Economic commentary

Introduction

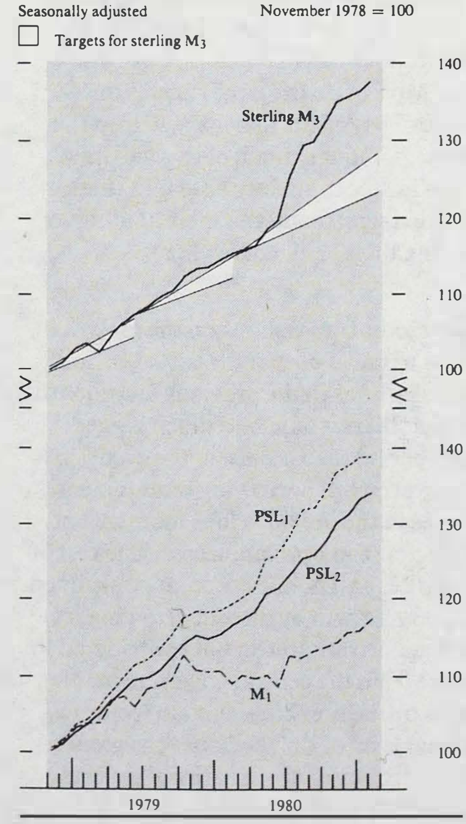
Heavy reductions in stocks (particularly in the second half of 1980), which in turn have been a major factor behind the trade surplus, have characterised the recession so far. Companies have also been forced to save labour and, especially in manufacturing industry, to curb spending on capital equipment. These cuts in spending are in part a response to the squeeze on profits and on the financial position of companies, with the high exchange rate making it difficult for cost increases to be recovered by an increase in prices. Consumer spending, on the other hand, has remained steady, sustained by recent rises in disposable income. Pay settlements have moderated substantially since last autumn.

The growth of sterling M_3 in the year to February considerably exceeded the target range of 7%–11%, although the narrower aggregates grew much more slowly. Recently, slower growth in sterling M_3 has been associated with a marked slowdown in the growth of bank lending to the private sector and with rather lower borrowing by the central government.

At an estimated £13½ billion, the public sector borrowing requirement (PSBR) in 1980/81 exceeded the projection made in March 1980 by £5 billion. In his March 1981 Budget, the Chancellor of the Exchequer judged that a PSBR of £10½ billion in 1981/82 (about 4¼% of GDP) would be consistent with the aim of 6%–10% growth in sterling M_3. To this end, he announced fiscal changes, whose direct effect is to reduce the PSBR by over £3¼ billion from the level it would otherwise have reached (or by £4 billion, if specific duties and income tax allowances and thresholds had been fully indexed). As well as these fiscal changes, various other factors—the slowdown in bank lending and in the growth of sterling M_3, progress in reducing inflation, and real interest rates which had become strongly positive—also influenced the decision to reduce minimum lending rate (MLR) from 14% to 12%.

Although the growth of **sterling M_3** *has slowed down, it has exceeded the target range.*

Seasonally adjusted November 1978 = 100



The monetary aggregates

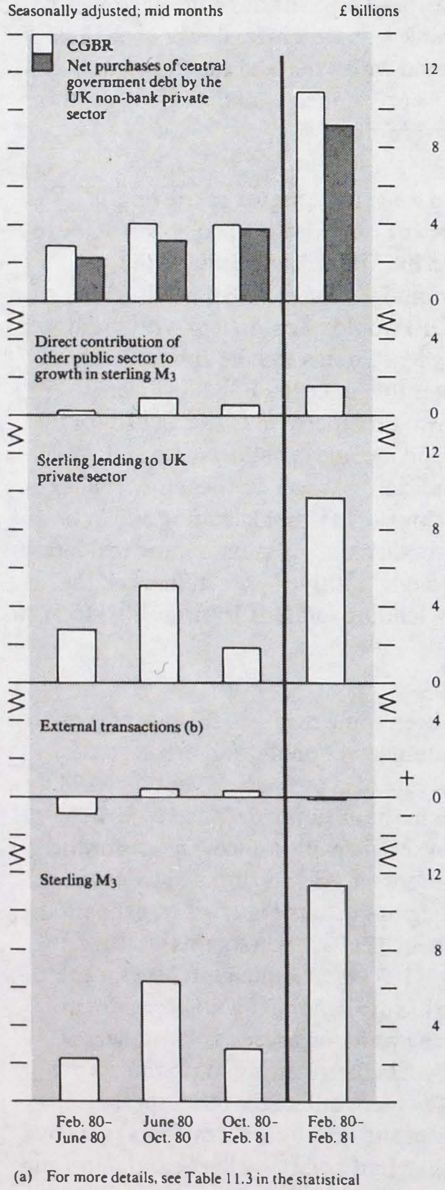
In recent months there has been some easing in the rate of growth of sterling M_3, largely reflecting lower public and private sector borrowing. Thus the annual rate of growth since February 1980, which had been nearly 25% in the autumn, declined to 20% by mid-February 1981. Moreover, when allowance is made for the return of business which the 'corset' had encouraged to leave the banking system before the beginning of the current target period, the rate of growth falls to about 17½%. Even so, this is still well above the target rate of 7%–11% (at an annual rate) set for the period February 1980–April 1981. Among other aggregates, for which targets were not set, the wider measure of private sector liquidity (PSL_2) increased by less than sterling M_3 in the year to mid-February, but total M_3 (which, unlike the other measures, includes foreign currency deposits held by UK residents) rose by rather more; M_1 grew less than half as fast, by 8½%; and notes and coin in circulation with the public, the largest component in most definitions of monetary base, grew least of all, by 6½% in the year.

In the four months to mid-February, sterling M_3 grew by $4\frac{1}{4}\%$, compared with $10\frac{3}{4}\%$ in the previous four months, when there had been substantial reintermediation. But there was not an equivalent reduction in the growth of two other wider aggregates. Total M_3 grew by $6\frac{1}{2}\%$, probably in response to high dollar interest rates; while the rise of $4\frac{1}{2}\%$ in PSL_2—which was less affected by the corset than sterling M_3—reflected the growth in deposits with building societies, whose competitive position *vis-à-vis* the banks improved following the reduction in MLR in November.

In his Budget speech, the Chancellor announced a new target for sterling M_3 growth of 6%–10% (at an annual rate) over the fourteen months to April 1982 from the stock outstanding in mid-February 1981.

More moderate bank lending, particularly to the private sector, has been the main factor behind slower **monetary growth**[(a)]

Seasonally adjusted; mid months £ billions



(a) For more details, see Table 11.3 in the statistical annex.
(b) Sterling lending to overseas, and external and foreign currency finance.

Recent developments affecting sterling M_3

Among the counterparts of the change in sterling M_3 in the latest four-month period, sterling lending to the private sector rose by £1.7 billion; this compares with an increase of £2.8 billion in the four months before the corset was abolished and £5.1 billion in the four months to mid-October. The end of distortions arising from the corset was one reason for these fluctuations: in the four months following the removal of the corset in mid-June acceptances held outside the banking system fell by almost £1.7 billion, equivalent to one third of the growth in recorded lending; while in the four months to mid-February, they fell by only £0.5 billion. After allowance for these temporary disturbances, the underlying growth of bank lending to the private sector in the four months to mid-February is estimated to have fallen quite sharply, to perhaps half the rate of the earlier period.

This slowdown may be attributed to a number of factors. Companies reduced stocks and labour particularly sharply in the fourth quarter, and also curbed fixed investment, thus reducing their need for finance. High interest rates in real terms will also have discouraged borrowing. Moreover, the large surplus on current account in the balance of payments may have helped the financial position of companies, although much of this will have been reflected in the reduction in stocks already noted. In these circumstances, companies added significantly to their holdings of liquid assets, as well as reducing their bank borrowing.

The direct net effect of public sector transactions on the growth in sterling M_3 in the four months to mid-February was £0.8 billion. Although this was only half as large as in the previous four months, it had earlier been expected that there would be a much bigger reduction in the PSBR in this period than seems, in the event, to have occurred. The central government borrowing requirement (CGBR) was much the same as in the previous four months, but more of it was financed by the non-bank private sector. The rest of the public sector (local authorities and public corporations) added less than previously to monetary growth by direct borrowing from sources other than the non-bank private sector, but contributed to the CGBR by borrowing more from the central government. Net purchases of gilt-edged stocks by the non-bank private sector fell somewhat from the exceptional level of the previous four months, but there was a much larger contribution from national savings, following various steps to make them more attractive.

