	− 8.8
Canada	3.8	10.1	− 5.7
Switzerland(b)	−8.2	3.3	−11.1
West Germany	1.4	5.5	− 3.9

(a) M1A.
(b) Year to June.

The pressure for monetary expansion has come from two main sources—a large PSBR and heavy demand for credit by the private sector. Some turnround in the PSBR in the first quarter of 1980/81 was always expected, because the figures had been influenced by a number of temporary and favourable factors towards the end of 1979/80. In the event, the central government borrowing requirement rose (in seasonally-adjusted terms) from a mere £200 million between mid-January and mid-April to £3,300 million in the following three months. Much of this high level of borrowing was on-lent to public corporations. The PSBR for the first quarter of the new financial year was nearly £4½ billion, against a Budget projection of £8½ billion for the year as a whole.

Bank lending in sterling both to companies[3] and to persons grew by over 20% in the year to end-June. In unadjusted terms, the rate of growth of lending to persons, though it slowed during the autumn and winter, was much the same in the second half of 1979 as in the first half of 1980, but lending to companies accelerated sharply between the two periods. Lending in foreign currencies to companies, facilitated by the end of exchange controls, also grew particularly fast in the first half of 1980.

Various conflicting factors have been at work in the company sector. Despite a considerable reduction in stocks, the financial

(1) The extent to which the bill leak distorts sterling M_3 depends on whether the holders of the bills are UK or overseas residents and whether or not the proceeds, when the bills are sold, are used ultimately to increase bank deposits (or holdings of certificates of deposit). It is not known how many bills are held by overseas residents.

(2) PSL1 comprises the private sector component of sterling M_3 (excluding over two-year deposits), money-market instruments (Treasury bills, bank bills, and deposits with local authorities and finance houses) and certificates of tax deposit. PSL2 includes, in addition, certain building society and other savings deposits and securities. Neither aggregate is therefore distorted by the bill leak or by switches of short-term local authority debt between banks and non-banks.

(3) Sterling lending to industrial and commercial companies, plus the difference between sterling lending to the personal sector and identified sterling lending to persons—most of this difference being lending to unincorporated businesses.

deficit of companies has risen sharply, increasing their overall need to raise money. Their liquidity position—the ratio of liquid assets to liquid liabilities—has declined to a point where liabilities considerably exceed assets. Moreover, although the volume of companies' transactions has fallen, the value continues to rise, albeit more slowly than earlier as the rate of inflation slackens. These various factors will have tended to encourage companies to borrow more. Against this, the cost of borrowing is high, whether in nominal or real terms: a company will usually have to pay 1%–3% above base rate, equivalent to some 17%–19% per annum at present, whereas the monthly rate of price increases has recently been below 1%. (Tax relief reduces the effective cost of borrowing only for companies with corporation tax to pay.) Moreover, companies reduced their holdings of stocks substantially in the first half of the year, and will probably continue to do so; since changes in working capital are often fairly closely associated with changes in borrowing from the banks, demand for credit could fall on this account.

Faced with the need to make very large debt sales to restrain the growth of sterling M_3, the authorities regularly took advantage of conditions which were often buoyant in the gilt-edged market (see financial review, page 284). Net official sales—excluding the purchase and resale agreements with banks—totalled some £2,500 million in the three months to mid-July. However, these figures included considerable purchases by the overseas and banking sectors, particularly in July, so sterling M_3 was not affected as much as the overall figures indicate. Other forms of central government debt were less in demand, with non-banks selling Treasury bills to banks (which were short of reserve assets) and making only modest purchases of national savings and certificates of tax deposit.

The combination of high debt sales and continued growth of bank lending to the private sector put severe pressure on the reserve asset ratios of the banks. Accordingly, the authorities were faced throughout the period with the choice of allowing very short-term interest rates to rise, perhaps precipitously, with the possibility of associated sharp swings in the exchange rate, or of providing assistance to ensure that the banks could meet their reserve asset ratio requirement. Having regard to current and prospective developments in the economy, as well as the outlook for the money supply, the authorities considered it more appropriate to provide liquidity; details of their operations are shown in the financial review.

One reason for the strength of bank lending to the private sector may have been the reluctance or inability of industrial companies to raise money on the capital market. In net terms listed companies raised a negligible sum in the first half of 1980. A higher July figure reflected the coincidence of two substantial rights issues and does not indicate a significant revival in borrowing. Companies' borrowing from finance houses, often in the form of fixed-rate instalment credit, is tending to grow; but, at £80 million a quarter last year and just over £100 million in the first quarter of this year, it is dwarfed by bank borrowing. Leasing, a source of finance which has grown to significance (now averaging about £500 million a quarter), probably increases bank lending since many of the largest leasing companies are affiliated to banks from which they receive most or all of their finance. (A special article on leasing begins on page 304.)

Industrial and commercial companies – selected sources of finance

£ millions

	Net UK capital issues	Loans and advances by finance houses and other consumer credit companies	Assets leased	Bank borrowing
1977	662	137	869	2,966
1978	759	244	1,408	2,890
1979 Q1	212	26	411	1,838
Q2	361	107	508	1,375
Q3	59	100	453	556
Q4	225	95	584	1,144
1980 Q1	31	104	480	1,900

Building societies face increased competition from the banks

Inflows into building societies in the first half of 1980 amounted to £1,330 million, £310 million below the corresponding period in 1979. In the past, building society ordinary shares have usually offered a higher return than seven-day bank deposits, but between end-November 1979 and end-June 1980 both yielded 15% (gross). In consequence, and in contrast to experience throughout most of the 1970s, building society shares and deposits have grown more slowly than personal sector time deposits with the banks. In July, however, inflows improved as the societies maintained an unchanged share rate following the reductions in MLR and in bank deposit rates.

The reduction in inflows between the first halves of 1979 and 1980 was more than offset by an increase (from £1,010 million to £1,490 million) in interest credited to accounts, arising from higher interest rates. Consequently, building societies were able to maintain their liquidity without reducing lending sharply. In the first half of 1980, gross advances averaged £680 million a month, only £40 million less than in the corresponding period of 1979.

In real terms, however, lending in the first half of 1980 was well below that of a year previously; this contributed to, and resulted from, the subdued state of the housing market. Housing starts have been low and increases in house prices have moderated. Demand for mortgages appears to have weakened; potential house-buyers may have been discouraged by the record 15% mortgage rate and by increased uncertainty about incomes and employment.

Net lending for house purchase

£ millions

	Total	Building societies	Local authorities and other public sector	Insurance companies	Banks
1975	**3,648**	2,768	752	68	60
1976	**3,872**	3,618	170	14	70
1977	**4,284**	4,100	31	23	131
1978	**5,344**	5,115	−118	72	275
1979	**6,413**	5,271	361	254	527

As well as competing more strongly with building societies for personal sector deposits, the banks have noticeably increased their lending for house purchase, although part of the increase has been in bridging finance. But their lending for house purchase remains small compared with that of the building societies and is often not directly competitive with them; it includes, for example, large loans which are difficult to obtain from building societies. The rates charged by clearing banks have usually been set 2%–3% above base rates, and are currently some 3%–4% above the rate recommended for building society mortgages (although the rate charged on many of these is above that recommended).

Large PSBR so far in 1980/81

In the June *Bulletin* it was suggested that the balance of fiscal changes in the Budgets of June 1979 and March 1980 represented a moderate overall tightening in policy. Although it is difficult to make exact comparisons, there cannot be much doubt that the projected PSBR of £8½ billion in 1980/81 represents a tighter fiscal stance than the outturn of almost £10 billion in 1979/80.

The £8½ billion PSBR was projected on forecasts for the economy contained in the 1980/81 Financial Statement and Budget Report. In particular, GDP was forecast to fall by 2½% in 1980. The GDP outturn in the first half of the year, however, appears to have been somewhat higher than the Government were forecasting in March.

