Economic commentary

This review describes the course of the economy and the main features of the monetary situation this year.

- *Manufacturing output rose in the third quarter; the slight increase in total output was the first for eighteen months (page 454).*

- *The impetus came from the behaviour of stocks, where the reduction seems to have been much less than in previous quarters (page 457). Otherwise, domestic demand remained weak.*

- *Imports grew much faster than exports: import penetration increased and, on any but a short comparison, the UK share in export markets has fallen. In both cases the deterioration probably reflects the earlier erosion of competitiveness (page 457).*

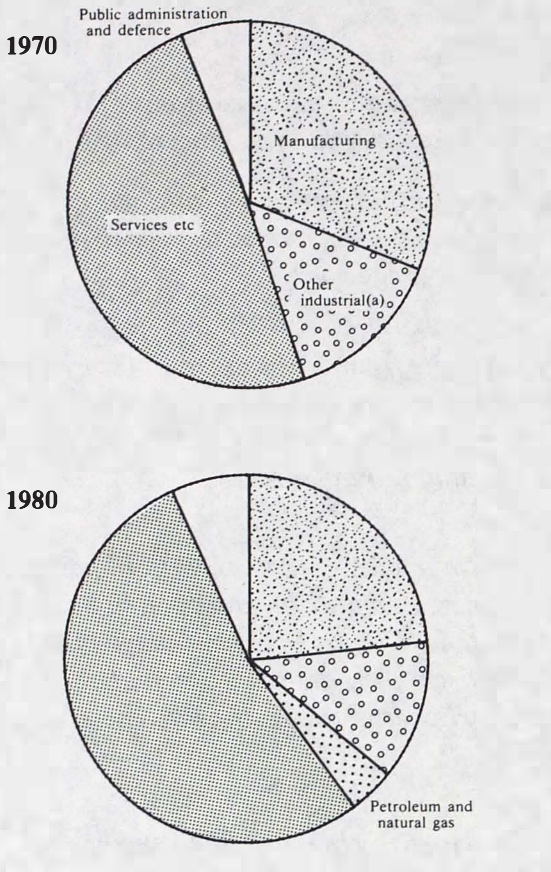
- *This year, productivity in manufacturing has increased substantially; unit labour costs have been fairly stable; and, helped by the decline in the exchange rate, competitiveness has improved (page 459).*

- *Higher fuel and materials prices have been an unwelcome effect of the decline in the exchange rate. Despite the restraining influence of labour costs, inflation has quickened somewhat (page 459). Most pay awards in the wage round so far have been moderate (page 458).*

- *The run-down of stocks and the delay in tax payments during the Civil Service dispute improved the financial position of companies in the first half-year. But these effects were temporary: companies' liquidity position could now be worsening (page 460).*

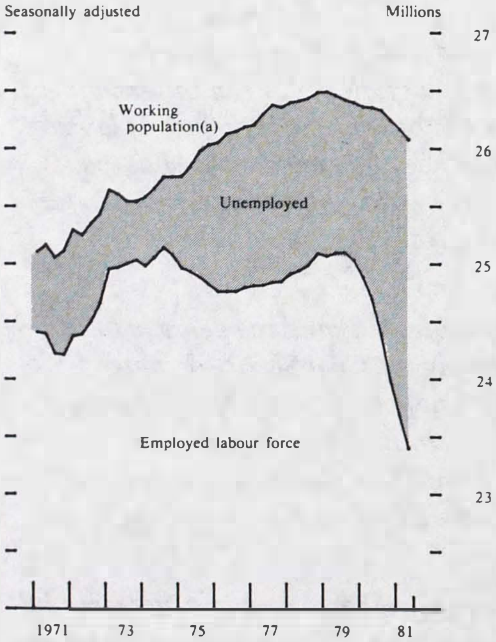
- *Though government borrowing was increased by the interruption to tax payments, this effect is now being reversed. The underlying pressure for monetary expansion is coming from bank lending to the private sector (page 463).*

The **share of manufacturing in total output** *fell to less than 25% during the 1970s.*



(a) Including agriculture.

Employment *fell by 1¾ million in the two years to June.*



(a) Employed labour force and those registered as unemployed.

Some recovery in output . . .

After declining by 1%–1½% a quarter in 1980, and a further 1% in the first half of this year, total output increased by ¼% in the third quarter. The improvement was most marked in manufacturing industry, where production rose by 1½% after six quarters of decline. But industrialists remain cautious: respondents to the CBI Quarterly Industrial Trends Survey in October[1] did not on balance expect to produce more for domestic markets in the ensuing four months, although they did expect to export more.

Outside manufacturing industry (which now accounts for less than a quarter of GDP) the pattern of production was uneven in the third quarter: construction remained depressed; the output of public utilities (gas, water and electricity) declined; oil and gas extraction was little changed; and non-industrial output fell.

The recent upturn in manufacturing production leaves it no greater than fifteen years ago and 14% below the average in 1979. GDP as a whole, as measured by output, was 5¾% below the 1979 average in the third quarter.

. . . reflected in the labour market

The labour market has in many respects reflected the levelling out or small upturn in activity:

- Total employment fell a little more slowly between the first and second quarters.
- In the third quarter, the decline in employment in manufacturing industry slowed down further, and the rise in unemployment was half what it had been at the beginning of the year.
- There has been a marked reduction in short-time working and an increase in overtime.
- Vacancies, though still few, were the most for a year in November.

Nevertheless, the decline in employment and the increase in unemployment remain large.

Total employment fell by 284,000 in the second quarter, against 306,000 in the first. In June this year, 1.7 million (7½%) fewer people were employed than two years earlier. Much of the reduction occurred in manufacturing industry, but jobs in the service sector have also been lost after a decade of growth. In the present recession, employment has fallen much more in relation to the reduction in output than it did in the mid-1970s. (The correspondingly better performance of productivity in manufacturing industry is discussed on page 459.)

In the third quarter, the reduction in the number of jobs in industry slowed down further; in manufacturing, overtime increased and short-time working became less widespread. In September, short-time working was barely one quarter as much as in the first quarter, and 20% more hours of overtime were worked. Unemployment increased in the third quarter by around 40,000 a month, compared with 57,000 a month in the second quarter and 81,000 a month in the first. By November, unemployment, seasonally adjusted and excluding school leavers, had reached 2¾ million (11.4%).

