Main economic and monetary developments

This review aims to provide a framework within which to assess the relationship between economic trends and monetary developments.

- *The decline in output has slowed down this year, and industrial production has levelled out. Reflecting these developments, unemployment is growing more slowly.*

- *Consumer spending has lost its buoyancy, fixed investment shows underlying weakness, and stocks continued to fall in the second quarter. Companies' financial position improved in the six months to March, though profitability remained very low.*

- *Economic activity abroad appears to have weakened in recent months.*

- *The fall in the exchange rate has brought a gain in competitiveness but higher prices for fuel and raw materials. Retail prices, however, have not grown faster, partly because the rise in wage costs per unit of output, unlike last year, has recently been very small.*

- *The Civil Service pay dispute caused a substantial temporary increase in government borrowing, which the authorities did not seek to fund fully. The dispute made companies more liquid, but the personal sector continued to borrow heavily from the banks. The underlying rate of growth of sterling M_3 has become increasingly difficult to assess.*

- *The authorities considered some rise in interest rates to be appropriate when sterling weakened sharply in July; more recently they have aimed to avoid further increases in very short rates, while leaving the structure of interest rates to be determined by the market.*

Output falls more slowly this year

Total production (as measured by the output estimate of GDP) fell by just under $\frac{1}{2}$% in the second quarter, much the same as in the first, but considerably less than in 1980, when the decline averaged nearly $1\frac{1}{2}$% a quarter. By the second quarter of this year, GDP was over $6\frac{1}{4}$% below the average in 1979; this was a much larger fall, spread over a longer period, than in the recession in the mid-1970s.

Like GDP, industrial output fell more gently in the first half of this year than in 1980. Whereas the underlying fall last year (adjusted for sales out of stock, and excluding oil and gas) was 3%–4% a quarter, this year there was a $1\frac{1}{4}$% fall in the first quarter followed by a very small decline in the second. Similarly, the rate of decline in manufacturing output was virtually eliminated in the second quarter. Most broad categories of manufacturing industry remain depressed, although the production of chemicals and metals recovered somewhat in the first half of the year. Other categories of industrial production show mixed results. Construction remained weak; output of various public utilities (gas, electricity and water) was low in the first quarter but recovered in the second; extraction of oil and natural gas, by contrast, rose by 5% in the first quarter, but eased back in the second.

Manufacturing production

Percentage change from previous half year

	1980 H2	1981 H1
Food, drink, tobacco	− 1.0	−0.7
Chemicals, coal and petroleum products	− 8.3	+1.7
Metal manufacture	− 2.8	+6.7
Engineering	− 8.1	−6.6
Textiles, leather, clothing	−10.4	−3.5

Unemployment rises more slowly

Demand for labour is still contracting, but at a slower rate. Total employment in the United Kingdom fell by more than a million (over $4\frac{1}{2}$%) during 1980. In manufacturing industry in Great Britain, employment fell by 10% in the year—a sharp steepening of the earlier trend. In the first half of this year, however, employment in manufacturing fell by 50,000 a month, compared with over 75,000 a month in the second half of last year.

The rate of increase in unemployment, although still rapid, has also been slowing since the end of last year. In the three months to August, the seasonally-adjusted total (which excludes school-leavers) rose by 37,000 a month, compared with 81,000 a month in the first quarter and 115,000 a month from October to December 1980. A change in regulations, delaying until September the payment of benefit to most young people leaving school without a job, appears to have reduced the number of school-leavers registered as unemployed in July and August, since one incentive to sign on was thereby removed. Nevertheless, the total of unemployed rose to 2.94 million, $12\frac{1}{4}$%, in August—double the number two years earlier.

In July, the Government announced various measures to reduce unemployment, including an expansion of the Youth Opportunities Programme and a subsidy to firms employing young workers. This will be paid for employees under the age of eighteen who are in their first year of work, provided that their earnings are less than £45 a week. The July measures will cost around £150 million in 1981/82.

Figures for short-time working and overtime provide further evidence that the deterioration in the labour market is slowing down. Whereas in the six months to March short-time working averaged $7\frac{1}{2}$ million hours a week, in the second quarter it had fallen to $4\frac{1}{2}$ million—still six times higher than in 1979. The amount of overtime worked has stopped declining, but it remains far less than in 1979.

Demand[1]

Consumer spending weakens

Real personal disposable income rose almost without check from 1977 until late last year. Since then it has fallen, under the influence of declining employment, smaller increases in earnings, higher rates of national insurance contributions and increases in specific duties, and the decision not to raise personal tax thresholds in line with inflation. Stimulated by extended New Year sales, retail trade was strong early in the year and consumer spending rose in the first quarter as a whole, implying a fall in the saving ratio. Retail sales later weakened, however, and in the second quarter consumer spending fell back. The personal sector borrowed heavily from the banks (see page 323).