External and foreign currency transactions and money supply

£ millions; *not seasonally adjusted*

Mid-month	1980 Feb–June	1980 June–Oct.	1980/81 Oct.–Feb.	Feb.–Feb.
Transactions affecting sterling M_3				
Current account (surplus +)	**– 370**	**+1,760**	**+2,560**	**+3,950**
Capital transactions:				
1 Net foreign currency deposits held by non-bank private sector (increase –)(a)	– 200	+ 510	–1,840	–1,530
2 Private sector net lending abroad (increase –); includes balancing item(b)	– 220	–1,880	– 390	–2,490
Net direct effect on sterling M_3	**– 790**	**+ 390**	**+ 330**	**– 70**
Other capital transactions:				
3 Banks' sterling lending abroad and net assets in foreign currency (increase –)	–1,050	–1,710	– 930	–3,690
4 Overseas holdings of sterling bank deposits and public sector debt (increase +)	+1,940	+1,860	+ 720	+4,520
5 Official reserves (net of public sector foreign currency borrowing) (increase –)	– 100	– 540	– 120	– 760

(a) Foreign currency deposits held by residents with banks in the United Kingdom are included in M_3 but not in sterling M_3.

(b) A residual.

Among the external influences on sterling M_3, the surplus on the current account of the balance of payments was even larger in the four months to mid-February than in the previous period. But a current account surplus contributes directly to sterling M_3 only to the extent that sterling bank deposits held by the UK private sector are thereby increased—as they are if the surplus is matched by transactions shown in lines 3–5 of the table. (As it happens, overseas residents have continued to add to their holdings of UK banking and public sector debt, although at a slower rate than earlier.) Sterling M_3 does not increase where UK suppliers take payment in foreign currency and retain it (line 1), or extend trade credit, or where the current account surplus is financed by a capital outflow in any form from the private sector (line 2), because in these cases the monetary effects cancel out. (Sterling M_3 can also be affected at any time by offsetting movements between lines 1 and 2 and lines 3 to 5 that do not involve the current balance.)

Despite the size of the surplus on current account, the direct effect of external and foreign currency transactions on sterling M_3 (including sterling lending to overseas, and seasonally adjusted) was only modestly expansionary in the latest four months. UK residents increased their holdings of foreign currency deposits substantially; and there must have been capital outflows from the private sector. (Capital flows in the fourth quarter of 1980 are described on page 17.)

Changes in the Bank's dealings with the money markets

The acute shortage of reserve assets throughout much of 1980 created upward pressure on some short-term interest rates, which the Bank took steps to offset. In November this pressure eased and, partly because the Bank reduced from 12½% to 10% the minimum reserve asset ratio which banks are required to hold, it was possible to avoid further serious pressure in the main tax collection season in January. But there was renewed pressure on very short-term interest rates in March, notably as a result of heavy payments of petroleum revenue tax and large official sales of gilt-edged stocks; these rates rose sharply and remained high for several weeks, despite a further reduction in the minimum reserve asset ratio to 8%. More generally, short-term rates (e.g. three-month rates) fell in January and February, and by the time of the Budget a fall in MLR of about two percentage points was already being discounted.

As foreshadowed in the note on monetary control issued in November, the Bank has been modifying its methods of intervention in the money market. The essential features of the new techniques include putting greater emphasis on open market operations (and less on discount window lending) and allowing market forces a greater role in determining the structure of short-term interest rates. Substantial progress has been made in these areas; fuller details can be found in the financial review (page 23).

On 12 March, the Bank circulated two papers to all banks and licensed deposit-takers (reproduced on pages 38 and 40). One discussed proposals for a future cash ratio requirement and outlined steps considered appropriate by the Bank to ensure the adequate functioning of the bill and gilt-edged markets. The other continued the discussion—begun in March 1980—of the liquidity of banks.

Building societies remain competitive

Net receipts by building societies, including interest credited to accounts, averaged £720 million a month in the four months to February, some £70 million more than in the previous four. By comparison, personal sector sterling deposits with the banks, which in the first half of 1980 had grown more rapidly than deposits with building societies, grew by an average of only £480 million a month in the fourth quarter of 1980.

The competitive position of the societies against the banks improved after the reduction in MLR from 16% to 14% on 24 November: the societies did not reduce their rates until the New Year and then cut the share rate (grossed up for tax at the basic rate) by only 1.8 percentage points to 13.2%, whereas the clearing banks reduced deposit rates by $2\frac{1}{2}$ points to $11\frac{1}{2}$% soon after the drop in MLR. The further reduction in the share rate from 1 April, to the grossed-up equivalent of 12.1%, will leave the societies more competitive against the seven-day deposit rates of the banks (which have been reduced to 9%). Rates in the money market, however, are more in line with those being offered by the societies.

The building societies have also faced competition from national savings, particularly the new index-linked certificate. The BSA estimate that receipts in November were especially affected by this.

On the lending side of the societies' business, mortgage advances and new commitments have continued the recovery which began in the autumn of last year, despite the depressed state of the housing market. The reduction in the BSA recommended mortgage rate to 14%, and the more recent reduction to 13%, left societies with a slight competitive edge over the banks for a loan of average size.

The Budget aim—a lower PSBR in 1981/82

The PSBR is estimated to have been about £$13\frac{1}{2}$ billion in 1980/81, compared with the projection of £$8\frac{1}{2}$ billion made in the March 1980 Budget. Central and local government current spending was about £3 billion higher than was expected last March, even after rebates from the European Community, which are treated as a reduction in spending. The increase largely derived from extra spending on goods and services (much of it on defence), higher subsidies, larger grants to the personal sector, and higher interest payments. Most of the rest of the difference is explained by tax revenues being somewhat lower than expected. Several nationalised industries have been allowed substantial increases in their external financing limits (that of the British Steel Corporation being almost doubled to £1.1 billion) but these have been met from the contingency reserve and so have not added further to the PSBR. About half of the £5 billion over-run of the PSBR is attributed to the recession being worse than expected, particularly in its effect on employment and short-time working.

For 1981/82, a PSBR of about £$7\frac{1}{2}$ billion was implicit in the medium-term financial strategy published in March 1980. But the projections for the PSBR were not targets, and various circumstances were foreseen in which a higher or lower PSBR might be compatible with monetary aims. With the economy in 1981/82 likely to be in deeper recession than was anticipated when the original projections were drawn up, a PSBR of £$7\frac{1}{2}$ billion would have been unduly restrictive. On existing public spending plans, and including the increases in national insurance contributions announced last November, the PSBR in 1981/82 would have amounted to some £14 billion at unchanged tax rates and allowances. In his 1981 Budget, the Chancellor judged that a PSBR of £10½ billion, equivalent to 4¼% of GDP, was appropriate.

The Budget was thus designed to reduce the PSBR by around £3½ billion. The tax measures consisted of increases in excise duties, on average about twice the rise in prices in 1980, to yield £2.4 billion in the financial year; a supplementary petroleum duty and changes in petroleum revenue tax, foreshadowed in the Chancellor's November statement, to yield £1 billion (net); and a once-for-all tax on non-interest-bearing sterling bank deposits, to bring in £0.4 billion. It was decided not to increase income tax allowances and thresholds. Against this, the revised scheme for stock relief, together with various changes in capital taxation and measures to encourage enterprise, was expected to reduce tax revenue by some £0.2 billion in 1981/82; and an increase in the contingency reserve and rises in the external financing limits of the electricity supply and gas industries might add £0.3 billion to public spending.(1)

To help finance the PSBR, the Chancellor announced a reduction in the eligible age for holders of the second issue of index-linked national savings certificates; a minimum bonus of 4% for new and existing holders; and plans for a non-marketable certificate, with a return linked to the value of the British National Oil Corporation's North Sea oil. In all, the Government intend to raise £3 billion (net) from national savings in 1981/82. A major innovation was the first issue of index-linked gilt-edged stock —£1,000 million (nominal amount) to be issued by tender, with an interest coupon of 2%. Ownership of the stock will be confined to certain pension schemes or funds and, in respect of their UK pension business, to life insurance companies and registered friendly societies.

Recent influences on the public sector deficit

Although large in absolute terms, the PSBR is still substantially smaller in relation to GDP than it was in the recession of the mid-1970s. The proportion was 6% in 1980/81 and is expected to be about 4¼% in 1981/82, compared with around 10% in the mid-1970s. But the stance of fiscal policy is perhaps better measured by the public sector financial deficit (PSFD), which records transactions as they accrue and not when cash is paid or received, and which, unlike the PSBR, excludes public sector net lending to other sectors, most asset sales and other financial transactions. In 1975 the PSFD approached 7½% of GDP. Subsequently there was some fall in the ratio, but it has grown a little in the last two years, from about 5% in 1978/79 to perhaps 5¼% in 1980/81, increasing in money terms by about £3½ billion. In 1981/82, however, it is expected to fall to 2½% of GDP.