(1) Over 1,750 firms in manufacturing industry, employing about half the labour force in the sector.

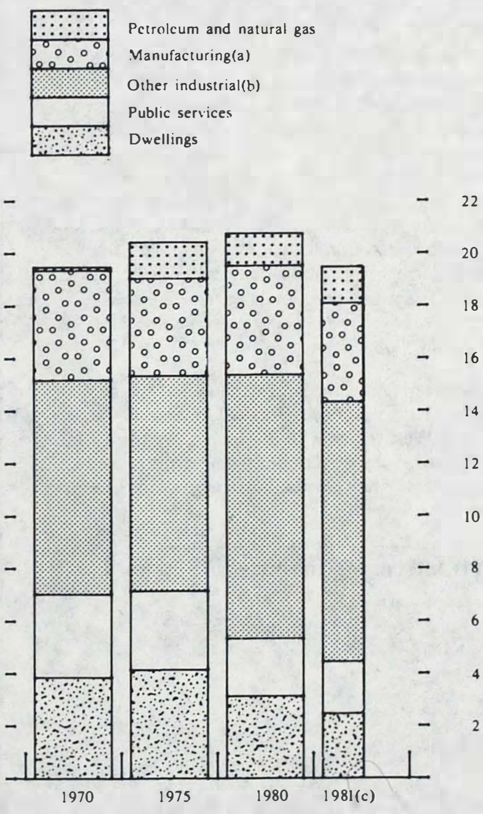
Employment and output

Percentage changes

	Last recession 1974Q3–1975Q3	This recession 1979 (average)–1981Q2
Employment:		
Manufacturing(a)	– 5.8	–14.8
Whole economy	– 1.0	– 7.4
Output:		
Manufacturing	–10.8	–16.1
GDP (output measure)	– 3.9	– 6.0

(a) Great Britain.

The share of **public service and housing investment** *has declined sharply.*



(a) Including assets leased.
(b) Other than manufacturing and oil and gas: includes agriculture.
(c) First half at an annual rate.

Industrial fixed investment

£ millions, 1975 prices; *seasonally adjusted*

	Quarterly rates				
	1979	1980		1981	
	Year	H1	H2	H1	Q3
Manufacturing	990	940	850	770	730
Distribution and services	1,470	1,570	1,660	1,630	1,710

The fall in employment over the last two years has coincided with a sharp reduction in industrial stoppages. The number of days lost in January–October was the lowest in any comparable period since 1967, with the exception of 1976.

Demand slightly stronger[1]

Because the overseas trade figures are incomplete, and some other components are not yet available for the third quarter, the changes in demand which have brought about the slight recovery of output cannot be identified fully. But the expansion seems to have derived from slower reductions in stocks; other elements in demand identified so far have remained weak.

Consumer spending

Until recently, consumer spending was one of the stronger components of demand; in the first quarter of this year it was $\frac{3}{4}$% higher than the average in 1979. The growth reflected earlier increases in real personal disposable income (RPDI), which in the second half of 1980 was 2% higher than in 1979. The saving ratio—the ratio of savings to personal disposable income—had risen from 14$\frac{3}{4}$% to an unusually high 16$\frac{1}{2}$%, before falling to 14$\frac{1}{2}$% in the first quarter of 1981.

In the first half of this year, however, RPDI fell. Among the influences were declining employment; the slower growth of average earnings in relation to consumer prices; and tax changes and increases in national insurance contributions implemented after the March Budget. Consumer spending fell slowly in the second and third quarters, and the saving ratio declined to about 12$\frac{1}{2}$% in the second quarter—low by the experience of the last three or four years, though not by earlier standards. The probable small rise in RPDI in the third quarter owed much to the timing of pay increases (including back pay when the Civil Service dispute ended) and is unlikely to be sustained.

Borrowing to finance consumption has increased very fast this year—see page 463. The effect of borrowing to sustain spending is to reduce the saving ratio without causing gross holdings of financial assets to be drawn down.

Fixed investment

Industrial investment[2] increased by $\frac{3}{4}$% in the third quarter; the pattern—growth in distribution and service industries (3$\frac{1}{4}$%) and a fall in manufacturing (4$\frac{1}{2}$%)—was similar to that in the previous quarter.

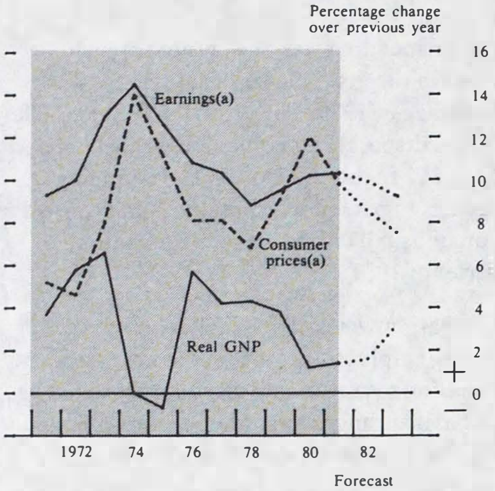
In these figures, assets leased by manufacturers from the service sector are included in investment by service industries, in which they form an important element. Tax considerations favour leasing: many manufacturing companies have insufficient profits to take full advantage of capital allowances if they buy assets, while leasing companies have profits against which their expenditure on capital assets can be set. Competition in the leasing business has reduced profit margins, and a manufacturing company that does not have sufficient profits may be able to borrow under a leasing arrangement at a cost no more than half that of market borrowing, merely by taking advantage of capital allowances received by the lessor.[3]

(1) Components of demand are expressed at 1975 prices.
(2) Investment by manufacturing, distribution and service industries.
(3) See 'Equipment leasing', in the September 1980 *Bulletin*, page 304.

World economic prospects

GNP growth in the major industrial economies [1] slowed sharply in the aftermath of the 1979 oil price increase, from about 4% a year in 1978 and 1979 to 1% or a little more in 1980 and 1981. The slowdown was less severe than after the 1973 rise in oil prices, but then the recession began from an exaggerated cyclical peak. The acceleration in inflation has also been less marked than in 1974/75, although in some countries, notably the United States, inflation rates have actually risen above the levels reached at that time. To the extent that the price response has been more restrained, the generally restrictive stance of fiscal and monetary policies this time may have helped, in particular by containing the reaction of nominal wages. But, at least in the short term, these policies have led to rises in real, as well as nominal, interest rates and have tended to reinforce the depressive effect of the oil price increase on domestic demand and activity.

