Economic commentary

Introduction

Price inflation has continued to abate throughout much of the year, with the retail price index rising recently by barely ½% a month. Weak demand and the appreciation of sterling have contributed to this outcome. For companies, the result has been a compression of profit margins, and in real terms profitability in the first half of this year was the lowest ever recorded. In contrast, the real earnings of those in work have risen.

Output has fallen further. Manufacturing industry continues to be the most severely affected: in the last year manufacturing production has fallen by 10% or so, to the lowest for thirteen years. Unemployment is the highest since the war. Recent surveys and forecasts suggest that demand and output will remain weak for some time yet.

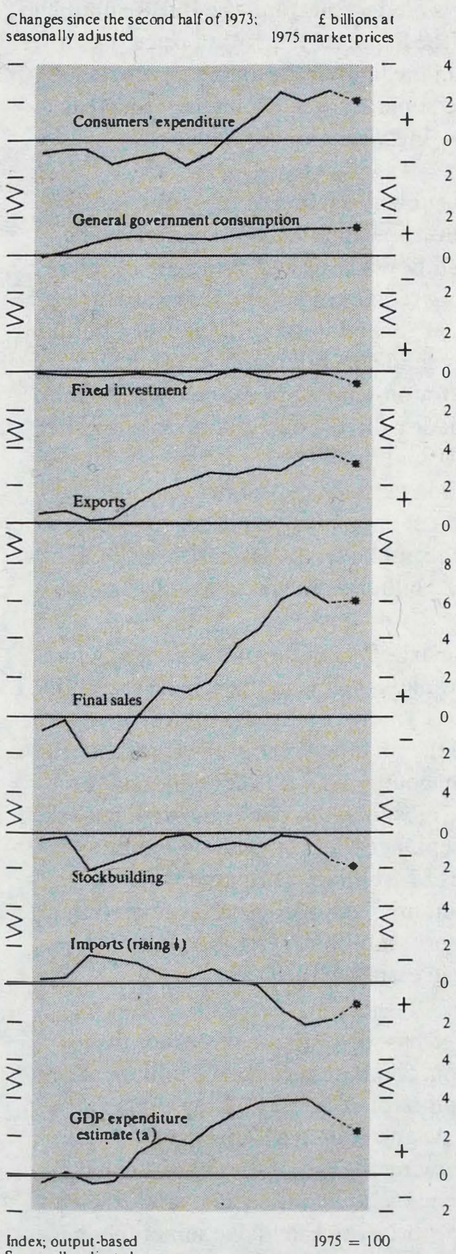
So far, few pay settlements have been reached in the current round, though such that have point to a smaller pay increase than in the previous round as the financial pressures on companies become more widely appreciated. In setting the Rate Support Grant for 1981/82, the Government have allowed for a 6% increase in wage bills; and they have indicated that other cash limits will be based on a broadly similar assumption.

Influenced by the recession, which is deeper here than abroad, external trade has moved into large surplus.

The growth of sterling M_3 has been well above target—perhaps 20% at an annual rate since the current target period began in February, even after allowing for the unwinding of distortions following the end of the supplementary special deposits scheme (the 'corset'). Other aggregates have grown more slowly, especially the narrow definition of money, M_1.

The recession is adding to the public sector borrowing requirement (PSBR), which amounted to £8 billion in the first half of the financial year. It is expected to be about £3½ billion in the second half—a reason, together with signs that sterling lending to the private sector is moderating, for expecting the growth of money supply to slow down. In November, the Chancellor of the Exchequer announced various changes in expenditure in 1981/82, and also a new tax on oil company revenues and higher rates of employees' national insurance contributions. Against this background, minimum lending rate (MLR) was reduced from 16% to 14%.

The decline in stocks has been the strongest contractionary force on **GDP**.

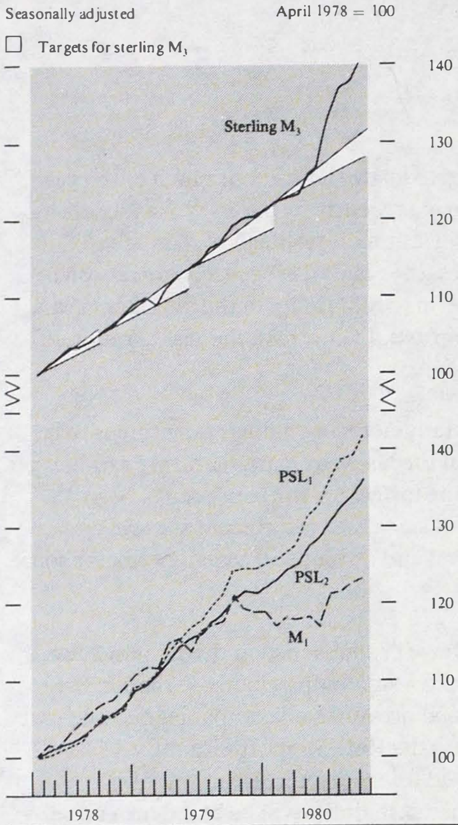


* Estimates.
(a) At factor cost.

The growth of the monetary aggregates

After very rapid growth in the two months following the end of the corset, sterling M_3 grew by 0.6% in the month to mid-September, but increased by 2% in banking October and by an estimated further 2% in banking November. By mid-November, on this estimate, it was 17½% above the mid-February base, a growth of 24% at an annual rate, compared with the target of 7%–11%. After allowing for the unwinding of distortions associated with the corset, it is

M_1 *has risen more slowly than other aggregates.*



Counterparts of the money supply[(a)]

£ millions; *seasonally adjusted*

Mid-month	Oct. 79– Jan. 80	Jan. 80– Apr. 80	Apr. 80– July 80	July 80– Oct. 80
Central government borrowing requirement	+2,382	+ 224	+3,301	+3,587
Net purchases (–) of central government debt by UK non-bank private sector	–3,125	–1,490	–1,930	–2,941
Other public sector(b)	+ 265	+ 62	+ 668	+ 217
Sterling lending(c) to:				
UK private sector	+2,252	+2,480	+3,186	+2,526
Overseas sector	+ 271	+ 412	+ 760	+ 669
Domestic credit expansion	**+2,045**	**+1,688**	**+5,985**	**+4,058**
External and foreign currency finance (increase –)	– 722	– 630	– 802	– 384
Net non-deposit liabilities (increase –)	– 249	– 210	– 533	– 190
Sterling M_3	**+1,074**	**+ 848**	**+4,650**	**+3,484**
Percentage change in sterling M_3	+ *1.9*	+ *1.5*	+ *8.2*	+ *5.6*
M_1	**– 468**	**– 212**	**+ 794**	**+ 449**
Percentage change in M_1	– *1.7*	– *0.8*	+ *2.9*	+ *1.6*

(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.

estimated that the underlying growth since mid-February has been about 20% at an annual rate. The wider measures of private sector liquidity, which were less seriously distorted by the corset, have grown slightly more slowly than sterling M_3 since mid-February, and the narrower aggregate, M_1, much more slowly—as have notes and coin in the hands of the public, the main component of what is usually meant by the monetary base.

On 24 November, MLR was reduced from 16% to 14%. The Chancellor said that the existing target for the growth of sterling M_3 in the fourteen months to mid-April would continue until the Budget. While monetary growth is likely to be above the top of the range over the target period as a whole, it should not now continue at the same rate as in the first nine months. There are signs that sterling lending to the private sector is moderating, and the PSBR should be smaller in the second half of the financial year. With price rises lower than earlier in the year, and in the light of the financial imbalance between the company and personal sectors, an unchanged MLR would have implied an increasingly restrictive policy.

In the three months to mid-October, sterling M_3 rose by over $5\frac{1}{2}$%, as against $8\frac{1}{4}$% in the previous three months, both periods being affected by reintermediation following the end of the corset. The central government borrowing requirement from mid-July to mid-October was very large, at £3.6 billion (of which over £2 billion arose in banking August). Around £1.4 billion of the total represented funds borrowed for on-lending to the rest of the public sector, which, in addition, made a direct contribution to domestic credit expansion (DCE) of £0.2 billion.[(1)] The non-bank private sector financed nearly £3 billion of the borrowing requirement by purchases of central government debt, mostly gilt-edged stocks, so that the net contribution of the public sector as a whole to DCE was £0.9 billion, compared with £2 billion in the previous three months.

Despite the smaller expansionary effect of the public sector (which, in so far as it reduced the flow of payments to the private sector, may to some extent have given rise to more private sector borrowing) the growth in sterling lending to the private sector in the three months to mid-October was £2.5 billion, compared with £3.2 billion in the previous three months. If the most obvious corset distortion is taken out—the change in bank acceptances held outside the banking system—the growth becomes £1.9 billion, compared with £2.7 billion in the previous three months. Altogether, the underlying rate of increase in lending in the three months to October was perhaps £250 million a month less than earlier in the year.

Lending in sterling to the overseas sector in the three months to mid-October was £670 million, compared with £760 million in the previous three. Of the six-month total, over £1 billion came in the banking months of July and August; much of it probably represented adjustments following the end of the corset, which in effect restricted all forms of bank lending in sterling. Also, the fact that interest rates in the euro-sterling market have sometimes been higher than those in the domestic market may have encouraged UK banks to lend more in the euro-sterling market.

DCE amounted to £4 billion in the three months to mid-October, as against £6 billion in the previous three.

(1) The contribution of local authorities and public corporations to the PSBR *less* finance provided by the non-bank private sector.

External and foreign currency finance—approximately, the surplus or deficit on the current account of the balance of payments and private sector capital flows—reduced the money supply by considerably less in the three months to mid-October than in the previous three months—by only £380 million as against £800 million. A very sharp improvement in the current account of the balance of payments was the most important reason (and it may have contributed to the slower growth in bank lending to the private sector and to increased sterling lending abroad). Nevertheless, overseas residents continued to add to their holdings of sterling bank deposits and public sector debt, though at a slower rate than earlier.

