General assessment

This assessment discusses world output and inflation as the background to developments at home; and suggests that the slackening pace of UK inflation, while partly reflecting worldwide recession, owes more to policies, and responses to them, at home. It goes on to discuss the problems, with private sector demand for bank loans unusually great, of maintaining control over the growth of broad money, and the role of debt sales in that context.

World growth slow but inflation receding

Industrial countries have continued to give priority to lowering inflation. In most, policy has been somewhat restrictive; and, for a variety of reasons, short-term interest rates have been strongly positive in real terms, particularly in the United States. Output in the major industrial countries, having remained flat in the second half of last year, has probably fallen since. Output forecasts have recently had to be revised downwards, but there seems a reasonable prospect of a rise in the second half of this year, and of growth next year of perhaps 2% to 3% (page 184)—though the strength of the upturn depends crucially on the expected recovery in the United States. Growth of that sort, however, would probably be insufficient to stop the continued growth of unemployment.

Since the onset of recession two years ago, world inflation has slowed markedly. The twelve-month increase in consumer prices in the major overseas economies has declined from an average of about 12% to about 7%. Much of the improvement has come from the weakness—not fully expected—of oil and commodity prices. The dollar price of internationally-traded oil is now about 8% lower than in early 1981. For other commodities, prices have fallen sharply since late 1980 in dollar terms—and, indeed, have fallen in terms of most other currencies.

Much of the weakness of primary product prices must be due to the anti-inflationary policies pursued by industrialised countries as a group—reflecting a sensitivity to the level of activity which would operate in the opposite direction in the event of any rapid recovery of activity. The weakening of commodity prices is seriously worsening the income and payments position of many developing countries; this, in turn, is tending to reduce their demand for imports from the advanced countries, and is thus one of the elements contributing to the general weakness in prospect.

Growth prospects in the United Kingdom

Total output in the United Kingdom rose by about $\frac{3}{4}$% during the second half of last year, and industrial production by rather more (by $1\frac{1}{2}$% between the second and third quarters). Since last autumn, however, there appears to have been no further increase, although the effect of exceptionally harsh weather around the turn of the year obscured the position. Although business confidence seems to have improved somewhat, surveys continue to suggest little early rise in production. The likely prospect is for a modest rise of output in the rest of this year, and continuing next year.

Sharp reductions in stocks led the economy into recession; the tapering off of this process has so far been the main source of recovery in domestic demand—and also of the sharp increase in the volume of imports in the last year. Exports have also risen, though much more slowly than imports; exports of manufactures, after earlier weakness, have returned to levels more in line with what would have been expected on the basis of world trade growth and the United Kingdom's competitive position—which might suggest continuing modest growth in the near future.

Public sector investment and housebuilding have been low, but the remainder of private investment has been remarkably strong. Indeed, in the first quarter of this year industrial fixed investment —mainly private investment by manufacturing, distribution and service industries—was back to its record rate of 1980. The long-continued decline in profitability gave place to an increase in the second half of 1981, but this was not sufficient to prevent companies from returning to financial deficit as their spending grew.

Inflation slows in this country

The weakness of primary product prices internationally has contributed substantially to the lower rate of inflation in the United Kingdom. Their cost in sterling terms, raised by the decline in the exchange rate, was increasing fairly rapidly till last summer. Since then, however, the exchange rate has stabilised; and the cost to manufacturers (in sterling) of fuel and materials has been roughly unchanged since August last year.

The more important reasons for the slowing of inflation have, however, been domestic. In particular, progress in reducing the growth of labour costs has been a good deal more rapid here than in most other countries, albeit from a relatively high initial rate.

Wage increases have become significantly more moderate, because of the pressures of policy and the extent of recession and unemployment. In manufacturing, wage settlements in the current round have averaged around 7%, perhaps two percentage points below the average for the last round and very considerably below the high level of settlements in 1979/80. At the same time, labour productivity in manufacturing rose consistently and substantially throughout last year, reflecting rationalisation of processes and lower manning levels provoked by current conditions. Though the pace of improvement may now be slowing down, unit wage costs in manufacturing have, as a result, recently risen very modestly, at a rate of under 3% a year, against 22% two years ago.