GNP, earnings and prices in the major countries



(a) GNP weighted.

To some extent, the slackness of domestic demand in the *major countries* has been offset by a rise in exports to the oil exporters. For the future, domestic demand should begin to recover slowly as inflation eases and real incomes pick up, while the external stimulus from OPEC is likely to fade as oil revenues level off or even fall in real terms. GNP growth for the major countries together may reach 3% per annum by the second half of 1982 and through 1983—probably not enough to prevent a further rise in unemployment, at least until the end of next year.

The timing and strength of the recovery is likely to vary from country to country. *France* (partly because of the fiscal concessions introduced in mid-year) and *Japan* may lead the way, while the present weakness of consumer spending in the *United States* seems likely to continue into the middle of next year, when there could be a fairly vigorous, but perhaps rather uneven, revival. In *West Germany*, consumer spending should start to grow again during 1982 with, perhaps, faster growth during 1983. Other components of domestic demand are unlikely to be buoyant. Government spending in most countries is being held back by tight fiscal policy, and it would be surprising if companies' spending on fixed capital and inventories grew strongly in the face of sluggish activity and high interest rates.

Inflation may moderate only slowly over the next two years. Raw material and especially oil prices seem likely to remain weak; but inflationary experience is now well entrenched in many of the major countries and nominal pay increases could stay high. Furthermore, any benefit to unit costs from productivity improvements will probably be held back by the general slackness of activity (although this has not been the recent experience in the United Kingdom). The combination of some slight easing of inflation and continuing high pay settlements does, however, lie behind the limited recovery of domestic demand.

In the *rest of the OECD*, demand may be more subdued than in the major countries. In part, this stems from a similar emphasis on counter-inflationary policies. But for some of these countries, concern about the balance of payments and external financing is a more direct constraint. External financing is an even greater worry for many of the *less developed countries*, where the average rate of import volume growth in 1982 and 1983 may be no more than half what it was before the latest oil price increase.

World trade generally seems to have been recovering during 1981 from the exceptional contraction in the second half of last year, but even by 1983 it may scarcely have regained the rate of growth of the late 1970s. UK export markets have suffered less in the last year or two than world trade in general and may now pick up rather less.

World trade and UK export markets

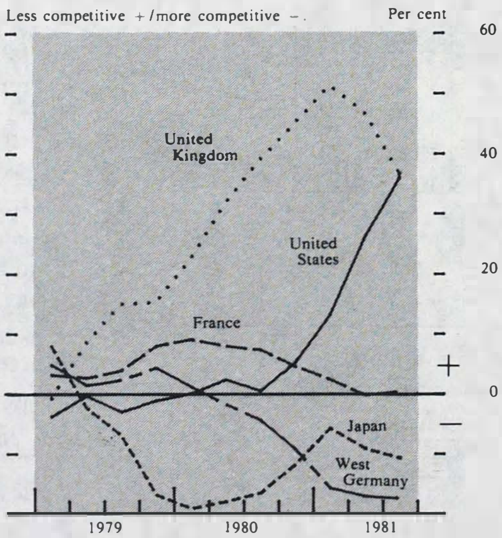
Percentage changes (volume)

	1979	1980	Forecasts 1981	1982	1983
World trade	+7	+1	—	+6	+6
UK export markets	+5	+3½	+1	+5	+5½
OECD	*+8¼*	*+ ¾*	*−2¾*	*+4½*	*+5½*
Other	*− ¼*	*+8¾*	*+8*	*+6½*	*+6*

While the aggregate volume of trade may grow steadily, if not very strongly, there are likely to be substantial shifts, both within the major country groupings and between them. The *oil exporters'* surplus has been contracting sharply, with oil export volume falling while import volume has grown rapidly. This will probably continue, and with some deterioration in the terms of trade could mean a current account surplus in 1982 less than half as large as in 1980. The main counterpart is likely to be a substantial improvement in the overall current account position of the *major industrial countries*, which in aggregate may be coming quite close to balance next year. Thereafter, however, a deficit could begin to re-appear as activity picks up. The *less developed countries* have collectively moved into a very large deficit since 1979, and this may persist in 1982 and 1983.

Within the major countries, significant swings in current account positions seem already to be in progress, with the US surplus disappearing, while both West Germany and Japan move from quite heavy deficit towards or into surplus. The chart shows the present pattern of competitiveness; the movements have been so marked that current accounts may well 'overshoot'.

Deviations from trend competitiveness(a)



(a) Based on relative normalised unit labour costs (NULC): trends estimated 1961 Q1 to 1980 Q4.

Demand and output in the major countries

Percentage changes (volume)

	1979	1980	Forecasts 1981	1982	1983
GNP	+3¾	+1	+1½	+1½	+3
Of which:					
Domestic demand	*+4*	*+ ¼*	*+ ¾*	*+2*	*+3*
Net external demand	*− ¼*	*+ ¾*	*+ ¾*	*− ½*	*—*

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

Changes in stocks

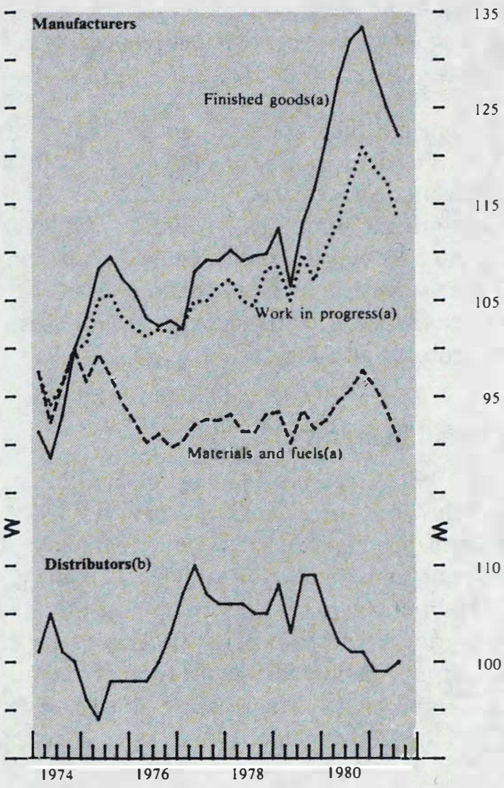
£ millions, 1975 prices; *seasonally adjusted*

	1980		1981		
	H1	H2	Q1	Q2	Q3
Manufacturing	−230	−1,020	−520	−380	−160
Distribution	−420	− 210	+120	−180	− 10
Other	+170	− 260	−450	−320	..
Total	−480	−1,490	−850	−880	..

