Economic commentary

The following are the main points:

- *Although the worst of the fall in output may be over, there are few signs of any sustained recovery.*

- *Demand is generally weak. Destocking continues and industrial investment is declining. Consumer spending—which rose in the first quarter—will probably not be sustained unless savings are run down.*

- *The increase in earnings—about 10% per year—is now no faster than overseas. With signs of some improvement in productivity, and the recent decline in the effective exchange rate, some of the very large deterioration in competitiveness may be recovered.*

- *Partly because of the fall in sterling, prices may continue to rise faster than in the second half of 1980.*

- *In real terms, company profitability was the lowest ever recorded in the last three months of 1980. But severe pruning of stocks and capital investment have led to some improvement in companies' financial position.*

- *In the first quarter, the probable large surplus on current account was matched by the largest net capital outflow ever recorded, with little change on balance in the effective exchange rate.*

- *Real interest rates have risen sharply abroad—in the United States in the pursuit of monetary control, elsewhere partly in response to exchange rate pressures; the United Kingdom stands in sharp contrast, and by international standards is no longer a high interest rate country. These developments have probably contributed to the recent fall in sterling.*

- *The underlying growth of sterling M_3 seems to be within the target range, but the picture is confused by the Civil Service pay dispute. Lending to the private sector (and, in particular, to persons) appears to be growing more rapidly.*

Background to the recession

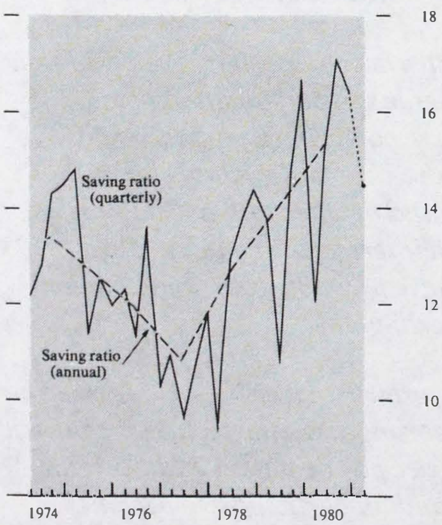
Although the incidence of strikes obscured developments during 1979, it is clear that output stopped rising then and unemployment started to increase. Businessmen began to reconsider investment plans, no doubt responding to the already severe loss of competitiveness. For some time, total final spending in the economy continued to expand, although at a decreasing rate. But it fell sharply during 1980 as fixed investment and exports declined, the latter influenced by slower growth of demand abroad as well as by lost competitiveness; and consumer spending eased back from the high level in the first quarter (which had been induced by tax rebates), although consumption recovered again later in the year.

Company profitability fell steeply. The company sector moved from approximate financial balance in 1978 to heavy deficit, and did not re-achieve balance (by curbing fixed investment, cutting stocks and discharging labour) until late in 1980. Being high in relation to output and sales, stocks were cut very sharply last year. Much of the impact fell on imports, but demand for domestic production was also reduced—and output fell more steeply than at any time since the war. It would, however, be wrong to regard the fall in stocks as an independent source of recession; rather, it represented part of the response of companies to their predicament. Earnings rose faster than prices, at least until last autumn, in the face of monetary and fiscal policies designed to moderate inflation. Interest rates remained high (and rose in real terms); and self-sufficiency in oil was another source of upward pressure on the exchange rate. The rising exchange rate and disparate behaviour of labour costs at home and abroad made competitiveness worsen further—although more recently the cost disadvantage may have been diminished. By early June, sterling was back to its level of early 1980 in effective terms.

Consumer spending strong, but reductions in stocks continue and investment weakens

Information available for the first quarter does not suggest any great change in the pattern of demand.

The **personal saving ratio** *has risen sharply in the last three years.*



* Bank estimate.

Consumer spending[1]

Consumer spending rose by $\frac{3}{4}$% last year, influenced by rising personal incomes. But in the first quarter of this year personal disposable income probably fell, and consumer spending might have been expected to become less buoyant. In the event, however, it rose by another $1\frac{3}{4}$%. The increase was most marked in clothing and household goods—no doubt a reflection of steady prices in the shops—and in alcoholic drink, where there was buying ahead of the Budget. These developments imply a rather sharp decline in the personal saving ratio to around 14%, which is still historically high.[2]

Real personal disposable income is now likely to come under further pressure. Average earnings are no longer rising faster than retail prices, even without the increase in indirect taxes announced in the Budget. Falling employment, increased national insurance contributions, and growing payments of income tax arising from

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

(2) Personal saving in most recent years before 1980 was, however, insufficient to maintain the real value of the personal sector's financial assets—see the article on page 232.

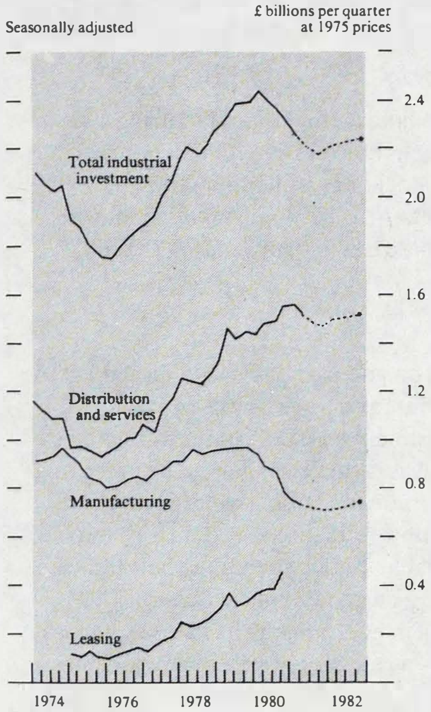
the decision announced in the Budget not to raise tax allowances and thresholds will all tend to diminish real disposable income.

Fixed investment

Industrial investment rose sharply between 1978 and 1979. It remained at this high level in 1980, but within the total manufacturing investment fell quite sharply, whereas investment in distribution and services increased.

Provisional figures for the first quarter of 1981 show a 1% decline in total industrial investment. Investment by manufacturing industry fell by a further 4% to more than 13½% below the quarterly average of 1980 and to as much as 22% below the average for 1979. These figures do not allow for leasing—for which first quarter figures are not yet available—and may therefore overstate the decline, since manufacturers have tended to lease a growing proportion of the fixed assets which they use. Fixed investment in distribution and service industries was little changed in the first quarter, at about 4% above the quarterly average in 1980 and nearly 10% above the average in 1979. Investment by service industries includes assets leased out to manufacturers; adjusting for this would reduce the growth in recorded investment in this category. Distribution and service investment is now almost twice as great as investment in manufacturing industry, whereas in the first half of the 1970s it was only slightly bigger.

Industrial investment *is expected to weaken this year, but to recover in 1982.*



* Forecasts derived from the Department of Industry survey of investment intentions published in May.