Company borrowing remained high in first half of the year

Although their borrowing may have slackened recently, industrial and commercial companies borrowed heavily in the first half of the calendar year, despite sizeable reductions in stocks which appeared to leave them in approximate financial balance. Companies continued to invest abroad and, in the second calendar quarter, added substantially to their holdings of liquid assets, having reduced them in the previous quarter. As a group, they extended trade credit. They borrowed mostly from the banks, and in nominal terms their bank borrowing has never been as high in a six-month period; on top of this, many of the commercial bills issued in this period were taken up outside the banking system.

In some respects, the situation was different in the mid-1970s recession. In 1975, a fall in the exchange rate made it easier for companies to recoup cost increases by raising prices, whereas in the current recession sterling has appreciated strongly; and the stock relief scheme introduced at the end of 1974 reduced company tax bills by some £0.8 billion—equivalent to at least £1½ billion at present prices.[1] Their total borrowing requirement fell, and with it their recourse to the banks.

Heavy reliance on the banks is not new. For several years now, companies have raised a significantly lower proportion of their financing needs outside the banking system than in the 1960s. Rapid inflation and large government borrowing in the gilt-edged market have brought high long-term interest rates, which, with associated uncertainty about future rates, have discouraged the issue of debentures and loan stock; and weak (real) equity prices, reflecting poor profitability, make the raising of more equity capital seem unattractive. The domestic market in variable-interest loan stock is not well developed. Thus, for a given company borrowing requirement, these considerations have led to greater dependence on bank finance.

External financing of industrial and commercial companies

£ billions

Percentages in italics

	Net borrowing requirement	of which, financed by:					
		Bank borrowing	*Share of total*	Issues of debentures and preference shares	*Share of total*	Other capital issues(a)	*Share of total*
1964–67	4.2	1.8	*42*	1.4	*33*	0.5	*11*
1968–71	5.3	3.1	*59*	0.9	*17*	1.0	*19*
1972–75	11.9	12.4	*105*	0.5	*4*	1.9	*16*
1976–79	12.3	13.2	*107*	−0.1	—	3.3	*27*

(a) Ordinary shares and capital issues overseas.

Banking liquidity under strain

It has already been noted that companies have borrowed heavily from banks during the current recession. But the banks have also increased their lending in sterling to the rest of the private sector and to overseas. This growth in lending has been well above the target rate of monetary expansion. Some change in the composition of the banks' assets has therefore been necessary to constrain the growth of their balance sheets—an increase in the share of claims on the private and overseas sectors and a reduction in the share of their holdings of public sector debt. Since, by and large, public sector

(1) This relief is still available. A recent consultative document proposes relief from the 'clawback' provisions in existing legislation (see below, pages 400/1).

debt, held directly by the banks or at one remove by the discount houses, provides the banks with the reserve assets they are required to hold (but some of which they would wish to hold in any case for prudential reasons), there has been a persistent shortage of reserve assets. If this shortage had not been relieved by the Bank, competition among the banks for reserve assets would have driven up interest rates in the money market, possibly to very high levels. The immediate effect would probably have been an expansion, rather than a reduction, of sterling M_3 (partly as firms borrowed from some banks at interest rates related to base rate and redeposited the proceeds with other banks at higher rates) and a further strengthening of the exchange rate. The Bank, while insisting that banks should hold the required amount of reserve assets at all times, ensured that sufficient reserve assets were available, mainly by buying securities from the banks with an agreement to resell them later. The amount of such assistance outstanding stood at £1 billion in mid-November, but by early December it had all been unwound.(1)

Building societies(2)

In the four months to October, net receipts by building societies, including interest credited to accounts, averaged £620 million per month, compared with £470 million in the first half of the year. An improvement in relative interest rates following the reduction in MLR to 16% in July and, perhaps, rising personal savings provide the main explanations. In the same four months, net advances rose less rapidly than receipts — by £500 million a month (compared with £395 million in the previous six months), and the societies' liquidity ratio rose from 17.8% to 19.1%. New mortgage commitments, however, rose quite strongly, and in October exceeded £1 billion in a single month for the first time. Although the extent to which these extra commitments will be called upon is unclear, the rise does suggest that demand for mortgages is recovering. House prices have been fairly steady, increasing by only 4% in the six months to September.

From mid-November, societies will have been facing increased competition from the new issue of index-linked national savings certificates; and some banks are becoming active in the mortgage market and also competing more keenly for savings. On the other hand, the cut in MLR in November has eased the societies' position; and on 12 December the Building Societies Association announced a reduction in the recommended mortgage rate to 14% and the net share rate to $9\frac{1}{4}$%.

PSBR higher than expected

A PSBR of £$8\frac{1}{2}$ billion was projected last March for the current financial year. But in November the Chancellor indicated that the outturn could be around £$11\frac{1}{2}$ billion, partly because the recession was proving deeper than had been expected.

In fact, the PSBR amounted to £8 billion in the first half of 1980/81, and before the Chancellor's statement in November the Government had taken various steps to curb it, including a temporary moratorium on new defence contracts. To encourage local authorities to spend less, the Government temporarily withheld £200 million of Rate Support Grant (and withdraw grants from some authorities); and in October a moratorium was imposed on new capital spending on housing by local authorities in England (which was later extended to spending by housing associations in

(1) More details can be found in the financial review, page 411.
(2) Figures in this section are not seasonally adjusted.

Scotland). On the other hand, the cash limit for defence spending was increased by £200 million. The external financing limits of the British Steel Corporation, British Shipbuilders and British Rail were also increased, by £400 million, £65 million and £40 million respectively, the additional resources being found from the unallocated contingency reserve within the planned level of public expenditure. In addition — but with its main effect in 1981/82 — the Government suspended the civil service pay agreement (under which pay increases were set with primary regard to wages and salaries for comparable jobs in the private sector) and announced that the Rate Support Grant for 1981/82 would allow for pay settlements giving increases in the wages bill of 6%. The Treasury subsequently indicated that broadly the same allowance for pay would be made in other cash limits.

It was expected that much of the total PSBR would occur in the first half of the current financial year. Various important receipts will not accrue until later in the year: the proceeds of special sales of assets and rebates from the European Community budget; revenue from the sale of licences for a fresh round of exploration in the North Sea; and the first advance payment of petroleum revenue tax (PRT). Moreover, other receipts from PRT (the next payment is in March) are rising fast. Nevertheless, the PSBR in the financial year as a whole is now expected to be around £11½ billion; of the £3 billion increase, some £500 million arises from higher interest payments, but more than half would be attributable to a deeper recession than had been expected in March. GDP is declining more steeply than the 2½% fall earlier expected for 1980, tending to increase government spending on social security benefits and to depress the trading surpluses of public corporations, although not, on balance, further reducing tax revenues to any significant extent.

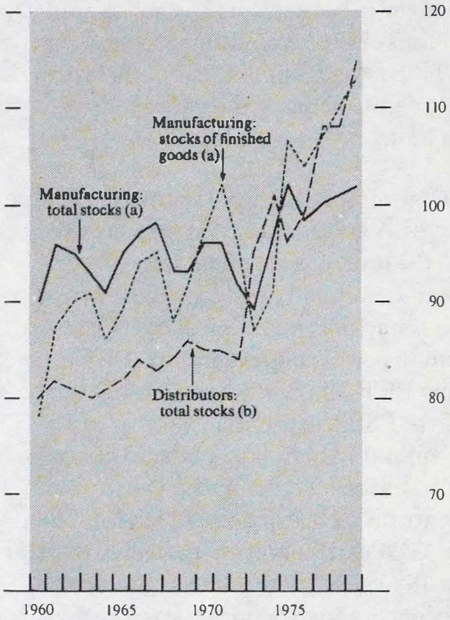
By itself, the continuing recession could add further to the PSBR next year. The medium-term financial strategy presented with the Budget suggested a PSBR in 1981/82 equivalent to 3% of GDP — £7½ billion or so. The projections for the PSBR were, however, not intended as targets in themselves; it was foreseen that various factors could significantly affect the finances of the public sector while still being consistent with the planned reduction in the growth of money supply.

In November, the Government announced various changes to planned public expenditure in 1981/82 from the levels contained in the March White Paper. Including the refund expected in 1981/82 from the European Community budget, these changes would bring a net fall in spending of some £750 million at 1981/82 prices. In addition, the rates of employees' national insurance contributions will be increased from next April, and a supplementary tax on North Sea oil revenues will be introduced. Each of these measures is expected to raise £1 billion in 1981/82. Altogether, the Treasury suggested that the PSBR next year might be somewhat lower in relation to GDP than this year, although the prediction is subject to a wide margin of error. The Government also announced the results of the usual annual review of earnings limits for national insurance contributions. As provided in legislation, the revised limits were related to the level of national insurance retirement pensions and will mean increased contributions by both employers and employees.

Even at recent levels, the PSBR is a good deal lower in relation to GDP than it was in the mid-1970s, when output last fell as sharply.

Stocks *have risen in relation to* **output** *for several years.*

Annual averages 1974 Q4 = 100



(a) Ratio of stocks to production.
(b) Ratio of stocks to retail sales.

Gross domestic fixed investment[(a)]

£ millions at 1975 prices; *seasonally adjusted*

	1979(b)		1980	
	H1	H2	Q1	Q2
General government	820	860	770	740
Public corporations	850	850	860	900
Total public sector	1,670	1,710	1,630	1,650
of which housing	*390*	*410*	*400*	*350*
Total private sector	3,360	3,520	3,540	3,420
of which housing	*480*	*510*	*480*	*470*
Total	**5,030**	**5,230**	**5,170**	**5,070**
of which:				
Manufacturing	*960*	*970*	*950*	*900*
Distribution and services(c)	*1,390*	*1,440*	*1,450*	*1,490*

(a) Figures may not add exactly because of rounding.
(b) Quarterly averages.
(c) Includes investment in assets for leasing. In 1979 an estimated £450 million of assets included in this category were leased to manufacturing industry. Investment by the shipping industry is excluded.

