Economic commentary

Introduction

This commentary summarises recent developments in the economy as the background to monetary policy. From this point of view, the most important developments concern prices and company finances.

The earlier decline in output was chiefly associated with the large run-down in stocks. Since stocks began to be reduced more slowly in the second half of last year, there has been a hesitant recovery (page 9).

Other influences on demand in the second half of last year were less important. Consumers' spending was broadly maintained during the year despite some fall in real personal disposable income (page 11). Industrial fixed investment was also virtually unchanged; within the total, the fall in manufacturing investment came to an end (page 12). Bank lending to the private sector grew strongly (pages 12 and 17). Exports were surprisingly strong, but imports grew even more rapidly; though the timing through the year, and thus the most recent trend, are uncertain (page 14).

The remarkable improvement in productivity in manufacturing industry continued (page 9)—so that, with moderate pay increases, wage costs in UK industry rose little last year. With the exchange rate declining until the autumn, industrial competitiveness improved during the year (page 15).

Price inflation, which accelerated slightly in the autumn, partly as a result of the earlier fall in the exchange rate, has slowed down again (page 16).

There has been some improvement in company profitability from a very low level (page 16). But companies' financial position, having benefited earlier from sharp reductions in stocks, weakened in the six months to September, and there are indications that their liquidity worsened in the fourth quarter when they made delayed tax payments (page 17).

The main features of the Budget are:

- A reduction in the national insurance surcharge, worth £640 million to private sector employers in 1982/83.
- Other tax reductions of £550 million (compared with what would have been the case if income tax allowances and thresholds and rates of excise duty had been increased in line with inflation); and a proposal to increase social security benefits in November by two percentage points more than expected inflation.
- Changes in oil taxation and in capital taxes.
- Measures to contain industry's energy costs, help the construction industry, and encourage small businesses.

- Government spending amounting to about £115 billion in cash terms in 1982/83, $9\frac{1}{2}$% more than estimated spending in 1981/82.

- A public sector borrowing requirement (PSBR) of about £$9\frac{1}{2}$ billion in 1982/83, £1 billion below the estimated outturn for 1981/82 and equivalent to $3\frac{1}{2}$% of GDP.

- A target range for monetary growth of 8%–12% in 1982/83, applying to the broad aggregates, sterling M_3 and PSL_2, and to M_1; the removal of restrictions on holdings of index-linked gilt-edged stocks.

Changes in output

Percentage change on previous quarter

	Manufacturing(a)	Other industrial	Non-industrial(b)	GDP
1980 Q1	−4.0	+0.5	+0.4	**−0.8**
Q2	−2.7	−2.5	−0.6	**−1.5**
Q3	−4.2	−1.9	−0.6	**−1.7**
Q4	−5.3	—	−0.3	**−1.5**
1981 Q1	−1.0	−1.6	—	**−0.5**
Q2	+0.6	−1.7	−0.5	**−0.4**
Q3	+2.0	+1.0	+0.1	**+0.7**
Q4	—	+0.5	+0.4	**+0.3**

(a) The implied level of output, after adjustment for sales out of stock.

(b) A residual.

A hesitant recovery in output . . .

After eighteen months of decline, total output rose by just under $\frac{3}{4}$% in the third quarter, when a sharp fall in the rate at which stocks were reduced brought a $2\frac{1}{2}$% increase in domestic demand. In the fourth quarter GDP rose slightly, making an aggregate recovery of around 1% following the 6% fall since 1979.(1)

Most of the improvement in the second half of last year was in industrial production. The rate of extraction of North Sea oil and gas increased again. Other industrial production rose by about $1\frac{1}{4}$% between the first and second halves, despite falling by $\frac{1}{2}$% between the third and fourth quarters. Experience in the fourth quarter varied from industry to industry: metal manufacture rose (though from a very low level), whereas chemical production slipped back, and the engineering and textile, leather and clothing sectors remained depressed. Altogether, manufacturing production in the fourth quarter was 14% below the 1979 average. Outside manufacturing, the output of public utilities rose by 4% in the fourth quarter, partly because the weather increased demand for gas and electricity; but construction activity appears to have been adversely affected by the weather after a recovery in the third quarter. In January, industrial production (excluding oil and gas) fell for the third successive month.

. . . reflected in labour market; productivity continues to rise

Employment continued to fall in the third quarter of 1981, but less rapidly than before. In manufacturing, employment in the fourth quarter declined at about the same rate as in the third (although with a rather large decrease in December), but much more slowly than in the first half of the year. By the autumn, more overtime was being worked in manufacturing(2) than earlier in the year and short-time working was far less widespread. Nevertheless, the increase in average hours worked was insufficient to offset the decline in the number employed, and total hours worked in manufacturing industry declined further.

The recession has accentuated an established trend in manufacturing employment; in the last ten years or so, such employment has fallen by more than two million (25%), over half of this in the last two years. There has been a similar trend in some other industrial countries (see box overleaf) but the recent sharp decline here—like the strong increase in productivity—has not been matched elsewhere.

(1) Between 1979 and the first quarter of 1981 (no second quarter figure is available), the expenditure measure of GDP declined by considerably less—some $3\frac{1}{4}$%. The average of the output, expenditure and income measures of GDP may be estimated to have declined by 4%–5% between 1979 and the middle of last year.

(2) The only sector for which figures are available.

Manufacturing productivity in the major OECD countries

The much slower growth of manufacturing output in the major economies since the first oil shock (2.5% per annum on average between 1973 and 1981, against 6.3% per annum between 1960 and 1973) has been accompanied by a marked fall in rates of productivity growth (see table). While output growth remains sluggish, it is difficult to know whether this represents a permanent slowing or merely the normal response to an (unusually prolonged) cyclical downturn.