In the first quarter of the current financial year, the PSBR was nearly £4½ billion—slightly more than half the projected amount for the full year. Since the timing of receipts and spending is not evenly distributed, it cannot be concluded that this outcome is inconsistent with achievement of the projection for the whole year. For example, the proceeds of special sales of assets and the rebate from the European Community budget are unlikely to accrue until late in the financial year, while receipts of petroleum revenue tax will rise strongly. Moreover, it appears that defence spending was running above projection during this period. The corresponding cash limit has now been increased, but by only £200 milllion, and steps have been taken to rein in the rate of spending to the new limit. On the other hand, the public corporations' borrowing requirement so far looks very high in relation to the Budget forecast; and it seems likely that local authority current spending has been higher than projected. Thus far, however, there is no sign that the recession has contributed anything to the PSBR above what was allowed for at the time of the Budget.

The medium-term financial strategy looks to a decline in the size of the PSBR from 5% of GDP (at market prices) in 1979/80 to $1\frac{1}{2}$% in 1983/84, compatible with a steady reduction in the monetary targets over that period. Clearly, close control of spending programmes is of central importance to this process. But that apart, pressure either way on the PSBR could emerge if the actual course of the economy were to diverge from the projections underlying the strategy. For example, an unanticipated deepening or prolongation of the present recession would, of itself, tend to increase the PSBR without necessarily implying any laxity of financial control or change in the Government's fiscal stance. Very roughly, the PSBR might be £1 billion a year higher for each 1% by which GDP was lower than assumed, provided of course that lower government spending or higher taxes were not the source of the lower GDP. Extra unemployment and other social security payments would be perhaps £$\frac{1}{4}$ billion; income and corporation tax receipts would be some £$\frac{1}{2}$ billion lower (though the decline in corporation tax would not be felt for some time); and receipts from taxes on expenditure and the public sector's gross trading surplus might together be reduced by £$\frac{1}{4}$ billion.

Output falling sharply, making for a weak labour market

The output estimate of GDP fell by $1\frac{1}{4}$% in the first half of this year, but this decline is less steep than in the first half of 1975 when the economy last turned down. The fall would be much the same if production of North Sea oil were excluded.

Most sectors of industry have reduced production, with much of manufacturing industry particularly hard hit. In the first half of the year, manufacturing output was 4% lower than in the second half of 1979, with textiles down by 9% and chemicals and related products falling by $4\frac{3}{4}$%.

Strikes and recovery from them make it difficult to judge the underlying position. On a comparison between the first half of 1980 and the average of 1979, manufacturing production has fallen at an annual rate of around 6%—again, rather less steeply than during 1975. Many plants have closed down, and in manufacturing industry alone employment was reduced by nearly 400,000 between December 1978 and June 1980. The decrease in employment accelerated from 6,000 a month in the first half of 1979 to 20,000 a month in the second half, and further to 40,000 a month in the

Labour market indicators and liquidations of companies

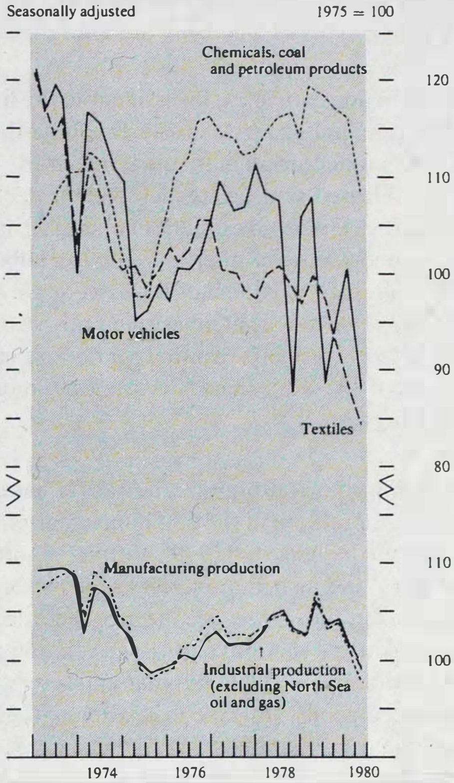
Thousands

	Manufacturing employment(a) (June)	Redundancies in year	Short-time and temporarily stopped (monthly average)	Liquidations in year
1973	7,800	80	20	2.6
1974	7,900	130	50(b)	3.7
1975	7,500	250	170	5.4
1976	7,200	170	90	5.9
1977	7,300	160	50	5.8
1978	7,200	170	40	5.1
1979	7,200	190	50	4.5
1980	6,800	400(c)	150(d)	6.2(c)

(a) Sources: Department of Employment and Department of Manpower Services, Northern Ireland. Figures for 1978–80 are partly estimated.
(b) Excludes first quarter which was distorted by the three-day week.
(c) First seven months at an annual rate.
(d) Based on estimates up to June.

Industrial production *is falling sharply.*

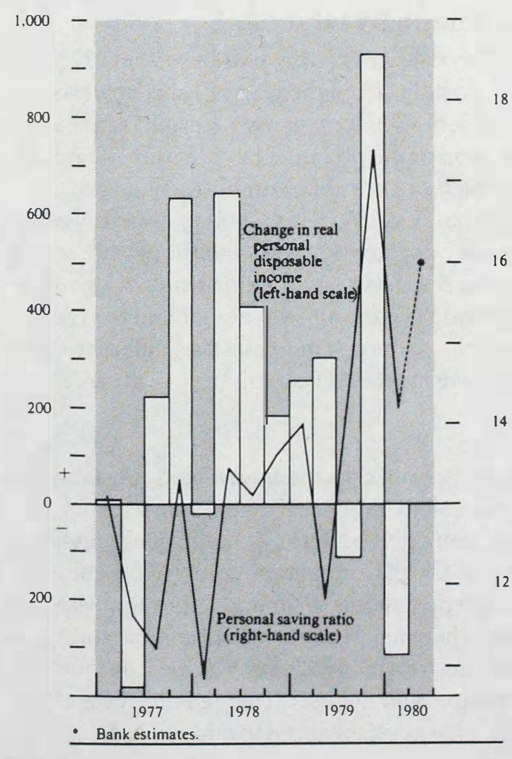
Seasonally adjusted 1975 = 100



Real **personal disposable income** *fell in the first quarter and the* **saving ratio** *dropped.*

Seasonally adjusted

£ millions Percentage



• Bank estimates.

first half of this year. In the six months to June, the Manpower Services Commission was notified of more than 150,000 redundancies in the manufacturing sector—more than in the whole of 1979. The textile and metal manufacturing industries were particularly affected. Productivity may have fallen slightly between 1979 and the first half of this year, even if account is taken of the number of hours worked per operative as well as the decline in the labour force.[1] Any recent fall is unlikely to signify anything about longer-term trends; a fall in production ahead of employment may be no more than a matter of timing. On the contrary, the smallness of any decline in productivity when output has declined so fast suggests that recent labour shedding has not simply been the response of companies to over-capacity but rather that, in addition, severe financial constraints required an immediate reduction in the rate of growth of unit costs. If this is correct, the comparative steadiness of productivity may herald yet further falls in employment.

Further support for this conclusion may be drawn from the sharp fall in overtime working in manufacturing industry and the corresponding increases in recent months in short-time working and temporary lay-offs. The number working overtime is usually lower in the holiday period, but this June's figure was the lowest for the month since 1975; and the number on short-time—over 200,000 operatives in manufacturing industry, more than $4\frac{1}{4}\%$ of the total—was the highest since 1975.

The Industrial Trends Survey for July by the CBI suggests that business confidence is almost as low as in the period of the three-day week in early 1974, and, new orders having deteriorated to the extent that 75% of the respondents to the survey regard their order books as below normal, output is expected to continue to fall.

Although output has fallen most heavily in manufacturing industry, other sectors of the economy have also been affected. In the construction, public utilities, and mining and quarrying sectors it has declined, and it has probably fallen slightly in the service industries. Even North Sea oil and gas has shown no growth. Altogether, unemployment—including school-leavers—was 2 million in August. Seasonally adjusted, adult unemployment reached 1.7 million. Unfilled vacancies shrank to 120,000.