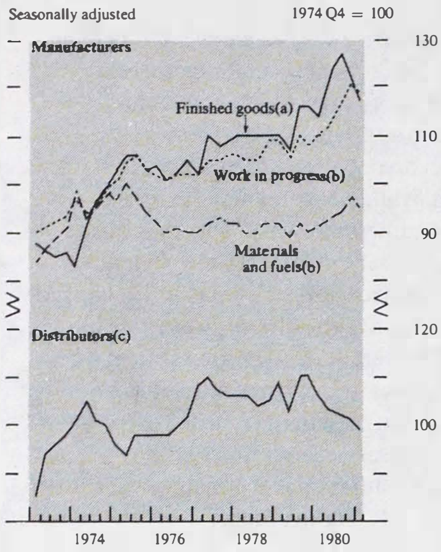
The investment intentions survey published in May by the Department of Industry points to a fall of 15%–18% in manufacturing investment this year (or 11%–14% if allowance is made for leased assets). A small increase in investment in distribution and services is indicated, giving in total a decline of 3%–6%, slightly better than the previous survey had suggested. For 1982, the survey indicates some growth in each category. As far as manufacturing is concerned, the forecasts for 1981 are in line with the CBI's expectations, but for 1982 the CBI are more pessimistic than the Department of Industry survey.

Company profits and finances in the second half of 1980, which are discussed in more detail below, suggest a decline in real profitability of existing assets to barely 2%, well below the current real cost of finance to companies, which no doubt goes far to explain the weakness of investment intentions this year.[1]

Housebuilding last year was the least since 1963. Although full figures for the first quarter of 1981 are not yet available, a strong increase of nearly 50% in the number of new houses started in the private sector represents some revival. But the increase was from an exceptionally low base, and even in the first quarter housing starts were running at a lower rate than in most recent years and fewer houses were under construction than at any time since 1974; also, starts in March and April were lower than in January and February. Nevertheless, building societies lent a record amount (and their lending was high even after allowance for the growth in house prices); new commitments to lend were also higher than they have ever been. The societies' liquidity ratio fell during the quarter as competition from national savings and a fall in interest credited to accounts reduced net receipts. Bank lending for house purchase has also been increasing.

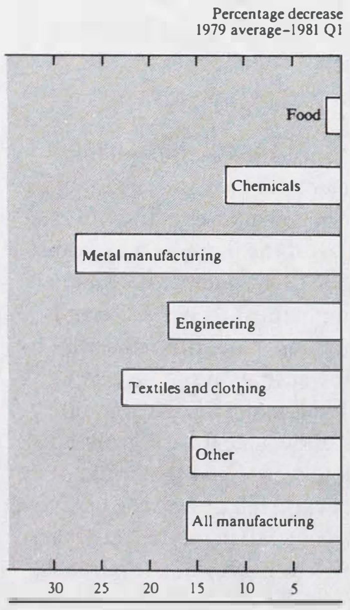
(1) The note on page 228 presents estimates for the valuation ratio (the ratio of the rate of return to the cost of capital, with appropriate allowance for tax).

Despite recent falls, **the ratio of manufacturers' stocks to their sales or output** *remains high.*



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

Metal manufacturing and textiles and clothing are categories of **manufacturing industry** *worst hit by the recession.*



The recovery in housing starts did not extend to the public sector, where activity is very low. Spending plans suggest less public sector housebuilding this year than in 1980/81.

Stockbuilding

Manufacturers' work in progress and stocks of finished goods have tended to rise in relation to output and sales for a number of years. The increase last year was rather steep, despite the substantial reductions in stocks, because output and sales were so sharply curtailed. Provisional figures for the first quarter show a further reduction, of £0.6 billion, in manufacturers' stocks, just under half of the reduction being in finished goods. By the end of March, manufacturers' stocks were the lowest since 1972. Even so, they still appeared to be higher in relation to production and sales than a year earlier—and unusually high in relation to the experience of recent years. Distributors' stocks, by contrast, rose by over £0.1 billion in the first quarter, with retailers accounting for the whole of the increase. With retail sales also increasing, however, there was a small further fall in the ratio of distributors' stocks to sales, after a decrease last year.

CBI surveys in April and May indicate that manufacturing companies still regard their stocks as excessive. The signs are therefore that manufacturers' stocks are still falling, though perhaps by diminishing amounts—a development which may be associated with larger recent increases in bank lending to the private sector.

Other components of demand

Government current spending on goods and services has tended to rise gradually in recent years, but investment in the provision of public services has fallen. Investment by public corporations was little changed in 1978–80, but was rather less than in the preceding years. Information about government current spending on goods and services and public sector non-residential fixed investment in the first quarter is not yet available. Public spending plans indicate little change in current spending on goods and services this financial year, but suggest a fall in non-housing fixed investment by central and local government—a category of spending which has tended to decline for a number of years. Fixed investment by public corporations, on the other hand—especially in telecommunications, electricity supply and gas—is expected to increase.

The Civil Service pay dispute has prevented compilation of trade figures since February. In the three months December to February, the volume of exports and imports of goods each fell by about 2%, implying little change in the trade balance in volume terms after a marked improvement during 1980. Provisional figures suggest that exports of services rose by about $\frac{1}{2}$% in volume in the first quarter, while imports of services fell slightly. (Trade in services accounts for about one quarter of trade in goods and services at 1975 prices.)

Output declining more slowly

The output measure of GDP fell by just under $\frac{1}{2}$% in the first quarter, to $5\frac{3}{4}$% below the quarterly average in 1979. Manufacturing production declined by 2%, to over 16% below the quarterly average in 1979.[1] Although the declines since

(1) Production in some sectors of industry is measured by sales. Adjusted to give a more accurate picture of output, the figures show falls of $1\frac{1}{2}$% from the fourth quarter of 1980 and $17\frac{1}{2}$% from the quarterly average in 1979.

1979 are considerably greater than those recorded in any other recession since the war, the rates of fall in the first quarter were the smallest for over a year. Indeed, manufacturing production actually rose in February, although it fell back in March; chemicals and metal manufacture in particular have shown some signs of recovery.

CBI surveys [a]

Percentage balance of replies[b]

	1980			1981		
	Apr.	July	Oct.	Jan.	Apr.	May
Optimism about business situation compared with four months previously	−41	−70	−54	−27	− 6	..
Total order book (volume)	−50	−71	−79	−73	−73	−67
Volume of new orders expected in next four months	−21	−47	−32	−17	− 2	..
Volume of output expected in next four months	−14	−41	−31	−16	− 4	− 1

.. not available.

(a) Reporting firms employ about 3 million people, approximately half the workforce in manufacturing industry. Replies are weighted by the size of the firm.

(b) A minus sign means that a greater proportion of respondents were more pessimistic than were more optimistic, expected their production to fall rather than to rise, etc.

Respondents to the April CBI Industrial Trends Survey, covering nearly 2,000 firms in manufacturing industry, were less gloomy about business prospects than they had been in previous surveys. Nevertheless, those expecting their own production to contract in the coming four months still narrowly outnumbered those who expected to produce more; more firms considered their order books below normal than above normal; and on the whole firms expected to receive fewer rather than more orders in the next few months. The CBI judged a levelling off or a small decline in the output of manufacturing industry to be likely in the four months to August. They saw in the results no sign of a strong recovery in output in the ensuing period. An abbreviated survey in May showed a similar picture.