Per cent

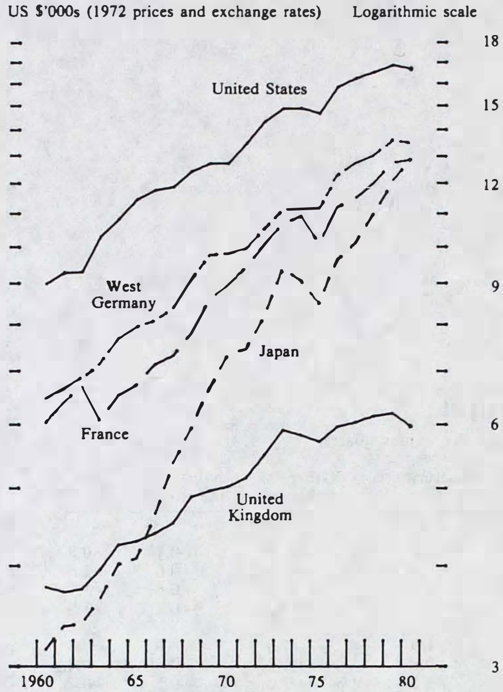
	1960–73		1975–81 (annual average)		
	Average annual growth in productivity	Net investment as proportion of GDP (whole economy)	Growth in: Productivity	Output	Employment
US	3.7	7.4	2.6	4.4	1.8
Japan	8.7	19.7(a)	7.4	6.6	−0.8
West Germany	4.2	15.5	3.2	2.4	−0.8
France	4.4	13.1	4.1	2.2	−1.8
UK	3.5	9.7	1.5	−1.9	−3.3

(a) 1965–73.

The determinants of productivity growth over the long run are imperfectly understood; changes in the size of the capital stock, in its suitability to meet demand, and in the technology which it embodies, are clearly important. Other factors may include the size and composition (in terms of age and skill) of the working population. In the United States, for example, weaker performance has been largely attributed to a slower rate of improvement in the quality of the capital stock—perhaps partly because the United States had already achieved a high absolute level of productivity. There is some evidence, too, that the growth rates of output and productivity are linked in the long run, but there is no agreement on the causal relationships—which, indeed, probably run in both directions. Again, as the table demonstrates, net investment as a proportion of GDP shows some correlation with long-term rates of productivity and output growth, but the causality is equally ambiguous.

In the short run, however, the rate of change in output has usually been the most powerful influence on productivity. But in the current recession, the UK experience has been quite contrary to the normal pattern. Despite the sharp drop in output, labour input has fallen even faster, giving rise to substantial productivity gains. One reason for this is probably the weakness of industrial profits over a period of years. This meant that the manufacturing sector entered the period of acute competitive pressure beginning in 1979 with little capacity to absorb any further erosion in its financial position. There was, consequently, an immediate need to achieve cost savings, with the impact falling mainly on employment but also on holdings of stocks. This combination of circumstances, at least in degree, has probably been unique to the United Kingdom, so that although labour markets in most other countries weakened rapidly after the middle of 1981, it seems unlikely that the United Kingdom's experience will be repeated elsewhere.

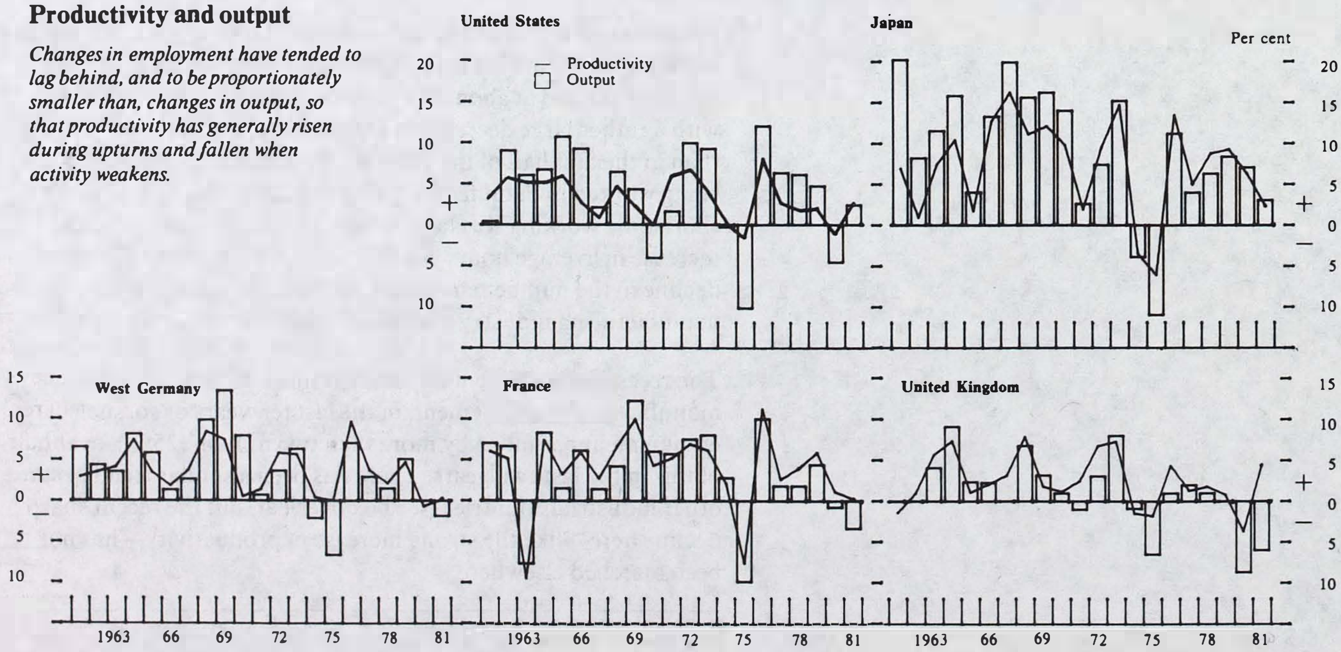
Productivity growth[a]



(a) Secular exchange rate shifts mean that the chart does not necessarily reflect changes in relative *levels* of productivity.