In the five quarters from mid-1979 the PSBR, at over £15 billion, was equivalent to about 6% of GDP at current prices. In the four quarters to the third quarter of 1975, at just under £10 billion, it was equivalent to some 10% of GDP.

Output and demand fall further . . .[(1)]

The recession has deepened. Total output fell by nearly 2% in each of the second and third quarters, to nearly 4½% below the quarterly average of 1979. The loss of output in the last year or so has been most severe in the manufacturing sector where, by September, output had fallen to its lowest level for thirteen years. Virtually every industry in the sector has shared in the fall, with chemicals, textiles and metal manufacturing among the worst affected. In the third quarter as a whole, manufacturing production was 11¼% below the average in 1979 — a fall of over 10% at an annual rate.

The reduction in stocks — £500 million in the first half of the year compared with an increase of £1,600 million in 1979 — has been the most contractionary element in demand. Distributors reduced their stocks particularly sharply, by £430 million; this partly explains why manufacturers failed to reduce their own stocks of finished goods, which fell in the first quarter but rose again in the second. The fall in manufacturers' stocks in the first half of the year was confined to raw materials and work in progress, which declined by £470 million. There was an increase in the 'other stockbuilding' category, some of it representing accumulation of unsold cars by the motor trade, and this reduced the overall fall in stocks. In the third quarter, manufacturers again added to their stocks of finished goods, but reduced their holdings of other stocks; distributors reduced their stocks by a further £100 million.

Before this year, stocks held by manufacturers and distributors had built up following the widespread destocking in 1975. With only modest growth in output and retail sales, stock/output ratios grew, continuing a movement which is not associated only with the introduction of stock relief in 1974 and negative real interest rates in the mid-1970s. Even the recent reduction in stocks has not lowered them in relation to output, at least for manufacturers.

Fixed investment has been a smaller contractionary influence than stockbuilding, although investment in public services fell by 13% between the average for 1979 and the first half of 1980. Housebuilding fell by 5% over the same period, and the number of housing starts, over 20% fewer in the first half year compared with the average for 1979, and a further 17% lower in the third quarter, indicates a further decline since then. Subsequently, in October, new public sector capital spending on housing in England was temporarily frozen in order to contain local authority spending. Investment in houses has tended to decrease in recent years, and is now at its lowest for at least fifteen years.

Fixed investment by manufacturing industry was about 4½% lower in the first half of 1980 than the average for 1979. If assets leased by manufacturers were included, the fall might be around 2% – 3%. In the third quarter, manufacturing investment fell further, to 9½% below the quarterly average last year. By contrast, investment in distribution and services (which includes assets for leasing) has tended to rise: in the first half year it was nearly 4% above the quarterly average last year, and in the third quarter, nearly 6% above it. Other fixed investment also rose, by 5½% between the

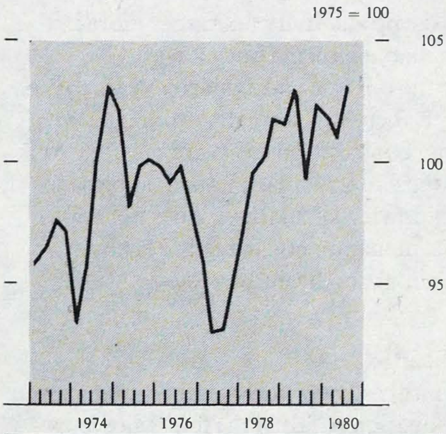
(1) Components of demand are expressed in 1975 prices.

average for 1979 and the first half of this year.[1] So far, the decline of fixed investment in manufacturing and the increase in the distributive and service industries seem consistent with the Department of Industry survey carried out in the spring.

Consumers' expenditure has so far weakened little, although the pattern from quarter to quarter has been uneven: compared with the average last year, it was 1% higher in the first half but slightly lower in the third quarter. Retail sales were supported by the extended summer sales and in the third quarter were only 1% lower than in the second and 2% below the quarterly average last year. Sales of food and clothing held up, though sales of household durable goods were well down on last year. Motor vehicle registrations increased by 7% in the third quarter, recovering some of the 19% drop in the second, but remained well below the average last year.

The resilience of consumer demand owes much to the absence of pressure so far on real incomes. On balance, earnings have risen much faster than prices over the last three years. The wider measure of income, real personal disposable income (RPDI), weakened only slightly in the second quarter, and the saving ratio moved up from 13% to 15%. In the third quarter, the boost to incomes from back pay, coupled with slower inflation, is likely to have raised RPDI substantially, perhaps to 2% – 3% above the quarterly average last year, despite the increase in unemployment and short-time working. With consumer spending virtually unchanged, the saving ratio would be back to around the peak of 16% reached in the fourth quarter of 1979, probably influenced by prevailing uncertainties about employment and incomes.

Real average earnings *have risen steeply over the last three years.*



Of the other components of demand, government current spending on goods and services was unchanged in the first half of the year, but the real trade balance improved; in the third quarter, the trade balance strengthened further, with the volume of imports $5\frac{1}{2}$% below the quarterly average last year, and the volume of exports of goods and services $\frac{1}{2}$% lower.

... and have already declined as much as in the last recession

Any comparison with experience in the mid-1970s depends on when the last recession is considered to have begun and ended. Output declined steeply between the third quarters of 1974 and 1975. However, the Central Statistical Office's index of coincident indicators shows an earlier peak — around mid-1973.[2] Moreover, falls in expenditure identified so far do not explain the total fall in output in the recent period. Later estimates may narrow the difference. For these reasons, comment in this section is tentative.

Between the quarterly average in 1979 and the third quarter of this year, output fell slightly more than between the third quarters of 1974 and 1975, but the rate of decline was about the same. In each period, reductions in stocks appear to have been the main contractionary element.[3] But changes in the other components of demand had rather different effects in the two periods. Fixed

Composition of the fall in GDP

Percentage changes at an annual rate
1975 prices; *seasonally adjusted*

	1974 Q3 – 1975 Q3		1979 average – 1980 Q3(a)	
	Contribution to total change in GDP	Change in component	Contribution to total change in GDP	Change in component
Consumers' expenditure	−1.2	−1.8	−0.1	−0.2
General government consumption	+1.6	+7.3	+0.2	+0.8
Gross fixed investment	+0.5	+2.6	−0.6	−3.0
Stockbuilding	−4.7		−2.4	
Exports (goods and services)	−2.0	−6.9	−0.1	−0.4
Imports (goods and services; decrease +)	+2.1	+6.4	+1.7	+4.9
Residual(b)	−0.2		−2.6	
GDP (output measure)	−3.9		−3.9	

(a) Figures for general government consumption in 1980 Q3 are wholly estimated, and those for fixed investment and stockbuilding are partly estimated.

(b) Includes the factor cost adjustment and the discrepancy between the output and expenditure measure of GDP.

(1) Investment apart from manufacturing, distribution and services, shipping, housing and public services.

(2) See *Economic Trends*, November 1980, page 68.

(3) In the two and a quarter years between the peak and trough as recorded in the CSO's index, output fell more slowly—at a rate of about 2% per annum. Again, reductions in stocks were the main force behind the decline. Figures for stockbuilding (and fixed investment) in the third quarter of this year are partly estimated, and figures for general government consumption of goods and services are wholly estimated.

investment and government current consumption of goods and services grew in the earlier period; recently, however, government spending has probably grown very little and fixed investment has declined. On the other hand, consumer spending has been more resilient in the last year or so than it was in the earlier period (RPDI having been stronger), and exports of goods and services have scarcely declined, whereas they fell sharply in 1974–75. In each period, imports fell—but by rather more in the mid-1970s.

These differences reflect the strong exchange rate during the present recession and government policy towards public sector spending. For a time at least, a high exchange rate boosts RPDI by reducing price rises. Bank estimates suggest that a 10% appreciation of sterling might lead RPDI to be ½%–1% higher a year later. At the same time, however, it worsens the trade balance in volume terms (an effect which has been concealed by growth in UK markets abroad and by an improving balance of trade in oil) and reduces company profitability.

During the present recession the fall in hours worked by operatives in manufacturing industry was slightly less than the fall in manufacturing production, which implies a slight fall in productivity. On the same basis, productivity fell rather more in 1974–75, when the decline in manufacturing output was approximately as steep. Over the full two and a quarter years to the third quarter of 1975, however, there was virtually no change in productivity in manufacturing. Such comparisons are sensitive to the exact period chosen, and the figures for output and employment are not on a consistent basis.(1) In view of all this, it does not appear that productivity performance in manufacturing in the last year or so has been significantly different from the mid-1970s.

Prospects for output and demand

In their replies to the CBI monthly survey in November, many more companies expected their production to fall in the following four months than expected an increase. The great majority reported below-normal order books and considered their stocks of finished goods to be adequate or excessive. The more detailed quarterly survey published late in October revealed that 85% of respondents were working below capacity; and replies to a question on capital investment led the CBI to the tentative conclusion that fixed investment by private manufacturing industry might be at least 10% lower next year than this.

The CBI survey also predicted reductions in manufacturers' stocks of finished goods—which are unusually high; but the small increase in retailers' stocks in the third quarter may herald an end to the contractionary impact of reductions in stocks.(2) (The further fall in distributors' stocks in total was accounted for by the wholesale trade.)