Industrial fixed investment

£ millions, 1975 prices; *seasonally adjusted*

	1979	1980		1981	
	Year	H1	H2	H1	H2(a)
Manufacturing	3,970	1,880	1,700	1,560	*1,430*
Distribution and services	5,890	3,140	3,320	3,250	*3,370*

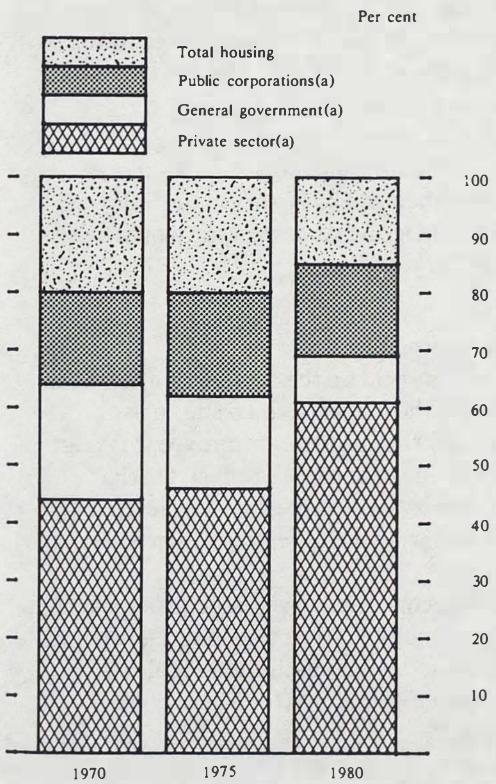
(a) The figures for 1981 H2 are those which would bring about a 16½% decline in manufacturing investment and a 2½% increase in fixed investment in distribution and services in the year as a whole (i.e. average forecasts from the Department of Industry survey).

Industrial fixed investment shows underlying decline

Provisional figures suggest that fixed investment by the manufacturing, distributive and service industries (excluding shipping) rose by 2½% in the second quarter. Within the total, manufacturing investment fell by only ½%, and it is possible that, if allowance were made for leasing, investment in assets for use in manufacturing industry would actually show an increase. Investment by the distributive and service industries—including investment in assets for leasing to manufacturers—rose by 4% in the second quarter.

Nevertheless, industrial investment in the second quarter remained below the average in 1979 and 1980; and developments so far this year appear to be consistent with the outcome for the year as a whole suggested by the Department of Industry (DoI) survey of investment intentions in May, which indicated a fall of 15%–18% in fixed investment in manufacturing industry (without allowance for leasing) and a small rise in distribution and services of less than 5%. The CBI survey in July indicated a similar fall in manufacturing investment this year. Where the two surveys differ is in prospects for next year: the DoI survey indicates some recovery in fixed investment, whereas the CBI poll suggests a further decline. Most respondents to the CBI survey in July reported spare capacity, although the balance was slightly smaller than in the two previous surveys. Businessmen's views about the rate of return on new assets, and so investment decisions, are no doubt influenced by the real profitability of existing assets, which fell again in the first quarter (the latest for which estimates are available).

***Industrial investment has increased its share in total* fixed investment.**



(a) Excluding housing.

Housebuilding remains depressed

Housing activity[2] in the first quarter was the lowest for eighteen years. The public sector was especially depressed, with housebuilding proceeding at only half the rate of the mid-1970s. In the second quarter, there was a decline in housing starts and in the number of houses under construction.

Low activity has been associated with slower rises in house prices: the price of new houses rose by only 9% between the first quarters of 1980 and 1981, compared with 27% in the previous year, and the growth has slowed down since. Nevertheless, finance for house purchase from building societies and banks has expanded rapidly. In the second quarter, building societies lent nearly half as much again as they had done a year earlier; and banks lent three times as much in the three months to mid-May as in the same period in 1980 (see page 323).

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

(2) As measured by investment in dwellings in the national accounts.

Other fixed investment

No information is yet available on other public sector fixed investment in the second quarter. Such investment by public corporations fell between the middle of last year and the first quarter of 1981. Investment in public services has declined steadily since the mid-1970s.

The chart on the previous page shows a substantial increase in the share of industrial investment in total fixed investment in the last ten years or so, at the expense of housing investment and investment in public services.

Stocks continue to fall

Provisional figures for manufacturing and distribution[(1)] suggest that stocks fell at an undiminished rate in the second quarter. Within the total, the decline in distributors' stocks resumed, but manufacturers ran down their stocks by the smallest amount for a year, reducing their stocks of finished goods by only £50 million compared with nearly £500 million in the previous six months—possibly a reflection of distributors' behaviour.

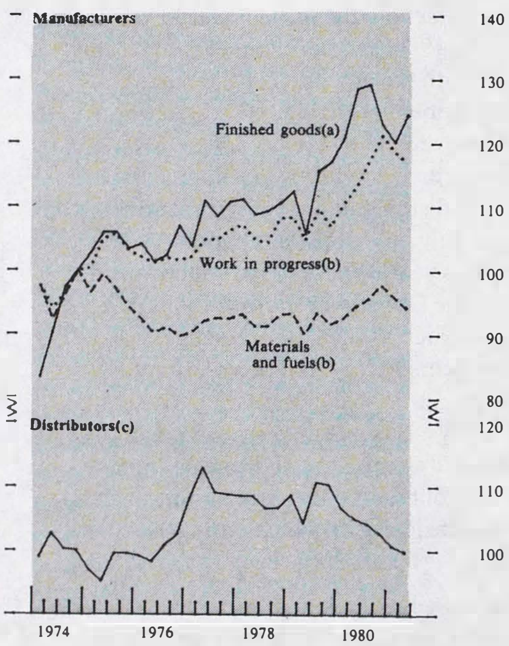
Change in stocks

£ millions, 1975 prices; *seasonally adjusted*

	1974	1975	1979	1980	1981	
	Year	Year	Year	Year	Q1	Q2
Manufacturing	+1,250	−1,100	+210	−1,250	−520	−230
Wholesale and retail	+ 180	− 360	+530	− 630	+120	−170

Manufacturers' **stocks** *remain high in relation to sales and output.*

Seasonally adjusted 1974 Q4 = 100



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

Since the decline began early last year, these stocks have been reduced by nearly £2¾ billion, 9% of their initial level. In absolute and proportionate terms, the fall—which is equivalent to over 1¾ % of GDP—exceeds the decline in 1975. Nevertheless, the ratio of manufacturers' stocks of finished goods to their sales appears to have been higher in June than at the end of last year, when it was still unusually high. Distributors, on the other hand, have reduced the ratio of their stocks to retail sales.