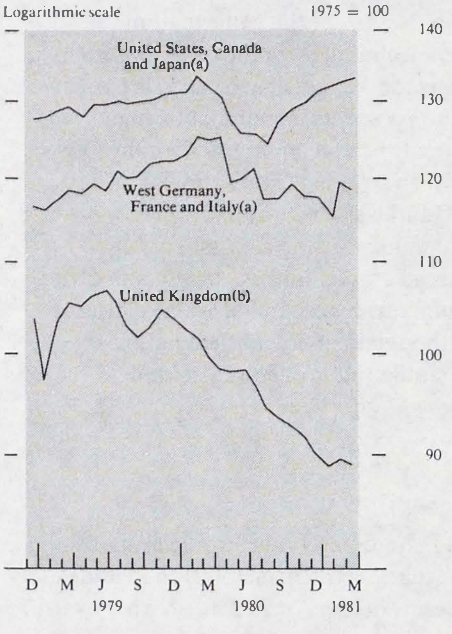
Manufacturing accounts for only 25% of the value of domestic production. Its share has been declining for some time and the present recession has hit the sector particularly hard. It is possible that current developments and prospects in manufacturing industry give too dark a picture for the economy as a whole. Other sectors of the economy have been stronger. Extraction of oil and gas grew, if unevenly, in 1980 and was a record in the first quarter of this year. Some other non-manufacturing components of industrial production, such as gas, water and electricity, have been less depressed than the manufacturing sector. The same is true of non-industrial activities—although in many of these output is harder to measure. A rather similar pattern emerged in the recession of 1974–75.

Sharp rises in share prices

The period shortly before and after Easter saw a surge in share prices, which took the FT-Actuaries industrial (500) share index to an all-time high in nominal terms in late April. This sharp upward movement in prices—which has since been partly reversed—took some of its strength from, and at the same time was seen to support, the view that the recession had bottomed out and that the economy was poised to recover. There is some evidence that movements in share prices have, in the past, foreshadowed changes in economic activity. Indeed, movements about trend in the FT-Actuaries index (the recent rise in which was considerably less than in the narrower 30-share index) are one of the five components in the CSO's longer leading indicators, chosen following statistical tests of their ability to signal turning points in the economy.

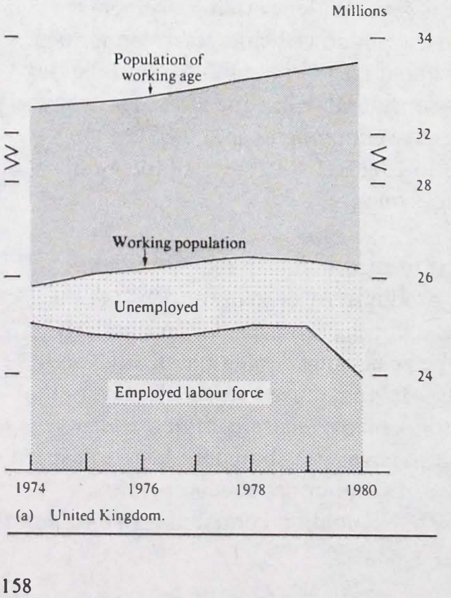
At present, with many reports of agreements to reduce manning and some evidence of higher productivity even in the depth of the recession, there are widespread hopes of substantial productivity gains and improvements in the position of companies in any upturn. Other considerations—falling interest rates (also one of the CSO's longer leading indicators) and the scarcity of new equity issues in recent years—may also have contributed to the rise in share prices. But how strongly a rise in share prices affects spending decisions is difficult to establish. No doubt it contributes to business confidence. More tangibly, it cuts somewhat the cost of new finance to companies. Although the effect may be more significant in individual cases, the average reduction in the present real cost of finance brought about by the recent increase in share prices—some one half of a percentage point—would leave the cost of finance, at about 4%, well above the estimated real rate of profit in the second half of last year. Nevertheless, interest in making rights issues has been growing and some of the proceeds may be used to increase company spending in the United Kingdom. Finally—though there is little evidence of such an effect in this country—a rise in share prices adds to the wealth of people who hold equities, directly or through financial intermediaries, and might, in principle, lead them to spend more.

Industrial production *in the United Kingdom has fallen much more than abroad.*



(a) GNP weighted. Excluding construction.
(b) Excluding oil and natural gas.

Employment[(a)] *shrank rapidly in 1980.*



(a) United Kingdom.

Uneven growth abroad

In other industrial countries, the decline in output was much less than in the United Kingdom; and some signs of recovery were apparent in the latter part of 1980. The tendency towards recovery continued in the early part of this year, but the pattern of growth was uneven. Outside Europe, activity was remarkably buoyant in the final quarter of 1980 and the early part of 1981. The recovery in the United States was particularly strong: GNP grew at an annual rate of $8\frac{1}{2}$% in real terms in the first quarter, with consumer spending, fixed investment and the external sector all contributing. In Canada and Japan, too, there was strong growth at the turn of the year, although this was due largely to external factors, domestic demand remaining weak. In the major European economies, by contrast, activity remained depressed. Cautious policies, together with a lack of consumer and business confidence and poor trade performance, have combined to inhibit growth, and no significant upturn is expected for several months.

The labour market continues to weaken, although more slowly

In recent months both the increase in unemployment and the decrease in numbers employed have moderated, although they remain rapid by previous standards. This slowdown accords with expectations: the recession in output seems certain to produce continuing rises in unemployment, but not at the rate of last autumn and early winter. Between August 1979, the lowest recent level, and May 1981, the number of unemployed doubled.

The number of adults registered as unemployed in the United Kingdom rose in April, by 72,000 seasonally adjusted, and by 62,000 in May to over $2\frac{1}{2}$ million, nearly $10\frac{1}{2}$% of the labour force; these increases compare with monthly average rises of 81,000 in the first quarter of the year and of 115,000 in the fourth quarter of 1980. (The corresponding increase in 1975 was about 40,000 a month.) The number of vacancies has not changed much in recent months.

The latest figures for total employment in Great Britain relate to the fourth quarter, when it fell by 385,000 (seasonally adjusted). bringing the fall over the year to more than one million. Most of the fall was in manufacturing industry, but—in contrast to the recession of the mid-1970s—employment also declined substantially in the service sector, by 100,000 in the fourth quarter and some 250,000 in the year as a whole. In the first quarter of this year, however, the fall in employment in manufacturing industry was 150,000, compared with 230,000 in the previous quarter (but still higher than the fall of 110,000 in the first quarter of 1980). In other industries contributing to the index of industrial production, employment fell by 50,000 in the first quarter (compared with 45,000 in the previous three months and 7,000 in the first quarter of 1980). Falls in employment continue to exceed rises in registered unemployment, although the population of working age is growing by 150,000–200,000 a year. Most of the gap appears to be accounted for by earlier retirement and a withdrawal of women from the labour force—the female labour force, measured by the number of women in jobs or registered as unemployed, started to fall last year after increasing rapidly throughout the 1970s.

In March only 60% as much overtime was being worked in manufacturing industry as a year earlier; and short-time working—affecting 12% of operatives—was vastly more widespread. But the fall in hours worked per operative appeared to have stopped.

Earnings here continue to grow more slowly than last year. . .

Pay settlements seem to be running at about 10%, about half the rate in 1979/80, and they appear to have moderated since the beginning of the pay round.