Lower fixed investment (a response to the poor profitability of existing capital assets, the extent of spare capacity, and the financial pressures on companies), weaker exports as recent losses of competitiveness take effect, and higher imports are likely to take over from stocks as the main depressants of output. Consumer spending may also ease. RPDI could fall over the next year or so under the influence of falling employment, higher national

(1) Manufacturing output measures production in the United Kingdom, whereas the employment figures cover manufacturing in Great Britain alone and the statistics of hours worked relate only to manual workers.

(2) To lessen the downward pressure on output, stocks need not increase; a smaller decrease would be sufficient.

insurance contributions, and smaller wage increases (a factor which would tend to depress spending); and general uncertainty about prospects for the economy may continue to induce caution. On the other hand, the saving ratio could fall, and experience in earlier periods of falling real incomes suggests that it will. Altogether, output seems very likely to be lower on average next year than it was in the third quarter, possibly with some fall during the year.

The labour market is very weak

The depth of the recession is illustrated by developments in the labour market. The rise in adult unemployment (seasonally adjusted) has lately been well over 100,000 a month—twice as much as earlier in the year and far more than in the mid-1970s. By November, adult unemployment had reached a post-war peak of 2,028,000—nearly $8\frac{1}{2}\%$ of the workforce. This represents an increase of 745,000 since a year ago (and the increase in total unemployment benefit and the reduction in tax payments and national insurance contributions have been factors raising the PSBR this year).

The number of unemployed school-leavers has fallen sharply from the peak of nearly 300,000 in the summer. Even so, at 111,000 in November, there were over twice as many school-leavers out of work as a year ago. The total number registered as unemployed—both adults and school-leavers—rose to 2,163,000[1] in November.

Employment[a]

Thousands

June	1973	1974	1975	1979	1980
Manufacturing	7,660	7,710	7,330	7,020	6,660
Other production industries	2,030	1,970	1,970	1,930	1,910
Other industries and services	12,480	12,620	12,910	13,360	13,340
All industries and services	**22,180**	**22,300**	**22,210**	**22,310**	**21,910**

(a) Great Britain. Figures may not add exactly because of rounding.

The latest available figure for the employed labour force (including HM Forces and the self-employed) relates to June. In the year to June, the total employed fell by about 400,000. In the same period, the number of adults registered as unemployed rose by only 250,000, and unemployment among school-leavers increased by about 40,000. Yet the population of working age is growing at around 200,000 a year. Thus, a substantial number of people of working age appear to have withdrawn, temporarily or permanently, from the labour force, or, if still looking for a job, are not registering as unemployed.

Employment in manufacturing, and indeed in other industries included in the index of production (mining and quarrying, building, and gas, electricity and water), fell in the year to June by much the same amount as it had in the mid-1970s. But, whereas employment in all other industries and services rose in the mid-1970s, it fell slightly in the year to June. These figures seem to indicate that productivity outside manufacturing has performed better recently than it did in the mid-1970s.

There continues to be a regular flow off the unemployment register, with about 265,000 leaving it each month—a number which has not changed much for a year. However, the difficulty in finding jobs is shown by the decrease in the number of vacancies reported to employment offices—97,000 in November, 137,000 fewer than a year earlier. Moreover, in the present recession there have been an unprecedented number of plant closures, as reflected in the number of redundancies—over 380,000—notified to the Manpower Services Commission in the first ten months of the year. Already twice as many redundancies have been notified this year as in the whole of

(1) This figure is not seasonally adjusted.

1979. With no early prospect of an increase in output, unemployment is likely to rise further next year.

The Job Release Scheme, under which employees approaching pensionable age can retire to make way for unemployed people, and the Temporary Short-Time Working Compensation Scheme, which would also have ended next year, have now been extended to 1982. In addition, the Government have expanded the Youth Opportunities Programme and announced various other changes, altogether adding some £250 million to spending in this area in 1981/82.

Lower settlements at the start of the new pay round

The increase in earnings in the pay round which ended in July was about 22%, after allowing for a large amount of back pay in July 1979 which would otherwise have depressed the comparison. This average conceals wide differences between groups of employees. With comparability payments adding up to ten percentage points to the increase in their pay, the earnings of public service employees rose substantially more than the average. The underlying increase in earnings in manufacturing was about $18\frac{1}{2}$%—less than in some private sector service industries.

The timing of various pay settlements accounts for the acceleration in the growth of earnings from under $1\frac{1}{2}$% a month earlier in the year to $2\frac{1}{2}$% in August and $3\frac{1}{2}$% in September. Nurses, teachers and some others in the public sector received substantial back pay in these months, and some industrial civil servants received pay increases earlier than usual. These factors, and the engineering dispute which reduced average earnings in September 1979, account for the increase in the year-on-year rise in the earnings index to 26% in September. On the other hand, growing short-time working and reduced overtime are depressing the index; by September, only two thirds as many overtime hours were worked as at the end of 1979[1] and 8% of manual workers in manufacturing industry were on short time. The effect was to reduce the increase in the index of average earnings in the whole economy by some two to three percentage points.

Few employees settle in the first three months of the new pay round (although rather more may have done so in this pay round than in the last one). Some in the motor and related industries have already accepted around 10% or less, with workers at BL Ltd settling for 6.8%; but a few other settlements have been around 15%. (The $8\frac{1}{4}$% settlement in the engineering industry was a national agreement, to be followed by bargaining at individual firms.) Most businessmen expect pay increases in the private sector to be much lower this year than last. In the public sector, the mineworkers have accepted an increase of just under 10% in basic rates (which, with improvements in productivity, may amount to an increase of 13% in earnings). The Government have suspended the civil service pay agreement (which bases pay on that for comparable jobs outside), and are calculating the Rate Support Grant for next year on the assumption that local authority wage bills increase by only 6%; broadly the same allowance will be made in other cash limits.

With the last comparability awards arising from the 1978/79 pay round now implemented in the public sector, and with recent

(1) Overtime in September 1979 was reduced by the engineering dispute.

settlements tending to moderate, the rate of increase in earnings should fall back, although the effect of the engineering dispute last year and some other factors may keep the index around 20% higher on the annual comparison until early next year. The state of the labour market and prospects for price inflation will be influential.

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
		46.7%	*10.7%*	*20.4%*	*22.3%*
1978 H1	**+4.0**	+2.2	—	+1.1	+0.7
H2	**+4.6**	+2.8	+0.8	+0.4	+0.6
1979 H1	**+5.6**	+2.4	+1.1	−0.1	+2.2
H2	**+9.3**	+4.3	+2.2	+1.1	+1.8
1980 Q1	**+3.9**	+1.8	+0.7	−0.1	+1.4
Q2	**+4.7**	+3.5	—	+1.5	−0.2
Q3(c)	**+4**	+3	+1		—

(a) The deflator for total final expenditure at market prices. As stated in the September *Bulletin*, page 272, this kind of statistical analysis reveals little about the causes of inflation, but it does indicate the composition of changes in costs.

(b) Mainly incomes of the self-employed, profits, trading surpluses of public corporations, and rent. Stock appreciation is excluded.

(c) Bank estimates.

Price increases continue moderate

The slowdown in domestic price increases which has occurred this year had no parallel in the recession of the mid-1970s. The prices which manufacturers pay for raw materials and fuels scarcely changed between April and November, while, against a background of weak demand and competition from industry abroad, their home selling prices rose by barely $4\frac{1}{2}\%$. In November, buying prices were less than 9% up on the year, compared with nearly 30% last March. Like manufacturers' selling prices, retail prices have risen by $\frac{1}{2}\%$ or so in most recent months; in October, the index was under $15\frac{1}{2}\%$ higher than a year earlier, a better result than had been expected for the fourth quarter at the time of the Budget. However, price rises in the public sector (for example, for gas, rail fares, local authority rents, coal, post and telephones) and seasonal increases in food prices are likely to impede any further fall in the monthly rate of increase in the near future. Nationalised industry prices have already risen much faster than other prices; in the six months to October, they contributed one percentage point to the increase of $4\frac{1}{4}\%$ in the index, although they have a weight of less than one tenth. Nevertheless, the year-on-year increase should fall again in the new year as the rise in the mortgage rate and the sharp increases in oil and commodity prices recorded last year drop out of the comparison.

Several other factors are relevant to prospects for prices in the early months of next year. First, market conditions are expected to remain weak—contributing to a moderation of cost increases and limiting the scope for raising prices. Second—and very important, given the weight of wages and salaries in total costs—the signs are that pay increases will be lower in the current round than last year. On the other hand, the war between Iran and Iraq has caused oil prices to harden again, and commodity prices have also risen in dollar terms (see page 404).

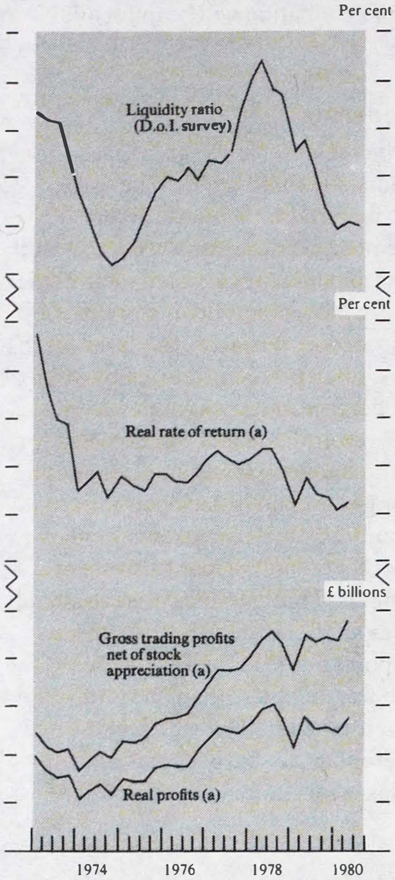
Altogether, the balance of respondents to the CBI Industrial Trends Survey in November who expected to raise prices over the succeeding four months was the lowest recorded in a monthly survey since monthly surveys were introduced in 1975, and lower than in any quarterly survey since 1967.