Demand generally weak[2]

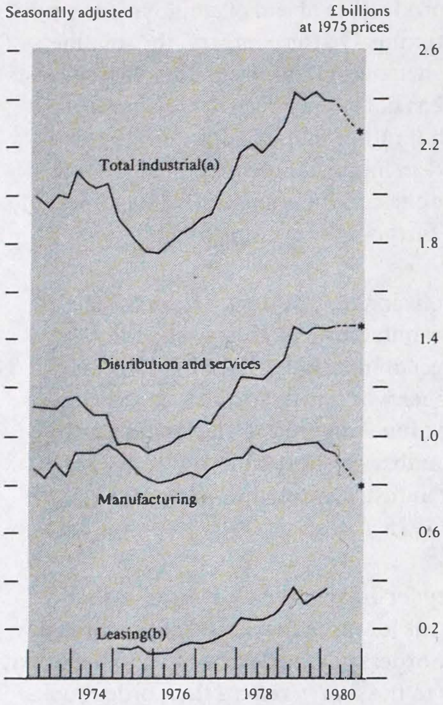
A number of factors have contributed to the decline in demand. Although real personal disposable income fell by $1\frac{1}{2}\%$ in the first quarter after the sharp rise (boosted by tax rebates) in the fourth quarter of 1979, consumer spending rose by over 2%, no doubt in response to the tax rebates, but also encouraged by attractive offers in the winter sales (which were themselves extended) and the imminence of the Budget. Spending on alcoholic drink, durable household goods, and cars and motorcycles all rose. At $14\frac{1}{4}\%$, the saving ratio, although reduced, was still fairly high. The increase in spending was more than reversed in the second quarter, when it fell by 3%. All categories except food and certain services were affected, particularly drink and cars, notwithstanding strenuous efforts on the part of retailers to stimulate sales. The volume of retail sales

(1) The decline in output per man-hour appears to have been less than it was in 1975, and less than was experienced in downturns in the economy in the early to mid-1960s (when the depth of recessions was much less than recently).

(2) Components of demand are expressed in 1975 prices.

fell again in July. Real personal disposable income has probably continued to fall despite the further growth in earnings. Even so, the saving ratio probably rose in the second quarter, general uncertainty no doubt inducing caution. High mortgage rates and curbs on local authority spending made for a depressed housing market.

Industrial investment *has declined from the high 1979 levels.*



* Based on the June 1980 Department of Industry survey of investment intentions.

(a) Manufacturing and distribution and service industries.

(b) Included also within 'distribution and services'.

There was a small increase in domestic fixed investment in the first quarter, excluding housing and public services investment, both of which were well down. In manufacturing industry alone, fixed investment fell by 3%, but if leased assets were included the decline would probably not be so great. Fixed investment in manufacturing, and also in the distributive and service industries, remained subdued in the second quarter. The latest Department of Industry survey suggests a decline of about 3% in industrial investment this year, with a further reduction in 1981. It points to a sharper decline in manufacturing investment, of 8%–12% in each year, rather more for this year than the CBI suggests.

As expected, the sharpest impact on output recorded so far has come from stocks, which fell by £210 million in the first quarter, after a rise of £230 million in the fourth quarter of 1979. Within the total, the volume of manufacturers' and distributors' stocks fell by some £670 million in the first quarter, the largest decline ever recorded. Distributors succeeded in reducing their inventories in relation to retail sales, although the ratio remains high; but manufacturers' stocks, particularly of finished goods, still rose in relation to their production. In the second quarter, manufacturers' stocks were virtually unchanged, but distributors reduced their inventories by over £200 million more. The CBI Monthly Trends Enquiry for August suggested that some 40% of manufacturers regard their stock of finished goods as 'more than adequate'.

The real trade balance moved favourably in the first quarter: exports of goods and services rose $1\frac{1}{2}$% in volume, while imports fell slightly.

Pay increases disappointingly large . . .

Average earnings will probably prove to have risen by some 22% in the 1979/80 pay round. To judge from the year to June, however, there were substantial variations among sectors. Earnings in the public sector rose more than in the private sector. Within the public sector, earnings rose much more in public administration and services (the non-trading part), where comparability awards were concentrated, than in public corporations. Within the private sector, earnings in manufacturing rose less than in service industries and in finance. The average increase in earnings was higher and the range wider than last year, and the pattern of increases was different—last year earnings appear to have increased faster in the private sector than in the public sector.

Comparability awards in the public sector contributed substantially to earnings in the last pay round. Altogether, approximately $2\frac{1}{2}$ million employees have been referred to the Standing Commission on Pay Comparability (the Clegg Commission), now to be wound up. Awards have been accepted in full so far and only a few cases are outstanding. In addition, there have been separate comparability exercises for other public sector employees such as local authority white collar workers, doctors and dentists. Taking both types of award together, the effect has probably been to add six and a half percentage points to earnings in the whole public sector and two percentage points to the increase in earnings in the entire economy.

Dispersion of settlements in manufacturing: 1979/80 pay round

Size of settlement	Per cent of employees	Per cent of settlements
Under 6%	0.1	1.0
6%–10%	3.5	5.9
11%–15%	44.3	40.7
16%–20%	40.3	42.0
21%–25%	10.7	8.6
26% and over	1.0	1.9

Source: Confederation of British Industry.

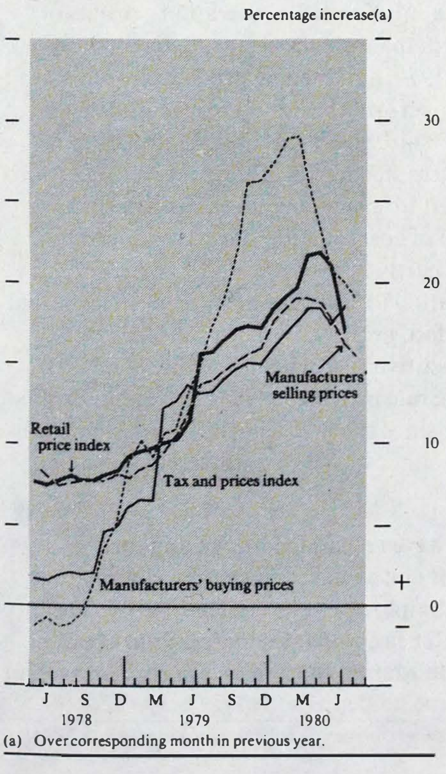
The rise of 17½% in earnings in manufacturing appears to have been associated with an average settlement in the sector of about 16%.[1] The CBI survey for July shows the dispersion of settlements within the sector. It is difficult to draw direct comparisons with the previous pay round because the CBI did not then provide separate figures for manufacturing, but the available evidence suggests that, up to the time of their July 1979 survey, settlements in manufacturing were around 10%.

The increase in the size of settlements has coincided with an acceleration in retail prices. During the 1978/79 pay round, the year-on-year increase in retail prices ranged from 7¾% to 11½% until, near the end of the round, it rose to over 15%. During the 1979/80 round, the year-on-year increase moved between 15¾% and just under 22%. The CBI survey noted that over half the reporting companies cited the cost of living as a 'very important factor' exerting upward pressure on the level of wages.

Many settlements in the latest round include improvements to working conditions. The CBI calculates that more than a quarter of settlements contain provisions to improve productivity. Apart from the national engineering agreement, which provided for a cut in working hours to 39 hours a week, only a minority of settlements have included reductions of this kind, though rather more have provided for longer holidays.

There is little firm indication of what may happen in the next round, but most regional offices reported to the CBI in August that settlements are expected to be lower than of late.

Price rises *are easing*



(a) Over corresponding month in previous year.

. . . but price inflation slowing down

There are encouraging signs that price inflation is lessening. Since May, the monthly rate of increase in retail prices has been below 1%, compared with an average of 1½% in December to March, and was only 0.2% in August. (Indirect tax increases contributed to the 3½% increase in April.) The monthly increase in manufacturers' selling prices fell to only 0.4% in August and their buying prices actually declined in May, and again in August, helped by the strength of the exchange rate and slower increases—or even falls—in the dollar prices of raw materials and fuel. The much-quoted year-on-year increase in retail prices fell from a peak of nearly 22% in May to 16¼% in August, to a large extent because indirect tax increases in the June 1979 Budget (which had added some 3% to the index) dropped out of the comparison, but also because the monthly increases have become less steep. Also, manufacturers' selling prices and the prices at which manufacturers buy fuel and materials have been rising much less steeply on the annual comparison; in the latter case, the year-on-year increase has fallen from almost 30% earlier in the year to 19% in August. An unusually small balance of respondents to the August CBI Monthly Trends Survey—only 16%, compared with 45% in May and 65% in January—expected to raise their prices in the next four months. Since most respondents to

(1) It is useful to distinguish between average earnings and settlements. Average earnings are computed by dividing the wage and salary bill by the number of employees; they include overtime, bonus payments, comparability awards, etc. Settlements, on the other hand, are usually expressed as the percentage increase in basic rates. Information on average earnings is collected by the Department of Employment from returns relating to 10 million employees in all sectors of the economy. Information on settlements is compiled by the CBI, from information provided by manufacturing industry and, for other sectors, from newspaper reports and other sources.