Any analysis of the change in a magnitude like the PSFD is to some extent artificial, because the components are in practice interdependent; the estimates in the text and the table should therefore be regarded as very approximate.

(1) This amount is in addition to the public spending plans set out in *The Government's expenditure plans 1981–82 to 1983–84* (HM Stationery Office, Cmnd. 8175). Altogether, general government expenditure in 1981/82 is now expected to be £6 billion higher than was projected a year ago.

Contributions to change in PSFD between 1978/79 and 1980/81[a]

£ billions

Recession	+2½ to +3
'Real' costs and prices	+2¼ to +2¾
Higher debt interest payments	+4¼
North Sea oil tax	−2½
'Real' discretionary changes in non-North Sea oil taxes	−1 to −1½
Other 'real' revenue and expenditure changes, including European Community rebates	−1½ to −3
Total	+3½

(a) See text for explanation of contributing factors.

The fall in output and employment in the two-year period between 1978/79 and 1980/81 may have worsened the public sector's financial position directly by about £2½–3 billion, through lower income tax receipts and national insurance contributions, higher social security payments and a lower public sector gross trading surplus. (The impact on company tax payments, which are made to the Government after a fairly long time lag, is not included in this estimate.)

If public sector revenues and outgoings are equal—and if the tax system is fully indexed—a rise of the same amount in all prices and wages will not affect the PSFD, since receipts and spending will rise in line. None of the change in the PSFD will therefore arise from general inflation. In 1978/79, receipts and spending, excluding interest paid on public sector debt (see below), were indeed in approximate balance. Accordingly, very little of the change in the PSFD between 1978/79 and 1980/81 can be attributed to general inflation.

Interest paid on public sector debt in 1980/81 was more than £4 billion above that in 1978/79. Perhaps £½ billion of this increase reflects the rise in the outstanding amount of debt due to recession. In addition, the rise in the rate of inflation of over five percentage points between the two years—in contrast to a rise in prices at a steady rate—at least partly explains the rise in interest rates over the period, and the consequent increase in interest paid out on newly-issued and variable-rate debt. Some £1–2 billion of the extra debt interest might be ascribed to this effect, although this estimate is very uncertain.

Altogether, therefore, the effect of recession and faster inflation may have corresponded to more than the whole of the increase in the PSFD over the two years, with the combined impact of other influences having little net effect. Wages rose faster than prices over the period, and pay in the public sector rose more than wages generally. These developments influenced the PSFD in two ways: income tax receipts on this account tended to rise faster than inflation; on the other hand, wage costs in the public sector rose faster still. On balance, the general behaviour of wages (and other prices paid by the public sector) in relation to prices increased the PSFD by perhaps £2½ billion between 1978/79 and 1980/81. Cuts in income tax rates added nearly £5 billion to the PSFD. Against this can be set higher real receipts from other sources—notably higher tax revenue from North Sea operations and a rise in the real yield of value-added tax (the rate having been increased in June 1979). Rebates from the European Community were received for the first time in 1980/81.

Output continues to fall, especially in manufacturing industry...

As measured from statistics of output, GDP declined by 1½% in the fourth quarter, to 5½% below the quarterly average in 1979.[1] Within the total, the decline in manufacturing production (4½% in the quarter) was even faster than that experienced earlier in the year, and the CBI industrial trends survey in January indicated that manufacturing production would fall further in the coming months, although less fast. But higher extraction of fuels and only a small fall in production by public utility industries (gas, electricity,

(1) The quarterly average is chosen for comparison to minimise the distortion caused by strikes in the first and third quarters of 1979 and recovery from them.

and water) made for a slower decline in industrial production as a whole; and activity outside the industrial sector fell more slowly than in the third quarter.

The fall of around 15% in manufacturing production in the year to the fourth quarter of 1980 is the largest recorded in any twelve-month period since the war: it compares with a 10% fall between the third quarters of 1974 and 1975. Recovery from the engineering strike boosted output in late 1979, but manufacturing production still fell by 10½% at an annual rate between the average in 1979 and the fourth quarter of 1980. Metal manufacture (where production recovered only weakly from the steel strike in the first quarter of last year) and textiles and clothing have been the hardest hit in this decline; and chemicals and the engineering trades have been almost as seriously affected. For various reasons, the relative importance of manufacturing in total activity in the economy has been declining for some years. In 1965, manufacturing represented 34% of the value of total output, having increased in importance in the first half of the decade; but in the early 1970s the share was around 30%, and it was probably under 25% last year, with oil and gas production in particular, but also various public and private services, growing in relative importance.

. . . but productivity appears to have been maintained

By the fourth quarter, the workforce in manufacturing was over 10% lower than the 1979 average—a larger fall in employment in relation to the fall in output than previous experience would have suggested. Falls in employment in manufacturing have been accompanied by falls in the average number of hours worked per operative. In the fourth quarter, over 10% of workers in manufacturing were on short time (compared with around 1% for much of 1979), and little more than half the amount of overtime was being worked. Altogether, each operative worked 5½% fewer hours on average in the fourth quarter of 1980 than in 1979. These figures suggest that output per man-hour in manufacturing industry was broadly maintained.

Employment and registered unemployment[a]

Thousands, in September

Percentage change in italics (calculated on unrounded levels)

	Last recession		This recession	
	1974	1975	1979	1980
Employment in:				
Manufacturing	7,750	7,280 *− 6.1*	7,040	6,490 *− 7.8*
Other production industries	1,980	1,970 *− 0.5*	1,940	1,880 *− 3.0*
Other industries and services	12,710	12,970 *+ 2.0*	13,460	13,330 *− 0.9*
All industries and services	22,440	22,220 *− 1.0*	22,440	21,710 *− 3.3*
Registered unemployment	620	1,100 *+77.4*	1,330	1,950 *+47.2*

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

Employment falls more than unemployment rises

The number of employees in employment in Great Britain fell by 730,000 in the year to September (the latest month for which figures are available); with an increase in HM Forces, the reduction in the employed labour force—720,000—was slightly smaller.[1] Some 550,000 of the decline occurred in manufacturing industry. Over the same period registered unemployment in Great Britain increased by 620,000 (or 540,000 if school-leavers are excluded), well short of the decline in the employed labour force, even though the population of working age continues to grow. This is in contrast to the 1974–75 recession, when the rise in registered unemployment was substantially more than the fall in the employed labour force. On this occasion, fewer people are working or registering as unemployed. This is thought to be mainly because of earlier retirement among men, but the female labour supply, which grew rapidly during the 1970s, has also started to fall.

The number of unemployed in the United Kingdom (excluding school-leavers) rose by a further 600,000 after seasonal adjustment,

(1) Until new information becomes available, the Department of Employment records the numbers of self-employed at the June 1975 level.

between last September and March, to 2.38 million, 9.9% of the labour force and 1.12 million more than in August 1979, which was the most recent low point. The total number of unemployed—including school-leavers, and not seasonally adjusted—stood at 2.49 million in March. The recent monthly rise in the seasonally-adjusted level of unemployment—over 70,000 in each of the last eight months and over 100,000 in three of them—compares with a rise of about 40,000 a month in the first half of 1980, which in turn was about the same as the monthly increase in 1975. The growth in unemployment has been fastest in the West Midlands, which has become one of the regions of highest unemployment in England, reflecting the large falls in employment in manufacturing industry. Unfilled vacancies have remained at around 100,000, under half the number recorded in late 1979; according to CBI surveys, very few firms report labour shortage of any kind as a constraint on production.

The pattern of demand may be changing[1]

Stocks

The reduction in stocks in the fourth quarter of last year—nearly £1 billion—was the greatest ever recorded. Between 1979 and the fourth quarter of 1980, the turnround in stocks amounted to the equivalent of most of the decline in output, although to a considerable extent it in fact fell on imports rather than on domestic production.

The decrease in stocks in 1980 as a whole—£1.8 billion, representing about 5% of stocks at the end of 1979—followed growth of £1.6 billion in the previous year (and a total rise of £2.8 billion in the three preceding years). Manufacturers' stocks alone fell by £1.4 billion, but even so their stocks increased in relation to their (greatly reduced) production. Retailers and wholesalers, on the other hand, succeeded in reducing stocks in relation to sales last year.

The CBI industrial survey in January indicated that a further decline in manufacturers' stocks was in prospect. In fact, stocks need not increase to contribute to the growth of output—a smaller decline is sufficient—but to the extent that the change in stockbuilding raises imports, there will be no net benefit.

The fall in stocks has also been an important means by which companies have kept their financial position manageable in very difficult trading conditions. The emergence of a substantial positive real rate of interest (to the extent that it can be separated from their financial position generally) may also have induced companies to reduce stocks, though it is difficult to quantify this effect.