Productivity and output

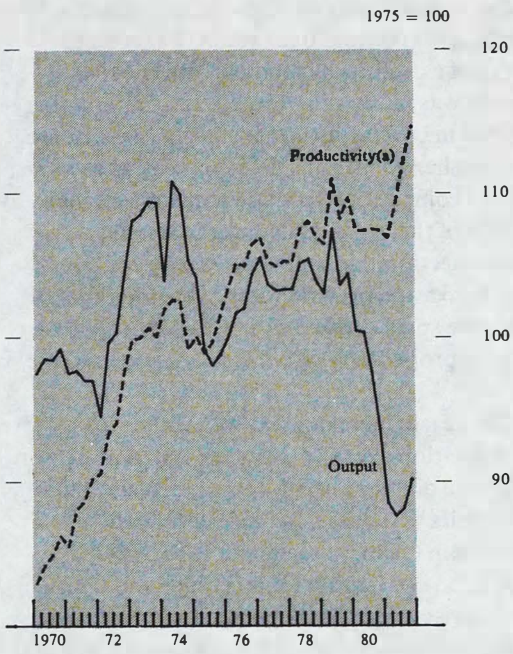
Changes in employment have tended to lag behind, and to be proportionately smaller than, changes in output, so that productivity has generally risen during upturns and fallen when activity weakens.



Duration of registered unemployment
Percentage of total registered unemployed

	Unemployed for: Up to 26 weeks	26–52 weeks	Over 52 weeks
January			
1979	58	18	24
1980	60	16	24
1981	61	20	19
1982	48	23	29

Productivity *rose by over 8% during 1981.*



(a) Output per man-hour.

Real personal income and spending(a)
1977 H1 = 100; *seasonally adjusted*

	1980 H2	1981 Q1	Q2	Q3
Income from employment(b)	113	111	109	109
Current grants from the Government	123	129	131	135
Other income	119	114	114	114
UK taxes on income(c)	98	96	101	102
Total disposable income	**120**	**119**	**117**	**117**
Consumers' expenditure	111	112	112	111
Personal savings	204	185	163	169

(a) Using the price deflator for consumers' expenditure.
(b) Wages and salaries, forces pay, and employers' national insurance contributions.
(c) Including employees' national insurance contributions and net transfers abroad.

Registered unemployment in recent months has been reduced by the transfer of some older men from the unemployment register to the long-term supplementary benefit scheme. By February, the change had reduced the recorded number of unemployed by perhaps 30,000. Even without this change, however, the monthly increase in adult unemployment (seasonally adjusted) slowed somewhat, from an average of 40,000 a month in the second half of 1981 to 34,000 in the latest three months. The total of unemployed, including school leavers and not seasonally adjusted, exceeded 3 million ($12\frac{3}{4}$% of the labour force) for the first time in January. A growing proportion of the total has been without work for six months or more—1.6 million in January, compared with 0.6 million three years earlier. But the number of vacancies reported to employment offices has picked up from the very low level of 90,000 or so in the middle of 1981 to about 110,000 in the latest three months.

The new index of output per man-hour in manufacturing industry[1] rose by nearly $8\frac{1}{2}$% during 1981, after a fall of $2\frac{3}{4}$% in 1980. Some growth in productivity would have been expected to accompany the modest rise in output last year. But the fall in productivity during 1980 was less than might have been expected, given the decline of nearly $15\frac{1}{2}$% in output. Thus by the end of last year productivity in manufacturing industry was higher—by perhaps 5%—than previous experience would have suggested. Previous *Bulletins* have noted possible reasons for better productivity. Widespread closures of unprofitable plants (in many of which productivity may have been below average) would themselves raise average productivity somewhat;[2] other influences probably include a rapid discharge of labour in response to falling profitability and financial pressures, and a benefit from more lasting changes in work practices.

Demand[3]

Consumers' expenditure

After earlier falls, real personal disposable income (RPDI) increased by 20% between the first half of 1977 and the second half of 1980, considerably faster than the 11% increase in consumers' expenditure. (GDP rose by $1\frac{1}{2}$% over the same period.) Although employment was falling, average earnings and other sources of personal income (including social security payments) were increasing considerably faster than prices, helped by the rising exchange rate. Personal savings increased as a proportion of disposable income, from $9\frac{3}{4}$% in the first half of 1977 to an unusually high $16\frac{1}{2}$%. However, probably half of the saving can be regarded as restoring the real value of assets eroded by inflation.[4]

More recently, by contrast, RPDI has fallen—by some 3% between the second half of 1980 and the third quarter of 1981. Reflecting the steep fall in employment, current grants from the Government continued to grow, but other categories of income declined in real terms, and a larger proportion of income was taken in taxes and employees' national insurance contributions. Consumer spending was little changed, so that personal saving fell substantially.