Manufacturers responding to the July and August CBI surveys expected on balance to reduce their stocks further in the following four months, but the replies indicated that destocking would be less rapid than in the first half of the year.

Trade and economic activity abroad

The Civil Service pay dispute has held up the compilation of trade figures since February. Among the influences on trade flows, competitiveness (discussed later) has probably improved this year, but earlier losses will have continued to exert an effect. On the other hand, UK economic activity has steadied at a low level; and continuing reductions in stocks will tend to restrict imports.

Another influence on exports, economic activity abroad, appears to have weakened again in recent months. After touching a low point in the second quarter of last year, activity in the other major industrialised countries[(2)] taken together was for a time quite strong. Between the spring of 1980 and the first quarter of this year, their combined GNP grew at an annual rate of about 3%, partly because of a strong recovery in domestic demand in the United States and, to some extent, Canada. In the major European countries, domestic demand remained depressed.

The recovery was not sustained in the second quarter, when GNP fell by nearly 2½% (annual rate) in the United States and, to judge from preliminary estimates, was unchanged or lower in Europe. Monetary and fiscal policies abroad are for the most part set

(1) Figures for other sectors are not yet available.
(2) United States, Canada, France, Italy, Japan and West Germany.

firmly against inflation, and any rise in public sector deficits has reflected recession rather than fiscal stimulus. Interest rates—both in nominal and real terms—have become very high in the United States and, largely in response, elsewhere.

Nevertheless, the recession abroad has been less severe than after the first sharp increase in oil prices in 1973, although policies appear to have been generally tighter. Profits have held up in most countries; fixed investment has on the whole been better maintained; and the stock cycle has been more muted.

Slower growth in the major industrialised countries affects prospects for the smaller OECD countries and the developing countries, especially where external debt already constrains economic policy. Oil producers—another important market for UK exporters—appear to have increased their imports sharply this year, following slow growth late last year on account of the war between Iran and Iraq. But the growth is likely to slow down again as the high absorbers face financial problems and others meet constraints on their capacity to absorb imports.

Invisibles, the capital account and sterling

Although figures for visible trade are lacking, estimates are available for invisible transactions in the second quarter. These suggest that the volume of exports of services fell by about 5%, while the volume of imports of services rose slightly. (Last year, trade in services amounted to about 23% of all external trade. Estimates of the volume of trade in services are frequently revised.)

The (seasonally adjusted) surplus on invisibles as a whole is provisionally estimated to have fallen to about £0.4 billion in the second quarter. But the exceptionally large surplus of some £1.3 billion in the first quarter was associated with the receipt of refunds from the European Community budget totalling over £0.5 billion. The travel account reverted to deficit in the second quarter with higher spending by UK travellers abroad and lower spending by overseas visitors to the United Kingdom. The interest, profits and dividends surplus fell: a drop in the overseas earnings of UK companies (including oil companies) more than offset a large improvement in the net earnings of UK banks from borrowing and lending in foreign currencies.

Among transactions on capital account, portfolio investment abroad in the second quarter continued at the rate of just over £1 billion. UK banks added further to their net external assets in foreign currency—a reflection of the extra foreign currency deposits which UK residents are holding with them (see page 324)—but other identified capital outflows were on balance rather less than in the first quarter; and overseas investment in the United Kingdom was larger. Altogether, identified capital movements showed a net outflow of £1.9 billion, compared with an exceptional £3.4 billion in the first quarter. The net outflow of £5.3 billion in the first half of the year compares with £1.6 billion in the previous six months.

Official financing was modest—a fall in the reserves, other than to repay official debt, of just under £0.2 billion, after an increase of £0.3 billion in the first quarter. On average, sterling fell by 3½% in effective terms in the second quarter, most of the decline being accounted for by a 10% fall against the dollar as US interest rates

Balance of payments

£ billions; *not seasonally adjusted*

	1979	1980		1981	
	Year	Year	Q4	Q1	Q2
Current balance	−0.9	+3.2	+2.4	..(a)	..(a)
Investment and other capital transactions					
Overseas investment in UK public and banking sectors	+4.3	+4.4	+0.4	+0.5	+1.0
Overseas investment in UK private sector	+3.4	+4.1	+1.2	+0.6	+0.9
Banks' net position in overseas currencies	+1.6	+2.0	+0.4	−0.6	−0.8
UK private investment abroad:					
Direct (including oil)	−5.6	−3.9	−0.8	−1.4	−1.2
Portfolio	−0.9	−3.0	−1.1	−1.3	−1.2
Other identified capital flows	−0.6	−5.1	−1.4	−1.2	−0.6
Balancing item	+0.4	−0.5	−0.9	..	..

.. not available.

(a) The surplus on visible trade in January and February is estimated at about £0.8 billion; the surpluses on invisibles in the entire first and second quarters are estimated at £1.2 billion and £0.2 billion, respectively.