Information compiled by the CBI on company agreements in manufacturing indicates an average level of settlements since December of 8%–9% (compared with 13% in August, the first month of the new pay round). 90% of pay deals in the engineering industry in February and March were reported by the Employers' Federation to be for 10% or less, with a third of the total for 6% or less. In the private sector outside manufacturing industry, settlements in the pay round have been rather higher on average, with a wide range. Settlements in the public sector can be put into two broad groups—roughly 6%–8% (local authority manual workers, health service ancillary workers, postal workers), and 10%–13% (miners, water, gas and electricity workers, Post Office engineers, armed forces).

The lower settlements achieved in the current pay round, together with the reduction in hours worked, are being increasingly reflected in average earnings, which by March were about 15% higher than a year earlier, as against some 22% in the middle of 1980. The month-to-month increase in average earnings seems to have settled down at about $\frac{3}{4}$%, compared with 2% or so last summer. Over the last six months, average earnings have increased at an annual rate of about 10%.

. . . but have not slowed down abroad

Having increased only moderately in the immediate aftermath of the second major increase in oil prices in 1979, earnings in the other main industrial countries accelerated in the second half of 1980 as wage earners sought to recoup losses in real income. By the end of the year, the rate of earnings growth had risen above 10% in all major countries except Japan and West Germany. This acceleration does not seem to have continued except, perhaps, in Canada and Italy. The annual wage settlements in Japan and West Germany have proved to be moderate.

Productivity in manufacturing industry

Percentage changes

	1979 average–1981 Q1	1980 Q1–1981 Q1
In the United Kingdom(a)		
Manufacturing production(b)	−17½	−13½
Number employed	−13	−10½
Average hours worked	− 5½	− 5½
Output per man-hour	+ ½	+ 2½
In other major industrial countries(c)		
Manufacturing production	+ ½	− 2
Number employed	− 2	− 1½
Average hours worked(d)	− ½	− ½
Output per man-hour	+ 2½	—

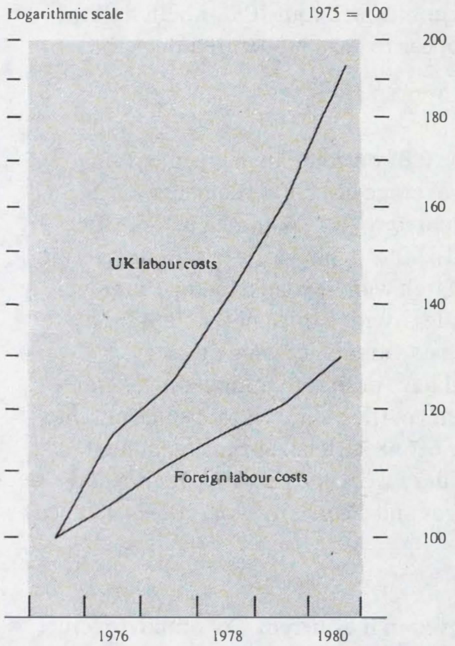
(a) Figures for the number employed and hours worked relate to Great Britain; figures for hours worked relate to manual workers.

(b) After adjustment for sales out of stock.

(c) United States, Canada, Japan, France, Italy, West Germany. Figures for 1981 Q1 are partly estimated.

(d) Figures for Italy are not available.

Labour costs *have risen much faster here than abroad in the last five years.*(a)



(a) Unit labour costs, adjusted for the economic cycle, in local currency terms.

Signs of improvement in UK productivity and cost competitiveness

There is a good deal of anecdotal evidence that productivity in many companies has improved during the current recession. So far, however, it is difficult to substantiate this. There are considerable statistical and conceptual problems in measuring changes in productivity. For example, the statistics of manufacturing production, numbers employed, and average hours worked, are sometimes revised; and the coverage of the various series is not the same. Nevertheless, the figures shown in the table suggest that output per man-hour in manufacturing rose by 2½% in the year to the first quarter of 1981, though the rise is exaggerated because the steel strike depressed output in early 1980; and there was very little change in productivity between 1979 and the first quarter of this year. The fall in output per man in the last year or so is rather smaller than might be expected, given the fall in manufacturing output.

In the mid-1970s, as in most earlier recessions, productivity tended to fall. Whether recent experience, if it is substantiated, reflects merely a quicker response to declining output, occasioned perhaps by financial pressures on employers, or, as some believe, an enduring change in working practices, remains to be seen. Whatever the reason, there are signs that output per man-hour has performed rather better here in the last year or so than in most other major industrial countries, despite the greater depth of the UK recession. Moreover, in the last six months average earnings have probably risen no faster in UK manufacturing industry than abroad—about 10% at an annual rate in each case—in stark contrast to earlier experience. With sterling having fallen in effective terms (by 7% between December and early June), UK cost competitiveness has probably improved to some extent—although the most commonly used figures, which take trend rather than actual changes in productivity into account, will not immediately reveal the full improvement, which in any case is modest compared with the deterioration which has occurred in recent years.

Monthly price rises increase

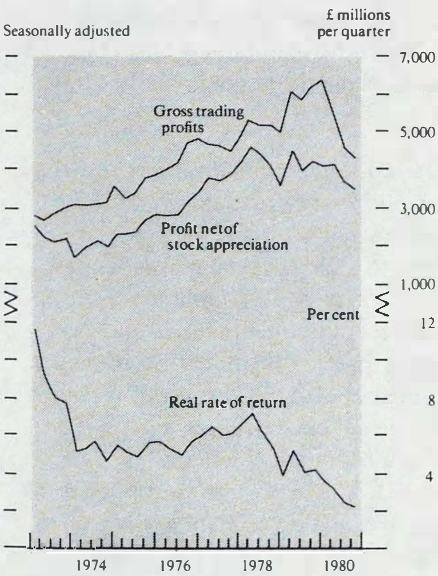
Influenced by the rise in the exchange rate and difficult trading conditions, which made it hard for firms to pass on cost increases, price inflation slowed down substantially last year. But there was little or no improvement in the monthly figures in the second half of the year, although price increases continued to fall on the annual comparison. More recently, increases in the dollar price of oil, the fall in the exchange rate against the dollar, and, in March and April, the higher excise duties announced in the Budget, have contributed to faster increases in wholesale and retail prices. Also important in the retail price index in April were rises in rates and local authority rents. On the other hand, reductions in mortgage rates in January and April partly offset other factors increasing the cost of housing; and the prices of clothing and footwear and durable household goods, have risen little, if at all, recently. The monthly increases in retail prices have, on the whole, continued to be less than they were twelve months earlier, so the year-on-year increase in prices has tended to fall—from over 15% in December to 12% in April.

Abroad, inflation remains around 10%

Consumer price inflation in other major industrial countries has on average remained a steady 10% or so in recent months (though once seasonal factors are taken into account the rate is currently slightly lower). External cost pressures have moderated: OPEC's contract prices have been fairly steady in dollar terms since the increases arising from the December meeting, while weak market conditions have forced reductions in producers' premiums and spot prices (though trading in the spot market has been thin). Following the OPEC meeting in May, official prices (except possibly those of Saudi Arabia) seem likely to remain steady for the rest of this year. Commodity prices have also fallen back in recent months, the *Economist* all-items dollar index (in part reflecting the dollar's strength) dropping in May to its lowest since 1979, mainly as a result of falling food prices.