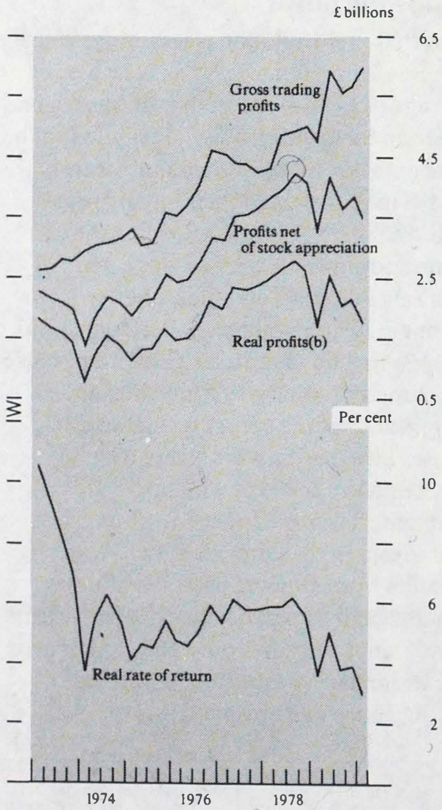
Counterparts to the general rise in UK prices[a]

Percentage change over previous period
Shares in final expenditure in 1979 in italics

	General prices	of which, attributable to: Labour costs	Net taxes on expenditure	Other factor incomes(b)	Import costs
		46.8%	*10.8%*	*20.0%*	*22.4%*
1977 H1	**+7.4**	+2.5	+1.3	+1.6	+2.0
H2	**+5.0**	+1.5	+1.2	+3.0	−0.6
1978 H1	**+3.8**	+2.4	+0.1	+0.6	+0.8
H2	**+4.8**	+2.2	+0.7	+1.3	+0.5
1979 H1	**+5.3**	+2.5	+1.0	−0.3	+2.1
H2	**+9.3**	+4.5	+2.4	+0.5	+1.9
1979 Q3	**+5.4**	+3.4	+1.9	−0.6	+0.6
Q4	**+3.5**	+1.9	+0.5	−0.1	+1.3
1980 Q1	**+3.3**	+1.7	+0.7	−0.5	+1.4

(a) The deflator for total final expenditure at market prices.
(b) Mainly incomes of the self-employed, profits, trading surpluses of public corporations, and rent. Stock appreciation is excluded.

Company profitability[a] *in real terms is the lowest recorded.*



(a) Excluding North Sea operations.
(b) Gross trading profits, plus rent, net of stock appreciation and capital consumption at replacement cost.

the fuller survey carried out in July expected costs to continue to increase, market conditions appear to be a significant constraint on price increases.

The table shows the separate contributions to the increase in the deflator for total final expenditure at market prices.[1] While this kind of statistical analysis reveals little about the causes of inflation, it does indicate the composition of changes in costs.

Although full figures for the second quarter are not yet available, the deflator probably rose quite sharply. The tax increases in the Budget added 1%–1¼% to retail prices, implying an increase of nearly ½% in the deflator. Thus net taxes on expenditure will have been one of the counterparts to the increase in prices in the second quarter but should not remain so thereafter. Neither, on present prospects for profits, should 'other' factor incomes—although prospective increases in nationalised industry prices will contribute in this category. Import costs probably contributed virtually nothing to the increase in prices in the second quarter. Competitors' costs have risen less sharply, in domestic currency terms, than costs here; sterling appreciated by about 1½% in the second quarter, both against the dollar and in effective terms and much of this has been reflected in the prices of imported manufactured goods (see also the article beginning on page 295). Moreover, oil and commodity prices have tended to stabilise, even in dollar terms, after earlier increases, and prices of many industrial materials have actually fallen. On the other hand, Bank estimates suggest that labour costs may have risen by some 6%, accounting in this statistical sense for an increase of 3% in the deflator.

The speed with which inflation decelerates will depend on the behaviour of labour costs. As noted in the previous section, there are reasons to hope that settlements in the coming wage round will be considerably lower than in the last one.

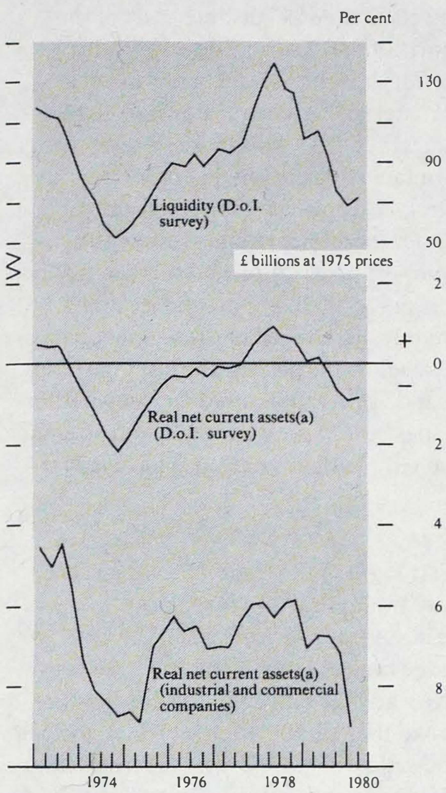
Profits under severe pressure

Steeper cost increases, worsening competitiveness, and the onset of recession brought a sharp fall in company profitability up to the early part of this year. Excluding North Sea operations, profits of industrial and commercial companies (net of stock appreciation) have been falling since mid-1979; and the real pre-tax rate of return declined to 3½%—its lowest yet—in the period from July 1979 to March 1980, having been 6% in 1978. Nevertheless, the fall in profitability has so far been less sharp than in the previous recession, though on that occasion it fell from a higher level. Both periods featured a steep acceleration of cost inflation (largely induced by rises in the price of oil) and, partly in consequence, a reduction in output. Though the acceleration in costs has recently been less rapid than it was in the earlier period, profits have been squeezed by a sharp deterioration in competitiveness, whereas in the mid-1970s depreciation of the exchange rate provided some protection. Profits have probably fallen further since the first quarter as price increases have slowed down while labour costs have continued to grow rapidly.

As noted above, companies have responded by curbing their spending on fixed investment and stocks, and surveys suggest that they will continue to do so. Employment has fallen sharply. The financial deficit of non-North Sea companies increased to about £2 billion in the six months to March; this is lower in real terms than

(1) The contribution of each category of costs is the increase or decrease registered in it multiplied by its weight in the total.

Company liquidity *has fallen sharply over the last year.*



(a) Deflated by the TFE deflator.

in 1974, mainly because companies have been better able to adjust their outgoings and thus to limit their financing needs.

Nevertheless, they have borrowed heavily from banks and reduced their holdings of liquid assets. Their liquidity deteriorated sharply between the first quarter of 1979 and the first quarter of 1980, when it was still slightly better than the worst levels of 1974–75; the recent Department of Industry survey indicated a slight improvement in the second quarter. Higher nominal interest rates have been largely responsible for a marked worsening in income gearing; with interest rates at their current level, the likely fall in profitability since the first quarter and continued recourse to bank borrowing suggest a further deterioration, perhaps to the level of 1974. Heavy bank borrowing has implied some worsening of capital gearing; even so, the cumulative inflation of the last five years has almost halved the real value of debt.

Financial pressures have brought a big increase in liquidations which, at 3,000 in the first half-year, were at the highest rate ever recorded.

Recent trade figures stronger than expected . . .