The rise in prices had earlier been boosted by increases in public charges—local rates, council rents and nationalised industry charges—as well as by higher indirect taxes and mortgage rates. About a fifth of the rise in the retail price index in the last two years could be attributed to increases in these elements going beyond the average price rise in the rest of the economy. In total, these elements of prices are now increasing less rapidly than earlier, and this too is contributing to the slower rise in retail prices.

The process of reducing inflation has followed a step-like path. The pace of inflation had been brought down appreciably by the beginning of 1981, but little further progress was made in the course of the year, when in terms of the usual twelve-month comparison the retail price index ran steadily at increases of about 12%. This year progress has been resumed. The April and May figures showed year-on-year increases of $9\frac{1}{2}$%—still a high rate of inflation, and somewhat above the average for other industrial countries. There could well be a significant further reduction—to 7% or 8%, or perhaps lower—in the course of the coming year.

The policies pursued in this and most other countries are clearly having a measure of success in countering inflation. The conditions which gave rise to this success, not without costs in other directions, are moreover likely to persist, and to produce a further ebbing of the pace of inflation in the period ahead.

Monetary growth and bank lending

Monetary developments in the most recent months are surveyed in detail in the review on page 194. Despite the greater uncertainties, markets reacted relatively calmly to the Falklands crisis. The growth of the narrow monetary aggregates has been markedly modest; that of the broader ones has been significantly faster but within the target range.

Over the last year, pressure for fast growth of the broad aggregates has been coming from the growth of bank lending to the private sector, rather than to the public sector. It is important to consider how far the pressure is likely to continue, and how it can best be met.

About a third of the increase in bank lending over the year to March was to persons. Of this, the most dynamic element was lending for house purchase, reflecting the more aggressive competition of the banks in this field. Even though such lending could now level off, it may well remain high.

The likely strength of bank lending to business is more difficult to gauge. A number of factors have led businesses to prefer to borrow via the banks, so that recourse to the long-term debt market has remained very low. A powerful factor in recent years has been the increased uncertainty coming from high but changeable rates of inflation and nominal interest rates, which has made borrowers unwilling to borrow at fixed rates. The capital markets, however, do not provide long-term funds at variable rates. In these conditions the banks have played an intermediary role in bringing borrowers and lenders together; and, under the spur of competition, the banks have become more resourceful and innovative in accomplishing such intermediation.

The large scale on which companies have felt it necessary to obtain outside finance can in one sense be regarded as the mechanical result of the overall financial position of companies—basically weak because of very low profits, recently eased by the running down of stocks, but now having worsened again. Even though companies' capital gearing is still low, there may be reason to expect that the surge of bank lending to industry will at some point recede as either banks or their customers attach more weight to the risks of further extension of credit. The potentially changing nature of the risks involved is an important consideration that also has to be kept in mind in the course of the Bank's prudential supervision of the banking system.

There is some evidence to suggest that some companies have simultaneously both increased borrowing and increased money on deposit with the banks—thus inflating both sides of the balance sheets of companies and of the banks. This would be borrowing ahead of the need to spend, perhaps in part from a desire to provide greater assurance of access to funds: though not highly costly it would involve some extra cost to companies. But such simultaneous borrowing and redepositing probably represents only a small part of the increase in bank lending to business.

Alternative approaches to high bank lending

The most obvious approach to the pressure on monetary growth created by high bank lending would be to seek to reduce the scale of such lending. This, however, would not be easy without having serious effects on much more than bank lending, unless it was replaced by other sources of finance.

The general level of interest rates depends largely on economic and financial conditions; but it is influenced also by fiscal and monetary policy as a whole. Too low a level of interest rates would not be consistent with appropriate restraint of the monetary aggregates. One route to reducing bank lending would be to seek to raise interest rates above the level appropriate for that purpose, and above the level they are now. If interest rates were raised sufficiently, industry would indeed be likely to borrow less in general, and less also from the banks. But this would only happen because industry cut back its investment, thus weakening economic recovery.

A more satisfactory outcome would be if industry came again to rely more on the capital market and less on the banks for its borrowing. It is to be hoped that this may indeed take place as inflation recedes and interest rates come back to a lower level. It has been suggested that, in order to encourage a fall in longer rates and thus facilitate this process, there should be a pause in government funding. The disadvantage would be that this would, in the meantime, help to produce faster growth of the broad aggregates, with implications for the future rate of inflation.