.. not available.

Manufacturers' stocks of finished goods *still look high.*

Seasonally adjusted 1974 Q4 = 100



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

Within a broadly unchanged total of fixed investment in the economy, the share of investment in public services and housebuilding has fallen substantially in recent years—indeed, investment in these two categories in the second quarter of this year was the lowest since at least the early 1960s. The number of houses under construction declined again in the third quarter, although more new starts indicate some revival in activity. (Mortgage lending is discussed on page 463.)

Stocks

To judge from provisional figures for manufacturing and distribution (where stocks fell by £170 million), stocks declined further in the third quarter, but at a far slower rate than previously. Manufacturers' stocks of finished goods were unchanged, but they reduced their stocks of fuel and materials, and work-in-progress; there was little net change in stocks held by distributors. The CBI survey (confined to manufacturing industry) pointed to further reductions in stocks in the coming months, although at a slower rate than earlier in the year.

Since the beginning of 1980, manufacturers' and distributors' stocks have fallen by £3 billion (at 1975 prices)—over 10% of their initial level, and a fall twice as sharp as that in 1975. Nevertheless by past standards manufacturers' stocks—especially of finished goods—were still high in the third quarter in relation to output. For distributors, the ratio of stocks to sales was rather low, although high real interest rates may induce further reductions.

Trade

The Civil Service pay dispute held up the compilation of trade figures after February. Full figures have now been published for September and October, and imports for March and April are also available.

The quality of the new data is uncertain. In any case, interpretation of figures for the two recent months without details for the intervening period is hazardous. Nevertheless, it may be useful to place the new information in context.

In the second half of 1980, visible trade moved into very substantial surplus—£1$\frac{1}{4}$ billion in the fourth quarter compared with a deficit of £$\frac{3}{4}$ billion a year earlier. The most important influence was the much deeper recession in the United Kingdom than overseas—in particular, the sharp reduction in stocks—which masked the adverse effects of weak competitiveness. The counterpart of worse competitiveness was a rise in the non-oil terms of trade which, by itself, added to the surplus. Finally, the balance of trade in oil improved by £0.4 billion between the fourth quarters of 1979 and 1980. In January and February of this year, visible trade continued in substantial surplus.

Previous issues of the *Bulletin* suggested that these surpluses were exceptional, because weak competitiveness would restrict the volume of exports (although not perhaps to their level at the turn of the year, when they were surprisingly low), and because the volume of imports would rebound once the rundown of stocks had abated. Slower inflation in the United Kingdom, together with the decline in sterling, was expected to weaken the terms of trade.

The September and October trade figures were broadly in line with these expectations. The surplus on visible trade was much reduced; indeed, the non-oil account was back in deficit. The main reason for

UK trade

	1979	1980		1981	
	Year	H1	H2	Jan.–Feb.(a)	Sept.–Oct.(b)
Visible trade (1975=100)					
Volume (excluding oil and erratic items):					
Exports	119	122	118	113	119
Imports	142	141	129	122	148
Terms of trade (unit values, excluding oil)	108	109	115	117	114
Balance in goods and services (£ millions; 1975 prices; quarterly rate)	−550	−400	—	+400(c)	−600(c)

(a) 1st quarter figures, where available.
(b) 3rd quarter figures, where available, or September-October at a quarterly rate.
(c) Bank estimates.

the deterioration was a rise in non-oil imports—21% higher (in volume) than the average in the first four months of the year; imports of manufactured goods (excluding erratic items) rose by about 25%. The volume of non-oil exports was $5\frac{1}{4}$ % higher in the autumn than in January and February, with manufactured exports (excluding erratic items) rising by 12%. The terms of trade (excluding oil) fell by $2\frac{1}{2}$%.

The early months of this year provide an insecure base for comparison. Over a longer period, the volume of exports (excluding oil and erratic items) has been little changed, although world trade has increased. The corresponding volume of imports, by contrast, has grown despite the weakness of domestic demand. At the same time, the balance of trade in services has tended to deteriorate in volume terms.

As a result of these developments, the volume of trade in goods and services deteriorated from balance in the second half of 1980 to a deficit in excess of £0.6 billion at a quarterly rate in the autumn—the change amounting to some $2\frac{1}{2}$% of quarterly GDP. To this extent, imports were satisfying domestic demand more than exports were adding to it. In some degree, slower reductions in stocks will have contributed to this development, but earlier losses of competitiveness were probably also a factor.

Prospects for output and demand

The Treasury's forecast for 1982 suggests a 1% increase in GDP. After the rapid reduction this year, there is expected to be a small increase in stocks; consumer spending and fixed investment rise slightly, although investment, in particular, remains weak. Some expansion of UK markets abroad helps to raise exports (see the box on page 456), but imports grow much more, partly because of the behaviour of stocks and output at home. Within the total of output, manufacturing production is projected to increase by $2\frac{3}{4}$% between the second half of 1981 and the second half of 1982.

Pay increases remain moderate

The increase in average earnings in the 1980/81 pay round—about $10\frac{1}{2}$%—was the lowest for four years, and compares with over 20% in the previous round. Pay settlements appear to have averaged around 9%—the difference between this and the rise in average earnings mainly representing bonuses, promotions and annual increments, and changes in the composition of the workforce. According to the CBI, settlements in manufacturing and retailing were close to the average, but in the rest of private services they were nearer to 11%. Many public service settlements were for $7\frac{1}{2}$% or less. Settlements in nationalised industries averaged nearly 10%; there was a clutch of settlements at 12%–13%, but elsewhere (British Steel Corporation, for example) awards were lower.

It is too soon to see any clear trend in the new pay round which began in August; early signs suggest that most awards in the first few months were in the 5%–8% range, but BL workers settled for under 4% on basic pay (possibly about 5% if guaranteed extra payments are included, similar in total to the national agreement concluded in the engineering industry). A number of companies are considering making no pay awards in this pay round; others are deferring settlements.