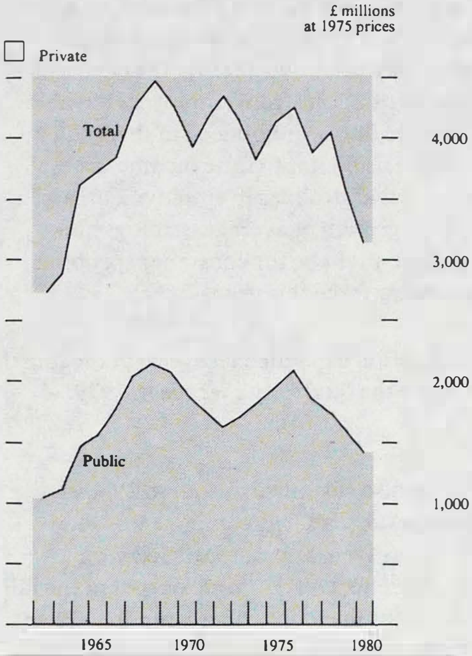
Fixed investment

Overall, fixed investment was a modest contractionary influence in 1980, falling by $2\frac{1}{4}$% in the year as a whole. By the fourth quarter, it was $5\frac{1}{4}$% below the quarterly average in 1979, and there are indications that it will fall considerably more sharply in 1981.

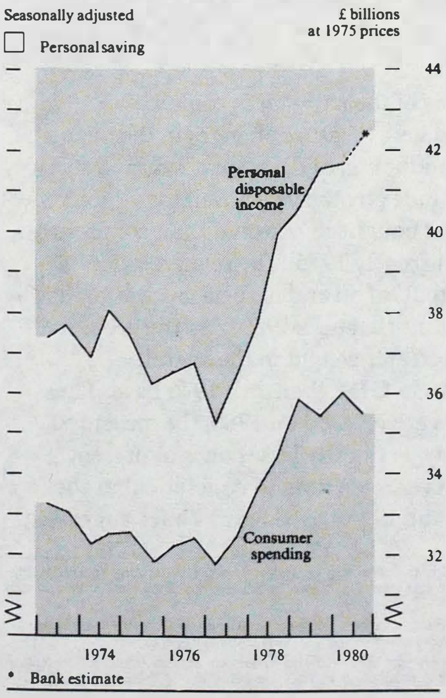
Housebuilding accounted for much of the fall last year. In the fourth quarter, investment in new houses was 25% below the

(1) Components of demand are expressed in 1975 prices and seasonally adjusted, unless otherwise stated.

Housebuilding *in 1980 was the lowest since 1963.*



Personal savings *increase—spending fails to keep pace with higher incomes.*



quarterly average in 1979. The decline in housebuilding has been evident for some time—investment in 1979 was itself substantially lower than in 1978—and the 1980 figure proved to be the lowest since 1963. To judge from housing starts, spending will be lower again this year: exceptionally few houses were started in 1980, barely half as many in the second half of the year as in the corresponding period in 1979. The main effect of the moratorium on local authority housing contracts has still to be felt.

Investment in the provision of public services has also tended to decline for a number of years, and the fall continued last year.

The volume of other fixed investment rose in 1980, although not strongly, and was the highest on record. Gross fixed investment by public corporations and non-residential investment by the private sector each increased by about 2%. The rather high level of investment and the recent decline in output must have created a record amount of spare capacity, which no doubt partly explains the expectations of lower investment during 1981.

Within the total of private fixed investment (other than housing) in 1980, there was a fall in investment by manufacturers but some increase in investment by the distributive and service industries (including leasing companies). Gross fixed investment by manufacturing industry fell by about 9% in 1980, and in the fourth quarter was 17% below the quarterly average of 1979. Including leased assets, investment in fixed assets for use in manufacturing probably fell by some $6\frac{1}{2}\%$ in 1980. Fixed investment by distributive and service industries, on the other hand, including investment in assets for leasing out, rose by about $5\frac{1}{2}\%$ between 1979 and 1980; if assets leased out to manufacturing industry are excluded, the rise is estimated to have been about $4\frac{1}{2}\%$.

As for prospects this year, the December Department of Industry investment intentions survey suggested a fall of 15%–20% in recorded manufacturing investment (11%–16% if leased assets are included)—very close to the decline indicated by responses to the CBI survey in January. If this materialised, investment in assets for use in manufacturing would be no higher than it was in 1976. The Department of Industry survey suggests little change in the level of investment (including assets for leasing out) by distributive and service industries this year. Altogether, the decline in fixed investment this year could amount to $1\%–1\frac{1}{2}\%$ of GDP.

Consumption

Despite the recession, real personal disposable income continued to rise, if rather jerkily, until the third quarter of 1980, but was probably little changed in the fourth. The decline in employment and, on the evidence of manufacturing industry, in the number of hours worked per employee, was more than offset by a faster rise in average earnings than in consumer prices.

Although consumer spending grew between 1979 and 1980, it fell behind the growth in income, and in the fourth quarter of 1980 expenditure was less than $\frac{1}{2}\%$ above the quarterly average in 1979. Consequently, the saving ratio, at about 15% on average in 1980, was over one percentage point higher than in the previous year, and in the third quarter of 1980 was the highest ever recorded, at about 17%. Consumer spending tends to fluctuate less than income, and changes in saving therefore absorb some of the variation in income.

The ratio of personal saving to income has also shown a tendency to increase as real incomes have grown. The marked rise in the ratio in recent years may be associated with the reduction in the real value of personal sector liquid assets (brought about by rapid inflation, first in the mid-1970s, and again, after some recovery in their real value, in 1979 and early 1980) as well, perhaps, as with uncertainty about employment. Although the saving ratio may decline this year, the impact may be outweighed by the effects of higher national insurance contributions from employees payable from April 1981; higher specific duties announced in the Budget; 'fiscal drag' arising from the decision not to raise income tax thresholds and allowances; further declines in employment; and a closing of the gap between the growth of average earnings and consumer prices. The net effect might be for consumer spending to become a modest contractionary force this year.

General government consumption expanded last year; in the fourth quarter it was about 3% above the quarterly average in 1979.

Exports and imports

Exports of goods and services also sustained output in 1980 as a whole, with expanding markets abroad overcoming a loss of perhaps 8% in effective competitiveness.(1) Imports fell very sharply, thereby mitigating the effect on domestic output of the fall in spending. The large reductions in stocks, where imports are an important factor, were chiefly responsible for this. Nevertheless, the loss of competitiveness (which in effective terms was likely to have been greater for imports than for exports),(2) and the tendency for imports to supply a growing share of the market over time, held import penetration of markets for manufactured goods steady. Altogether, the change in the trade balance in volume terms increased GDP by nearly $1\frac{1}{2}$% last year, but competitiveness effects taken separately—ignoring changes in income at home and abroad and other influences—may have worked to reduce GDP by about $2\frac{1}{2}$%. The contractionary effect of weak competitiveness could be even greater this year, perhaps tending to reduce GDP by $2\frac{1}{2}$%–3%, working mainly through exports; and the overall effect of changes in the trade balance is likely to diminish domestic output.

Taken together, these various influences may tend to reduce GDP again this year.

A digression on the rebasing of the national accounts

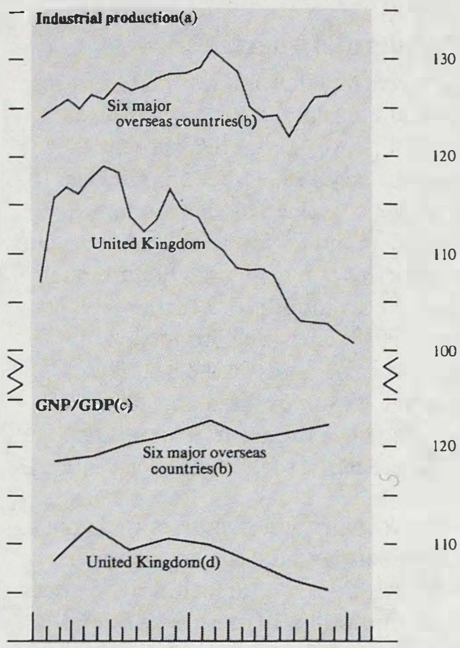
The estimates of GDP used here measure changes in the quantity or volume of output, the production of different goods and services being combined in a single index by the use of weights which reflect their value, net of the cost of bought-in materials and components, in the base year, which is currently 1975. The relative price, or value added per unit of output, of oil and natural gas was higher in 1980 than in 1975. This means that on a 1980 base the growth in output of oil and gas has a greater weight in the overall measurement of movements in GDP than on a 1975 base. Thus when the national accounts are rebased on 1980, the measured decline in GDP in 1980 may be slightly less than is at present recorded.(3) It would, however, be wrong to conclude that the recession is less deep than the 1975-based figures have suggested.