(1) See *Economic Trends*, January 1982. The figures take account of hours worked by non-manual workers.
(2) Output has tended to contract most in those sectors of manufacturing industry in which value added per head was lowest in 1979, the latest year for which figures are available.
(3) Components of demand are expressed at 1975 prices, and seasonally adjusted.
(4) In 1978–80, inflation reduced the real value of the personal sector's net assets fixed in money terms by over £30 billion. Personal saving in the period amounted to about £60 billion. See the June 1981 *Bulletin*, page 233.

In the fourth quarter, saving probably fell further (consumer spending rose by 1% and RPDI was probably little changed).

At 13% or so, the saving ratio would still be high by past standards. Nevertheless, committed saving and capital expenditure by the personal sector may have amounted to more than the whole of savings, implying that other (discretionary) saving was negative, as it has been quite commonly in the past.[1]

This need not mean that people were drawing on their assets: a fall in the saving ratio can reflect borrowing to maintain or increase consumption in the face of a decline in income. Until the fourth quarter, consumer credit was increasing rapidly. In addition, there has been a very sharp rise in borrowing on mortgage. In each case, the banks increased their share of the business. Some houseowners, taking advantage of keen competition to lend on mortgage, may have borrowed on the security of their houses in order to finance consumption. In this connection, the Bank issued a notice on 20 January, asking the banks and other lenders to ensure that mortgage borrowings were spent on buying a house or on improvements to existing property.[2]

Consumer credit[(a)]

£ millions; *not seasonally adjusted*

	Quarterly rates				
	1980		1981		
	H1	H2	H1	Q3	Q4
Banks(b)	285	295	510	650	400
Non-bank finance houses	180	135	110	30	..
Retailers	– 15	50	– 50	– 60	170
Insurance companies	15	10	10	15	..
Total	465	490	585	630	..

.. not available.

(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 monetary sector (including the trustee savings banks), excluding lending for house purchase.

The Budget proposed increases in income tax allowances and thresholds in excess of inflation over the past year, and increases in excise duties below the rate of inflation. Moreover, pensions and other social security benefits will rise in November by two percentage points more than the expected increase in prices. Nevertheless, the likelihood of a further fall in employment, price increases in excess of pay rises, and the increases in employees' national insurance contributions announced in December, are likely to bring some further decline in RPDI this year.

Growth in consumer spending this year would thus depend on a further reduction in the saving ratio. The possibility of this occurring is increased by the lower rate of inflation now in prospect (the Treasury forecast a 9% rise in retail prices in the twelve months to the fourth quarter of this year and 7½% in the year to mid-1983), which might encourage spending by reducing the amount which people have to save in order to preserve the real value of their monetary assets.

Fixed investment

In the recession of the mid-1970s, industrial investment[3] fell by 12%. North Sea investment increased strongly, but remaining fixed investment fell somewhat on balance, leaving total fixed investment little changed. Previous issues of the *Bulletin* have noted the change in recent years in the composition of investment—away from housebuilding and public services and towards industrial investment. In the present recession, industrial investment has been maintained near its peak of 1980, whereas investment in housing and public services has fallen sharply.

Fixed investment

£ billions, 1975 prices

	Last recession			This recession		
	1974	1975	1976	1979	1980	1981
Manufacturing, distributive and service industries(a)	8.3	7.4	7.3	9.9	10.0	9.6(b)
Petroleum and natural gas	0.7	1.4	1.8	1.3	1.2	1.4(c)
Housing	3.8	4.1	4.3	3.6	3.1	2.4(c)
Public services	3.2	3.0	3.0	2.3	2.2	1.9(c)
Other	4.1	3.9	3.6	3.1	3.6	3.2(c)
Total(d)	**20.1**	**19.8**	**20.0**	**20.2**	**20.1**	**18.5**

(a) Excluding shipping.
(b) Provisional.
(c) First three quarters at an annual rate.
(d) Excluding transfer costs of land and buildings.

It is perhaps surprising that industrial investment should have remained so high in the last two years, given the pressure on companies' financial position and the low profitability of their existing assets in relation to the cost of finance. On the other hand,

(1) See 'Committed and discretionary saving', *Economic Trends*, November 1981.
(2) The text of this notice is reproduced in footnote 4 on page 23.
(3) Fixed investment in manufacturing, distributive and service industries.

the number of people employed in industry has fallen much more sharply in the current recession than in the mid-1970s. Exact comparison is not possible, but the percentage fall in employment in industry since 1979 has probably been two or three times as large as in the earlier recession. In the present recession, therefore, it seems that companies have been more ready to shed labour than to cut their investment plans.

In 1981 industrial fixed investment (excluding shipping) was 4% lower than in 1980, but considerably higher than in earlier years (except 1979). In the fourth quarter, it rose by about 1%, leaving very little change between the two halves of the year. Within the total, investment by manufacturing industry (including an allowance for leased assets)—about one third of the whole—rose slightly in the fourth quarter, but in the year was 13% lower than in 1980.

The December Department of Industry investment intentions survey suggested a rise of perhaps 2% in total industrial investment this year, but a fall of about 1% in manufacturing investment (including leased assets). However, manufacturing investment would recover in the course of the year. This is a better prospect for manufacturing than the fall of 5%, year on year, suggested by the January CBI industrial trends survey; nevertheless, the CBI also expects investment to recover during the year and to grow quite rapidly in 1983.