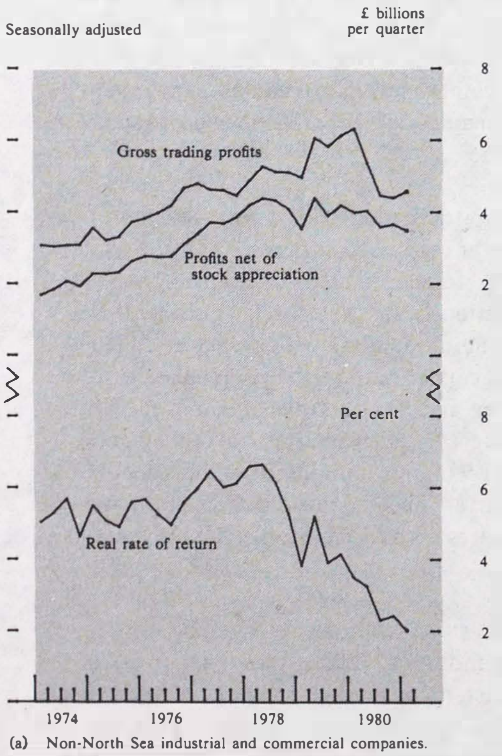
continued to rise. Sterling has since fallen further; in early September, the dollar rate was about 14% lower than the average in the second quarter, and the effective rate 10% lower.

In recent years, improvements in the terms of trade, partly accounted for by the appreciation of sterling, have helped to sustain real national disposable income in relation to the other measures of income and output. Even though the output measure of GDP fell by over $4\frac{1}{2}\%$ between 1979 and the second half of the last year, and the average estimate fell by $3\frac{1}{4}\%$, real national disposable income declined by only $\frac{1}{2}\%$. Much of the benefit probably went to those in employment. In the absence of trade returns, it is impossible to be sure that the recent decline in sterling has been accompanied by weaker terms of trade. If it has been, real national disposable income will on that account have tended to be weaker than the other measures—a development which could be related to the decline in real personal disposable income and, perhaps, to a recovery in profits as some of the constraints on the setting of prices have eased.

Prospects for UK demand and output

With average earnings likely to continue to rise no faster than prices, and employment still falling, further declines in real personal disposable income in the second half of this year and in 1982 are likely to depress consumer spending. Against this, any further fall in the saving ratio would tend to raise consumption. Lower fixed investment is also likely, at least in the second half of 1981. Another contractionary influence could be a deterioration in the trade balance (at constant prices), as past losses of competitiveness take effect. By contrast, a decline in the rate at which stocks are run down, followed perhaps by an increase in them next year, will have an expansionary effect (although a good part of it will be absorbed in imports) and tend to offset any weakening in final demand.

The **real rate of return** *fell again in the first quarter.*[a]



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

Company profitability remains low, but finances have improved

The real rate of return earned by industrial and commercial companies (other than on operations in the North Sea) continued to fall in the first quarter. In the six months to March, real profitability is estimated at just over 2%, compared with $2\frac{3}{4}\%$ in the previous six months and over 4% in 1979.

Nevertheless, the financial position of companies has, on many measures, improved—although an unusually large change in unidentified transactions suggests that the estimates should be treated with caution.[1] The main effect on their financial position in the six months to March came from a reduction of over £$3\frac{1}{2}$ billion (at current prices) in their holdings of stocks. They also reduced their fixed investment slightly, even at current prices. Furthermore, falls in interest rates following the reductions in MLR in November and March (altogether from 16% to 12%) were more than sufficient to offset the effect on interest payments of growth in company debt outstanding, and income gearing fell back to 36% in the first quarter; companies also paid out less in dividends, although—mainly because of growing payments of petroleum revenue tax—tax payments were higher.

(1) What follows relates to all industrial and commercial companies, including North Sea operations, because separate data for North Sea operations are not available.

As a result, the £2¼ billion financial deficit in the six months to last September turned into a surplus of £½ billion in the following six months, all of the surplus accruing in the first quarter of this year. Nevertheless, companies continued to take up funds, some £3¼ billion altogether, partly by issues of shares. Thus companies were able to make further substantial acquisitions of liquid assets—over £2 billion in the six months to March, more than half in the form of foreign currency deposits with UK banks, no doubt reflecting attractive rates of interest on dollar deposits and exchange rate expectations.

Evidence of productivity gains, and the weaker exchange rate—in early September sterling was about 13% lower in effective terms than in the six months to March, which will relieve companies of some of the pressure from international competition—suggest that profitability should be improving somewhat irrespective of the course of output. Although the rate at which stocks were run down in the six months to March cannot be expected to continue, further cuts in fixed investment, together with better profits, should help the financial position of companies.

Productivity in manufacturing industry may have continued to improve

Estimates in the June *Bulletin* (page 160) suggested an improvement in productivity (output per man-hour) in the year to the first quarter of 1981, and a slight gain from the quarterly average in 1979 (which subsequent revisions to the figures have raised from ½% to 2%). In the second quarter, manufacturing production (adjusted to take account of deliveries from stock) appears to have been steady, whereas the total number of hours worked by operatives again fell (the change comprising a fall in numbers employed but rather less short-time working and more overtime). These figures, which should be treated with caution, indicate some further improvement in output per man-hour in the second quarter, when it was perhaps 3%–4% better than in the fourth quarter of last year. It must be uncertain whether the rise in output per man-hour reflects an enduring change in work practices, as many observers believe, or an effect of widespread closures of unprofitable plants (in many of which productivity may have been below average) and a temporary response elsewhere to falling profitability and financial pressures on companies.