Company profitability and liquidity

The deepening recession has brought yet a further fall in companies' real profitability. The real rate of return of industrial and commercial companies (excluding North Sea operations) now appears to have declined to $4\frac{1}{4}\%$ in the first half of this year, compared with $4\frac{3}{4}\%$ in the second half of 1979 and about $5\frac{1}{4}\%$ in the recession of the mid-1970s.[1] Costs have risen less fast than they did five years ago, but the appreciation of sterling, while helping to contain cost increases, has made it much harder to raise prices, contributing to the squeeze on margins.

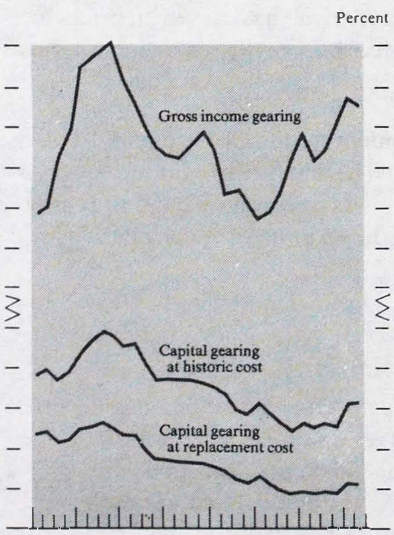
(1) Figures for company profits have been substantially revised since the September *Bulletin*. The note on page 455 provides further details.

In the first half of 1980, **real profitability** *was barely 4%.*



(a) Excluding North Sea operations

Despite recent increases, **gearing ratios**(a) *remain below 1974 levels.*



(a) For all industrial and commercial companies.

Gross trading profits (at current prices) rose by no more than $1\frac{1}{2}\%$ in the first half of 1980. Profits net of stock appreciation rose somewhat more, by $4\frac{1}{4}\%$; in part, this reflected the slower rise in the prices of fuels and raw materials held in stock than in the previous half year. Nevertheless, after allowance for depreciation of fixed capital at replacement cost, real profits appear to have been virtually unchanged, representing about $6\frac{1}{2}\%$ of national income, compared with just under 7% in the previous half year (and $7\frac{1}{4}\%$ in 1975).

Figures for the appropriation of income and the financial balance are available only for all industrial and commercial companies, including their North Sea operations. With interest rates and outstanding borrowing both higher, interest payments, at £4 billion, were over 21% more in the first half of 1980 than in the second half of last year. Income gearing (the proportion of after-tax income pre-empted by interest payments) rose to 33%—still below the 1974 peak of 39%. Dividend payments fell from the very high level of the previous six months (when they had been boosted by the abolition of dividend controls in July 1979), but were still much greater than in the first half of 1979. Tax payments rose by 6% because of bigger payments of petroleum revenue tax and advance corporation tax. Despite the increased appropriations, however, the increase in profits (net of stock appreciation) and the sharp reduction in stocks left companies in approximate financial balance in the first half of the year, after a financial deficit of over £2 billion in the previous six months.

Even so, their borrowing requirement rose by £$2\frac{3}{4}$ billion. The main reason appears to have been a change in their net trade credit position as a group: having previously been net debtors, they appear to have extended trade credit on balance in the first half of this year. Factors behind this change included payments to the Post Office after the billing dispute and advance payments for oil to the British National Oil Corporation. Company liquidity—measured by the ratio of liquid assets to liquid liabilities—fell, although companies remained more liquid than five years ago. Manufacturing companies were much less liquid than the rest of the sector. Increased borrowing brought a rise in capital gearing (the ratio of debt to total trading assets at replacement value) from $9\frac{1}{2}\%$ to $10\frac{3}{4}\%$ in the first half year, but this was still well below the peak of 18% in 1974.

Since the middle of the year, prices have continued to rise less than costs, and demand has declined further, putting greater pressure on profit margins; on the other hand, companies have again reduced stocks substantially. In the third quarter, company liquidity fell back somewhat. There are indications from the CBI's October Survey that the liquidity position of the manufacturing sector will worsen slightly over the coming six months. Without any improvement in profit margins, it is likely that companies will move back to financial deficit unless they make further substantial cuts in their capital expenditure.

Broadly speaking, companies have been able for some years to offset increases in the value of stocks held (whether arising from a physical increase in stocks or from an appreciation in their value) against their liability to corporation tax. However, the Inland Revenue have been able to reclaim ('claw back') the relief in the event of a subsequent fall in the value of stocks, although more recently payment of the reclaimed amount could be deferred for a year. Recent reductions in the volume of stocks, combined with smaller rises in the prices of industrial raw materials, have caused the value of stocks held by many businesses to fall in 1980, raising the prospect of extra tax payments next year or early in 1982. The new scheme proposed in the Inland Revenue's consultative document[1] on stock relief published in November proposes that tax relief should not be recovered after a fall in the value of stocks,[2] unless the business ceases to trade. Relief will, however, be abated for the largest businesses, where stocks are financed by trade credit or other borrowing.

Current account in large surplus . . .

The surplus on current account which had emerged during the second quarter grew to £1,080 million in the third. In the first nine months of this year, the current account was in surplus by some £820 million, compared with a deficit of £1,670 million in 1979 as a whole.

Balance of payments: current account

£ millions; *seasonally adjusted*

	1979		1980		
	Year	Q4	Q1	Q2	Q3
Visible balance	−3,404	−785	−633	−262	+ 774
of which:					
Oil balance	*− 779*	*−157*	*−107*	*− 8*	*+ 155*
SNAPS balance(a)	*− 83*	*+ 74*	*+ 56*	*−182*	*+ 62*
Underlying non-oil balance	*−2,542*	*−702*	*−582*	*− 72*	*+ 557*
Invisible balance	+1,734	+196	+442	+198	+ 302
Current balance	**−1,670**	**−589**	**−191**	**− 64**	**+1,076**

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

Following a deficit averaging over £200 million a month in January to April, visible trade was roughly in balance in May. However, trade in the first few months of the year had been distorted by the steel strike (which had worsened the balance of trade in iron and steel) and by an exceptional surge in imports of silver bullion. If these categories of trade, and the usual erratic items, are excluded, the move out of deficit in visible trade appears to have begun as early as February. Altogether, the balance on visible trade has turned from a deficit of almost £800 million in the fourth quarter of 1979 to a surplus of similar size in the third quarter of this year. Trade in oil accounted for some £300 million of the improvement, and better non-oil terms of trade for about £500 million. The rest came from a drop in the volume of imports other than oil.

Price and volume components of visible balance changes[a]

£ millions; *seasonally adjusted*

Balance of payments basis

	Change in visible balance over previous period	Contribution of:			
		Oil		Non-oil	
		Price	Volume	Price	Volume
1978	+ 733	+100	+ 672	+1,304	−1,343
1979	−1,858	−336	+1,556	+1,364	−4,442
1980 Q1	+ 152	− 96	+ 146	− 287	+ 389
Q2	+ 371	+101	− 2	+ 408	− 136
Q3	+1,036	+ 73	+ 90	+ 296	+ 577

(a) For details of the calculation, see footnote (a) to Table A on page 301 of the September *Bulletin*.

Apart from the reversal of special factors affecting iron and steel and silver, there have been several noteworthy influences on non-oil trade. The fall in domestic demand, including attempts to reduce stocks of finished goods, was primarily responsible for a drop of over 10% in the volume of imports of finished manufactures (excluding erratic items) between the fourth quarter of 1979 and the third quarter of this year; within that, imports of cars fell by 25%. Other imports have also been affected by reductions in stocks and by falling production, and have declined substantially. Altogether, the volume of imports (other than oil) fell over 8% between the fourth quarter of 1979 and the third quarter of this year. The volume of non-oil exports was sustained by strong demand from oil-producing countries, where UK exporters are well established, and fell by only ½% in the same period.

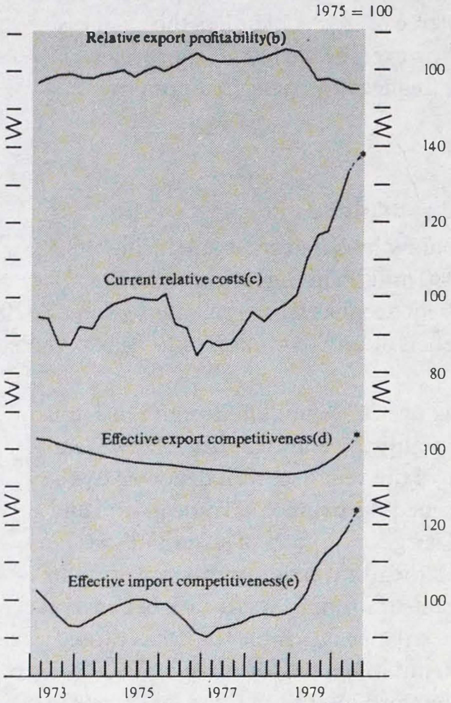
The improvement in the balance of trade in oil, from a deficit of £160 million in the fourth quarter of 1979 to a surplus of similar size in the third quarter of this year, was caused by a sharp fall in domestic use (some 14½% lower in the first nine months of this year than in the corresponding period in 1979); domestic production was little changed.

Next—and a factor which has tended to weaken the trade balance in volume terms—the competitive position of the United Kingdom has continued to deteriorate. Measured by relative labour costs per unit of output, adjusted to allow for the stage of the economic cycle, competitiveness in the third quarter is estimated to have been nearly

(1) 'Stock relief: a consultative document', Board of Inland Revenue, November 1980.

(2) From companies whose accounting year ends on or after the date of the consultative document (14 November).

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.