It is sometimes argued that, in order to encourage greater recourse to the capital markets, tax measures might be taken that would reduce the cost of such finance. It is, however, difficult to find ways of doing this that would not involve a costly element of subsidy, which in any case might not prove effective in reducing the demand for bank finance.

In the absence of any quickly effective means of reducing bank lending that would not have damaging effects, the authorities have made heavy sales of government debt outside the banking system. In 1981/82 debt was sold to the non-bank private sector on a scale in excess of that required to finance the public sector borrowing requirement (PSBR), so that the contribution of the public sector to the counterparts of sterling M_3 was negative—thus partly offsetting the positive contribution implied by the rapid growth of bank lending. This sort of 'overfunding' has occurred before but was unusually large last year. This reflected the fact that last year's PSBR has turned out to be £$1\frac{3}{4}$ billion smaller than thought at the time, while bank lending to the private sector was substantially larger than expected.

The implications of funding policy

It is useful to place last year's experience in the perspective of funding policy more generally. Emphasis has always been placed on financing the public deficit in a non-inflationary way, so as to keep within proper limits the growth of holdings of liquid assets in the economy. The scale on which such financing was required varied with circumstances, and in particular depended on the pressures making for monetary expansion—which include not only the public deficit, but also the scale of bank lending to the private sector. For, other things being equal, an increase in lending by the banks will be reflected in increased deposits—which sales of government debt to the public will reduce. Ensuring an appropriate growth of money may thus at times point to debt sales less than the public deficit; and at other times greater.

It is useful to emphasise that funding operations in fact entail a three-sided exchange of assets—involving the public sector, the non-bank private sector, and the banks. Sales of debt by the Government to the non-bank public are paid for by the latter reducing their bank deposits, and transferring cash from the commercial banks to the Bank of England as the Government's bank. The banks' balances at the Bank of England which are run down to make the transfer are, however, relatively small and close to the operational minimum. If the cash thus lost was not restored through operations by the Bank in the money market, each bank's efforts to make good its cash holdings would cause steep increases in the interest rates paid by the banks for short-term money. This would inevitably bring a general rise in interest rates above the levels needed to achieve the degree of monetary control already decided as appropriate on more general grounds. The sequence is therefore completed, as the third leg of the exchange, by the Bank acquiring assets from the banking system to replenish the banks' balances. Money market operations of this sort are thus a corollary of debt sales when these are high in relation to the borrowing requirement.

In the past, the Bank's money market operations normally took place in Treasury bills. Over recent years, however, holdings of Treasury bills by the banks have been reduced to such a low level that official money market operations have come to be conducted mainly in commercial bills.

High debt sales, together with consequent operations in commercial bills to replenish the cash drain on the banks, are sometimes presented as a process in which the public sector is lending (via the banks) to the private sector, borrowing long term in order to do so. But there is no essential difference between this process and one where money market operations are in Treasury bills. When operations are in commercial bills it is important to remember that the assets acquired by the Bank are claims on the banking system, not on the non-bank private sector, and that the lenders' risk is borne by the banks, not the public sector.

The greater scale of the Bank's money market operations has enlarged the demand for commercial bills. This will have reduced the relative cost to companies of this form of borrowing; and it is sometimes said that it has created profitable opportunities for direct arbitrage. Careful investigation suggests that such opportunities for companies to borrow in this form and invest elsewhere at a higher return have been few, and the potential profitability small (page 201).

Conclusions

These considerations suggest that bank lending is providing a valuable element in facilitating industrial recovery, for which it may not be possible quickly to find substantial alternatives. Though it is not clear how long the rate of bank borrowing will remain at its present level, a relatively high demand for bank finance could therefore continue for the present as the background for monetary policy. On the other hand, there remain strong grounds for avoiding an inflationary growth of liquidity in the hands of the public, and thus for seeking to limit the growth of the broad monetary aggregates. Business demand for outside finance may have passed its peak, and business may well come to be less dependent than recently on bank finance. This would reduce the need for high debt sales in relation to the borrowing requirement. But there are clearly many uncertainties; and the ability to vary the scale of funding remains an essential part of effective monetary policy.