Lending for house purchase

£ millions; *not seasonally adjusted*

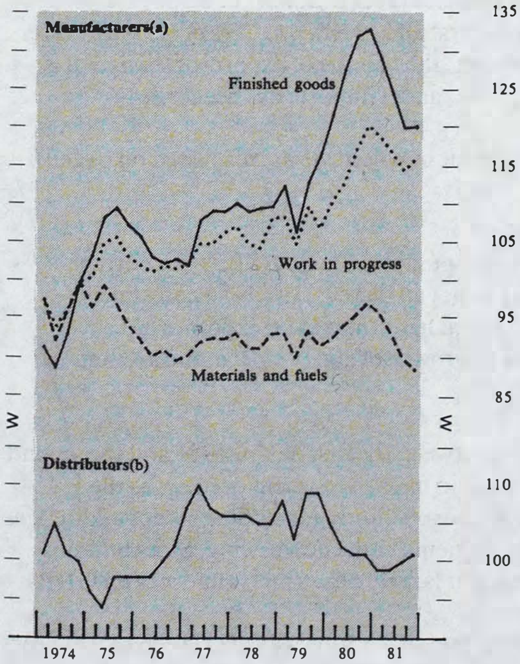
	Quarterly rates				
	1980		1981		
	H1	H2	H1	Q3	Q4
Building societies	1,250	1,610	1,685	1,560	1,270
Banks	100	145	300	730	870
Other lenders	310	275	225	275	..
	1,660	2,030	2,210	2,570	..

.. not available.

Last year, less than half as much housing was begun as, on average, in the mid-1970s, with starts in the public sector especially low; the number of houses under construction declined throughout the year. There was no real sign of recovery in activity until January, although bad weather probably accounted for some of the decline in starts in the fourth quarter. House prices have been stable or falling since last summer, despite a record amount of mortgage lending last year. The banks, whose share grew substantially, accounted for nearly a quarter of the lending, and building societies for about two thirds.

Stocks ***now look more reasonable in relation to output and sales.***

Seasonally adjusted 1974 Q4 = 100



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

Stockbuilding

Stocks were reduced very sharply in 1980 and the first half of 1981—altogether by £4 billion (at 1975 prices), equivalent to about $2\frac{1}{2}$% of GDP in the period. In the third quarter of last year, by contrast, stocks fell by less than £0.2 billion, and figures for the fourth quarter suggest that stocks fell by under £0.1 billion. It is the *change* in the amount by which stocks are reduced that contributes to the growth in output, and the turnround in the second half of the year amounted to over £$1\frac{1}{2}$ billion, most of the impulse to output occurring in the third quarter.

Despite the large reduction that has already taken place in manufacturers' stocks, the balance of respondents to CBI surveys[(1)] reporting excessive stocks of finished goods has remained at around 20% since last summer (and, at 24% in February, was the highest since last April). Other categories of stocks are perhaps at a more reasonable level in relation to output and sales.

Fixed investment and stockbuilding are discussed further in the context of company finance on page 17.

(1) The excess of respondents reporting 'more than adequate' stocks of finished goods over those reporting 'less than adequate' stocks.

External trade in goods and services

During 1981 the balance of trade in volume terms deteriorated, as expected after the earlier loss of competitiveness and the sharp reduction in the rate of destocking. Although the figures are not complete and are distorted by changes affecting the recording of exports, the broad outcome is clear: exports of goods and services increased by perhaps 8% between the early months of 1981 and the fourth quarter; imports rose by 16%.

The volume of exports of goods (other than oil, which grew rapidly, and the usual erratic items) rose by 10½% between the beginning of the year and the fourth quarter. With markets abroad growing at less than half this rate, the increase in exports must seem surprising in view of the earlier loss of competitiveness. But exports were exceptionally low last January and February, and early 1980 is a better basis for comparison.[1] Since then, exports of manufactured goods (excluding erratic items) have fallen slightly, while markets have grown by perhaps 3½%.

The volume of non-oil imports of goods (excluding erratic items) rose by 24% from the very low level at the beginning of 1981, the most pronounced growth being in finished manufactures. Slower reductions in stocks from mid-year were no doubt an influence; on the other hand, the gain in competitiveness over the last year would, on past experience, have reduced imports quite quickly. Imports were surprisingly low early last year—even more so than exports—perhaps reflecting the depth of the recession, which had no recent precedent. Between early 1980 and the fourth quarter of last year, however, their growth was also much faster than past experience would have indicated. Imports of finished manufactured goods (excluding erratic items) grew by 9½% in volume during the period, despite the fall in domestic demand. The implied rise in import penetration since the first quarter of 1980 cannot be fully explained either by movements in competitiveness or by the long-established tendency for imports to rise over time irrespective of changes in competitiveness and domestic demand.

Exports and imports of services rose at about the same rate—a little under 2%—between the first and fourth quarters of last year. Over the longer period, however, the volume of exports of services has tended to decline, whereas that of imports has been steady.

Other aspects of the balance of payments are discussed on page 18.

Prospects of some growth

Although real personal disposable income is likely to contract further, the Treasury predict an increase of ½% in consumers' expenditure this year. Fixed investment and exports are also expected to contribute to growth of about 1½% in the average measure of GDP.

In the eighteen months between the first half of 1981 and the second half of this year, exports and fixed investment are seen as the strongest elements in final expenditure (excluding stockbuilding), as they were the weakest elements in the downswing. Stockbuilding and imports are strong, but largely offsetting, influences on GDP.

The average error in the Treasury's forecasts of GDP in recent years has been 1%. Exact comparison with leading independent

(1) See the December 1981 *Bulletin*, page 458.