40% worse than the average for 1975.[(1)] Such a deterioration has no parallel in recent history, either in this country or among its major competitors. According to relationships estimated in the Bank, changes in effective competitiveness have probably reduced the volume of manufactured exports by 4% between the fourth quarter of 1979 and the third quarter of 1980, and significantly increased the volume of imports of finished goods.[(2)] But the full effect of recent losses of competitiveness on the volume of trade has yet to be felt; this may take as long as four years for manufactured exports, although a shorter period for manufactured imports.

Excluding oil throughout, a 1% change in the terms of trade affects the trade balance by about £100 million a quarter. The 5% improvement in the non-oil terms of trade between the fourth quarter of 1979 and the third quarter of this year to some extent mirrors the loss of competitiveness. The rise in sterling (9% in effective terms over the period) contributed to this result, as did the faster rate of domestic price rise in the United Kingdom than abroad.[(3)] Another reason for the higher terms of trade recently is that the dollar prices of industrial materials—of which the United Kingdom is a net importer—rose rapidly around the turn of the year, but then steadied or declined in relation to those of manufactured goods.

The volume of imports fell sharply again in October, when, excluding oil, it was $16\frac{1}{2}$% below the monthly average in the fourth quarter of last year; imports of cars were 45% lower. Non-oil exports also fell, by $5\frac{1}{2}$%. The non-oil terms of trade improved further, to show a gain of 6% from the fourth quarter of last year. The surplus on trade in oil increased to £150 million. Altogether, the surplus on visible trade was £460 million, the largest ever recorded.

First estimates for invisibles indicate a surplus of some £300 million in the third quarter, after about £200 million in the second (which was depressed by net rebates of tax to US companies under the new double taxation convention between the United Kingdom and the United States). After allowing for this and for other special factors, there appears to have been some underlying deterioration over recent quarters,[(4)] although more recent estimates are subsequently often revised upwards.

In the third quarter, the surplus on services continued to decline. The growth in UK personal incomes and unfavourable movements in competitiveness have led to a further deterioration in the travel account, with lower expenditure by overseas visitors in the United Kingdom and higher spending by UK residents abroad. Earnings from shipping also fell, probably largely reflecting a lower volume of oil carried by UK operators. Elsewhere in the accounts, widespread industrial depression and the strength of sterling adversely affected the overseas earnings of UK companies; but the earnings of foreign oil companies in the United Kingdom also fell. Interest payments abroad rose as a result of large increases in sterling bank deposits held by overseas residents with UK banks.

(1) The calculation depends on the weights attached to the other countries in the comparison, and the correction made for the state of the economic cycle. The IMF measure used in the Bank shows a smaller loss of competitiveness than the measure calculated by the CBI (which is not cyclically adjusted).

(2) 'Effective' changes in competitiveness measure the estimated effect of current and past actual changes on trade flows in the current period.

(3) See the article 'Recent developments in the terms of trade' in the September *Bulletin*, page 295.

(4) For an account of influences tending to reduce the surplus, see the September *Bulletin*, page 274.

Balance of payments and external and foreign currency finance

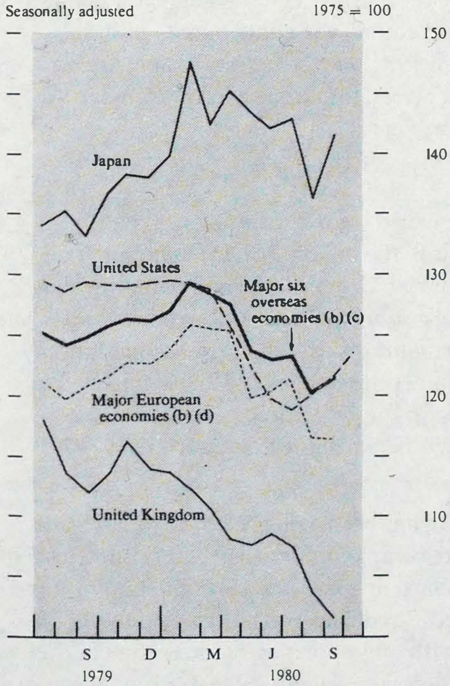
£ millions; *not seasonally adjusted*
Net outflows –

	1979		1980		
	Q3	Q4	Q1	Q2	Q3
Current balance	+ 233	− 358	− 376	− 275	+1,164
Capital flows affecting external and foreign currency finance:					
Private sector external capital transactions(a)	−1,582	− 659	+ 179	− 641	−1,442
Private sector net foreign currency borrowing from UK banks	+ 297	− 398	+ 69	+ 563	+ 65
UK banks' sterling lending overseas	− 92	− 1	− 423	− 606	− 807
Other	− 247	+ 478	+ 290	− 52	+ 105
External and foreign currency finance(b)	**−1,391**	**− 938**	**− 261**	**−1,011**	**− 915**
Other capital flows:					
Overseas holdings of public sector debt	+ 743	− 14	+ 270	+ 551	+ 245
Overseas sterling deposits with UK banks	+ 402	+1,441	+ 439	+1,177	+ 806
Banks' net foreign currency liabilities	+ 513	− 506	+ 104	− 443	+ 161
Other	+ 30	− 12	− 43	− 28	− 18
Balance for official financing	**+ 297**	**− 29**	**+ 509**	**+ 246**	**+ 279**

(a) Including balancing item.
(b) See Table 11.3 in the statistical annex.

Industrial output(a) *has fallen much further here than abroad.*

Seasonally adjusted 1975 = 100



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

. . . with accompanying changes in capital flows

The balance for official financing in the third quarter was £280 million, slightly more than in the second. Nevertheless, the reserves fell by about £225 million, largely because of the prepayment of £480 million ($1,150 million) of euro-dollar borrowings by the Government. Sterling rose by a little over 2% in effective terms.

The composition of the balance of payments changed markedly in the third quarter. The current account (not seasonally adjusted) moved from a deficit in the second quarter to a surplus of over £1,150 million; with the balance for official financing little changed, there was a corresponding movement on capital account, from inflows—including the balancing item—of over £500 million to net outflows of nearly £900 million.

Sharp increases in US short-term interest rates helped to bring about this change in capital flows with relatively modest upward pressure on sterling—on three months' rates, the uncovered interest differential fell from over 7% in favour of London to less than 2%. In addition, capital flows closely connected with the financing of trade compensated to a large extent for the change in the current account. Identified trade credit increased by nearly £300 million, and the balancing item, part of which is thought to represent unidentified trade credit (and some of which responds to interest rates), changed by nearly £1,100 million between the second and third quarters. The private sector borrowed much less heavily in foreign currency from UK banks than it had in the previous quarter; the banks lent more in sterling abroad, much of it in the euro-sterling market; and overseas holdings of sterling bank deposits and public sector debt increased less than in the second quarter. On the other hand, the banks switched into sterling, and remaining identified outflows from the private sector fell, although preliminary returns suggest substantial portfolio investment abroad.

On balance, despite the current account surplus, external and foreign currency transactions tended to contract the money supply again in the third quarter.

The course of recession abroad

In the second quarter of this year, there was a remarkably synchronised downturn in economic activity overseas, which encompassed virtually all OECD countries. Although GNP in the six largest overseas economies[1] fell at an annual rate of 5½% in the second quarter, and a further decline may have been recorded in the third, it is likely that the present downturn will be substantially less severe than in the 1974–75 recession. This contrasts with experience in the United Kingdom.

The second quarter decline was shared by all the major overseas economies apart from Japan; even there, GNP growth slowed sharply. The main contractionary factor everywhere was the squeeze on real personal incomes as consumer price inflation accelerated in the wake of higher oil prices. Consumption, which had earlier been sustained by reduced rates of saving, fell in the second quarter in all the major countries apart from Japan, where it grew only slightly. In the United States, where the biggest fall in output was recorded (nearly 10% at an annual rate), housing and business investment were also weak.

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

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

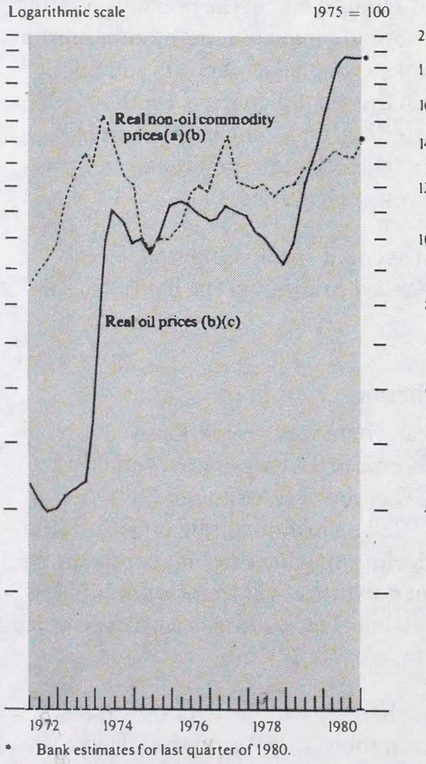
Per cent; *not seasonally adjusted*

	1979 Q4	1980 Q1	Q2	Q3	Oct.	Nov.(c)
	Change over previous quarter				Change in latest three months on previous three	
Oil prices(d)						
Six major countries	24.3	16.0	2.8	−0.5	1.4	3.5
United Kingdom	27.6	10.8	1.3	−3.3	−1.4	0.6
Other commodity prices(e)						
Six major countries	5.7	6.5	−0.5	3.8	6.0	7.3
United Kingdom	8.6	1.7	−1.9	0.8	3.1	4.3
Unit labour costs(f)						
Six major countries	1.4	1.8	2.1	..	..	..
United Kingdom	5.4	3.2	5.9	..	..	..
Consumer prices						
Six major countries	2.5	3.3	3.2	2.0	1.9	..
United Kingdom	2.8	4.7	5.8	2.1	1.7	..