The current account is estimated to have been in deficit by £230 million in the first half of 1980, an improvement of some £400 million over the second half of 1979; a visible deficit of £930 million was offset by a surplus on invisibles account of £700 million. The strengthening in the underlying non-oil trade position was more substantial. Excluding trade in oil and the usual erratic items, the visible deficit was only £610 million. If allowance is made for two special factors—the steel dispute, and the sharp and erratic movements in the balance of trade in silver—underlying trade was in rough balance in the first half of the year, improving substantially in the second quarter. The outcome was much better than had been forecast.

There was a further strong improvement in the trade balance in July, to an exceptional monthly surplus on visible trade of £260 million. About £100 million was accounted for by the highest surplus yet achieved in trade in oil, but most categories of imports fell. The volume of exports (excluding oil) also declined, though by less. The non-oil terms of trade rose again, by some ¾%.

The volume of exports (other than oil) increased only slightly in the first half of this year. Within the total, exports of manufactures (excluding erratic items) changed little. Exports of intermediate goods did best. As the volume of world trade in manufactures, weighted by UK markets, is estimated to have grown by over 7% at an annual rate in the first half of 1980, the market share of UK exports fell substantially, no doubt reflecting the erosion of competitiveness over the past few years.[1] Effective competitiveness —which takes account of the lags between changes in competitiveness and their impact on trade volumes— deteriorated quite sharply. For the future, the further loss of competitiveness may adversely affect trade volumes, while UK export markets may grow more slowly or decline. An unchanged volume of manufactured exports in the second half of the year would be consistent with the July CBI Industrial Trends Survey.

Balance of payments: current account

£ millions; *seasonally adjusted*

	1979			1980	
	Year	Q3	Q4	Q1	Q2
Visible balance	−3,404	−492	−785	−632	−301
of which:					
Oil balance	*− 779*	*−158*	*−157*	*−126*	*+ 19*
SNAPS balance(a)	*− 83*	*− 56*	*+ 74*	*− 14*	*−202*
Underlying non-oil balance	*−2,542*	*−278*	*−702*	*−492*	*−118*
Invisible balance	+1,541	+497	+146	+470	+233
Current balance	**−1,863**	**+ 5**	**−639**	**−162**	**− 68**

(a) Ships, North Sea production installations, aircraft and precious stones.

World trade and UK export markets(a)

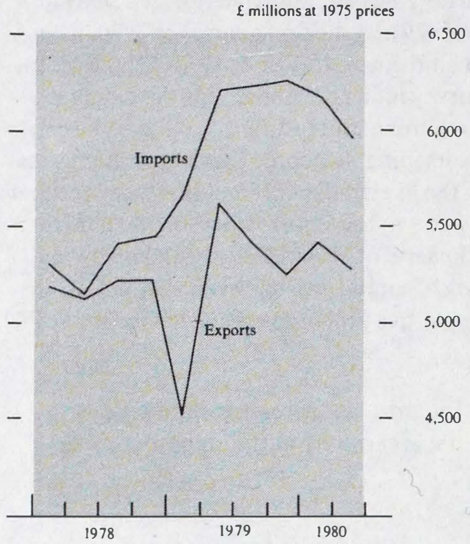
Percentage volume increase from previous period at an annual rate

	1979		1980		1981
	H1	H2	H1	H2	H1
World trade (all goods)	6¼	6½	2¼	−1½	2¼
UK export markets (manufactures)	2	10¾	7¾	2	4

(a) First half of 1980 partly estimated; second half of 1980 and first half of 1981 forecast.

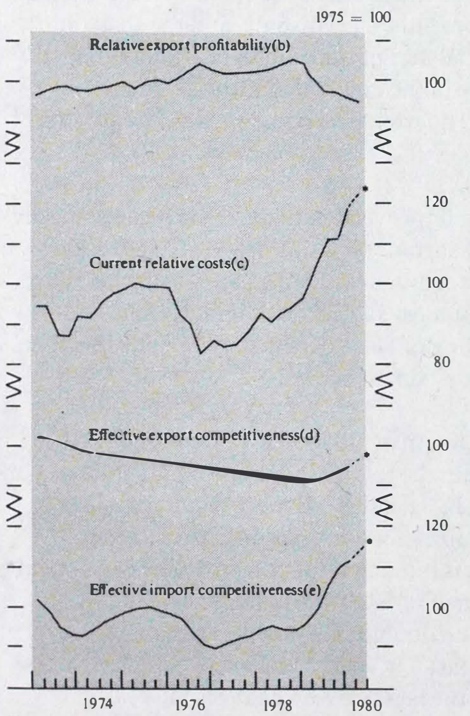
(1) UK markets grew faster than world trade generally, because OPEC markets, in which UK exporters are well established, were buoyant.

The underlying[(a)] **volume of imports** *(other than oil) is falling faster than that of* **exports.**



(a) Excluding erratic items.

Competitiveness *continues to worsen.*[(a)]



• Bank estimates

(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 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.

The volume of imports (excluding erratic items) fell by some 4% between the second half of 1979 and the first half of 1980 and would have fallen further but for very high silver imports in the first four months of the year and the effects of the steel dispute. Part of the decline was due to lower imports of fuels. In addition, imports of food, drink and tobacco so far this year have been below historic levels, while imports of basic materials have come down from the high level of the last three quarters of 1979; this latter development is consistent with the fall in manufacturing output and reductions in manufacturers' stocks of materials. The behaviour of imports of finished manufactures was rather more surprising. Despite the seemingly established rise in import penetration and further erosion of competitiveness (which appears to affect imports faster than exports), they were approximately unchanged in the second quarter from a year ago and some $5\frac{1}{2}\%$ below the peak in the last quarter of 1979. It appears that the demand for manufactured goods, whether home-produced or imported, has been especially weak; and attempts by wholesalers and retailers to reduce stocks may also have led to lower imports.

Another source of the recent strength of the trade balance has been an improvement in the terms of trade (the ratio of export prices to import prices): the non-oil terms of trade—as measured by unit values—rose by 4% between the first and second quarters. Because domestic prices appear to have a greater influence on the prices at which UK goods are sold abroad than on the prices at which foreign products are imported (see the article on page 295), the terms of trade improve as sterling strengthens and as prices in domestic currency terms rise faster in the United Kingdom than abroad. In addition, the rise in primary product prices relative to the prices of manufactured goods came to an end.

... but invisibles surplus reduced

First estimates suggest an invisibles surplus of about £230 million in the second quarter, after £470 million (revised from £300 million) in the first. In the second quarter, net payments to the European Community budget were responsible for nearly £170 million of the deterioration as the transitional arrangements for phasing in the UK contribution came to an end. A fall in the overseas earnings of UK oil companies reflected the world-wide surplus of oil and the reduced industrial demand for petrochemicals. The surplus on travel services fell by over £100 million as UK residents made more visits abroad and spent, on average, more on each visit. The direct investment earnings account, which moved erratically in 1979 on account of changes in the treatment by UK companies of deferred tax liabilities, deteriorated by some £75 million (net) as refunds of tax were made to parent companies under the new double taxation convention between the United Kingdom and the United States. By contrast, UK banks' net euro-currency earnings moved from a deficit of over £40 million to a surplus of nearly £160 million, and the sea transport services account, usually in near balance, recorded a surplus of £100 million after a recovery in the dry cargo sector.