Company profitability lower still, but financial position improves[1]

Real profitability *fell further in the second half of last year.*[a]



(a) Non-North Sea industrial and commercial companies.

There have been further falls in company profits and in the rate of return on capital as a result of falling output and trading conditions which have discouraged price increases. Excluding North Sea operations, the gross trading profits of industrial and commercial companies fell by almost 25% in the second half of last year. Because stock appreciation was much less in that period, gross trading profits net of stock appreciation fell only about half as much. Nevertheless, the decline in real profits is estimated to have approached 30%, taking the real rate of return[2] to barely 2% in the fourth quarter. This compares with over 5% in the recession of the mid-1970s and 10% or more for most of the 1960s.

Company interest payments were roughly unchanged between the first and second halves of last year, the effect of further growth in the stock of outstanding debt being broadly offset by the cuts in MLR in July and November; the subsequent reduction of two percentage points in MLR in the Budget should reduce interest payments by a further £$\frac{3}{4}$ billion a year. (These figures relate to all industrial and commercial companies, including their North Sea operations.) Nevertheless, income gearing—the ratio of interest payments to after-tax profits—rose to over 43% in the second half of 1980, because profits fell so sharply. A slight increase in dividend payments similarly resulted in a sharp rise in the share of dividends in profits.

Despite reduced profits and increased appropriations, companies' financial deficit was reduced by £$\frac{1}{2}$ billion in the second half of the year, and indeed was virtually eliminated in the fourth quarter. Companies slightly increased their spending on fixed capital assets, by about £0.2 billion at current prices between the two half years, but they reduced stocks by £2.8 billion in the second half, over £2.1 billion more than in the first. This reduction in stocks was the largest ever recorded, even allowing for inflation. A reduction in trade credit extended to other sectors and in investment abroad allowed companies to strengthen their liquidity position; although they continued to borrow, even in the fourth quarter, they did so far less than earlier in the year and added substantially to their holdings of liquid assets. The liquidity of a group of large companies sampled by the Department of Industry remained low

(1) The note on page 228 reviews developments over a longer period.
(2) The ratio of profits net of stock appreciation and capital consumption at replacement cost to the written-down value of capital employed at replacement cost. These figures are frequently subject to substantial revision. No allowance is made in this section for the effect of inflation in reducing the real value of companies' net monetary liabilities—see the note on page 232.

in the first quarter, although slightly better than in late 1974, and indeed deteriorated again outside the manufacturing sector; the April CBI survey (covering manufacturing industry) indicated only a small improvement in the year to October.

A current account surplus, accompanied by larger capital outflows, in the first quarter

Although the trade figures are incomplete, the substantial surplus on current account which emerged in the second half of last year must have continued into the first quarter of 1981. However, interest rate considerations and a continuing response to the end of exchange controls helped to induce a record capital outflow and there was little effect, on balance, on the sterling effective exchange rate.

The surplus on visible trade in January and February was estimated to be about £1 billion, seasonally adjusted. No trade figures are available for March. The surplus on invisibles rose by £0.3 billion to some £1 billion in the quarter as a whole, mainly because of refunds of over £0.5 billion from the European Community budget. The balance of interest, profits and dividends moved back into surplus as the earnings of UK oil companies overseas recovered; the impact of the supplementary petroleum duty, effective from the beginning of the year, largely offset the increase in offshore earnings of foreign oil companies in the United Kingdom.

Balance of payments

£ billions; *not seasonally adjusted*

	1979	1980			1981
	Year	Year	Q3	Q4	Q1
Current balance	−1.4	+2.8	+0.9	+1.9	..(a)
Investment and other capital transactions					
Overseas investment in UK public and banking sectors	+4.2	+4.2	+1.2	+0.4	+0.5
Overseas investment in UK private sector	+3.4	+3.3	+0.7	+1.2	+0.7
Banks' net position in overseas currencies	+1.6	+2.1	+0.6	+0.4	−0.6
UK private investment abroad:					
Direct (including oil)	−5.7	−3.9	−0.5	−0.7	−0.6
Portfolio	−0.9	−3.0	−1.0	−1.1	−1.2
Other identified capital flows	−1.1	−3.5	−1.2	−0.5	−1.4
Balancing item	+1.6	−0.7	−0.7	−1.4	..

.. not available.

(a) The surplus on visible trade in January and February is estimated at about £0.8 billion; the surplus on invisibles in the whole of the first quarter is also put at about £0.8 billion.

When full current account details become available, therefore, they will no doubt show a sizable surplus in the first quarter. At the same time, identified capital outflows, at £2.6 billion, were the largest ever recorded. According to highly provisional estimates, portfolio investment abroad was in excess of £1.1 billion for the second quarter in succession. Direct investment abroad and investment by oil companies were together no more than in the previous quarter, but banks contributed to the outflow by reducing their net external liabilities in overseas currencies, in part as they on-lent to overseas residents the substantially increased foreign currency holdings of UK residents. The banks also continued to lend heavily abroad in sterling. Overseas investment in the United Kingdom slackened; in particular, foreign official and private holdings of sterling bank deposits, government debt and money-market instruments increased by £0.5 billion, a much lower rate than in most of 1979 and 1980.

There was a modest increase in the official reserves. On average, sterling was just over 1% higher in the first quarter than in the previous three months, though it ended the period 5% below its recent peak (late January). It fell more sharply against the dollar, being at an interest rate disadvantage throughout the quarter.

Shifts in world payments positions during 1980 . . .

The current account surplus of the oil-exporting countries declined rapidly during 1980, although in the year as a whole it was much larger than in 1979. They imported more, and the volume of their exports fell dramatically because of weak oil demand and, towards the end of the years, the war between Iran and Iraq. The main counterpart to the falling surplus of the oil exporters was an improvement of $22 billion in the current account surplus of major OECD countries between the two halves of the year. Falling import volumes accounted for most of the improvement,

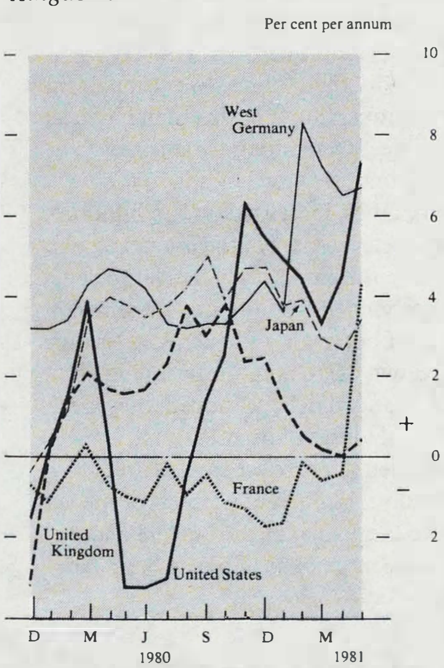
Current balances[a]

$ billions; *seasonally adjusted*

	1979 Year	1980 Year	H1	H2
United States	− 0.8	0.1	− 5.0	5.1
Canada	− 4.3	− 1.4	− 1.7	0.3
France	1.1	− 7.4	− 3.9	− 3.5
Italy	5.1	− 9.9	− 3.4	− 6.5
Japan	− 8.8	− 10.8	− 9.1	− 1.7
West Germany	− 5.2	− 15.9	− 7.2	− 8.7
Six major overseas countries	− 12.9	− 45.3	− 30.3	− 15.0
United Kingdom	− 3.4	6.6	—	6.6
Other OECD	− 18.8	− 37.0	− 18.0	− 19.0
OECD	− 35.1	− 75.7	− 48.3	− 27.4
Oil-exporting countries	66	106	62	44
Other developing countries	− 41	− 64	− 32	− 32

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

Real interest rates *have risen abroad, in contrast to the United Kingdom.*[a]



(a) End-month nominal three-month interest rates deflated by the expected rate of inflation as proxied by the change in consumer prices in the preceding and subsequent half years (including forecasts for the latest observations).