Pay rises were lower in the round just ended

The sharp reduction in pay settlements this year is highlighted (despite slightly different coverage) by a comparison of the CBI surveys of pay settlements in August this year and last. The average for settlements in manufacturing reported to the CBI in this year's pay round is 9½% (compared with over 16% last year). Elsewhere in the economy, the CBI estimate that settlements in the private services sector ran at 9½%–11%, in nationalised industries at 10%, and in public services at 8½%. In the year to July, which broadly coincides with the 1980/81 pay round, average earnings will probably have increased by 10%–11%, rather less in manufacturing industry, and a little more on average elsewhere in the economy.

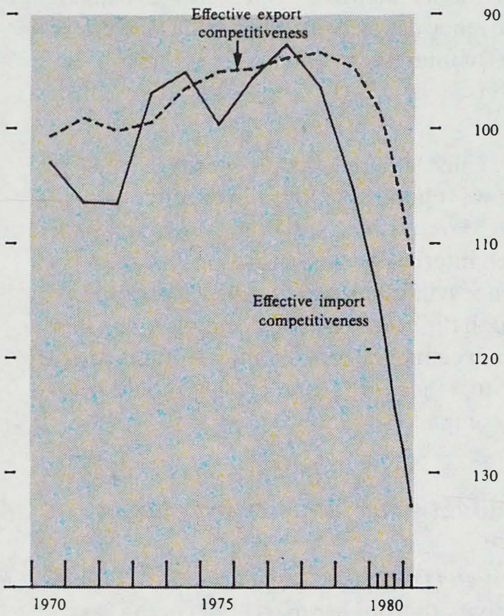
Percentage of settlements in manufacturing industry in various ranges

	Aug. 1979–Aug. 1980	Aug. 1980–Aug. 1981
0–10%	7	76
11%–20%	84	23
21% and over	9	1

Source: Confederation of British Industry.

A third of pay settlements in manufacturing reported to the CBI this year were linked to productivity improvements, compared with one quarter last year. About a third of settlements provided for longer holidays, and a fifth for a shorter working week.

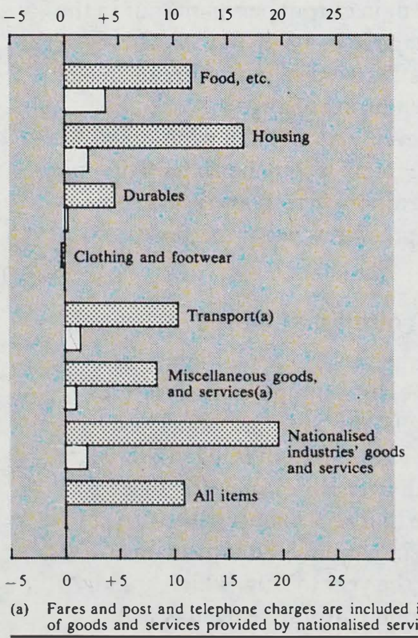
Earlier losses of **competitiveness**[(a)] *continue to influence trade.*



(a) Effective competitiveness, shown in the chart, measures the impact in the period shown of current and past changes, with due allowance for time lags. A fall in the line indicates a deterioration in competitiveness.

(b) The indices of actual competitiveness from which effective competitiveness is derived are based on 1975 = 100.

Prices *of household goods, clothing and footwear continue to be steady.*



(a) Fares and post and telephone charges are included in prices of goods and services provided by nationalised services.

Some loss of competitiveness regained

Taken with the growth of productivity, the underlying rise in earnings of rather under $\frac{3}{4}$% a month in manufacturing industry implies very little increase in wage costs per unit of output—perhaps $\frac{1}{2}$%–1% between the fourth quarter of last year and the second quarter of this year. Tentative calculations for other major industrial countries suggest that unit wage costs there rose by perhaps 3%–4% on average in local currency terms over the same period. If allowance is made for sterling's $2\frac{1}{2}$% depreciation between the two quarters, the competitive position of industry may have improved by some 5%.[(1)] More recently, sterling has depreciated further, and, if labour costs at home and abroad have continued to develop at the rates suggested above, perhaps ten percentage points of the massive earlier loss of competitiveness were regained in the first eight months of this year—with an uneven incidence on different products and markets. But because of the delay with which changes in competitiveness affect trade, and because of their size, earlier losses of competitiveness will continue to exert a dominant influence for some time.

Retail prices still rising moderately

The sharp increases recorded earlier this year in the prices paid by industry for fuel and raw materials have continued: these prices rose by 12% between December and June, compared with 2% in the previous half year, and by a further 3% in July and August. Oil prices, which have a weight of 25% in the index, accounted for most of the increase, following a rise in the dollar price of oil early in the year and the more recent weakening of sterling against the dollar (although the dollar price of oil softened). But a lower rate of increase in unit labour costs, possibly under 1% in the six months to June compared with $6\frac{3}{4}$% in the second half of last year, may have offset much of the increase in the cost of fuels and materials. In any case, weak domestic demand has no doubt continued to discourage price rises. The steep rises in manufacturers' selling prices and retail prices following the increases in specific duties announced in the Budget, have not persisted, and in July retail prices were less than 11% higher than a year earlier. Housing costs and prices charged by nationalised industries have continued to account for much of the increase in retail prices; the prices of textiles, clothing and household durable goods have been much steadier.

A note on page 365 considers the relationship between changes in the exchange rate and domestic prices. Although the prices of primary products have risen in sterling terms in recent months, there have been substantial falls in dollar terms and lesser decreases in terms of special drawing rights (SDR)—probably a better measure when exchange rates are very volatile. There is spare capacity in the production of most industrial materials, and prices have to some extent been supported by producer stockpiling. World food prices, however, are generally less sensitive to industrial activity, and recent falls in SDR terms are probably more closely associated with changing supply conditions.