Looking at developments over a longer period, the annual surplus on invisibles account, which has traditionally been large, declined by $£1\frac{1}{4}$ billion between 1976 and 1979, and the available evidence suggests that the underlying deterioration, after allowing for distortions in the direct investment earnings account, may have continued into 1980, although early estimates of the invisibles

Components of the invisibles balance

£ millions; *seasonally adjusted*

	1979			1980	
	Year	Q3	Q4	Q1	Q2
Net services	+3,579	+ 919	+ 954	+1,046	+ 988
of which:					
Private sector and public corporations	*+4,379*	*+1,114*	*+1,169*	*+1,239*	*+1,197*
General government	*– 800*	*– 195*	*– 215*	*– 193*	*– 209*
Net interest, profits and dividends	+ 289	+ 213	– 174	– 34	– 109
of which:					
Private sector and public corporations	*+ 762*	*+ 308*	*– 50*	*+ 66*	*+ 30*
General government	*– 473*	*– 95*	*– 124*	*– 100*	*– 139*
Net transfers	–2,327	– 635	– 634	– 542	– 646
of which:					
Private sector	*– 253*	*– 96*	*– 104*	*– 88*	*– 82*
General government	*–2,074*	*– 539*	*– 530*	*– 454*	*– 564*
Net invisibles balance	**+1,541**	**+ 497**	**+ 146**	**+ 470**	**+ 233**

Balance of payments and external and foreign currency finance

£ millions; *not seasonally adjusted*
Net outflows –

	1979		1980	
	Q3	Q4	Q1	Q2
Current balance	+ 194	– 415	– 358	– 293
Capital flows affecting external and foreign currency finance:				
Private sector external capital transactions:				
Identified	–1,652	–1,219	–1,377	–1,188
Unidentified	– 21	+ 617	+1,090	+ 450
Private sector net foreign currency borrowing from UK banks	+ 297	– 398	+ 278	+ 652
UK banks' sterling lending overseas	– 91	+ 24	– 456	– 548
Other	– 107	+ 444	+ 629	– 54
External and foreign currency finance(a)	**–1,380**	**– 947**	**– 194**	**– 981**
Other capital flows:				
Overseas holdings of public sector debt	+ 741	– 14	+ 270	+ 513
Overseas sterling deposits with UK banks	+ 402	+1,441	+ 439	+1,177
Banks' net foreign currency liabilities	+ 513	– 506	+ 83	– 424
Other	+ 21	– 3	– 89	– 39
Balance for official financing	**+ 297**	**– 29**	**+ 509**	**+ 246**

(a) See Table 11.3 in the statistical annex.

balance are subsequently often revised upwards.[1] The deterioration is mainly attributable to three factors. The most important is the increase in the earnings of foreign oil companies operating in the United Kingdom. In earlier years, profits from operations on the UK Continental Shelf were low because of heavy exploration expenses and a small volume of production; but more recently the build-up of production has led to mounting profits (over £1¼ billion in 1979). In addition, the sharp rise in oil prices has produced larger onshore profits (£¾ billion in 1979). The second factor is a £1¼ billion increase in the net flow of government transfers abroad: about two thirds of this represents growing budgetary payments to the European Community, and the remainder mainly larger economic grants abroad and increased subscriptions and contributions to other international organisations. Following the agreement reached at the end of May to limit the United Kingdom's contribution to the European Community budget, the deficit on government transfers should diminish—though not much benefit will be seen until the first quarter of next year. Third, there has been a rise of £1 billion in the earnings of foreign companies operating outside the oil sector in the United Kingdom: special factors (such as taxation changes) account for some of the increase, but there appears also to be an underlying rise in such earnings which has not been matched by the earnings of UK companies operating abroad. The effect of these three factors on the invisibles balance has been partly offset by large improvements in the net financial and 'other' services accounts, which together contributed nearly £1½ billion more in 1979 than in 1976.

Non-resident holdings of sterling increase, but net capital inflows lower

To some extent under the influence of continuing high interest rates, sterling appreciated by about 2½% between April and June, compared with nearly 3½% in the previous three months. Before repayments of official foreign currency debt and new borrowing, the reserves rose by some £250 million in the second quarter, about half as much as in the first. The upward pressure on sterling, which had been substantial in the first three months of 1980, eased in the second quarter but has intensified more recently. The deficit on current account, not seasonally adjusted, fell by £65 million in the second quarter. Thus net capital inflows, including the balancing item, were over £300 million lower. Within these, overseas holdings of public sector debt and bank deposits expanded by nearly £1,700 million, £1,000 million more than in the first quarter, with most of the increase coming in private, rather than official, holdings. The banks, on the other hand, switched out of sterling, their transactions representing a turnround of £500 million from the first quarter. Identified outflows from the non-bank private sector and the banks' lending abroad in sterling continued at a high level, but net unidentified inflows shrank by almost £650 million—these flows, together with the deficit on current account, ensuring that external and foreign currency transactions tended to contract the money supply in the second quarter. Although the 'corset' remained in place until near the end of the second quarter, some of the inflow into sterling bank deposits, and the banks' own foreign currency operations and lending abroad in sterling, may have been influenced by its removal.

The first half of the year saw a modest rise in outward portfolio investment, mainly through financial institutions, and some increase

(1) See the December 1979 *Bulletin*, page 370 and *Economic Trends*, August 1979, page 109.

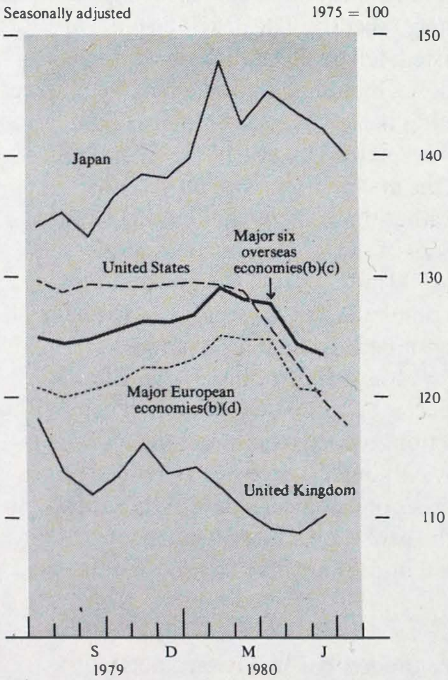
in outward direct investment. These developments no doubt reflect a lack of suitable opportunities to invest at home as well as the end of exchange control. On the other hand, companies have continued to borrow foreign currency from the banks, probably influenced by the strength of sterling and high domestic interest rates.

Depletion of North Sea oil and gas may be slower than expected

Helped by a substantial reduction in domestic consumption, partly because of the mild winter but also because of the recession and higher real energy prices, trade in oil was in approximate balance in the first half of 1980 and showed a strong surplus in July. Oil production in the five years 1980–84 is now expected to be rather less than previously thought, rising from 80–85 million tons this year to 95–135 million tons. This is not because oil reserves are now believed to be smaller, but because of greater technical constraints on the pace of extraction and restrictions on gas flaring. At these levels of output, government revenues from North Sea oil and gas will exceed £3$\frac{1}{4}$ billion this year and rise to about £6$\frac{1}{2}$ billion in 1983/84 (at 1980 prices); and the contribution to GNP (which allows for extra profits paid abroad) should rise from 3% this year to some 4$\frac{1}{4}$% in the mid-1980s.

The previous Government gave assurances that no curbs would be imposed on the extraction of oil found before the end of 1975 until 1982, or four years from the start of production, and some finds since 1975 are protected from curbs on production until 150% of capital invested in them has been recovered. These commitments constrain depletion policy in the short term. However, the Government wish to prolong high levels of production to the end of the century and seek to postpone some production from the 1980s, when the United Kingdom will be a substantial net exporter, to the 1990s. Accordingly, they have begun to discuss deferral of some projects.

Industrial production[a] *in major overseas economies is falling*



(a) Excluding construction.
(b) Trade-weighted.
(c) United States, Canada, France, Italy, Japan and West Germany.
(d) France, Italy and West Germany.

Recession spreads abroad...

Economic activity in the six main industrial countries overseas[1] was surprisingly buoyant at the end of 1979 and the beginning of 1980. In most countries, consumer spending sustained demand as households cut their rate of saving to counter the squeeze on real incomes and, perhaps, to finance purchases in anticipation of future price rises. In Europe this was accompanied by relatively strong corporate spending, partly reflecting healthy profits. More recently, however, the outlook has deteriorated as other countries have followed the United States into recession.

In the United States, GNP fell at an annual rate of 9% in the second quarter, as steeply as at any point in the 1974–75 recession. Industrial production fell again in July, but there are indications, in some sectors at least, that the worst of the decline may now be over. In most other countries, indications of weaker activity have appeared more recently. It seems that households, responding to the squeeze on their real incomes, are leading the downturn and inducing companies to cut output in order to avoid an excessive build-up of stocks. As yet, fixed investment in most countries has been maintained.