Contributions to the change in GDP

Percentages; annual rates

	1979 (average)–1981 H1(a)		1981 H1–1982 H2(b)	
	Change in the component	Contribution to the change in GDP	Change in the component	Contribution to the change in GDP
Consumers' expenditure	+0.2	+0.1	+ 0.4	+0.3
Government current expenditure on goods and services	+1.3	+0.3	+ 0.8	+0.2
Gross fixed investment	−4.6	−0.9	+ 3.1	+0.6
Exports (goods and services)	−2.1	−0.7	+ 4.2	+1.3
Final expenditure on goods and services (excluding stockbuilding)	−0.8		+ 1.6	
Stockbuilding		−2.9		+2.7
Imports (goods and services) (increase −)	+6.2	+2.1	−11.0	−3.5
Adjustment to factor cost (increase −)	+0.9	+0.1	− 2.7	−0.3
GDP (expenditure measure)		−1.9		+1.3
GDP (average measure)		−3.2		+1.5

(a) Partly estimated.
(b) Industry Act forecast.

Volume and price components of GDP[(a)]

Percentages, annual rate

	GDP	of which: volume	price
Changes between			
1970 and 1975	+16.7	+2.0	+14.4
1975 and 1980	+15.4	+1.3	+13.9
1981 Q1 and 1982 Q1(b)	+10	+1	+ 9

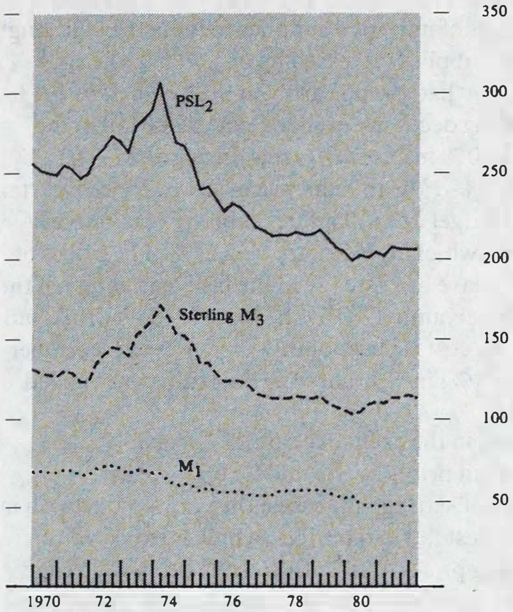
(a) GDP (expenditure measure) at factor cost.

(b) Estimates.

Liquidity *has risen slightly in the last year, but remains lower than for much of the 1970s.*

Seasonally adjusted

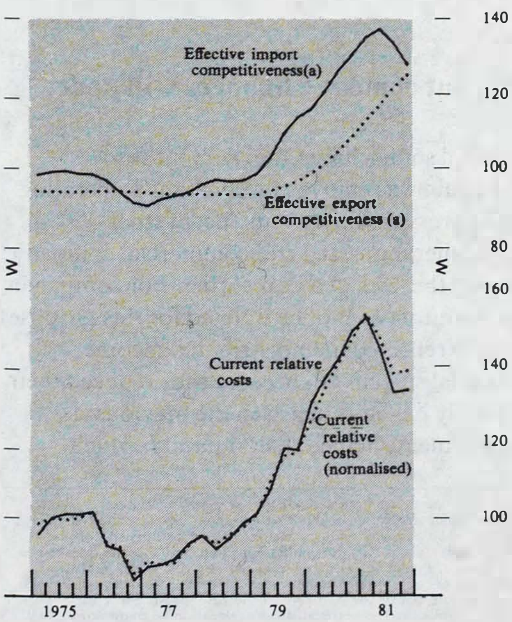
Per cent of GDP(a)



(a) Estimated since 1981 Q1.

Last year **labour costs** *in UK industry fell in relation to costs abroad.*

1975 = 100



(a) Effective competitiveness measures the impact in the period shown of current and past changes in relative labour costs, with allowance for time lags. A rise indicates a deterioration in competitiveness.

forecasts is not possible, but the official forecast appears broadly in line with independent forecasts if allowance is made for the effect of the Budget and the fall in oil prices (see the table on page 5).

Slower growth in nominal national income

The change in GDP at current prices is made up of the change in the volume of income or spending and the change in overall prices. In the year to the first quarter of 1982—a period which closely approximates to the first twelve months of the current target period for sterling M_3—GDP probably grew by about 10% at current prices, much more slowly than for most of the last decade. There may have been a small increase in volume.

In the twelve months to mid-February, sterling M_3 increased by $14\frac{1}{2}$%, M_1 by $8\frac{3}{4}$% and PSL_2 by 12%, with the banks' growing share in the financial system boosting sterling M_3 in relation to the other aggregates. Despite the recent small increase in the ratios of sterling M_3 and PSL_2 to GDP, liquidity ratios are still well below those that prevailed for much of the 1970s. The ratio of M_1 to GDP has been falling gradually over a period of years. Monetary developments are discussed at length in the review beginning on page 19.

The Treasury forecast an increase of $9\frac{3}{4}$% in nominal GDP in 1982/83, following an estimated rise of $10\frac{1}{2}$% in 1981/82.

Pay settlements continue moderate . . .

Average earnings rose by over 20% in the year to July 1980. In the subsequent twelve months, the increase was halved to 11%. The year-on-year increase in earnings has continued at around this level in recent months, still largely reflecting settlements in the previous round as well as a substantial increase in average hours worked in manufacturing. The rate at which settlements are being made in the current pay round is much lower than this—around 7% on average in manufacturing, with a range of outcomes around this figure elsewhere in the economy. The recent offer to the Civil Service was in line with the 4% allowed for increased pay in cash limits. The underlying monthly increase in average earnings (which includes the effect of changes in hours worked) is estimated by the Department of Employment to be about $\frac{3}{4}$%. If earnings continue to rise at this rate, the increase in this wage round, after allowance for temporary factors, will be about 9%.