Nevertheless, the reduction in short-time working and increased overtime have raised the monthly rate of increase in average earnings from ¾% in the first half of the year to around 1%.

Productivity in manufacturing industry
Percentage changes

	1979 (average) to 1981 Q3	1980 Q4 to 1981 Q3
Output(a)	− 14	+ 2
Employment	− 17	− 7
Average hours worked	− 3	+ 3
Total hours worked	− 19	− 4
Productivity (output per man-hour)	+ 5	+ 6

(a) After allowing for sales out of stock.

Productivity, labour costs and competitiveness

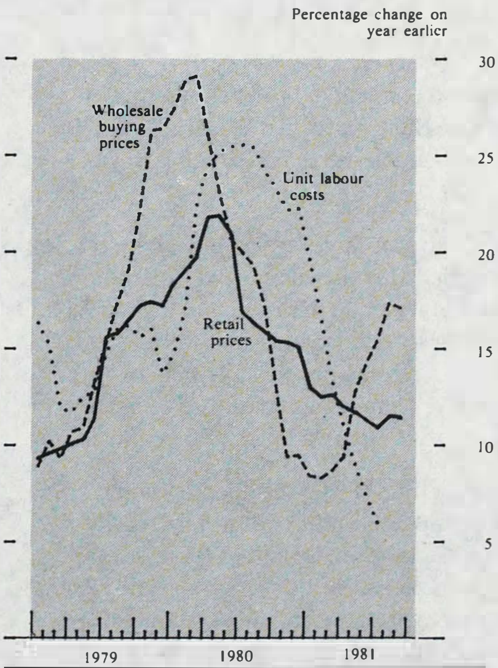
Output per man-hour in manufacturing industry increased by a further 2% in the third quarter. Production rose by about 2½%[1] and total hours worked increased slightly. In the third quarter, productivity in manufacturing was over 5% better than the average in 1979 and 6% better than in the fourth quarter of 1980.

Despite the rise in productivity, labour costs (wages and salaries per unit of output) in manufacturing industry probably rose a little in the third quarter, partly because of the timing of implementation of pay awards. Nevertheless, labour costs in manufacturing seem to have been broadly stable this year, in marked contrast to the experience of the last ten years, when they nearly quadrupled.

Labour costs abroad are probably rising faster than here. With the fall in the effective exchange rate (7% between the second and third quarters, and 10% between the fourth quarter of 1980 and the third quarter of this year) there has probably been a sizable gain in competitiveness—perhaps 10%–15%—to set against the larger losses suffered earlier.[2]

Because the present recession is so much deeper, it is difficult to know what significance to attach to a comparison with earlier episodes. But it seems that the fall in productivity last year was less than might have been expected, given the decline in output, and that the improvement in productivity this year has been somewhat greater. As noted in previous issues of the *Bulletin*, the measurement of changes in productivity is difficult. Moreover, because the reasons for the improvement are unclear (though many can be advanced), it is difficult to forecast developments with any confidence—gains may continue, or they may be reversed.

Slower rises in **labour costs** *have offset faster increases in* **fuel and material prices**.



Some rise in inflation

In contrast to labour costs, fuel and raw material costs paid by industry have risen rapidly this year, because of the earlier decline in the exchange rate. Much of the rise is accounted for by crude oil, which has a weight of 25% in the index; while the total index rose by 16½%, the prices of other fuels and raw materials in the index increased by only 12¼% in the year to November. But the rate of increase has slowed from 2% a month or more earlier in the year; between August and November there was no increase.

Manufacturers' selling prices rose considerably more slowly than the prices which they pay for fuel and materials in the first eight months of the year. The monthly rate of increase has fallen from 1%–1½% at the beginning of the year to ½%–1%. If the prices of petroleum products are excluded, the rise in selling prices in the year to November was 9½%. The slower rate of increase in selling prices partly reflects the behaviour of unit labour costs, but also the

(1) Some components of industrial production are based on figures for sales, which may misrepresent current output. The figures in this section correct for this by adjusting for sales out of stock.

(2) Competitiveness discussed here is computed from actual changes in productivity and labour costs, not 'normalised' changes which apply to actual increases in labour costs the rise in productivity which is estimated to be consistent with unchanged (normal) intensity of use of factors of production within manufacturing. For the United Kingdom, this 'normal' increase in productivity is considerably lower than the actual increase this year. Statistical work (see 'Measures of competitiveness in international trade', June 1978 *Bulletin*, page 181) suggests that the normalised measure has in the past proved the best measure of cost competitiveness, in the sense of providing the best statistical explanation of trade flows. It would probably cease to do so (until the better performance was well enough established to affect the estimate of 'normal' productivity growth) if productivity moved to a significantly higher level or rate of growth, but firm evidence must await longer experience and fuller trade figures than are yet available.

effect of weak markets in containing price increases. The decline in the exchange rate will, however, have eased this constraint, and recent CBI surveys indicate that more manufacturers intend to raise their prices.

Indeed, there is already some sign of a faster increase in the prices of certain categories of manufactured goods included in the retail price index. Retail prices rose by almost 1% in October, somewhat larger than recent monthly increases. With some more increases in nationalised industry prices to come, as well, probably, as further effects of sterling's depreciation,[1] the prospect is for the somewhat higher rate of increase to be sustained for a few months. In addition, the two-point increase in mortgage rates announced in October will add altogether $\frac{1}{2}\%$–$\frac{3}{4}\%$ to the index in November and December. The recent Treasury forecast is for a rise of 10% over the next twelve months.

Temporary factors improve companies' financial position

Companies[2] moved into financial surplus in the first half of 1981, following two years in which they had been in sizable deficit. Their undistributed income rose sharply; they continued to run down stocks heavily; and the financial surplus also reflected reduced tax payments as a result of the Civil Service dispute.[3] North Sea operations apart, real profitability, at just over 2%, was lower than ever before recorded.

After a deficit of £1.0 billion in the second half of 1980, companies (including those operating in the North Sea) showed a surplus of £1.1 billion in the first half of this year. Perhaps £$\frac{1}{4}$ billion of this is attributable to delayed payment of corporation tax. Gross trading profits (after deduction of stock appreciation) were higher, and companies paid out less in dividends and interest. Consequently, their undistributed income rose substantially.

Reduced capital spending also contributed to the improvement in companies' financial position: there was a further large reduction in stocks, worth £2.8 billion—much the same as in the previous half year.