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

Costs[a] in the United Kingdom and six major overseas countries[b]

Per cent

	1979		1980			
	Q3	Q4	Q1	Q2	July	Aug.(c)
	Change over previous quarter				Change in latest three months on previous three	
Oil prices(d)						
Six major countries	20.1	24.3	16.0	2.8	0.3	−0.5
United Kingdom	13.2	27.6	10.8	1.3	−1.8	−3.1
Other commodity prices(e)						
Six major countries	4.4	5.7	6.5	−0.5	—	1.4
United Kingdom	− 1.7	8.6	1.7	−1.9	−2.0	−1.3
Unit labour costs(f)						
Six major countries	1.6	1.5	1.3	..	..	..
United Kingdom	2.0	5.3	2.7	..	..	..

.. not available.

(a) Expressed in national currencies.

(b) United States, Canada, France, Italy, Japan and West Germany; GNP weights.

(c) Estimated.

(d) Average OPEC price (including spot prices).

(e) The Economist all items index.

(f) IMF unit labour costs, cyclically adjusted.

Average earnings in manufacturing

Percentage changes on year earlier(a)

	1979		1980		
	Q3	Q4	Q1	Q2	
United States	8.5	7.5	7.4	8.0	*14.4*
Canada	8.8	9.4	9.9	9.6	*9.6*
Japan	8.4	8.0	7.9	8.5	*8.3*
West Germany	5.9	6.8	6.2	7.1	*5.9*
France(b)	12.3	13.1	13.9	14.6	*13.7*
Italy(b)	20.4	22.1	22.4	22.1	*20.8*
Average(c)	9.2	9.1	9.0	9.6	*12.1*

(a) Figures in italics represent the increase in consumer prices in the year to 1980 Q2.

(b) Wage rates.

(c) GNP-weighted.

Changes in current balances, 1978-79

$ billions

	Components				Total change in current balance(a)
	Oil price	Other terms of trade	Trade volume	Invisibles	
United States	−16	+ 8½	+8¾	+8¾	+13¼
Canada	− ¼	+ 3¾	−3	—	+ ¼
Japan	−10	− 2	−8¾	−2½	−25¼
West Germany	− 5¼	− 1½	—	−6¼	−14½
France	− 4¼	+ 3¾	−1½	+ ½	− 2¼
Italy	− 3½	+ 3½	−2½	+2¾	− 1¼
Total	**−39¼**	**+16**	**−7**	**+3¼**	**−29¾**

Source: *OECD Economic Outlook*, July 1980.

(a) Includes, as well as the identified components, valuation effects arising from exchange rate changes, changes in trade balances not directly attributable to either volume or terms of trade effects, and rounding errors.

...and inflation eases

Price rises abroad seem to have passed their peak. After easing last autumn, consumer price inflation in the major overseas economies rose to an annual rate of 15%[1] in April. Since then, the average has dropped back to 11½% (or even less, after allowing for seasonal factors). Also, the range of inflation rates has narrowed. Nevertheless, substantial cost increases have still to pass through, and, although recession may diminish their effect on final prices, further declines in inflation are likely to come more slowly.

Previous issues of the *Bulletin* have noted the modest rise in domestic costs in the main overseas economies as a whole. Oil prices, by contrast, had been rising fast, and other commodity prices also showed strong growth throughout 1979 and in the early months of 1980. Both have eased in recent months. Official oil prices (measured in dollars) have edged up further, but weak markets have caused spot prices to continue the fall which began at the end of 1979. At the same time, the Economist commodity price index in dollars fell between February and June in the face of world recession and has only recently regained its February level.[2] There has been a distinct slowing of raw material price increases measured in currencies other than the dollar, whose effective rate fell by 8% between early April and August.

Wages continue to rise moderately in the major overseas economies. As a result, labour costs have grown only slowly in most countries, in sharp contrast to 1973–74 and to the present UK experience. In some countries—most notably West Germany, where last year's settlements were very low—wage settlements have been higher than last year, but they have quickened less than prices.

A changing pattern of current account imbalances in OECD countries

As oil prices rose, the OPEC current account moved from virtual balance at the start of last year to a surplus close to an annual rate of $130 billion at the end. Further price rises in the first half of 1980 will have pushed it even higher. In the second half, however, as world recession cuts into OPEC exports and their imports recover strongly, the surplus should fall back somewhat. Even so, for 1980 as a whole the surplus may approach $130 billion.

OECD countries, particularly the major oil-importers, have provided the main counterpart to this surplus, and are likely to continue to do so. But while the position of some of the larger countries has already begun to improve, that of the smaller OECD countries could deteriorate as their trading partners move into recession—a development which they cannot easily afford. The non-oil developing countries, too, are unlikely to be able to sustain much bigger deficits. In contrast, the trade balance of the centrally-planned economies in aggregate improved in 1979 and could do so again in 1980.

Among the largest OECD countries, the deterioration on current account last year was concentrated in Japan and West Germany. While higher oil prices were significant, rapid domestic growth in Japan and a widening of the West German deficit on invisibles

(1) Increase, at an annual rate, between latest three months (February–April) and previous three (November–January).

(2) The prices shown in the table for the United Kingdom cannot be directly compared with UK import prices or manufacturers' buying prices, since the composition of the Economist commodity price index is different.

account were also important. Lower inflation than elsewhere (and, in Japan, a weak currency) contributed to a worsening of their (non-oil) terms of trade, in contrast to Italy and France, where the terms of trade held up and the current account remained in surplus. Improved terms of trade, strong exports, and better invisibles brought a significant fall in the US current account deficit.

In the first half of 1980, over three quarters of the further deterioration in the OECD area's current account appears to have been concentrated in France and Italy. The West German deficit has stabilised, and that of Japan has narrowed.

Financing the imbalances

Data prepared by the Bank for International Settlements (BIS)[1] suggest a shift early this year in the pattern in which the international banking system contributed towards financing the deficits of oil-importing countries. In the first quarter of 1980, the growth of international lending within the reporting area more than doubled, to \$26 billion, and new lending to developed countries outside the area was maintained at nearly the same level (\$$2\frac{1}{4}$ billion) as in the fourth quarter of 1979. But new lending to non-oil developing countries and the Eastern bloc fell back sharply,[2] although their net use of funds declined somewhat less as they drew down their deposits, having built them up—partly from the proceeds of borrowing—in 1979. Identified new deposits by oil-exporting countries were approximately \$1 billion lower than in the fourth quarter, but repayments of borrowing resulted in an increase in their net supply of funds to the reporting banks to \$$15\frac{1}{2}$ billion, some \$$3\frac{1}{2}$ billion greater than in the previous quarter.

Medium-term euro-currency bank credits arranged during the first seven months of 1980 show a similar pattern. Announced new credits for the non-oil developing countries amounted to only \$12 billion, compared with \$$19\frac{1}{2}$ billion in the same period of 1979, and for the Eastern bloc to \$$1\frac{1}{2}$ billion, compared with \$$2\frac{1}{2}$ billion. In contrast, the OECD countries arranged new financing of \$$19\frac{1}{2}$ billion, against \$$14\frac{1}{2}$ billion.

The need to finance current account deficits has led Japan and West Germany to accept more readily than hitherto the use of the yen and the deutschemark as reserve currencies. The Swiss, although not in current account deficit last year, have also adopted a more flexible attitude to the use of the franc as a reserve currency. Each country has relaxed restrictions adopted to block the portfolio demand for its currency, and the West German and Japanese authorities have made direct sales to Saudi Arabia of financial instruments denominated in their currencies. In the last few years there has been a significant increase in official reserves held in these three currencies. For example, deposits by official monetary institutions in deutschemarks held with commercial banks in West Germany and elsewhere in the BIS European reporting area, Canada and Japan, amounted to the equivalent of \$$27\frac{1}{2}$ billion at end-1979, compared with \$9 billion at end-1976. The respective figures for the yen and Swiss franc were \$5 billion (\$$\frac{3}{4}$ billion) and \$$6\frac{1}{2}$ billion (\$4 billion). Bank deposits are only one form in which official reserves are held, and total official holdings of assets denominated in these three currencies may be somewhat larger.

(1) For the scope of the data and for more details, see Table 15 in the statistical annex and also the financial review, page 291. As far as possible, the figures in this paragraph exclude the effects of exchange rate movements and the double-counting resulting from redepositing between reporting institutions.