. . . contributing to slow growth in unit labour costs

The combination of moderate pay increases and the rapid growth of productivity has meant that wage and salary costs per unit of output in manufacturing industry have risen very little. In the fourth quarter these costs were only $2\frac{1}{2}$% higher than in the fourth quarter of 1980. (In 1980, by contrast, they were 23% higher than in 1979; even in 1977, the best recent year, the increase was $8\frac{1}{2}$%.) In the economy as a whole, the improvement—although still substantial—was less marked. In the third quarter of 1981, unit costs were $6\frac{3}{4}$% higher than a year earlier (compared with whole-year increases of 22% in 1980 and 8% in 1977).

In contrast to the experience of earlier years, the rise in industrial wage costs last year was lower here than in most major industrial countries. With a fall of 10% in the sterling effective exchange rate over the year, there was a substantial gain in industrial cost competitiveness to set against the huge loss of earlier years.[1]

Price rises easing again

As well as contributing to industrial competitiveness, the behaviour of labour costs is reflected in domestic costs and prices generally. Modest growth in unit labour costs in the economy helped to keep the rise in the GDP deflator[2] down to 9% or so in the course of last year, although profits (and the gross trading surpluses of public corporations) rose by 20%. In the year as a whole, the increase in the deflator may have been about 11%—compared with 18% in 1980.

Retail prices

Percentage changes

	Increase in year to January	Contribution to total increase over year to January(a)
Food, drink, and tobacco	14.6	4.7
Housing	22.8	3.1
Household durables	3.7	0.2
Clothing	− 0.2	—
Transport(b)	12.0	1.6
Miscellaneous goods and services(b)	8.4	1.0
Goods and services provided mainly by nationalised industries	10.9	1.1
All items	**12.0**	

(a) Contributions will not sum to the total change since the table excludes some small items contained in the RPI.

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

The GDP deflator, being based on factor cost, omits indirect taxes, with their periodic and uneven effects, and, as an index of home costs, excludes the prices of imported supplies to industry. Although the prices of bought-in supplies increased by only 1% in the six months to February, they had risen sharply in the first half of 1981 under the influence of the declining exchange rate. The fall in the exchange rate—about 10% in effective terms during 1981—has, by itself, probably added 1%–1½% to retail prices so far. Moreover, tax increases in the 1981 Budget are still influencing the year-on-year increase in retail prices, which in February was 11%. The prices of many household items have been steady in the last year; much of the increase in the index is accounted for by the price of food, drink and tobacco, and by housing costs. The monthly increases in December and January were only ½%; in February the index was unchanged.

Last year's depreciation in the exchange rate will probably add a further 1%–1½% to retail prices by the middle of next year. Nevertheless, there are offsetting influences: the very slow growth in unit labour costs; the latest fall in oil prices, which is expected to reduce wholesale buying prices by 2%; the recent cut in mortgage rates; and the Budget measures—notably the reduction in the national insurance surcharge from August, the various steps to contain industry's energy costs, and the decision to raise excise duties by less than the rise in prices over the past year. The official forecast is for retail prices to rise by 9% in the year to the fourth quarter of 1982, and by 7½% in the twelve months to the second quarter of 1983.

Profits rise slightly, but company finances still under pressure

Company profits recovered somewhat in the six months to September. Much of the gain was enjoyed by companies operating in the North Sea, but the gross trading profits (net of stock appreciation) earned by other industrial and commercial companies rose by over 5%, to regain the level of a year earlier. For companies as a whole (North Sea operators cannot be isolated for this purpose), the rise in profits was fully reflected in undistributed income. Nevertheless, their financial surplus fell because they reduced their holdings of stocks by barely half as much as in the previous six months. Delays to tax payments helped their liquidity, which

Companies' income and expenditure

£ billions; *seasonally adjusted*

	Six-month periods			
	1979 Q4–1980 Q1	1980 Q2–Q3	1980 Q4–1981 Q1	1981 Q2–Q3
Income				
Gross trading profits (net of stock appreciation)	12.4	11.6	11.7	12.9
Excluding North Sea operations	*9.3*	*8.1*	*7.7*	*8.1*
Other income	4.2	3.6	3.9	3.8
Total	**16.6**	**15.2**	**15.6**	**16.7**
Allocation of income				
Dividends, interest, profits due abroad	8.2	8.2	7.4	7.0
UK taxes on income	2.4	2.5	3.3	3.4
Balance: undistributed income	**5.9**	**4.5**	**5.0**	**6.2**
Expenditure				
Fixed investment	7.5	7.8	7.8	7.6
Stocks	0.4	− 1.4	− 3.7	− 1.9
Taxes on capital (net of capital receipts)	− 0.1	− 0.2	− 0.2	− 0.3
Balance: financial surplus +/ deficit−	**− 1.9**	**− 1.7**	**+ 1.1**	**+ 0.8**

(1) Competitiveness discussed here is computed from actual changes in productivity and labour costs, not 'normalised' changes which adjust actual increases in labour costs by 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 in the last year or so. 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.

(2) The average price (in relation to some base date, at present 1975) of all goods and services produced in the economy.

(to judge from partial information) deteriorated in the fourth quarter when there was a net recovery of delayed tax.