Companies continued to add to their holdings of financial assets in the first half of 1981, although on a reduced scale: at £2.9 billion, they acquired nearly £1 billion less than in the second half of 1980. They also invested £1.7 billion abroad. Against this, they took far more trade credit (mostly representing delayed payment of tax) than they themselves extended. Companies continued to borrow from the banks and other sources, but on a much reduced scale.

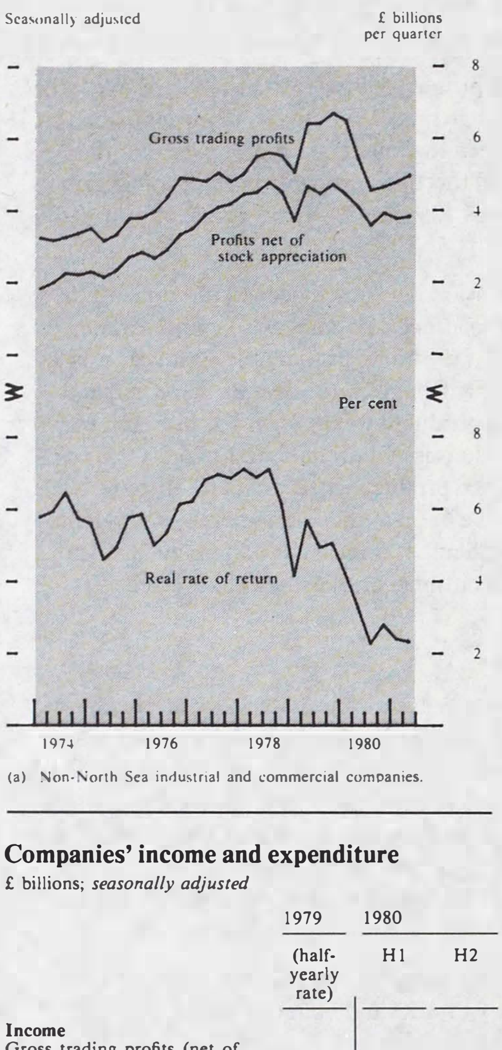
The figures discussed so far include North Sea operations. Present estimates suggest that profits in other industries were virtually unchanged, and—despite reductions in the labour force—were below those earned in recent periods, even in nominal terms. Profit margins have been under severe pressure and most sectors of industry have experienced substantial falls in output. In the process, real profitability has fallen to $2\frac{1}{4}\%$—compared with the previous recorded low point (before the recent declines) of over 5% in 1974. There are no figures for the financial position of non-North

(1) See 'Sterling and inflation', September *Bulletin*, page 365.

(2) Industrial and commercial companies.

(3) When the financial surplus or deficit of companies is computed, no account is taken of corporation tax until it is paid. Delay in paying corporation tax therefore temporarily adds to the financial surplus. VAT, PAYE, and national insurance contributions, on the other hand, are entered on an accruals basis; late payment therefore does not affect the financial surplus or deficit, although it does temporarily improve company liquidity.

Real profitability *is the lowest recorded.*[a]



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

Companies' income and expenditure

£ billions; *seasonally adjusted*

	1979 (half-yearly rate)	1980 H1	1980 H2	1981 H1
Income				
Gross trading profits (net of stock appreciation)	11.2	11.9	11.2	12.0
Excluding North Sea operations	*8.9*	*8.6*	*7.5*	*7.6*
Other income	3.9	4.2	3.5	3.6
Total	**15.2**	**16.0**	**14.8**	**15.6**
Allocation of income				
Dividends, interest, profits due abroad	7.0	8.3	7.8	6.8
UK taxes on income	1.9	2.4	3.1	3.2
Balance: undistributed income	**6.2**	**5.3**	**3.8**	**5.6**
Expenditure				
Fixed investment	6.9	7.7	8.0	7.6
Stocks	1.1	− 0.3	− 2.9	− 2.8
Taxes on capital (net of capital receipts)	− 0.3	− 0.1	− 0.3	− 0.3
Balance: financial surplus +/ deficit −	**− 1.6**	**− 2.0**	**− 1.0**	**1.1**

Influences on company sector profitability

Percentage change on a year earlier

	Output		Costs(a) in manu-facturing	Output prices(b) in manu-facturing	Competi-tiveness(c)
	GDP	Manu-facturing			
1979	1.7	0.2	12.6	11.4	15.9
1980	−2.0	− 9.4	17.3	15.1	23.9
1981 H1	−4.5	−11.1	11.3	9.3	10.8

(a) A weighted average of labour and raw materials costs.
(b) A weighted average of domestic selling prices and the unit value of exports (partly estimated for 1981 H1).
(c) Relative unit labour costs. An increase in the index indicates a deterioration in competitiveness.

Capital flows

£ billions; *not seasonally adjusted*

	1979 Year	1980 Year	1981 Q1	Q2	Q3
Banks' net external lending in foreign currency	+1.6	+2.0	−0.6	−0.8	+0.1
Banks' sterling lending overseas	+0.2	−2.5	−1.2	−0.4	−0.8
Outward portfolio investment	−0.9	−3.1	−1.3	−1.0	−0.6
Net direct investment overseas	−2.5	+0.1	−0.9	−0.2	−0.4
of which, oil	*−1.5*	*+0.5*	*+0.2*	—	*+0.4*
Sterling balances(a)	+3.4	+3.8	+0.4	+1.1	+1.1
Other flows	+0.3	−1.7	+0.3	−0.6	−0.2
Total identified capital flows	**+2.2**	**−1.4**	**−3.3**	**−1.9**	**−0.7**

(a) Exchange reserves and other external banking and money market liabilities in sterling.

Sea companies alone, but temporary factors such as heavy reductions in stocks and delayed payment of corporation tax must have helped to sustain it. Delayed payment of other taxes will have contributed to a substantial improvement in the liquidity position of companies in the second and third quarters.(1)

The recent improvement in productivity, together with the fall in the exchange rate, may bring some relief to profit margins. Against this, the rise in interest rates since the summer will mean higher debt service costs.

The difficulties experienced by many firms are underlined by the number of enterprises going out of business—about 30% more in the first nine months of this year than in the same period of 1980. Against this, there was some increase in the number of new companies registered.