(1) A weighted average of current and past changes in competitiveness, representing the estimated effects of these changes on trade in manufactured goods in the period concerned, after allowing for lags.

(2) As calculated, the greater loss of effective import competitiveness arose from the faster speed with which a change in competitiveness is believed to affect imports than exports.

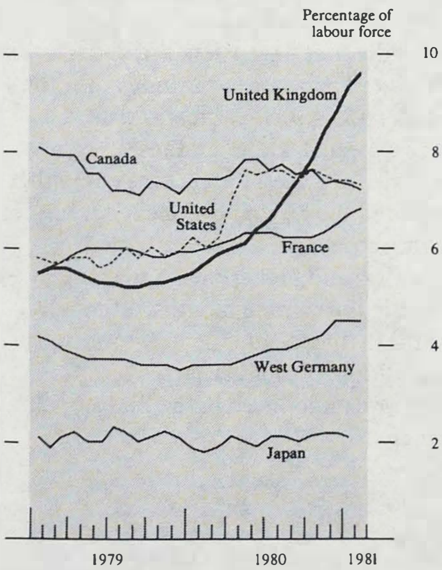
(3) Other developments in the economy since 1975 will also affect the weights, and the Central Statistical Office will revise individual production series. The net effect of these changes is at present uncertain.

Production *has fallen much further here than abroad.*



(a) Excluding construction.
(b) United States, Canada, France, Italy, Japan and West Germany; GNP weighted.
(c) 1980 fourth quarter partly estimated.
(d) Average estimate of GDP.

Unemployment *in the United Kingdom has risen more sharply than abroad.*[a]



(a) Because recording practices differ, rates of unemployment in different countries are often not comparable. The data in this chart have not been standardised in line with international definitions; if this were to be done, past experience suggests that the UK unemployment rate would be higher than recorded here and the rate for other countries would be broadly unchanged, or lower.

The degree of recession is a matter of the difference between actual and potential output (however hard it may be to assess potential output) and rebasing the accounts will affect estimates of both in proportion.

Signs of recovery abroad

Although industrial disputes made for an uneven pattern of production in the United Kingdom during 1979, it is clear that output began to decline then and it has been falling almost without interruption since. In other major industrial countries[1] there was no significant fall in output until early in 1980, and in the third quarter their combined GNP actually expanded once more, at an annual rate of about 2%; only Italy experienced a further decline. Nevertheless, there was little strength behind domestic demand in the second half of the year; total output rose again in the fourth quarter, but the pattern was mixed, with renewed falls in activity in France and West Germany outweighed by further growth elsewhere. Altogether, output in the main industrial countries abroad increased by about 1¾% last year; growth is unlikely to be much faster this year, partly because policy in most countries continues to be aimed principally at reducing inflation.

So far, the recession abroad has been much shallower than here, with smaller increases in unemployment. The pressure on the profitability and finances of UK companies, which has induced such large reductions in stocks and employment, with the prospect of more to come, is not paralleled in the other major industrial countries. A distinguishing factor in the United Kingdom has been the rise in the exchange rate; also, in many other countries, wages have risen more moderately than here in the last couple of years.

Pay increases in United Kingdom declining

Settlements in the current pay round have been much lower than last year and the rate appears to have slowed during the round; agreements in manufacturing industry monitored by the CBI moderated from around 14% in August to 8%–9% on average in February. Workers at Ford, normally regarded as pacesetters, accepted 9½%. Outside manufacturing industry, however, some private settlements have continued to be struck at around 15% or even higher, although others have been at 5% or lower. As for pay in the public service sector, the Government announced that the cash limits for 1981/82 would include allowance for an increase in earnings of 6%. Local authority manual workers and school-teachers accepted 7½%. Elsewhere in the public sector, however, water-workers received an increase of over 12%, which was worth about as much as the mineworkers' settlement reached earlier in the pay round.

Although in January probably less than a third of employees were being paid under deals settled in the 1980/81 pay round, the influence of more moderate increases than last year was discernible in the year-on-year increase—after allowance for temporary factors—of 17½% in the index of average earnings, compared with about 22% in the middle of 1980. After allowance for back-pay and other temporary factors such as the timing of settlements, the monthly increase in average earnings declined from nearly 2% in

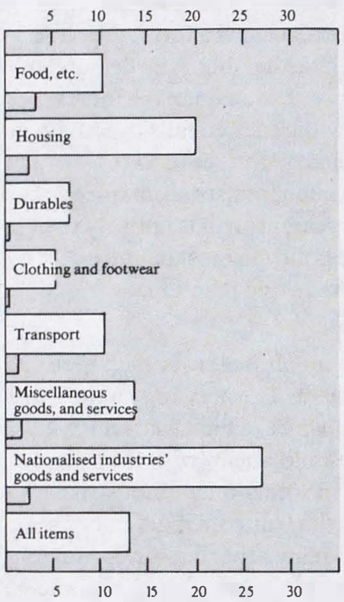
(1) United States, Canada, France, Italy, Japan and West Germany.

The increase in **retail prices** *over the past year embraces wide variation among the components.*

Contribution to increase in retail prices
Jan. 1980–Jan. 1981

Percent

Percentage change
Contribution to total percentage change

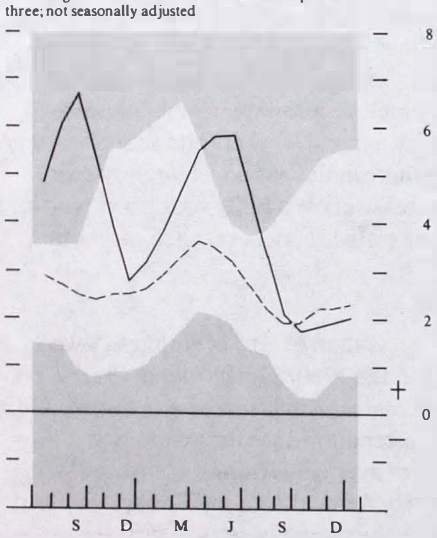


In the fourth quarter of 1980, **price inflation** *in the United Kingdom was in line with overseas experience.*

Per cent

Range in six major overseas countries (a)
Average in six major overseas countries (b)
United Kingdom

Percentage increase in latest three months on previous three; not seasonally adjusted



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

the summer to $\frac{3}{4}\%$ in the four months to January, although part of this deceleration arose from a decline in the number of hours worked per employee.

Prices continue to rise moderately here . . .

The prices at which manufacturers buy fuel and raw materials rose significantly in both January and February, largely because of an increase in the sterling price of oil; nevertheless in February they were only 8% higher than in February 1980 (when the rise over the previous year had been nearly 30%). Helped by this modest increase, and also by depressed demand for industrial products and competition from imports, the prices at which manufacturers sell their goods rose by only 4% in the six months to February, when they were $10\frac{1}{2}\%$ higher than a year earlier. The proportion of manufacturing firms expecting to raise prices in the next few months (as revealed in replies to CBI surveys) remains low, although it has tended to increase since the autumn under the pressure of costs generally and as excess stocks have been reduced.

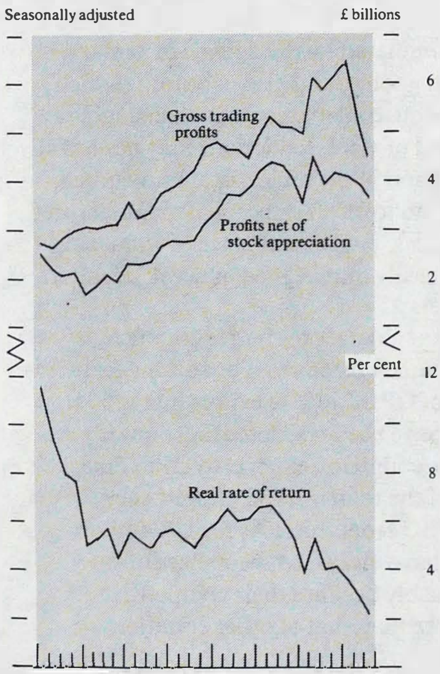
The index of retail prices includes many non-manufactured goods and services, such as fresh food, rents and the cost of mortgages, rates, and the products of public utilities; it also includes the prices of items imported for direct consumption. In most recent months, the index has risen by around $\frac{1}{2}\%$, and the year-on-year increase has declined from 22% last May to $12\frac{1}{2}\%$ in February. Prices of durable household goods, clothing and footwear, and food, have risen by 10%, or less, over the past year, and the prices of imported goods which are consumed directly, rather than used as inputs to domestic production, have risen by some 6%. Despite pressures on profit margins, price increases for these types of product should remain subdued for at least a few more months, because of weak trading conditions and the time it will take for the earlier rise in the exchange rate to work fully through to retail prices. By contrast, prices charged by nationalised industries have risen fast, and account for a large part of the overall increase in the index over the year, despite their weight of under 10%; further increases in nationalised industry prices are expected, although these may now be more in line with the general rise in prices. Despite the cut in the mortgage rate at the beginning of January, which alone reduced the retail price index by $\frac{1}{4}\%$, housing costs have also contributed substantially to the rise in the index; and higher rates and council house rents will add further to it in the coming months, although there will be some offset from the further reduction in the mortgage rate announced in March. In addition, the higher duties on alcoholic drinks, tobacco and petrol announced in the Budget will directly add some 2% to the index.