Growth of various monetary aggregates

Percentages; *seasonally adjusted*

	Jan. 1981– Apr. 1981	Feb. 1980– Apr. 1981(a)
Notes and coin in circulation	2.1	6.8
M_1	5.8	11.4
Sterling M_3	3.0	18.5(b)
M_3	4.9	21.0
PSL_1	2.9	15.7
PSL_2	3.5	13.9

(a) At an annual rate.

(b) 15½%–16%, adjusted for the estimated distortion during the period arising from the abolition of the 'corset'. No adjustment is made for the effect of the Civil Service pay dispute.

notably in the United States and the United Kingdom. Only Japan and, to a lesser extent, Canada achieved any export growth.

There was a marked redistribution of current account positions among the major economies. The United States, Japan, Canada and the United Kingdom all recorded substantial improvements between the two halves of 1980, whereas the major continental European economies remained in deep deficit throughout the year. These developments reflect the varying degrees of recession in different countries, as well as the cumulative effects of changes in competitiveness and other factors: for example the large UK surplus which emerged in the second half of 1980 was largely due to the severity of the UK recession relative to other countries. With activity depressed in the major industrialised countries, the smaller OECD countries remained in large deficit. The developing countries' deficit also remained large, with imports holding up.

... with pressure on money and exchange markets

In early 1980, current account positions had been financed without great difficulty. The position may have been helped by the fact that the counterpart deficits to the OPEC surplus had been evenly spread; that economic policies were relatively synchronised; and that many countries had absorbed the initial deterioration in their current account positions through reserve movements.

Around the middle of the year, however, signs of greater strain began to appear. A significant factor was the redistribution of current account balances, already noted, in favour of a small number of industrial countries. There was a reduction in the use of official reserves, and many countries sought to generate capital inflows, provoking a combination of higher interest rates, large-scale borrowing and exchange rate changes; the dollar, with US interest rates rising for domestic reasons, generally strengthened. Some of these pressures have intensified this year so that, by May, real interest rates in France, West Germany and the United States were much higher than they had been a year earlier; the United Kingdom stands in sharp contrast, a fact which may account for some of the recent pressure on sterling.

Monetary developments at home

Experience in the last target period has been discussed in previous *Bulletins*. Nevertheless, as the complete figures are now available, a brief account is presented here as a background to developments in the first few months of the current target period. So far, it appears that—after allowance for distortions arising from the Civil Service pay dispute—the growth of sterling M_3 has been within the new target range of 6%–10% (annual rate).

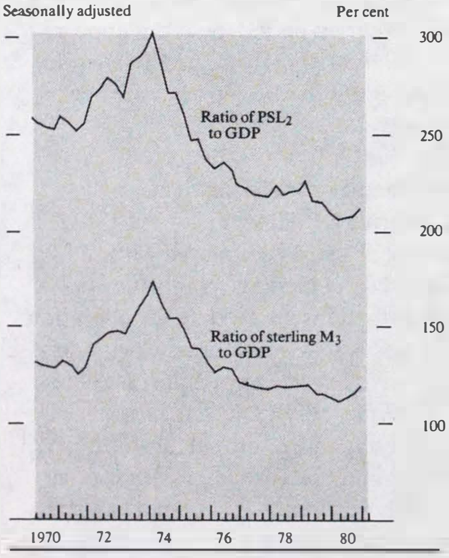
Target overshot last year but monetary conditions tight

In the last target period (mid-February 1980 to mid-April 1981) sterling M_3 grew at an annual rate of 18½%, compared with the target of 7%–11%. Of this, some 2–3 percentage points may be attributed to the unwinding of distortions induced by the operation of the supplementary special deposits scheme before the beginning of the period. Furthermore, the Civil Service pay dispute inflated the money supply at the end of the period. But even if allowance is made for these factors, the underlying rate of growth of sterling M_3 must be put at around 15% per annum. Recorded growth was very rapid during the summer and early autumn; but subsequently it grew at a rate consistent with the target range.

Despite the overshooting of the target, monetary conditions must be judged to have been tight throughout the period. The authorities did not, therefore, raise interest rates; indeed, they reduced them. To explain why monetary growth was so rapid in this period two rather different considerations may be adduced. The first is to examine the strength of demand for bank finance in the widest sense and the banks' willingness to satisfy it: in effect, this seeks to explain why the assets side of the banks' balance sheets grew so much faster than expected. A general qualification must be made: the increase in any credit counterpart to the growth in money supply will tend to be offset in greater or lesser degree by changes in other counterparts and to that extent will not be reflected in sterling M_3. The second approach is to explain the strength of the demand for deposits. The two approaches overlap. For example, a larger public sector borrowing requirement (PSBR) or a balance of payments surplus may add to the private sector's demand for bank deposits in the process of adding to holdings of financial assets generally. Nevertheless, it may be useful to consider the influences separately.

Subject to the qualification noted above, unexpectedly strong growth in various of the counterparts contributed to the rapid growth of sterling M_3. The first was that the PSBR, at over £13 billion, was some £5 billion more than forecast—although the non-bank private sector financed much more of this than had been expected. The borrowing was concentrated in the first three quarters of the financial year. Second, sterling lending to the private sector, most of it to companies, increased by £9½ billion, much more than expected. In the earlier part of the financial year, companies borrowed heavily from the banks: they had large deficits to finance, and raising money by bond and equity issues seemed unattractive. By the autumn, their borrowing slackened as savings achieved through the running down of stocks and the laying off of labour almost eliminated their financial deficit. Indeed, they were able to add substantially to their holdings of liquid assets. The personal sector, however, continued to borrow heavily from the banks throughout the year. Finally, the current account of the balance of payments moved into large surplus during 1980, and external influences on money were more expansionary than had been foreseen.

The rise in the **ratio of liquid assets to GDP** *last year was from a low point.*



But there was also strong demand to hold bank deposits. Companies and the personal sector each appeared keen to build up their financial assets. Persons were, perhaps, anxious to repair the losses caused by inflation; companies may have wanted to build a reserve. In early 1980, the ratio of sterling M_3 to the money value of GDP was lower than at any time in the 1970s and only two thirds of its peak in 1974. Starting from this low point, the ratio has grown by about 6% in the last year.