Pre-tax profits are struck (and real profitability is calculated) after deduction of local authority rates, which are treated as a cost of production rather than as a tax. The increases in rates in the last couple of years must have adversely affected profits. This would be in contrast to the picture suggested by rough estimates(2) for 1975–79 when industrial and commercial companies (excluding North Sea operations) paid a slightly smaller share of total rates in 1979 than in 1975 and when the rates they paid rose no faster than their capital stock. Redundancy payments are also treated in the national accounts as a cost of production and, although no precise estimate is possible, they, too, will have contributed to the fall in profitability. Company accounts suggest that, in some cases at least, the cost of closing down plants—of which redundancy payments would often be a large part—has been substantial in relation to profits.

Current account surplus and capital outflows both reduced

The very large surplus on current account which emerged in 1980 (£3 billion in the second half alone) was probably sustained in the first quarter of 1981. Since then, however, the surplus on invisibles has fallen sharply (from £1.3 billion in the first quarter to £0.3 billion in the third), and the surplus on visible trade has shrunk from over £1 billion in January and February to £130 million in September and October.

Among invisible transactions in the third quarter, the surplus on interest, profits and dividends contracted by nearly £0.3 billion: earnings of foreign-owned companies in the United Kingdom, both within and outside the oil sector, recovered, while earnings of UK (non-oil) companies fell back, reflecting the world recession. The surplus on services declined, with more spent on travel abroad.

Identified capital outflows were only £0.7 billion (net) in the third quarter, compared with over £5 billion in the first half of 1981. Portfolio investment abroad, at £0.6 billion, was the least for over a year. The main change, however, was in the banks' external position in foreign currency: a resumption of sizable foreign

(1) Based on a survey of 210 major companies conducted by the Department of Industry.
(2) Non-domestic rates are paid by public corporations, various central and local government bodies, unincorporated businesses and financial companies as well as by industrial and commercial companies (ICCs). The split between domestic and non-domestic rates is published in *Local Government Trends*. Evidence in the Layfield Report (relating to 1974) and information on the replacement cost of buildings owned by ICCs and financial companies respectively suggests that perhaps two thirds of non-domestic rates are paid by ICCs.

currency borrowing by the private sector, perhaps reflecting interest rate movements, led the banks to increase their net liabilities abroad. By contrast, the banks lent more abroad in sterling: recently there has been an increase in lending to overseas residents in the form of sterling acceptances, possibly indicating an increase in the use of sterling in financing international trade.

Official financing—the fall in the reserves after allowance for repayment of official foreign currency debt—amounted to £0.7 billion in the third quarter, compared with under £0.2 billion in the second. On average, sterling was over 7% lower in effective terms.

Public finance consistent with Budget projection . . .

At the time of the Budget, the public sector borrowing requirement (PSBR) in the current financial year was projected at £10.6 billion. In the first six months, the PSBR was £9½ billion (seasonally adjusted), the Civil Service pay dispute having added perhaps £4 billion to it by delaying the receipt of taxes. Most of this is expected to be recovered by next March. The outcome for the PSBR in the 1981/82 financial year as a whole appears to be in line with the Budget projection.

. . . representing a tighter fiscal stance

At £10.6 billion, the PSBR this year would be £2.6 billion less than in 1980/81, even though the recession would have tended to raise it. (The delayed effects of the fall in output in 1980/81 and the immediate effects of the further, but smaller, decline this year would be expected to result in higher unemployment benefit and social security payments; lower direct and indirect tax revenues; and reduced surpluses or increased losses by public corporations, etc.)[1] Thus the projected PSBR represents a tightening of fiscal policy. It is consistent with a fall in the ratio of the value of outstanding public sector debt to GDP at current prices and, probably, with a decline in the proportion of private sector financial wealth held in public sector debt.

In one respect, however, the lower PSBR may be a misleading guide to the stance of fiscal policy. North Sea tax revenues will probably increase by about £2 billion, to £6 billion or so, this financial year. Only if the extra tax payments reflect higher sterling oil prices does their effect on the economy resemble that of an increase in indirect taxation, in that purchasing power is transferred from buyers of oil to the Government. If they arise instead from increased oil production, from a higher rate of levy on the oil companies, or from the exhaustion of tax allowances, the extra revenues do not have the same economic impact as equal increases in other main types of taxation or cuts in public spending.

Spending plans for next year

In his statement on 2 December, the Chancellor announced that public spending in cash terms in 1982/83 would be about £5 billion more than the £110 billion implied by the Public Expenditure White Paper published in March (and perhaps £8 billion higher than the outturn this year—still implying a reduction in real terms). The main elements in the increase in spending plans are current expenditure by local authorities and spending by nationalised industries not financed from internal sources

(1) No exact measure of the effect of recession on the PSBR is possible. See the Treasury's *Economic Progress Report*, February 1981, for a discussion of the difficulties.

(£2.7 billion altogether), spending on employment and training (£0.8 billion, including special employment measures announced in July), and spending on defence (£0.5 billion). Higher social security payments arising from the uprating of benefits and an expected further small rise in unemployment will be matched by higher national insurance contributions.

Monetary developments

The Civil Service dispute has had a substantial effect on monetary conditions during the course of the year. Over the period of the dispute (March to July inclusive), the net effect was to delay the payment of some £5–6 billion from the private sector to the Government (perhaps £$\frac{3}{4}$–1 billion of it falling in 1980/81). The shortfall of revenue was reduced in August, but thereafter to mid-October VAT repayments in advance of the collection of delayed VAT receipts were greater than the recovery of Inland Revenue duties. It was not until the November banking month that the shortfall was again reduced. The cumulative shortfall at mid-November was perhaps £4$\frac{1}{2}$ billion.

In the meantime, the liquidity position of the private sector—mainly companies—has improved substantially and the cash pressure which the banking system had experienced before the dispute began has been alleviated. Nevertheless other factors, notably large official sales of gilt-edged stocks, drained cash from the markets in the three months to mid-November, and the authorities replaced it by buying Treasury bills and eligible bank bills. The recovery of revenue delayed by the dispute may well extend into 1982 and the next major tax-paying season (the first calendar quarter). To the extent that they have not made adequate provision, companies could experience liquidity problems. The cash drain from the private to the public sector resulting from the payment of taxes could also place severe pressure on financial markets and the banking system.