For companies not operating in the North Sea, the improvement in profits followed declines, even in nominal terms, since 1979. The share of their gross trading profits (net of stock appreciation) in domestic income shrank from $10\frac{1}{2}\%$ in 1979 to $7\frac{1}{2}\%$ in the six months to March 1981. (The inclusion of North Sea operations gives a smaller decline, from $13\frac{1}{2}\%$ to $11\frac{1}{2}\%$.) The real profitability(1) of companies (excluding North Sea operations) followed a similar course. From 5% in 1979, it fell to barely 2% early last year, before recovering slightly to $2\frac{1}{2}\%$ in the third quarter; real profitability of about 10% had been normal in the 1960s and early 1970s. At recent levels, and allowing for tax, profitability on existing assets is substantially less than the real cost of finance.(2)

Very little of companies' financial surplus in the six months to September was accounted for by delays to tax payments, since the bulk of taxes due from companies is entered on an accruals basis and not a payments basis when the financial surplus is computed. However, delayed tax payments—amounting to about £$3\frac{1}{4}$ billion in the period—would have benefited their holdings of liquid assets substantially. Companies borrowed another £$3\frac{1}{4}$ billion from the banks. Despite a rise of £$5\frac{1}{2}$ billion in their identified holdings of liquid assets (including revaluation effects), their liquidity position (treating delayed tax as a liquid liability) appeared to deteriorate.

Figures for the financial transactions of industrial and commercial companies in the fourth quarter are not yet available. Profits increased further, but the banking figures suggest that businesses continued to borrow heavily (with a revival of foreign currency borrowing and a reduction in foreign currency deposits); and the 210 large companies sampled by the Department of Industry experienced a deterioration of about £1 billion in their net current assets. Delayed tax payments contributed to this.

Among the Budget proposals, industry will benefit most from the reduction in the national insurance surcharge, worth over £0.6 billion to private sector employers in 1982/83, and the measures to contain energy costs, which will save industry perhaps £150 million in the coming year. In addition, support for innovation and enterprise and the various proposals to encourage building and improvement work will help businesses. Together with the $\frac{1}{2}\%$ cut in bank base rates following the Budget, these proposals might benefit the business sector by over £1 billion in the coming year. Much of the gain will no doubt be passed on in prices, but companies' cash flow should also benefit.

Although a further improvement in the profitability of industrial and commercial companies is in prospect with a further rise in the share of profits in income, there could nevertheless be some deterioration in their financial position as expenditure on stocks and fixed assets recovers.

(1) Gross trading profits, net of stock appreciation and depreciation at replacement cost, as a percentage of trading assets valued at replacement cost. Because stock appreciation has slowed down, profitability including stock appreciation has improved less. Positive real interest rates will have held down the real rate of return on the equity interest in companies (in contrast to the return on trading assets in the conventional measure).

(2) See the June 1981 *Bulletin*, page 229. The ratio between the average rate of return on trading assets and the cost of capital (both expressed in post-tax real terms) has improved little, if at all, since 1980.

Current account surplus large but diminished

The surplus on visible trade fell to some £0.6 billion in the fourth quarter of 1981, rather less than half the rate early in the year.[1] With the contribution from oil probably little changed, the deterioration was entirely on non-oil account. With the surplus on invisibles also reduced, the surplus on current account was £1.5 billion—compared with an estimated quarterly rate of nearly £3 billion in January and February 1981.

Although the surplus on invisibles fell in the course of last year, it was larger in the year as a whole (£3¼ billion) than in 1980 (£1¾ billion). A gain of £1¼ billion in the interest, profits and dividends account, from a small deficit to a (more normal) surplus, was the main contributory factor: UK banks earned more from borrowing and lending in foreign currencies, and foreign oil companies earned less from their UK operations. Net transfers to the European Community budget were £¼ billion less than in 1980.

From these invisibles figures, and from what is known of visible trade, the surplus on current account is estimated to have been £8 billion in 1981, but it is likely to be considerably smaller this year.

Interest rate differentials moved strongly in favour of sterling in the fourth quarter. Identified capital flows were in slight surplus, following a period of sizable net outflows, but there was a very large negative balancing item. Among identified flows, the banks' net external borrowing in foreign currencies was heavy, as their customers switched into sterling, partly to finance tax payments delayed by the Civil Service dispute. On the other hand, portfolio investment abroad may have increased a little, although the outflow was smaller than in the second half of 1980 and the first half of 1981, when it averaged over £1 billion per quarter.

Official financing in the fourth quarter (the fall in the reserves, excluding amounts to repay foreign currency debt) amounted to £0.1 billion. Sterling was under pressure at times in October, but recovered to close the year at 90.9 in effective terms (1975 = 100). Although weaker against the dollar, mainly on account of interest rate differentials, it has been little changed on balance in effective terms in the first quarter. Conditions in the foreign exchange market were, however, subject to fluctuating influences, and exchange rate considerations continued to affect domestic financial markets and the operation of monetary policy.

Capital flows

£ billions; *not seasonally adjusted*

	1980	1981			
	Year	Q1	Q2	Q3	Q4
Banks' net external lending in foreign currency	+2.0	−0.6	−0.8	+0.1	+2.6
Banks' sterling lending overseas	−2.5	−1.2	−0.4	−0.8	−0.5
Outward portfolio investment	−3.2	−1.3	−1.1	−0.8	−0.9
Net direct investment (non-oil)	−0.5	−1.0	−0.2	−0.9	−0.6
Sterling balances(a)	+3.8	+0.4	+1.1	+1.2	+0.1
Other flows	−1.0	+0.5	−0.6	+0.1	−0.6
Total identified capital flows	**−1.4**	**−3.2**	**−2.0**	**−1.1**	**+0.1**
Balancing item	*−0.4*	..	..	..	*−2.1*

.. not available.

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

(1) Figures for exports of goods are available for January, February, and September–December. Figures for imports of goods are available for January–April and September–December. Compilation of invisible transactions was not held up by the Civil Service dispute. Estimates for the current account in the first quarter, and for the whole year, are therefore based on partial information.