.. 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.

Real oil prices *have increased steeply in the last two years.*



• Bank estimates for last quarter of 1980.
(a) The Economist all items index; dollar terms.
(b) Deflated by index of export prices of manufactures in dollars.
(c) Average OPEC price (including spot prices); dollar terms.

Industrial production again fell sharply in the third quarter, although the decline in total output was probably less pronounced. Indeed, in the United States industrial production fell at an annual rate of 8% in the third quarter, whereas GNP is estimated to have risen by 1%.

In the second half of this year, a slower rate of stockbuilding may well have become the main recessionary force overseas. But cautious business behaviour over the past two years means that the adjustment of stocks is likely to be neither as prolonged nor as severe as in 1974–75, and by early next year the decline in activity in the major overseas countries as a whole should have ended. By then, real incomes should be picking up as price inflation falls back, leading to some recovery in personal consumption in most countries. But, with monetary and fiscal policy likely to remain tight everywhere, the recovery will probably be slow; between the second halves of 1980 and 1981, domestic demand in the six major overseas economies as a whole may rise by little more than 2%.

Price inflation eases

Coinciding with the weakening in activity, consumer price inflation in the major overseas economies has fallen from its peak in the second quarter. By October, it was down to about 8% at an annual rate, compared with 15% in April,[1] and only a small part of this easing can be attributed to seasonal influences. Several factors may make further reductions in inflation more difficult to achieve. Although high stocks and weak consumption have kept oil prices fairly steady even after the near cessation of exports from Iran and Iraq, recent spot price developments in crude and product markets suggest that the supply/demand position is delicate. Furthermore, non-oil commodity prices—in particular, food prices—began to rise again in the late summer, having stabilised earlier in the year, and in November were about 16% higher in dollar terms than a year earlier.

Although earnings overseas have continued to grow only modestly, they may now be rising faster than before. This is likely to impede a further decline in inflation and could even contribute to a slight quickening in the early part of 1981. Nevertheless, if there are no further major increases in oil prices, inflation should resume its gradual slowdown during next year.

World trade falls back

In the early part of this year, world trade continued to expand strongly. Although imports into the major OECD economies had ceased to grow by the first quarter, demand was buoyant elsewhere, especially in the oil-exporting countries. Since UK exporters are well represented there, UK export markets, which in the second half of 1979 had grown as fast as at any time since mid-1976, continued to expand rapidly. UK markets for manufactured goods were also strong, growing by nearly 10% between the first quarters of 1979 and 1980.

More recently, however, there has been a downturn in world trade. In the second quarter, import volume into most OECD countries fell steeply, with a particularly sharp drop in imports of oil; but imports of manufactures also declined. Trade has probably fallen further in the second half of the year, with oil imports even lower than in the first half. With the expected recovery in activity in 1981, however, trade should also grow, though probably only slowly by historic standards.

(1) Three-month moving averages ending in October and April.

World trade and UK export markets

Percentage volume changes at an annual rate; *seasonally adjusted*

	1979	1980		1981	
	H2	H1	H2(a)	H1(a)	H2(a)
World trade(b)	6¾	2	−4¼	4¼	6
UK export markets(c)	7½	6	−1½	4	6
of which:					
Larger OECD countries(d)	6½	−2	−7¼	3¾	6¾
Smaller OECD countries	7¾	3½	−3¾	½	3¾
Non-oil developing countries	2	12¾	−9¾	5¼	3¾
OPEC	25¼	16¾	19	15	12

(a) Bank forecasts.

(b) Excluding imports into the United Kingdom.

(c) All goods.

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

Current balances(a)

$ billions; *seasonally adjusted*

	1979	1980		1981
	H2	H1	H2	Year
Six major overseas countries	−15	−30	−17	−15
Other OECD	−16	−18	−15	−30
Oil-exporting countries	51	64	47	82
Developing countries	−21	−34	−27	−61

(a) The columns do not sum to zero because of incomplete country coverage, timing assymetries in the recording of trade, and incomplete recording of invisibles transactions. Figures for the second half of 1980 and for 1981 are Bank estimates/forecasts.

OECD: balance of payments

$ billions; *not seasonally adjusted*

	1978	1979		1980	
	Year	Year	Q4	Q1	Q2(a)
OECD excluding United States					
Current account	26	−37	−16	−24	−18
Capital account	24	23	8	10	24
Balance for official financing(b)	50	−14	−8	−14	6
United States					
Current account	−14	−1	—	−2	−1
Capital account	−23	18	6	14	−2
of which, reported official assets of OPEC and developing countries	*−1*	*7*	*6*	*4*	*5*
Balance for official financing(b)	−37	17	6	12	−3

(a) Partly estimated.

(b) Fall in assets/rise in liabilities −. The US balance for official financing comprises changes in the US net official position together with changes in US liabilities to the authorities of industrial countries arising principally from exchange market intervention.

The growth of imports in OECD countries may not be concentrated in those which are important UK markets. It may instead be strongest in North America and Japan, which together take only one eighth of UK exports, and sluggish in Europe, where balance of payments problems are likely to limit import growth, particularly in many of the smaller economies. More serious financing constraints are likely to affect the developing countries (see below). OPEC imports will continue to bolster UK markets, although their growth may slow during next year.

Distribution of current account imbalances

The current account surplus of the oil-exporting countries peaked at an annual rate of about $135 billion in the first quarter of this year. High interest rates, which boosted investment income, added to the surplus. The subsequent decline in interest rates, combined with buoyant imports and weak demand for oil, will have reduced it in the second and third quarters. In the fourth quarter, the surplus is likely to have dropped sharply, with the very sharp fall in exports by Iran and Iraq not wholly made up by increased production by other OPEC members.

The deficits which correspond to the oil exporters' surplus have been widely spread, with the major OECD countries, notably Japan and West Germany, bearing a much greater share than in 1974–75. In recent months, however, while the West German deficit has stabilised, that of Japan has quickly declined under the influence of substantial gains in competitiveness, weakening domestic activity and the adjustment of stocks. By contrast, France and Italy have only recently moved into large deficit. The United States has run a moderate deficit throughout, the impact of higher oil prices having been offset by the effects of domestic recession and strong export performance. The deficits of other OECD countries and the developing countries rose quickly during 1979 and in early 1980, and many of them have now introduced restrictive policies.

If there is no further large rise in oil prices, and if their imports continue to grow strongly, the combined current account surplus of the oil exporters could fall to about $80 billion in 1981. The counterpart reduction in deficits is likely to be concentrated in the large industrial countries, reflecting the impact of recession and subsequent slow recovery. The smaller OECD and developing countries may remain in heavy deficit next year, despite policies to restrain demand.

The $63 billion deterioration in 1979 in the combined current account of the OECD area—except the United States—was met entirely by an offsetting swing in official reserve transactions. After substantial accumulations in 1978, their aggregate reserves fell in 1979, reflecting attempts—in particular by Japan and West Germany—to resist downward pressures on their exchange rates. These pressures arose partly from the fact that a disproportionately large share of the oil exporters' revenues was being invested in US dollars; but they were exacerbated by a widening of interest-rate differentials between the United States and elsewhere. In effect, importers have paid for their oil by transferring to OPEC the ownership of their reserve assets held in the United States. By using their reserves to offset the exchange rate pressure induced by the deterioration in their current account, many countries have so far been able to avoid the cost (in terms of higher interest rates or exchange rate depreciation) of attracting sufficient capital flows to cover their enlarged deficits. In the first half of 1980, however, when

Developing countries: balance of payments
$ billions; *seasonally adjusted*

	1978	1979		1980	
	Year	Year	Q4	Q1(a)	Q2(a)
Current balance	–26	–40	–11	–15	–18
Capital balance	41	48	13	13	17
of which:					
Direct investment	*6*	*7*	*2*	*2*	*2*
Capital market finance	*28*	*39*	*12*	*7*	*10*
Other(b)	*7*	*2*	*–1*	*4*	*5*
Balance for official financing	15	8	2	–2	–1
Financed by:					
Borrowing from IMF	—	1	—	1	—
SDR allocations	—	1	—	1	—
Reserves (increase–)	–15	–10	–2	—	1

(a) Bank estimates/forecasts.
(b) Includes official flows, trade credits, errors and omissions.

their current balance worsened again, capital inflows to these countries increased—especially in the second quarter when interest-rate differentials moved temporarily against the United States.

The increase of $14 billion in the developing countries' current account deficit in 1979 (to $40 billion) was met roughly equally by a rise in capital inflows (mainly market borrowing) and by a slower rate of addition to their reserves. During the first half of 1980, their current account deficit widened again, to an annual rate of over $60 billion. Once again, a larger capital inflow met about half of the increase; other information available so far indicates some slackening in market borrowing, thus implying a significant rise in other capital inflows, including, perhaps, trade credits. Their reserves fell slightly.

Assessment

The growth of the broad monetary aggregate, sterling M_3, has been faster in this financial year than allowed for in the monetary target. For this there have been a number of reasons; and the behaviour of sterling M_3 has probably not adequately reflected the stringency of financial conditions. The pressures on industry have been particularly severe as compared with other sectors of the economy. Policy has, however, been effective in slowing down inflation. It will be important for the future to maintain the thrust of monetary restraint.

Monetary policy and the economy

The onset of recession, together with other influences at work over the past year, has had a large effect on the pattern of financing in the economy. This change of pattern, probably in part temporary, may explain a good deal of the behaviour of sterling M_3. The recession has not only enlarged the PSBR but, along with the high exchange rate and high wage settlements, has exacerbated the financial difficulties of companies, particularly those in manufacturing. Personal incomes have benefited from large wage increases and the high exchange rate, and personal savings have grown. Companies have continued to be almost exclusively dependent for external finance on the banks—which have thus provided a channel whereby the enlarged surplus of the personal sector has been on-lent to companies. This combination of circumstances probably goes far to explain why bank lending to the private sector has been large.