. . . but some acceleration abroad

In the three months to January, consumer prices in the major overseas economies were rising at an annual rate of $9\frac{1}{2}\%$ on average—rather faster than last autumn. There was a tendency during the course of last year for the growth of labour costs in most countries abroad to quicken, though on average they were still rising much more slowly than in the United Kingdom; on the other hand, the appreciation of sterling largely sheltered UK manufacturers from a renewed rise in commodity prices in the autumn. Moreover, general trading conditions and the strength of the exchange rate made it difficult for UK producers to raise prices, whereas competitors abroad were less constrained.

The **real rate of return** *fell to an estimated 2% in the third quarter of 1980.*

Non-North Sea industrial and commercial companies



Balance of payments: current account

£ millions; *seasonally adjusted*

	1979 Year	1980 Year	Q2	Q3	Q4
Visible balance	−3,497	+1,177	−320	+616	+1,269
of which:					
Oil balance	− 774	+ 273	− 11	+157	+ 222
SNAPS balance (a)	− 126	+ 10	+ 48	+ 56	+ 79
Underlying non-oil balance	−2,597	+ 894	−357	+403	+ 968
Invisible balance	+1,867	+1,560	+232	+254	+ 616
Current balance	**−1,630**	**+2,737**	**− 88**	**+870**	**+1,885**

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

Profitability of UK companies declines further

The gross trading profits of industrial and commercial companies, excluding North Sea operations and net of stock appreciation, fell again in the third quarter of 1980, and in the six months to end-September they were more than 9% lower than in the previous six months. After allowance for capital consumption at replacement cost, the fall in profits was over 20%. Dividing this measure of profits by the capital stock valued at replacement cost yields a rate of return on trading assets in the third quarter at present estimated at 2%—little more than half the rate in the second half of 1979. Although the rise in fuel and raw material prices moderated in the six months to September, unit labour costs continued to increase rapidly and companies restricted their price increases because of depressed demand and keen competition from abroad. Recent revisions have reduced the estimates of profits and of the rate of profitability, but without affecting the trend, which has been downwards since early 1978.

Despite the cut in MLR in early July, companies probably borrowed at slightly higher cost on average in the six months to September than in the previous period; together with increased indebtedness this meant that interest payments were substantially higher in the more recent period. With profits lower, income gearing accordingly rose to almost 45% in the third quarter, higher than the previous peak in 1974. Yet companies reduced stocks (and also curbed spending on fixed investment) to such an extent that their financial deficit in the second and third quarters was no more than in the previous six months, and because they took trade credit or extended less of it, and because their investment abroad fell, they borrowed less. 'Real' capital gearing—the ratio of net financial liabilities to capital assets valued at replacement cost—was less than 11%; this was well below the peak of 18% reached five years earlier, with inflation having substantially raised the value of company assets in relation to their financial liabilities.

The cuts in MLR in November and March, each of two percentage points, should together reduce companies' interest payments by over £1 billion a year. The Budget contained various other proposals to help companies, notably an extension of stock relief which is expected to reduce their tax payments by about £0.2 billion in 1981/82.

Helped by very large reductions in stocks, company liquidity improved in the fourth quarter, although it remains rather low. The position of non-manufacturing companies eased more than that of manufacturers.

Current account in substantial surplus

In the fourth quarter, a sharp decline in imports—reflecting large reductions in stocks—and an improvement in the non-oil terms of trade increased the surplus on visible trade by some £0.7 billion, to nearly £1.3 billion. The current account as a whole was in surplus by just under £1.9 billion, making £2.7 billion for the year. Most of the difference between the outcome for 1980 and the forecasts of a deficit made a year ago can be explained by the unexpectedly large decline in the volume of imports (partly but not wholly because the domestic economy was more depressed than had been foreseen) and by higher terms of trade associated with the strong exchange rate.[1]

(1) Bank studies suggest that UK export prices for manufactured goods are influenced about equally by domestic and foreign prices, whereas UK import prices are mainly influenced by foreign prices. See 'Recent developments in the terms of trade', in the September 1980 *Bulletin*, page 295.

Changes in trade in manufactures[(a)]

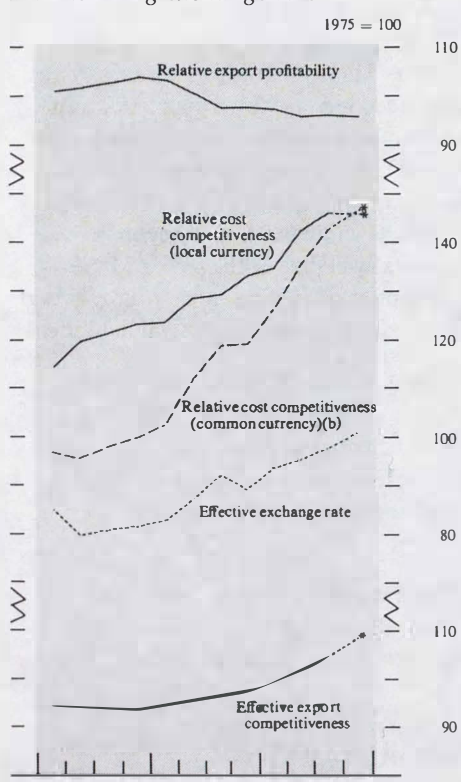
Factors affecting changes in the volume of UK exports and imports of manufactured goods

Per cent

	1980 H1	1980 H2	Year
	Change from previous half year		Change from 1979
Exports			
World markets	+2¼	—	+ 4
Competitiveness	−2½	− 3	− 4¼
Other	− ½	− ¾	− ¼
Total	− ¾	− 3¾	− ½
Imports			
UK demand	−7½	−13	−16½
Competitiveness	+3¾	+ 5	+ 9½
Other	+3	− 2½	+ 3¾
Total	− ¾	−10½	− 3¼

(a) Excluding erratic items; the estimated contribution of world markets (or domestic demand) and competitiveness is derived from studies done in the Bank.

The loss of **competitiveness** *in recent years derives both from the faster rise in labour costs here than abroad and the rising exchange rate.*[(a)]



• Bank estimates.

(a) Except for relative export profitability an upward movement in a competitiveness series indicates a worsening of competitiveness.

(b) The product of the change in relative unit labour costs in local currency terms and the change in the exchange rate.

The improvement continued into early 1981, with an aggregate current account surplus of over £1½ billion in January and February.

For 1980 as a whole, there was a surplus of over £1 billion on visible trade, after a deficit of £3.5 billion in 1979. The swing into surplus in the balance of trade in oil, largely brought about by a fall in domestic demand for fuel, accounted for just under a quarter of the change. The rise in the non-oil terms of trade (nearly 4%) accounted for about £1¼ billion of the improvement. The remaining £2¼ billion was the result of a 1½% increase in the volume of exports and a 3¾% decline in the volume of imports, in each case excluding oil.

Within these volume changes, and after the exclusion of erratic items, exports of manufactured goods were little changed, while manufactured imports fell by 3¼%.[(1)] The growth in UK markets abroad (estimated at nearly 5%) and weaker competitiveness were approximately offsetting influences on exports. Although the loss of current cost competitiveness in 1980 is thought to have exceeded 20%, the effective loss (see the first footnote on page 12) was much less, perhaps about 8%. During the year, the contractionary effect of worsening competitiveness intensified.

The course of imports was dominated by the decline in demand (which mainly affects finished goods), and also in output (which affects especially imports of industrial materials), in particular by reductions in stocks. The effect of stock reductions may not be fully recorded in the figure for demand in the table. As already noted, changes in competitiveness tend to affect imports of manufactured goods more quickly than exports, but the influence of worsening competitiveness in 1980 was easily outweighed by weak demand.

There have been few significant changes in the geographical distribution of UK trade in the last three years or so. One feature is a recent decline in the share of OPEC in UK export markets. Iran and Nigeria (where imports have been restricted) account for the fall, but, even excluding these countries, exports to OPEC markets did not increase their share of the total in 1980, despite the above-average growth in OPEC economies. As for UK imports, Japan and the United States have increased their share of manufactured goods, presumably because their competitive position has improved by more than that of other countries.