(1) The measure of competitiveness usually quoted (and shown in the chart) divides labour costs by the estimated trend growth of productivity. The calculations presented in this section use instead the actual growth of productivity.

Inflation abroad

Helped by the stronger dollar, price inflation in the United States has tended to moderate in most recent months. In France and West Germany, on the other hand, inflation has recently tended to worsen. On average, consumer prices in other main industrial countries rose at an annual rate of about 8% in the second quarter.

Government finance

At the time of the Budget, the Government expected the public sector borrowing requirement (PSBR) in 1981/82 to be £10.6 billion, about £2¾ billion less than the outcome in 1980/81. The projected figure represented a significant fiscal tightening—a fall from about 6% to some 4¼% in relation to GDP at current prices—particularly since the fall in output in 1980/81 would be having a delayed effect on the PSBR in 1981/82.(1) Excluding the contribution of recession, the PSBR in 1981/82 would represent the equivalent of only 3% or so of GDP at current prices.(2)

The PSBR amounted to £6.8 billion, seasonally adjusted, in the first quarter of the current financial year. Some £3.5 billion is attributed to the Civil Service pay dispute, and recovery of this has begun. The remaining £3–3½ billion appears to be in line with the projection for the year since, other things being equal, the timing of receipts from North Sea activities makes the PSBR larger in the first half of the financial year than in the second half, even after seasonal adjustment. Unlike last year, when unexpectedly deep recession added substantially to the public sector deficit, there is no sign that developments in the economy are having any unexpected effect on government finances. The recent increase in the external financing limits of British Telecom and the National Coal Board, totalling £430 million, and the various employment measures announced in July, costing £150 million in 1981/82, will be met out of the £2.5 billion contingency reserve allowed for in the projection for the PSBR. The central government borrowing requirement (CGBR) was projected at £11.5 billion in the Budget; in the first five months of the financial year the outturn was £9.3 billion (not seasonally adjusted), about £4 billion of which is attributed to the pay dispute.

Background to monetary policy and developments

Since the end of last year, there have been significant shifts in the balance of the economy. The following paragraphs discuss the pressures which these changes have brought, the responses which have been judged appropriate, and the outcome for monetary growth. A fuller account of monetary developments and official operations is contained in the following article: the main points only are summarised below.

Previous issues of the *Bulletin* have discussed the interaction between economic trends and monetary developments. 'The recession', it was noted in December,(3) 'has not only enlarged the PSBR but, along with the high exchange rate and high wage settlements, has exacerbated the financial difficulties of companies. . . . Companies have continued to be almost exclusively dependent

(1) See *Economic Progress Report*, HM Treasury, February 1981.
(2) See the March *Bulletin*, page 21.
(3) December 1980 *Bulletin*, page 406.

for external finance on the banks—which have thus provided a channel whereby the enlarged surplus of the personal sector has been on-lent to companies'. This combination of circumstances helped to explain why bank lending was large, and the growth of sterling M_3 was rapid, though other monetary aggregates had grown more slowly. Despite the growth of sterling M_3, financial conditions were judged to have been tight last year.

The fiscal changes in the March Budget—notably the increases in specific duties and employees' national insurance contributions, and the decision not to raise income tax bands and allowances in line with inflation—aimed to reduce public borrowing below the level of the previous year. This, it was hoped, would ease the strain on financial markets. Other factors also made it seem appropriate to reduce interest rates—in particular the slowing down of inflation, which had led to interest rates which were high in real terms by past standards in the United Kingdom; and the fact that the growth of sterling M_3 and the pace of bank lending had, by then, slowed down. Accordingly, MLR was reduced in the Budget from 14% to 12%, and there was a widespread expectation that further reductions in interest rates would follow.

Influences on bank lending

Since the Budget, the underlying trend towards a reduction of the PSBR has been obscured by the effect of the Civil Service dispute, which interrupted the flow of tax payments, thus greatly adding to the Government's need to borrow and temporarily benefiting the liquidity position of the private sector.

As noted above, there has also been some underlying improvement in the position of companies, chiefly as a result of reductions in stocks and labour employed. In marked contrast with last year, there has been a spate of capital issues, reflecting perhaps the need for companies to consolidate their financial position and the improvement this year, despite the trend of profits, in equity prices. Some £0.9 billion (net) was raised by UK companies in the six months to the end of (calendar) August, including £0.3 billion by British Petroleum.(1) In some degree, capital issues will have been a substitute for borrowing from the banks.

The delay in tax payments arising from the Civil Service dispute has chiefly affected companies rather than persons. It has been reflected in part in higher bank deposits by companies, and in part in reduced borrowing from the banks. In fact, borrowing by industrial and commercial companies was little changed in the first six months of this year after a rise of £5.8 billion last year. How much companies would otherwise have borrowed—and how, by implication, their borrowing might develop—is impossible to gauge.

Bank lending to unincorporated businesses has been growing very rapidly—by around 15% in the first six calendar months of 1981. It is probably influenced by much the same factors as lending to companies but it may have been affected differently by the Civil Service dispute: a higher proportion of unincorporated businesses than of companies may have been left short of funds by delayed refunds of value added tax and (so far as farmers are concerned)

(1) With a further £0.3 billion to be raised on a second call in December.