High borrowing by both the public and the company sectors was an expansionary influence on the money supply. Despite large sales of gilt-edged stocks, and despite the maintenance of interest rates at high nominal levels—and, latterly, significantly positive also in real terms— the growth of sterling M_3 has therefore been rapid. In the period before the removal of the corset controls disintermediation reduced its growth, and reintermediation after their removal increased it. Discounting these distortions, the growth of sterling M_3 has probably been running at a rate of about 20% a year since the beginning of the current target period in February 1980. The other monetary aggregates have grown more slowly; and in particular M_1 has grown less than half as fast over the same period.

Two indirect indications of tight financial conditions are the behaviour of the exchange rate and of prices. Sterling has risen against an average of other currencies by some 10% since the beginning of the year, after rising by about 10% in the course of last year. Much of the rise must be attributed to the way that the United Kingdom stands to be affected by the major world payment imbalances that now exist. Given international uncertainties regarding reserve currencies, and the growing importance of North Sea oil, this country has been an attractive destination for internationally mobile funds—a source of pressure which may have been increased by the OPEC countries having again moved into surplus as a result of the rise in the world price of oil. These powerful world influences, as well as the pursuit of a firm domestic policy stance, are likely to continue to underpin the exchange rate. Another factor has been the emergence of a large surplus on current account. The strength of the exchange rate has also owed something to the level of interest rates, which for much of this year were highly favourable to London compared with those in other centres. The recent rise in interest rates in the United States first narrowed and then reversed the interest differential in favour of sterling; this—together, perhaps, with some anticipation of the reduction in minimum lending rate—has in recent weeks led to some retreat of the exchange rate from its peak levels.

The substantial slowdown of price inflation has been greatly assisted by the strong upward trend in the exchange rate. Since the spring, manufacturers' buying prices have not risen, and their selling prices have on average risen by only around ½% per month in the six months to November. Retail price increases have also slowed down, the annual rate in the six months to October—though assisted by seasonal factors—having fallen to under 10%; while the rise over twelve months, which was nearly 22% in May, had come down to 15½% in October.

Looking ahead, there now seems good prospect that the increase in earnings in the present pay round will slacken considerably. Companies facing difficult business conditions have in many cases been able to secure acceptance of much lower increases than last year. The forces causing pay restraint in the private sector seem likely to continue. The need now is for equivalent restraint in the public sector: moderation in the private sector will be crucially assisted if public sector increases are limited. The determination of the Government to secure this is indicated by the relatively low allowance for wage increases to be included in cash limits (see page 393). Even, however, with the better prospects for next year, inflation will need to be further reduced.

Recession and its financial effects

The steep fall in output over the last eighteen months has followed a period when the growth of production—aside from North Sea oil—has been slow, and unemployment is rising rapidly. Companies' profits, already low, must have been reduced further in real terms; and, although expenditure cutbacks apparently enabled companies to achieve virtual financial balance earlier in the year, their financial position has remained difficult. The fall in output to date has been accounted for almost entirely by the turnround, prompted in part by financial pressures, from stockbuilding last year to destocking this year. The running down of stocks may continue for some considerable time, but output, depressed by it this year, seems unlikely to be further depressed by this factor next year.

It seems as likely as not, however, that output will show some further fall during next year, by reason of two other trends. The first is investment. In manufacturing, investment has been falling; but investment in distribution and services has so far increased. Cuts now seem likely to become more severe and more general. Looking to the longer term, reductions in fixed investment are more damaging than stock-cycle adjustments.

Second, the course of exports and imports may now become an important recessionary influence—as it has not been so far. High wage increases have combined with the rising exchange rate, both last year and this, to produce a rise of unprecedented extent in UK costs as against those in competing countries; and the full effects on trade volumes have yet to be seen. This year, though worsening competitiveness would by itself have raised imports, that effect has been outmatched by the reduction in demand: next year, imports may rise despite low domestic demand. This year, too, exports have held up well because demand in this country's overseas markets outside the United States continued strong, despite worsening competitiveness. But the trend could be weaker next year.

The recession, and the persistence until recently of high rates of wage inflation, have not only created difficult conditions for industry, but have in degree, as already argued, made monetary restraint more difficult. Despite vigorous efforts at pruning—in stocks, in payrolls and in investment programmes—companies' financing needs have remained very large. The associated borrowing appears to have been particularly insensitive to high interest rates. It would, however, be wrong to assume that the high rate of bank lending to the private sector seen this year will continue indefinitely; indeed, it has tended to slow down in the past few months.

Public sector borrowing, too, has been augmented by recession, which has reduced revenues and increased some expenditures. On the basis of a rough rule of thumb, it can indeed be estimated that the fall in output in 1980/81 as against the previous financial year may add as much as £4 billion to the PSBR this financial year, as compared with a situation in which output had not fallen. A considerable fall in output was of course expected at the time of the Budget, but the unanticipated depth of the recession may—as noted earlier—have swollen the PSBR by some £1½–£2 billion as compared with what was budgeted for. Other factors also contributed to borrowing being well above the Budget target (see page 393). While it is normal for the size of the PSBR not to be closely predicted, the fact that the scale of public borrowing in the first part of the year was considerably underestimated tended to increase the difficulty of operating monetary policy.

Prospects for the monetary aggregates

It is likely that the growth of sterling M_3 will be slower in the remainder of the financial year, and that the margin by which it exceeds the target for the year as a whole will be less than at present might appear. The PSBR (seasonally adjusted) is expected to be nearer balance in the last quarter of the financial year, helped by the steps that have been taken to curb expenditure, and by various favourable factors that will affect the final quarter—including rebates from the European Community, the first advance payment of petroleum revenue tax, and receipts from asset sales. Next year, though the PSBR may again be swollen by recession, its size will be moderated by the fiscal changes announced in November. Moreover, the financing of the public sector will be substantially assisted by the increased emphasis being placed on national savings, intended to yield £3 billion in the next financial year: in addition to the new issues of index-linked certificates, some other national savings instruments have been made more attractive by the steps taken in November. Sales of these instruments will help to tap the large volume of personal savings directly, and so reduce dependence on sales of gilt-edged stocks. By taking some of the pressure off long-term interest rates, this could in due course give encouragement to companies themselves to go to the capital market, which would be helpful in reducing their dependence on bank finance.

The Chancellor's November measures should also go some way towards mitigating the severity with which financial pressures have borne on industry. Companies will benefit directly from the cut in short-term interest rates, and could benefit indirectly in so far as these make for a level of the exchange rate below what it would otherwise have been. The relative burden of national insurance contributions has been changed to bear more on employees, and companies will pay less tax as a result of the virtual removal of 'clawback' on stock relief promised last month.

These policy effects should help to moderate both public borrowing and private bank borrowing and thus restrain monetary expansion next year. It is generally agreed that a broad aggregate such as sterling M_3 cannot be closely controlled in the short term. But a number of the distortions which appear to underlie the rapid growth of sterling M_3 this year should be temporary; and the easing of inflation, and consequent rise in interest rates in real terms that has already occurred during the summer, should prove helpful. In view of the uncertainties at this stage affecting the growth of sterling M_3, the Government decided not to roll forward the present target, but to announce a new target in the Budget, together with whatever further measures might appear necessary. The aim must be to keep monetary expansion to a rate which will maintain the thrust of anti-inflation strategy.

Changes in methods of monetary control

Methods of monetary control have been under careful examination, and a series of consultations have been held on the Green Paper on this subject published in March.[1] The conclusion of this examination is that it is not possible immediately to move to a form of base money control, nor to judge at this stage its possible later desirability. A number of modifications in the present methods of control have, however, appeared desirable in present circumstances. They would be consistent with the eventual adoption of a monetary base system, if that should later be considered advisable; and could in the meantime provide necessary information about the properties of such a system. In this context, the Bank will be discussing with the banks the collection of further statistics.

The general examination of policy instruments has confirmed the view taken in the Green Paper that a minimum ratio for reserve assets is not a necessary part of monetary control. It will therefore be abolished as soon as prudential safeguards have been agreed with the banks. This will ease one factor which has this year complicated the operation of monetary policy. The rapid growth of lending by banks to the private sector has in recent months frequently threatened to leave them short of the liquid assets which the $12\frac{1}{2}\%$ reserve asset ratio requires them to hold; and at such times the Bank has had to make special arrangements to provide them with additional liquidity (see page 411). Further

(1) *Monetary Control* (HM Stationery Office, Cmnd. 7858).

consideration will also be given to the $1\frac{1}{2}\%$ cash ratio, which at present applies only to the London clearing banks, with the aim of seeking arrangements that, while equitable within the banking system, would allow the desire of the banks to hold cash at the Bank of England to be monitored.

Changes are also envisaged in the Bank's methods of intervention in the money market to allow market factors a greater role in determining the structure of short-term interest rates, and permit greater flexibility in these interest rates. One consequence could be the adoption by banks of more flexible pricing of overdraft facilities: this could help to prevent short-run distortions to the money stock ('round-tripping') that sometimes now occur when it becomes profitable for bank customers to borrow on overdraft to on-lend elsewhere in the banking system. Initially, the Bank's aim would be to keep very short-term interest rates within an unpublished band which (like minimum lending rate at present) would be adjusted from time to time; at a later stage the Bank might cease to announce its minimum lending rate.

These changes, set out more fully in the note on methods of monetary control published on 24 November and reproduced on page 428 of this *Bulletin*, will not entail changes in the stance of monetary policy itself. They are, rather, modifications in the techniques of monetary management which, while consistent with and necessary for a move to a monetary base method of control, were that later to be adopted, should also, in present circumstances, allow such management to be operated more flexibly and efficiently.