A higher exchange rate helps to keep domestic prices down by reducing the sterling prices of materials and components (and thus manufacturers' costs); by reducing the prices of imported foodstuffs and manufactured goods which are bought directly by consumers; and by subjecting domestic producers to keener price competition. For any of these effects to be felt, it is necessary for sterling appreciation to be reflected in UK import prices. In 1980, the sterling prices of imported manufactured goods rose somewhat faster than the prices of manufactured goods in world trade (converted into sterling), but considerably more slowly than UK manufacturers' domestic selling prices; this would be expected if, as suggested above, UK import prices mostly reflect world prices but are influenced also by the prices of competing home-produced goods.

(1) Manufactured goods represented 84% of exports of goods except fuel and erratic items in 1980, and 71% of comparable imports (many imported industrial materials being classed as manufactured goods).

A further sharp fall in imports accounted for most of the increase in the surplus on visible trade to a record £740 million in January. A rise in the surplus on trade in oil and a further small increase in the non-oil terms of trade also contributed. The volume of exports, excluding oil, eased back. In February, the surplus fell to £310 million; this was largely due to changes in non-oil trade volumes (exports fell by about 5% while imports rose by over 7½%), but there was also a fall of ½% in the non-oil terms of trade.

Invisibles

First estimates put the surplus on invisibles transactions at just over £0.6 billion in the fourth quarter, after under £0.3 billion in the third. A fall in the deficit on transfers—most of it arising from a lower net contribution to the European Community—accounted for most of the rise in the surplus, and net receipts from services increased by £0.1 billion. In 1980 as a whole, however, the surplus on invisibles shrank by £0.3 billion to £1.6 billion, reflecting a substantial deterioration in the interest, profits and dividends account, only partly offset by improvements in services and transfers.

Capital movements

Official financing—the rise in reserves, excluding the net effect of official borrowing—was under £0.2 billion in the fourth quarter, about £0.1 billion less than in the third. Identified capital outflows and the balancing item (most of which probably reflects unidentified capital outflows) accordingly almost matched the surplus on current account—an outcome which was associated with a rise of about 3½% in the effective exchange rate for sterling. Among recorded capital flows, UK direct investment overseas grew and portfolio investment abroad—according to the very provisional figures available—remained at the high rate recorded in the third quarter. Overseas residents continued to add to their holdings of sterling bank deposits, although at a reduced rate, but they reduced their holdings of public sector debt and invested less in the UK private sector. The banks lent more abroad in sterling.

In 1980 as a whole, net capital outflows (including the balancing item) amounted to just over £1.5 billion—equivalent to just over half the surplus on current account. Private investment abroad is estimated at £6.9 billion, and the banks lent £2.5 billion abroad in sterling, most of it after the removal of the 'corset'. On the other hand, non-residents added £4.4 billion to their sterling holdings, and the banks borrowed about £2 billion more in foreign currency from non-residents than they lent abroad. During the year sterling rose by 12% in effective terms, influenced at times by an uncovered interest-rate differential in its favour (although this was reversed in the fourth quarter) and by developments in the oil market.

International payments positions

The strengthening of the United Kingdom's current account between 1979 and 1980 was the largest recorded by any OECD country, and was in contrast to the general experience of industrial countries.

The main feature of international payments last year was the increase in the current account surplus of the oil-exporting countries from $66 billion to $105 billion. During the year,

Current balances(a)

$ billions; *seasonally adjusted*

	1979	1980(a)		
	Year	Year	H1	H2
United States	– 0.8	0.1	– 5.0	5.1
Canada	– 4.4	– 1.2	– 1.6	0.4
France	1.2	– 7.4	– 3.9	– 3.5
Italy	5.1	–10.9	– 3.1	– 7.8
Japan	– 8.8	–10.8	– 9.1	– 1.7
West Germany	– 5.3	–15.5	– 7.4	– 8.1
Six major overseas countries	–13.0	–45.7	–30.1	–15.6
United Kingdom	– 3.5	6.6	—	6.6
Other OECD	–18.1	–37.9	–19.6	–18.2
OECD	–34.6	–76.9	–49.7	–27.2
Oil-exporting countries	66	105	62	43
Other developing countries	–40	–65	–32	–33

(a) The columns do not sum to zero because of the incomplete country coverage, timing differences, and unrecorded invisibles transactions.

(b) Partly estimated.

OECD: balance of payments

$ billions; *not seasonally adjusted*

	1978	1979	1980 (a)		
	Year	Year	Year	H1	H2
OECD excluding United States					
Current account	26	−34	−77	−46	−31
Capital account	24	20	74	38	36
Official financing balance (b)	50	−14	− 3	− 8	5
United States					
Current account	−14	− 1	—	− 3	3
Capital account	−23	18	12	14	− 2
of which, reported investment of official assets of OPEC and other developing countries	*− 1*	*7*	*19*	*8*	*11*
Official financing balance (b)	−37	17	12	11	1

(a) Partly estimated.

(b) Fall in assets/rise in liabilities −. For the United States, this item comprises changes in net official reserves and changes in US liabilities to the monetary authorities of industrial countries.

Developing countries[(a)]: balance of payments

$ billions; *not seasonally adjusted*

	1978	1979	1980	
	Year	Year	H1	Q3
Current balance	−26	−40	−29	−17
Capital balance	41	48	26	18
of which:				
Direct investment(b)	*6*	*7*	*4*	*2*
Capital market finance	*28*	*39*	*17*	*13*
Other(c)	*7*	*2*	*5*	*3*
Official financing balance	15	8	− 3	1
Financed by:				
Borrowing from IMF	—	1	1	1
SDR allocations	—	1	1	—
Reserves(d) (increase −)	−15	−10	1	− 3

(a) Excluding oil-exporting countries.

(b) Bank estimates.

(c) Includes official flows, trade credits, errors and omissions.

(d) Adjusted to exclude valuation changes.

however, their surplus tended to fall, under the influence of buoyant imports, weak demand for oil, and interrupted supplies from Iran and Iraq. The United States and Canada improved their current accounts, partly because of domestic recession; this also played a part in the sharp fall in Japan's deficit in the second half of the year, although in this case the delayed effect of stronger competitiveness was an important additional factor. By contrast, the major continental European economies moved into larger deficit, and the smaller OECD countries were in much heavier deficit in 1980 as a whole, with little or no improvement during the year. The deficit of the developing countries also widened.

The $43 billion deterioration in 1980 in the current account of the OECD area, except the United States, was more than financed by additional net capital inflows; US banks have become increasingly active lenders. Official financing was rather less than in 1979, and in many cases there was some fall in effective exchange rates. However, in West Germany, where domestic banks continued to lend abroad, downward pressure on the exchange rate was greater than elsewhere, and the authorities responded by reducing reserves, which, despite substantial official borrowing, fell by some $15 billion—approximately as much as the current account deficit. West German interest rates have since been raised sharply.

The current account deficit of the developing countries rose from $40 billion in 1979 to nearly $50 billion in the first three quarters of last year, and may have reached $65 billion in the year as a whole. On the evidence of the first nine months, their borrowing from banks, although high, was little greater than in 1979. In total, capital inflows to the developing countries rose, but not as much as their current deficit; correspondingly, considerably less was added to reserves than in 1979.

Assessment

This assessment concentrates on monetary policy in particular; and seeks to set in perspective its present evolution, along with current developments in technical methods of monetary control and of prudential supervision. Monetary policy needs to be seen in the context of developments in the economy. On a broad view, financial conditions must be judged to have been tight last year. The stance of monetary policy should be somewhat eased as a result of the monetary steps announced with the Budget, whose aim is to bring about a further reduction of inflation, while holding out the prospect of lower interest rates.

Evaluation of past monetary trends

It is convenient first to set out the indicators needed to form a view about recent monetary developments—starting with the course of the different monetary aggregates. These do not paint a uniform picture. The growth of sterling M_3 has slowed down in recent months; but by the end of the financial year it was stili a long way above the target range, even when distortions due to the corset are discounted. The wider aggregates—PSL_1 and PSL_2—have grown almost as fast: total M_3, even faster. The growth of narrow money (M_1) has been much slower, and perhaps broadly in line with the path that might have been envisaged had there been a formal target for this aggregate. There are various possible definitions of monetary base (M_0) but its largest component by far, on any wider definition, is notes and coin in the hands of the public.(1) Over the last year this component, like M_1 of which it forms a sizable proportion, has also grown relatively slowly.