Sterling lending to private sector by UK banking system

£ billions; *not seasonally adjusted*
Percentage increases in parentheses

	end-June 79–end-June 80	end-June 80–end-Dec. 80	end-Dec. 80–end-June 81
Lending to:			
Personal sector	+3.5	+1.6	+2.8
	(29)	(10)	(16)
of which:			
persons, households and individual trusts	*+1.7*	*+0.9*	*+1.7*
	(24)	*(10)*	*(17)*
unincorporated businesses	*+1.8*	*+0.6*	*+1.1*
	(36)	*(9)*	*(15)*
Industrial and commercial companies(a)	+4.7	+2.3	—
	(18)	(8)	(—)
Other financial institutions	+1.4	+0.1	+0.5
	(36)	(3)	(9)
Total(a)	+9.6	+4.0	+3.3
	(23)	(8)	(6)

(a) Including commercial bills held by the Issue Department of the Bank of England.

Lending for house purchase

£ millions; *not seasonally adjusted*

	1980		1981	
	Quarterly rate			
	H1	H2	Q1	Q2
Building societies (net advances of principal)	1,250	1,610	1,560	1,810
Banks (increase in outstanding loans)(a)	85	150	140	300

(a) The banks report their lending for house purchase at mid-quarters and not at end-quarters. The figures used here represent the increase over the three months from the middle of the previous quarter.

interrupted payments from the Agricultural Intervention Board. Receipt of delayed payments may now cause this class of bank lending to grow less rapidly than in recent months.

Two other categories of bank lending have also been growing very fast. Lending for house purchase (including bridging finance) rose by £440 million (16%) between mid-November 1980 and mid-May, and this percentage rate of growth seems to have been maintained since. Some clearing banks have recently sought to promote lending of this kind. To the extent that lending by banks replaces lending by building societies, sterling M_3 tends to be swollen, but not the wider liquidity aggregate, PSL_2. Lending by building societies also grew fast in the first seven months of 1981, averaging £575 million a month compared with £475 million a month in 1980. Nevertheless, activity in the building industry remains very low, and house prices have continued to increase only moderately.

Other lending to persons has also recently grown fast. It seems that, as in lending for house purchase, the banks may have increased their share in consumer credit business; in particular, consumer credit extended by retailers has grown weakly and in some recent months has declined: shops have apparently sought to sell by price cuts rather than by offers of cheap credit. Another factor may be that people have used temporary bank borrowing to finance subscriptions to national savings issues (especially in May when £$\frac{3}{4}$ billion was raised, the attractive nineteenth issue of certificates being then still available). Previously, bank lending to persons (in real terms) tended to move in line with real personal disposable income, and its recent buoyancy has been a surprise, given that real personal disposable income has fallen.

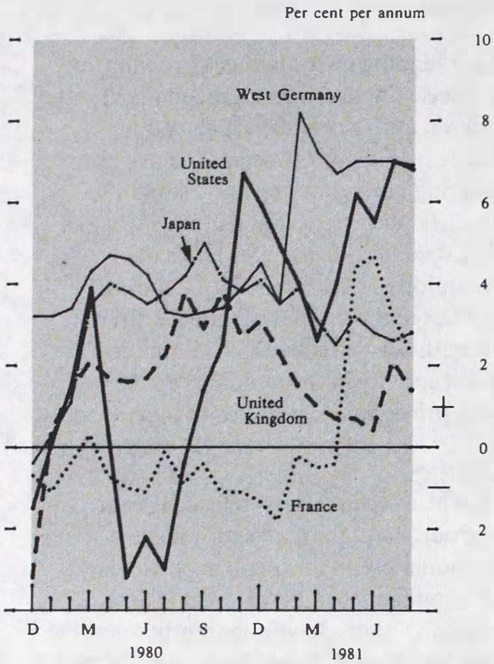
Interest rates rise since the Budget

In recent months the authorities have increasingly confined themselves to influencing very short-term interest rates through their operations in the money market, leaving market forces to determine the structure of rates.

Operations have been conducted against the background of the Civil Service pay dispute. In one way the dispute helped, although it increased day-to-day uncertainties. Before the strike, the overfunding of the public deficit necessary to restrain the growth of sterling M_3 had drained the banking system of liquid assets. This would have raised short-term interest rates sharply unless the authorities had provided assistance to the banks (see previous issues of the *Bulletin*). The interruption to tax payments reversed this process by adding liquidity to the banking system on a large scale; and the Bank was able to withdraw the assistance previously given to the banks. The boost to the CGBR thus temporarily removed liquidity shortages, which re-emerged when the dispute ended and may worsen, especially if the company sector's demand for funds recovers.

Nevertheless, interest rates have risen since the Budget, contrary to expectations at that time, and financial markets have experienced a phase of unease. Markets were influenced by high and variable interest rates in the United States; uncertainties in the exchange market; the implication of the fall in sterling for domestic prices; and the difficulty of interpreting the trend in monetary growth. As noted in the detailed account of the operation of monetary policy below, the authorities concluded, following a sharp fall in sterling

Real interest rates *are lower in the UK than abroad.*[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).

early in July, that some rise in short-term rates would be appropriate, and conducted operations so as to encourage such a movement. More recently, policy has aimed to keep very short-term rates around the higher levels established after the move in early July. Longer-term rates have also gone up: the three-month inter-bank rate stood at $13\frac{1}{2}\%$ in early September compared with $12\frac{3}{4}\%$ immediately after the cut in MLR from 14% to 12% announced in the Budget. Over the same period the yield on twenty-year gilt-edged stocks rose from $13\frac{1}{2}\%$ to about 15%.

Though the basis for estimating real interest rates is difficult, it can probably be reckoned that a small positive rate persists. On the new index-linked gilt-edged stocks—longer-dated instruments which pay a yield in real terms—the yield in early September was $2\frac{1}{2}\%$–$2\frac{3}{4}\%$. Short-term real interest rates in this country have recently been much lower than in other financial centres.