(2) New lending to non-oil developing countries amounted to \$4 billion in the first quarter of 1980 compared with \$$12\frac{1}{4}$ billion in the fourth quarter of 1979, and new lending to the Eastern bloc fell from \$3 billion to practically nothing.

Assessment

In recent months the real economy has been subject to considerable financial pressures. These pressures have been worsened by the stubborn persistence of inflation at a high level, though there are now encouraging signs that the pace of inflation is slackening. The financial aggregates, on the other hand, have risen faster than earlier envisaged. To some large extent their fast expansion has been due to special or temporary factors, which need to be taken account of in assessing future trends.

The pressures on the real economy

In the first half of this year, manufacturing output was 4½% below the average for 1979. Adult unemployment has risen by nearly 400,000 to 1.7 million in August. The chief feature of demand has been the heavy rundown of stocks. As noted earlier in this commentary, manufacturers and distributors reduced their stocks by some £900 million in the first half of this year. Even so, stock levels were still higher in relation to sales and production at the middle of the year than at the end of 1974; and they have probably not yet been reduced to desired levels, particularly in manufacturing. The rundown of stocks is, by its nature, a temporary phenomenon whose contractionary force should reverse as the process slows down. Other recessionary factors are, however, now likely to be operative.

Activity in the developed economies was stronger until early 1980 than had been generally expected. In the United States recession may have bottomed out; but, with a delayed recession in the other major economies now clearly established, a marked downturn in world activity and trade is in train which seems likely to continue for some time. Continued growth in activity, together with rising oil-producer incomes, was associated with relatively brisk growth of about 8% per annum in UK export markets up to the first quarter of this year. Thus, the impact of the substantial weakening in world demand has only just begun to impinge on the UK economy.

The pressures on the economy will also be increased by the rise in the exchange rate, the effects of which were masked in the first part of the year by the continuing growth of UK markets. The effective exchange rate has risen by 9% this year—while domestic costs have continued to increase considerably faster than elsewhere. With earnings in most major overseas countries continuing to rise more slowly than in the last cycle, inflation abroad has not reached its previous peak and, indeed, appears in general to have eased back in the last few months. This country's problems need to be seen against the background of competitor countries' relative success in containing inflation.

Encouraging signs of inflation slowing

The prime aim of policy in this country is the reduction of inflation; and the prospects now look encouraging. The rise in prices has moderated—very much as envisaged in earlier *Bulletin* assessments. In July, when the June 1979 VAT increases dropped out of the annual comparison, the rise in the retail price index compared with twelve months earlier was reduced to just under 17%, and to a little over 16% in August—against comparable rises of just under 22% in May and 21% in June. Still more encouragingly, the rise on a month-on-month basis has been continuously below 1% since May and was only about ¼% in August.

Another sign of reduced inflationary pressures can be found in the behaviour of property prices. Earlier signs of rapid price increases and speculative activity have disappeared. The housing market has weakened, and the rate of inflation of house prices has eased noticeably. There appears to be little property speculation; and land prices, particularly for agricultural land, now seem to have steadied.

The annual rate of price rise is likely to come down quite rapidly in the early part of next year, although much will depend on the next wage round. The year-on-year increase should fall when various factors which raised prices quite sharply last winter and early spring—in particular, higher oil and commodity prices, and also higher mortgage rates—fall out of the comparison. The total effect might be worth 4%. Both the recent appreciation of sterling and the slackness of markets generally should also moderate price increases. It is significant that only a third of respondents to the CBI August enquiry expect to raise their prices over the next four months, the lowest proportion for about a decade. Despite increases in labour costs and nationalised industry prices, the total rise in retail prices over the next twelve months is thus likely to be substantially less than over the last year.

Companies are finding it increasingly difficult to pass on higher labour costs in higher prices—above all in sectors exposed to international competition. Other factors too may help to produce lower settlements. There is now no longer the former explicit commitment to comparability for the public sector (which directly accounted for some two percentage points of the overall earnings rise of 21.7% in the year to June). Whereas little success was achieved in persuading wage bargainers to accept that the 1979 VAT increase did not affect the underlying rate of inflation—and was broadly offset by the cuts in direct taxation—the fact that the VAT effect has now fallen out of the twelve-month series should certainly be helpful. But most important should be the further deceleration of inflation, recorded and prospective.

Public borrowing set to decline

The public sector has shown a large deficit in the financial year so far. In the first financial quarter the PSBR was nearly £4½ billion, compared with the Budget estimate for the full year of £8½ billion. For central government borrowing, later figures, but not seasonally adjusted, are available: in the first five months of the financial year, it has been £7 billion, compared with £9¼ billion projected for the full year. Borrowing needs in the first part of the year have been inflated by a number of special factors. The profile of borrowing is expected to fall away sharply later in the financial year—as indeed happened last year, for some of the same reasons. Factors operative this year will be fast-rising receipts of petroleum revenue tax; receipts from asset sales; and rebates from the European Community budget. All of these will substantially reduce borrowing in the later part of the financial year.

Though the PSBR has been affected by the recession, it does not so far appear to have been more greatly affected than was expected at the time of the Budget. If deeper recession now emerges, this could reduce Exchequer revenues (in particular from PAYE and VAT) below earlier forecasts, and increase Exchequer outgoings, in particular unemployment benefit; and would reduce the trading surpluses and increase the borrowing requirement of the public corporations. This underlines the importance of maintaining control over the course of the larger part of public expenditure which is not directly sensitive to the level of activity.

Monetary developments and the new savings instruments

It was widely appreciated that the supplementary special deposits scheme (the 'corset') had artificially held down the rate of expansion of the money supply as measured by sterling M_3; and that the termination of the control would result in a large upward adjustment. In the event the initial adjustment was very large: sterling M_3 grew by no less than 5% in the banking month of July, and in August there was further growth, smaller but still unusually rapid. As indicated earlier in this commentary, it seems clear that a major part of the recent expansion represents adjustments to the ending of the corset—that is, the banks resuming kinds of lending which had previously been diverted into other channels. As a result, sterling M_3 grew by a little over 16% in the year to mid-July. Wider measures of private sector liquidity have grown approximately as fast as sterling M_3; but the money stock on the narrower definition, M_1, has grown by only $4\frac{1}{2}$% in the twelve months to July.

In the period ahead, the rates of expansion of the money stock on the narrow and wider definitions should become much less divergent. The two chief counterparts to the rapid growth of sterling M_3 have been the large PSBR—which should decline substantially in the second half of the financial year; and bank lending to the private sector, which has also been large, and which is also expected to moderate.

Heavy bank lending to the corporate sector reflects a distortion in the pattern of financing. The financial deficit of the company sector has increased sharply; and, with low profits and high long-term nominal interest rates, companies have been unable or unwilling to raise large sums on the capital market, so that the bulk of their finance has come via the banks. Large corporate deficits have been accompanied by even larger personal sector surpluses, which have in part flowed into deposits with the building societies and banks, the latter thus being one counterpart to the banks' lending to companies. In part, personal sector surpluses have also flowed into life assurance and pension funds; they, in turn, have channelled much of the flow into purchases of gilt-edged stocks.

The nature of these developments suggests that it would be desirable for the public sector deficit to be financed more directly by tapping personal savings. In the period from mid-April to mid-August, total net official sales of gilt-edged stocks were £$4\frac{1}{2}$ billion. Receipts from other central government debt were, however, disappointing, and sales of national savings and certificates of tax deposit raised only £$\frac{1}{2}$ billion in the same period. The decision by the Chancellor of the Exchequer to increase substantially the availability of the index-linked national savings certificates and the Save As You Earn scheme should enable the PSBR to be financed without such large reliance as in the past on sales of gilt-edged stocks.

The effect of these steps should be to help control of sterling M_3 to be maintained with long-term interest rates lower than otherwise; and thus with better hope of achieving, more especially as inflation declines, interest rates lower than now. This could, in due course, help to promote greater recourse to the long-term capital market, reducing the dependence of companies on money-creating sources of finance. The considerations relative to the real economy outlined above emphasise the importance of such a shift.