In face of such developments, the authorities vigorously maintained sales of gilt-edged stocks; and investment in the various forms of national savings was encouraged, notably by making index-linked certificates more widely available. For several reasons, minimum lending rate (MLR) was not increased, and was in fact reduced on three occasions. Sterling M_3 was expanding much faster than M_1 and notes and coin in circulation with the public; and was also growing more quickly than other wider aggregates of money and liquidity. Other developments indicated that monetary policy was tight: sterling was very strong; real short-term interest rates, on any measure, had become high; and many companies were under severe financial pressure. Perhaps most important of all, the rate of inflation was falling faster than had been expected.

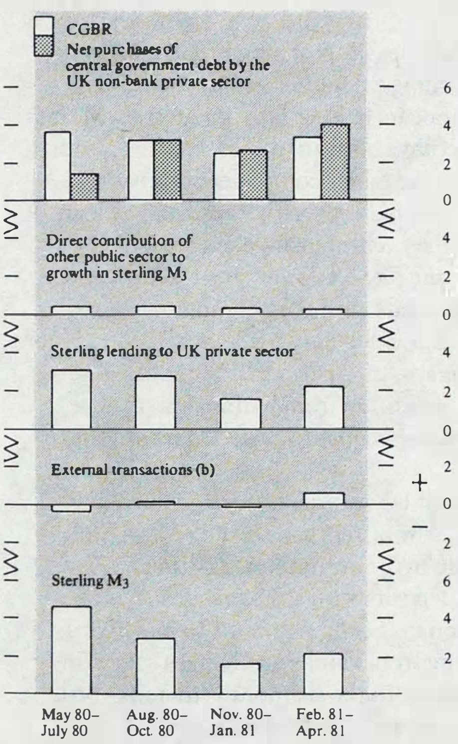
Given the decisions about MLR, the authorities took steps to alleviate reserve asset shortages, particularly when more funds were absorbed by debt sales to non-banks than were being injected into the system by the PSBR, thereby over-funding the borrowing requirement. If such shortages had not been offset, they could have put upward pressure on some money-market interest rates, widening the gap between rates related to the banks' base rates (and so, under present arrangements, to MLR) and other rates, thus further inflating, in the short run, bank lending and sterling M_3.

Underlying monetary growth in recent months probably within target range

Sterling M_3 grew faster in the three months to mid-April than in the previous three months—as also did the other measures of money and private sector liquidity. But the figures for March and, more particularly, April were inflated by the effects of the Civil Service dispute: tax cheques were not paid in, which inflated public borrowing but also allowed potential taxpayers to reduce their borrowing from the banks. After allowing for this, it seems that sterling M_3 grew within the new target range of 6%–10% (at an annual rate). The effects of the pay dispute will continue to obscure the underlying position for some time, even if the dispute is settled soon.

Effects of the Civil Service pay dispute added to the growth of **sterling M_3** *in March and (especially) April.* [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.

The dispute is thought to have added over £$1\frac{1}{2}$ billion to the central government borrowing requirement (CGBR) in the three months, most of it in banking April, and this more than accounted for the (seasonally adjusted) increase in the CGBR compared with the previous three months.[1] But it cannot be concluded that sterling M_3 was similarly inflated. Although much of the money that would normally have been paid to the Exchequer will have remained in bank deposits—as seems to be confirmed by the sharp rise in sight deposits—some of the tax payments would probably have been financed by bank lending, which may therefore have been lower than it would otherwise have been. There may also have been other offsets to the enlarged CGBR: for example, the delayed payment of taxes may have influenced external flows and their effect on the money supply.

But for the Civil Service pay dispute, the increase in sterling lending to the private sector would therefore probably have been even larger than the recorded growth (of over £2 billion) in the three months. On balance, the underlying growth of lending in sterling to the private sector in March and April could have been up to £$\frac{3}{4}$ billion a month, considerably more than the estimated growth in the closing months of last year, although less than earlier in 1980. Slower declines in holdings of stocks, and in output, may have been an influence.

The sectoral analysis of bank lending in sterling to the private sector in the first quarter of the year (see Table 6 in the statistical annex) shows that about half of the total rise of £2.8 billion went to the personal sector. Much of this was lent to unincorporated businesses and for house purchase, but there was still an unusually

(1) See also the article on seasonal adjustment on page 200.

large rise, of about £0.6 billion, in lending to individuals for other purposes, probably mostly for consumption. Bank lending to the personal sector has grown by about 30% in the last year.

The non-bank private sector acquired £4 billion of central government debt in the latest three months, compared with £2.6 billion in the previous period. Sales of gilt-edged stocks, which were especially heavy following the Budget, raised £2.5 billion net (£0.6 billion being provided by the first two calls on the index-linked issue). National savings contributed £1.3 billion, in the process exceeding the Government's target of £2 billion for 1980/81 as a whole.

The effect of external transactions on the money stock was very small. It was expansionary in the three months as a whole, but contractionary in banking April, and the figures imply that the private sector's balance of payments surplus on current and capital account, which had been very large in previous months, was eliminated. (In the absence of trade statistics, there is no indication of the split between the current and capital accounts, which the money figures alone do not provide.) UK residents added further to their holdings of foreign currency deposits.

Like sterling M_3, all the other measures of money and private sector liquidity were also to some extent inflated by the Civil Service dispute. The effect appears to have been greatest on M_1, but lower interest rates may also have been an influence. The growth in notes and coin in circulation, the major component of a wide definition of the monetary base, may be partly explained by fears of a bank strike; but some of it may reflect insufficient seasonal adjustment, the April reporting day being very near to the Easter holiday. Slower growth in deposits with the building societies restricted the increase in PSL_2 (which nevertheless expanded faster than sterling M_3 in the January–April period). The building societies were affected by competition from national savings, particularly savings certificates (which are excluded from PSL_2).

The continued rapid growth of UK residents' foreign currency deposits caused total M_3 to grow faster than sterling M_3 in each month, as it had started to do in the autumn. Altogether, UK residents' foreign currency deposits with the banks rose by the equivalent of over £1.5 billion in the three months to mid-April, about half the increase arising from valuation changes as sterling weakened against the US dollar. In the six months to mid-April, foreign currency deposits rose by £2.7 billion — over 50%.

Preliminary indications suggest that sterling M_3 grew about $1\frac{1}{2}$% in banking May; some $\frac{3}{4}$%–1% may perhaps be ascribed to the effects of the Civil Service pay dispute.

Assessment

Last year the combination of still rapid pay rises, together with the stronger exchange rate, produced various distortions as between different sectors of the economy. This assessment comments on the next stages in the process of reducing inflation, and on the stance of monetary policy.

The effect of inflation on the balance of the economy

The rise in the exchange rate last year, partly as a result of developments in the world oil situation, in itself helped to reduce inflation; but rapid pay rises continued throughout the 1979/80 pay round. The combination of a substantial rise in internal costs with an appreciating exchange rate led to a marked decline in competitiveness.

The effective exchange rate rose 10% in the course of 1979; and another 13% in the course of 1980[1]—a rise which has now in part been reversed by the fall in the exchange rate this year. There are in general reasons to expect depreciation, over a period of time, to go with faster-than-average inflation; and appreciation with slower inflation. If that happens, changes in the external value of a currency, and in internal costs and prices, tend to offset each other; competitiveness, or the real exchange rate—the product of the two—is less affected. In contrast, what happened in this country was that until recently, despite the exchange rate appreciation, domestic wage costs continued to grow more rapidly than in other countries.