The evidence, diverse as it is, of the monetary aggregates needs to be interpreted in the light of wider financial and economic indicators. Progress in slowing down inflation has been faster than earlier expected. The strength of sterling, though not closely related to movements in the monetary aggregates, must owe much to the stance of policy. Even after its recent easing, the effective rate is much higher than was foreseen as likely a year ago: this has helped to moderate the course of inflation; has added to the financial pressures on companies arising from the depth of the recession; and must have contributed to the slowing down of wage increases. The rate of inflation fell more rapidly than interest rates, and real interest rates, it can be judged, had become rather high—especially for the private sector, whose selling prices have risen relatively little; and the level of interest rates will have affected business decisions, particularly the scale of reductions in stocks.

Monetary policy, it thus seems clear, exercised a restrictive effect over the last year; and, as was increasingly realised as the year went by, sterling M_3 has been a poor indicator of its stance.(2) The growth of broad money was indeed probably increased by the particular effects of recession—which inflated the scale of public borrowing, and at the same time led to high borrowing by industry from banks. The recession has also been marked by high personal saving, and a strong growth of savings deposits; the accumulation of liquid resources, as revealed in the growth of the broad money aggregates, represents in part a desire to rebuild savings balances eroded by inflation.

The decision in the context of the Budget to reduce MLR from 14% to 12% was based therefore, as were the cuts in November and July last year, on a range of considerations going wider than the evidence of the monetary aggregates. Thus, in addition to a prospective slowing down of the growth of broad measures of money, the level of real interest rates, and developments in the economy more generally, were judged important.

Economic expansion dependent on better competitiveness

Last year's recession (as argued in the last issue of this *Bulletin*) is now likely to change in character. So far the economy has been adjusting to a situation in which stock levels had become excessive—an adjustment made all the more severe by the financial pressures bearing on firms. This adjustment may still have some way to go, but stocks may now be run down progressively less rapidly. On its own, such a slow-down in the rate at which demand is met out of stocks would, as in previous cycles, lead to a recovery of output. In the present cycle, as the Budget forecasts indicate, demand elsewhere is likely to weaken. International competitiveness has been greatly eroded in the last two years—by cost increases more rapid than in competing countries and by the rise in the exchange rate; and the profitability of exporting, or

(1) Statistics of monetary base series are published on page 59.
(2) A similar interpretation was, for instance, given in the September 1980 *Bulletin* (page 281) and in the Governor's speech at the Mansion House in October, reproduced in the December *Bulletin* (page 457).

competing with imports, has been sharply reduced by this double squeeze. These pressures have been mitigated in many companies by reductions in manning ratios and changes in product mix; but the loss of competitiveness is likely to have further lagged effects on exports and imports in coming years. In addition, business investment is likely to be cut back in response both to weak demand and to poor profits. Whatever the exact course of the economy this year, unemployment seems likely to rise more slowly than last autumn and winter. Taking a long view, prospects of expansion stand to be largely dependent on how far industry can improve its competitive position; and, in this, the course of domestic inflation is crucial.

The pace of inflation has moderated encouragingly, but still needs to be further reduced. It may now be no faster than the average in competing countries; but the prospects for recovery would be much brighter if this country could now become a country where inflation was clearly below the international average. Many wage settlements in industry have been for percentages less than the rise in retail prices over the preceding twelve months, and this is often thought of as involving a cut in real wages. But a backward-looking comparison of this sort is misleading. At a time when inflation is decelerating, the current rate of increase of both wages and prices must tend to be less than it was in the recent past. In order that a fall in the rate of inflation can take place, there has to be a more or less parallel reduction in the rate of both wage and price increases, each permitting, and providing justification for, the other.

Given the likely economic climate in the next twelve months, wage increases in the next round could again show a further substantial deceleration. A marked slowing down is certainly desirable. The need is to improve competitiveness: this will require greater moderation than hitherto, in one form or another, of domestic costs. The slowing down of inflation and the smaller size of wage increases as compared with last year has been helped by the rise in the exchange rate; but that can hardly continue indefinitely. The need will be to continue reducing the pace of inflation, even without the assistance of a rising exchange rate. The alternative of a falling exchange rate would not evade the problem, which would then appear in a new, but equally difficult, form: the problem would then be to prevent the resulting gain in competitiveness from being eroded by a faster rise in costs. Either way, there is much the same problem of restraint. It is the real, rather than the nominal, exchange rate that matters; and it is only by controlling costs in this way—along with successful exploitation of new products and services—that industry can restore some or all of the huge erosion of its competitive position that has taken place over the last two or three years.

The economy has made progress towards the necessary adjustment. In many cases the attitude to wage claims, to improved efficiency and to more rational manning levels has moved towards greater realism. But there is clearly a long way to go before this country is in advance of its competitors. It is continued progress in this direction—hard though the standard is to match—that must provide the key to resuming sustained growth.

A strict Budget and lower interest rates

The Budget is designed to be in line with the medium-term financial strategy. The Budget changes are calculated to bring a fall in the PSBR, from an outturn of about £13½ billion in 1980/81 to

£$10\frac{1}{2}$ billion as now forecast for 1981/82, at a time when recession is working to increase it. As a percentage of GDP the PSBR is expected to decline from 6% to something over 4%. To serve roughly as an indicator of fiscal policy the PSBR should be adjusted for the effects of changes in activity: without these it would have declined still more, possibly to 3%. Despite the high nominal figure for the borrowing requirement, the Budget proposals must therefore be regarded as financially strict.

The effect of the tax increases on activity will in part be offset by the stimulating effect of lower interest rates and possibly of a lower exchange rate. Before 10 March, in anticipation of a cut in MLR, sterling fell to a level over 5% below its peak in late January, though well above the levels ruling through most of last year; and so far has remained below that peak.

The course of the broad monetary aggregates, as last year's experience has shown, is difficult to predict. Nevertheless, it seems likely that their growth in 1981/82 will be a good deal slower than in the financial year now closing. The demand for money should grow more slowly inasmuch as money incomes are likely to expand less rapidly than last year. Of the counterparts of sterling M_3, public sector borrowing should be less, as probably also industry's borrowing from the banks. The growth of the narrower monetary aggregates—base money and M_1—may however be faster than last year, particularly if interest rates come down further as inflation recedes. Though all the aggregates will continue to be monitored, sterling M_3 remains as the target aggregate. The new target is for an annual rate of increase of 6%–10% for the fourteen-month period to April 1982; and starts from the February 1981 level, making no correction for the overshoot last year.

The financing of the public sector—and hence the control of broad money—will be facilitated by the increased emphasis on national savings, and the greater availability of index-linked certificates announced in the Budget. The innovation of an index-linked gilt-edged security, besides its wider effects, should also bring advantage from the point of view of monetary control. These steps—along with the cut in MLR—may take pressure off long-term interest rates; and help to encourage companies to rely more on the capital market for finance, and less on the banks.

Evolution of monetary control and supervision of banks

More technical modifications in methods of monetary control have been under way since the autumn and will be carried further in the course of the year.(1) These changes are likely to have the technical advantage of allowing the Bank to bring to bear an influence on short-term interest rates in a more flexible manner. They have been introduced smoothly and have not resulted in a greater volatility of interest rates. They do not entail a change in the general thrust of policy, which will continue to be along the lines indicated above. While no decision has been taken to introduce monetary base control, which would represent an important change of policy, the present moves would be consistent with a gradual evolution in that direction.

Various modifications have been made in the Bank's method of intervention in the money market. In dealing with the discount

(1) For details see 'Monetary control: next steps', page 38. This paper was released by the Bank on 12 March along with a paper on 'The liquidity of banks' (reproduced on page 40) which sets out concomitant changes regarding the arrangements for the prudential supervision of the banks.

houses, the Bank now relies chiefly on buying and selling bills; direct lending to the market has been greatly reduced (see page 23). The interest rate on this lending has been generally somewhat above comparable market rates, and less closely related than previously to MLR. The level of MLR as announced has thus come to have less operational significance than hitherto.

Looking ahead, it is envisaged that the Bank will aim to keep very short rates within a band, which will not be announced, and which will be adjustable in the light of circumstances more flexibly than has been possible with MLR. The practice of having an announced MLR may in due course be suspended; but decisions on short rates will continue to take account of the whole range of monetary indicators and of more general factors which affect the interpretation to be placed on these indicators.

Once discussions with the banks have been completed on the arrangements needed to ensure that the Bank can operate effectively in bill markets, the minimum ratio for reserve assets held by the banks will not be required for purposes of monetary control. But banks have been asked not to change their policies on holdings of reserve assets when the ratio is abolished, if at that time discussions with them have not been completed as to the appropriate prudential level of holdings of such assets.(1) Discussions are also under way with a view to transforming the $1\frac{1}{2}\%$ cash ratio, which has till now applied only to the London clearing banks, into an arrangement applying to banks more broadly.(2)

(1) See paragraph 10 of paper reproduced on page 40.
(2) See paragraph 3 of paper reproduced on page 38.