Growth of sterling M_3 affected by Civil Service dispute

Sterling M_3 grew rapidly—by 17% at an annual rate in the first six months of the current target period (to mid-August)— the dominating factor being the high PSBR resulting from the Civil Service dispute (and in August the figure was also inflated by round-tripping). The significance of the high recorded rate is likely to be different from that of an increase in the money stock arising from a more permanent cause, for companies must have regarded some of their increase in deposits as hypothecated against future tax liabilities and as not fully liquid. It has become increasingly difficult to assess the underlying rate of growth.

The authorities took the view that it was more appropriate to base their funding on the underlying trend in public borrowing. After exceptionally heavy sales both of gilt-edged stocks and of national savings in the three months to mid-May, funding in the following three months was somewhat reduced. Nevertheless, the estimated strike-adjusted CGBR in the period was more than fully funded. In the first six months of the current target period, debt sales to the non-bank public exceeded the (strike-adjusted) PSBR by perhaps £$1\frac{1}{2}$ billion.

The recorded increase in sterling M_3 in the target period so far has considerably exceeded the growth of GDP at current prices, which is likely to have been rather under 10% (at an annual rate). The liquidity ratio—the ratio of sterling M_3 to GDP[1]—must therefore have risen further from the low point reached in early 1980.

Significance of the growth of other aggregates

The other monetary aggregates have grown at very varied rates. At one extreme, the wider monetary base, which has not been affected by the Civil Service dispute, has increased very slowly—its behaviour is discussed on page 327. M_1, which was heavily affected by the dispute, grew at an annual rate of 11% in the period as a whole. At the other extreme, total M_3, which includes UK residents' foreign currency deposits with banks in the United Kingdom, has grown by some 25% at an annual rate.

It is not clear how the increase in liquidity represented by these foreign currency deposits should be interpreted. Between mid-February and mid-July, they grew by the equivalent of £2.9 billion; of this, £1.6 billion reflected valuation changes

(1) See the June *Bulletin*, page 164.

UK private sector foreign currency deposits and loans

£ billions(a); amounts outstanding

	Deposits			Loans		
	With UK banks	With banks abroad (b)	Total	From UK banks	From banks abroad (b)	Total
End-Sept. 1979	4.7	..	..	8.3	2.7	11.0
End-Sept. 1980	5.7	2.5	8.2	9.2	3.0	12.2
Mid-Feb. 1981	7.0	..	..	9.0	..	..
End-Mar. 1981	8.0	2.8	10.7	10.0	3.5	13.5
Mid-July 1981	9.9	..	..	11.5	..	..

.. not available.

(a) Converted at market exchange rates.

(b) Banks in the BIS reporting area. Deposits include commercial paper and bankers' acceptances denominated in US dollars. Figures for loans are partly estimated; they include borrowing through US dollar commercial paper.

resulting from movements in the exchange rate. The increase is the most recent phase in a development which began last year. (UK residents have also acquired more foreign currency—and sterling—deposits with banks outside the United Kingdom but within the BIS reporting area; these are not included in any UK monetary aggregate.)[1] Virtually all of the increase in foreign currency deposits with UK banks has been in time rather than sight deposits; and most of it has consisted of holdings by industrial and commercial companies, which accounted for 60% of the total at the end of June.

The growth of international business and continuing reaction to the end of exchange controls would explain some of the growth in foreign currency deposits.[2] Apart from such factors, there seem to be two possible explanations: exchange rate expectations, and the fact that interest rates available on bank deposits in foreign currencies have risen in relation to comparable sterling rates. These considerations may have influenced UK residents with debts in foreign currencies: net of deposits these debts amounted to the equivalent of £4 billion at the end of September 1980. The exchange risk inherent in foreign currency borrowing and much of the interest cost could have been covered by matching deposits. (It is not always possible to repay bank loans before maturity without incurring penalties.) The desire to cover foreign currency debts may have been particularly acute at a time when the cost of servicing them was high and the prospects of a fall in the exchange rate may have seemed fairly strong.

In the absence of official intervention, conversion of foreign currency deposits into sterling would lead to a rise in the exchange rate; spending them would therefore not carry the same implication for domestic inflation as the spending of sterling deposits. Nevertheless, foreign currency deposits represent a considerable element—over 20%—in corporate liquidity; and even though their sterling value is uncertain, unless the holders have covered forward, they may affect plans to spend.

Monetary conditions and the economy

The general financial climate, which last year appeared tight, has been modified in a number of directions by developments this year. Companies have eliminated their previous financial deficit. But this has been achieved only by severe retrenchment; and profitability, though for many firms helped by the fall in the exchange rate this year, must also have been held back by the continuance of recession and certainly remains very low. Companies have been able to raise considerable finance from new capital issues, but they remain quite largely dependent on the banks as a channel of finance; and interest rates, though lower than last year in nominal terms, are in real terms now to be regarded as positive. The rise in retail prices has not shown signs of acceleration in face of the fall in the exchange rate—the much slower rise in labour costs in the last wage round must have been a considerable offsetting factor. Looking at the more purely monetary aspects, the private sector holds in real terms more liquid assets than a year ago. But much of this represents the effects of the Civil Service dispute, and does not have the implication that it might in other circumstances. These temporary effects make the underlying situation difficult to evaluate.

(1) Based on statistics up to end-March 1981. The data on sterling deposits are shown in the table on page 342.

(2) See also the article on page 369.