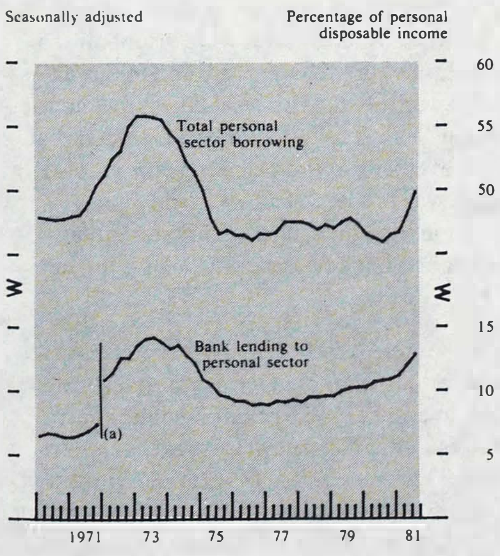
These questions are discussed further in the review of the operation of monetary policy (page 472).

Lending for house purchase
£ millions; *not seasonally adjusted*

	Quarterly rates			
	1980		1981	
	H1	H2	H1	Q3
Building societies(a)	1,250	1,610	1,690	1,560
Banks (increase in outstanding loans)	100	145	300	730
Other lenders	280	245	185	..
	1,630	2,000	2,175	..

.. not available.
(a) Net advances of principal.

Lending to the personal sector ***has turned up sharply this year.***



(a) Break in series.

Bank lending to persons expanding fast all year

Bank lending to persons rose by 20% between mid-February and mid-August, and this rate of growth may have been sustained in the following three months. Although the increase to some extent reflects gains by the banks in their share of the market for mortgages and other loans, the ratio of total borrowing by the personal sector(1) to personal disposable income has risen rapidly in the course of the year as real incomes have come under pressure. Nevertheless, the ratio remains lower than in the early 1970s.

Mortgage lending by banks has grown particularly fast. Up to the middle of the year, this expansion did not appear to be having much effect on the building societies, although the share of other lenders, mainly local authorities and insurance companies, did fall. Since then, however, there has been a slowdown in building society lending, and the banks' share of new net advances may by now have reached 30%. Despite the rapid increases in total mortgage lending, house prices have risen very little over the past year, and in some cases have fallen; housebuilding has been stagnant, although there may have been some increase in turnover in the housing market, and housing starts in the third quarter rose somewhat.

(1) The chart relates to the statistical 'personal sector', which includes unincorporated businesses as well as persons. But the discussion in the text refers to persons only.

Increases in consumer credit[a]

£ millions
Percentage share in italics

	Lending by					Total
	Banks(b)		Non-bank finance houses(c)		Retailers	
1979 (Quarterly rate)	283	*57*	158	*32*	55	496
1980 Q1	127	*47*	130	*48*	14	271
Q2	551	*74*	227	*31*	− 38	740
Q3	407	*68*	208	*34*	− 16	599
Q4	275	*62*	65	*15*	104	444
1981 Q1	462	*94*	55	*11*	− 27	490
Q2	676	*86*	168	*21*	− 58	786
Q3(d)	714	*103*	30	*4*	− 54	690

(a) Figures for retailers and finance houses exclude unearned interest charges and are not strictly comparable with those for the banks.

(b) Lending to persons by institutions in the banking sector and the trustee savings banks, *excluding* lending for house purchase.

(c) Including other specialist consumer credit grantors.

(d) Provisional and party estimated.

House owners appear to have increased the ratio of their mortgage debt to the value of their houses.

Bank lending to persons for purposes other than house purchase has also grown fast, although without accelerating during the year. The banks have secured a large increase in their share of the consumer credit market over the last year, but the total increase in credit outstanding this year has been substantial.

Bank lending to businesses appears to be growing more rapidly

The underlying rate of increase of bank lending to the business sector[1] has been obscured by the effects of the Civil Service dispute. Nevertheless, there appears to have been a considerable increase in the underlying rate of growth of lending since last winter. One influence may have been the depreciation of sterling, which increased the cost of fuel and raw materials; in addition, there seems to have been a marked reduction in the rate at which stocks are being reduced. A further recovery in output, especially one led by business spending, might be expected to raise business demand for bank finance yet more; and the need to pay taxes held up by the Civil Service dispute as well as the normal seasonal tax payments, may also increase recourse by businesses to the banks in the next few months.

Factors determining interest rates

Between the end of August and the morning of 14 September, sterling's effective exchange rate fell by 5%. This reflected weakness not only against the US dollar, which was boosted by high interest rates, but also against other leading currencies. A further sharp fall would have had serious consequences for inflation. While the domestic situation gave conflicting evidence, growing bank lending to the private sector and signs of quicker growth in money supply pointed the same way as concern about sterling. For these reasons the authorities concluded that an increase in interest rates was appropriate. Operations in the money market on 14 September were consequently conducted so as to achieve this (see page 470). As a result, the one-month inter-bank rate rose from just over 13% to $14\frac{1}{8}$%, and bank base rates rose from 12% to 14%.

Interest rate developments abroad continued to have a strong effect on UK financial markets. After a brief recovery in the exchange rate, market hopes of a fall in US interest rates were disappointed. This led to renewed weakness in the exchange rate and to increases in longer-term money rates, while equity prices fell heavily and the gilt-edged market was again weak. The authorities concluded that resistance to this market movement would be inappropriate, and the rates at which the Bank was prepared to deal in the money market were brought into line with the longer-term rates already established there. On 1 October, bank base rates rose by a further 2%, to 16%.

Further upward pressure on interest rates remained for a time, but was resisted by official operations. Early in October, interest rates in the United States began to ease. This had an immediate effect, which the Bank did not resist, on UK money rates and bank base rates. The gilt-edged market also recovered. US rates fell further at the end of October and early in November; the repercussions of this, together with the effect of the BL pay settlement, led to further reductions in longer-term money rates and bank base rates. But

(1) Sterling lending to the private sector, other than to persons.

when market rates again fell sharply in mid-November, the Bank acted to slow the decline.

The growth of money supply

The course of the various monetary aggregates is described on page 468. At $17\frac{3}{4}\%$, at an annual rate, the growth of sterling M_3 between mid-February and mid-November was well above the target range of 6%–10%. M_1, by contrast, grew at a rate of 10% in the nine months to mid-November. But most of the monetary aggregates were affected by the Civil Service dispute.