In the last two years, labour costs in the United Kingdom have risen almost 40%. Those in her main competitors have risen on average by only 12%, so that relative labour costs rose by almost 25% to the United Kingdom's disadvantage.[2] In combination with the accompanying rise in the nominal exchange rate, the real exchange rate thus rose (and competitiveness worsened) sharply—by some 20% in 1979, if such a measure is to be believed, and by even more last year.[3] In the last decade there have been significant changes in real exchange rates—larger, indeed, and more lasting than general presumptions would lead one to expect. Among these, the rise in the real exchange rate of the United Kingdom in recent years stands out as the largest.

Looked at from the domestic point of view, this process has helped to distort the balance between sectors—against industry and in favour of consumers. Companies, notwithstanding the benefit of cheaper imported materials, have not been able to maintain profits in face of recession and their less competitive structure of costs; in the last three years profitability in general[4] has fallen from 6% to barely 2% in inflation-adjusted terms, and a number of manufacturing firms have reported losses in their most recent accounts. This has compelled adjustments which, while improving productivity, have reduced employment.

Consumer prices in general have been kept down by the rise in the exchange rate while wage earnings in industry have increased considerably faster. Between spring 1978 and the end of last year real earnings of those in work rose by some 7%. This situation and the increased resistance of employers to high wage claims must be among the factors which have produced greater moderation in the current pay round.

Weaker competitiveness has not been the only factor behind the recession; but its effects on external trade must already have been helping to reduce output last year. This does no more than reflect the fact that many companies had difficulty in selling exports

(1) Changes between fourth quarters.
(2) Change in normalised unit labour costs in domestic currencies, as estimated by the IMF, from fourth quarter 1978 to fourth quarter 1980.
(3) Changes between fourth quarters in labour costs converted into a common currency.
(4) Industrial and commercial companies excluding their North Sea activitity.

abroad or selling at home in competition with imports. Firms are likely to continue to find it difficult to maintain their position unless they can make themselves substantially more competitive; and they will thus have a powerful incentive to do so.

Several other countries seem to have found that they can adapt to an appreciating real exchange rate; not all the loss of competitiveness needs to be reversed. Even partial reversal would plainly require a change in trend, either as regards productivity or the scale of pay increases or a combination of these. Output per head in this country is only two thirds that of competing countries, and the loss of competitiveness could over time be made good by closing this gap—that is, by a growth of productivity faster than elsewhere. But the change which might produce larger or faster gains would be a slower growth of earnings than in competing countries; in recent years, as already noted, wage earnings in this country have, on the contrary, been growing much more rapidly than elsewhere. In many cases sustained improvement could require that for a number of years wage awards are negligible, except where wage increases come out of higher productivity.

In this situation, adjustment of the exchange rate may appear to offer an easier solution. But competitive advantage obtained by exchange rate depreciation tends to be eroded by reason of the inflationary impulse which depreciation gives to domestic costs: only if wages fail to accelerate, despite the faster rise in retail prices, can the competitive advantage be preserved. The substance of the problem thus remains. The solution—both for firms, and for the economy as a whole—must be to do better than competing countries for a number of years rather than continue to do worse. The situation may be one which only firms themselves can remedy—though it is proper for them to get support in the form of a determined stand on public sector pay.

Already, significant progress has been made. The rise of prices has slowed down. Wage earnings in this round are rising only half as fast as in the previous one. There are indications that productivity has been increased in many firms; and available figures for manufacturing as a whole suggest that output per man-hour, despite the depth of the recession, is starting to rise. This probably means that in the course of the last year the competitive position *vis-à-vis* other countries has at least ceased to deteriorate, and may already have started to improve. The probability must be that companies will continue to make great efforts to improve their competitive position.

The position of monetary policy

It is now widely accepted that last year, despite the overshooting of the sterling M_3 target, monetary conditions were tight; and something of the same sort applies to fiscal policy. For a number of years, the PSBR has tended to increase less rapidly than nominal GDP, so that as a ratio to GDP the PSBR has been falling. Last year the PSBR was much higher than intended. But if the effects of recession on government revenues and spending are excluded, the PSBR as a ratio to GDP would have continued to fall—so that in this sense fiscal policy was stricter than appeared.

The way that financial conditions affected the economy can be illustrated by the changes that have occurred in the financial surpluses or deficits of different sectors. For much of last year industrial and commercial companies were in large financial

Financial surpluses and deficits[a]

£ billions
Surplus + /deficit −

	Public sector	Personal sector	Industrial and commercial companies		Overseas sector(c)
			All	Excluding North Sea operations(b)	
1978	−8.1	+ 8.7	−0.1	+0.5	−0.7
1979	−8.3	+11.6	−4.4	−5.0	+1.6
1980 Q1	−1.8	+ 2.4	−0.5	−0.8	−0.1
Q2	−3.1	+ 4.1	−1.2	−1.2	+0.1
Q3	−3.4	+ 5.0	−1.1	−1.1	−0.9
Q4	−2.8	+ 5.0	−0.1	−0.2	−1.9

(a) Financial companies and institutions and the residual error are omitted.
(b) Estimates.
(c) A minus sign means a surplus in the UK current account balance of payments.

deficit. This went along with the large and growing surplus for the personal sector, reflecting high saving out of high real incomes; and against this, the large public sector deficit. By the fourth quarter of last year there had been a large shift of balance. Companies had by then greatly improved their cash position, despite the decline in output, through strict pruning of stocks, employment and fixed investment—as well as benefitting from lower interest rates. The main counterpart was seen in the balance of payments, which swung into huge current surplus—as a result largely of the fall in imports induced by companies cutting back stocks; and in the second half of the year the personal sector surplus also rose. The stronger financial position of companies could underlie some of the more confident tone displayed by industry in recent months.

The Budget aimed to create conditions in which inflation could be further moderated: at the same time the pressures on the corporate sector could be somewhat eased. As a result of the tax increases and the resulting reduction of the borrowing requirement, interest rates were able to be reduced. The reduction of MLR at the time of the Budget must have helped to ease somewhat the financial pressures on industry resulting from continued recession.

Since the Budget there has been a steep rise in international interest rates. Higher interest rates in the United States have posed awkward problems for some other countries—more especially those with relatively low inflation rates but large current account deficits to finance.[1] Though the sterling exchange rate has declined recently, the United Kingdom has been relatively insulated from these pressures, by the strong current account performance and by the benefits of North Sea oil.

Since last autumn, the growth of sterling M_3 has decelerated. The slowdown in the growth of bank lending apparent around the turn of the year may have been checked; but sales both of government stock and national savings investments have been well maintained. The dispute with the Civil Service unions is now causing interruption to the flow of tax receipts—essentially a postponement, not a loss, of tax revenue—so that the CGBR has been artificially very large. This has obscured the underlying trend in the first three months, mid-February to mid-May, of the current target period; present indications are, however, that, but for these distortions, the growth of sterling M_3 in the target period so far would have been within the 6%–10% target range.

(1) See the Governor's speech on the world economy, reproduced on page 245.