Company profitability and finance

This article reviews the performance of UK industrial and commercial companies (ICCs) during 1988. Among the main points are:

- *The rapid increase in demand in 1988 ensured that the UK corporate sector continued to flourish. Profitability was at its highest level for twenty-five years.*
- *Although most manufacturing companies were operating at a relatively high level of output, they were able to respond to the increase in demand. However, the labour market remained tight.*
- *The investment performance in 1988 was exceptionally strong, largely owing to the rapidity of output growth in the previous year and the high levels of capacity utilisation.*
- *Companies moved into financial deficit, mainly on account of buoyant capital expenditure and rising dividend payments. It is likely that the sector will remain in deficit in 1989.*
- *Company liquidity has deteriorated rapidly since the crash; equity issues have been subdued, and there was a substantial outflow of cash from the sector associated with the high level of takeover activity.*
- *The combination of strong bank borrowing and the rise in interest rates increased income gearing in the second half of the year. Capital gearing also rose sharply.*

Introduction

By the end of 1988 the UK economy had enjoyed a period of seven years of sustained growth, at an average rate of 3½% per annum. Despite the stock market crash in the autumn of 1987, growth continued to be strong throughout 1988, partly on account of the subsequent relaxation in the stance of policy. However, as 1988 progressed it became increasingly evident that the pressure of demand was excessive, and was leading to a rising rate of inflation and a deteriorating current balance. Policy was accordingly tightened, and appears to be restoring demand growth to a more sustainable path. Nevertheless, economic growth through 1988 was sufficient to ensure that company profitability remained unusually high.

Economic background

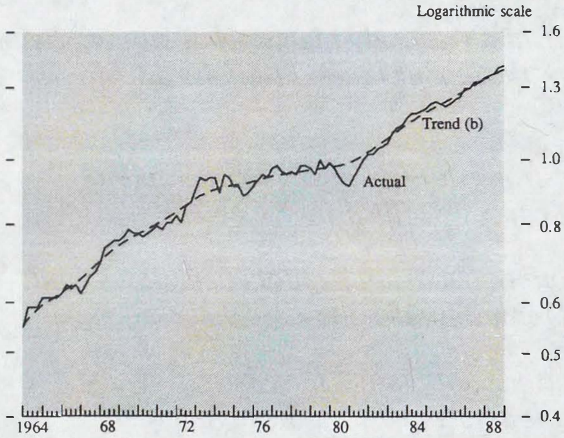
As output grew strongly last year, both of the principal components of domestic demand, consumers' expenditure and fixed investment, rose extremely rapidly. The precise extent of output growth has been difficult to gauge, owing to statistical discrepancies in the national accounts—the difference between the output and expenditure measures of the level of GDP last year was 1¾%, and there is a reasonable presumption that the expenditure measure understates actual growth. Even without taking this likely underrecording into account, however, the official figures indicate that the level of consumers' expenditure was 6½% higher than in 1987, the fastest rate of growth for over forty years. The increase in gross domestic fixed capital formation was almost as exceptional—it rose by 12%, a rate last exceeded in 1964.

The buoyancy of domestic demand in 1988 resulted in a rise in imports of around 12%, and, although growth was strong abroad, exports grew much less rapidly. In the second half of the year, the trade position was weakened by lower oil production, following the Piper Alpha disaster. The main part of the deterioration of the current account, however, was related to developments in the manufacturing balance, with the deficit in manufactures widening by £7 billion. Competitiveness worsened during the year, as sterling appreciated, although the impact of this development on trade patterns was probably small, in comparison to demand changes.[1] The supply response of the domestic manufacturing sector was in fact rather impressive, with manufacturing output rising 7% at a time when firms were already operating at a high level of capacity utilisation. Nevertheless, with domestic demand for manufactures rising rapidly, even such a strong performance could not prevent a substantial worsening of the manufacturing balance.

(1) See the note on page 332.

Results from the 1988 Labour Force Survey indicate that the number of employees in the manufacturing sector was higher throughout 1988 than previously thought, and had been rising since the beginning of 1987. One consequence of these revisions was to lower the estimate of manufacturing productivity growth in both 1987 and 1988, although the performance of the sector in this respect still appears to have been close to trend (see Chart 1). In 1988, output per man hour in the manufacturing sector rose by almost 5%, following a rise of 5¾% in the previous year. The fact that productivity growth has fallen recently may be taken as an indicator that, with capacity utilisation already at a high level, little slack exists and companies seeking to increase output have needed to expand capital and labour inputs.

Chart 1
Productivity[(a)] in manufacturing



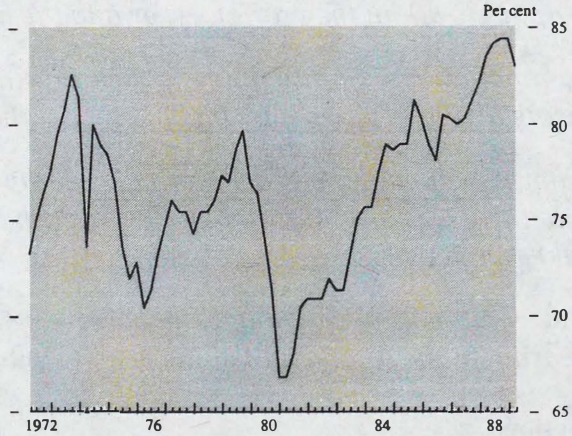
(a) Output per person.
(b) Generated through application of a Kalman Filter as described in the August 1987 Bulletin, page 336.

As manufacturing growth has decelerated since the autumn of last year, it has become evident that 1988 can be viewed as the peak year of the last output cycle, enabling some longer-term comparisons to be made. Since 1980, output per man increased at a rate of about 4¼% per annum, as compared with just over 1% per annum in the middle and late 1970s, and about 4% in the late 1960s and the early 1970s. These kinds of comparison are somewhat crude[(1)] although the main message to emerge from them—that underlying productivity growth has returned to the rates observed prior to the first oil crisis—is not in doubt.

The sustainability of growth

During the course of 1988, responses to the CBI's quarterly industrial trends survey continued to indicate the tightness of capacity constraints. In most respects, it appeared that by the middle of the year the constraints were tighter than they had been during the two previous cyclical peaks, in 1973 and 1979—for example, fewer than one third of respondents were operating below a satisfactory level of output, indicating that capacity utilisation was higher than at any time since the early 1970s (see Chart 2). The situation in the labour market, however, although also suggestive of some tightening, appeared to be less serious than during the 1973 cyclical peak, and similar to the situation in 1978. The proportion of companies reporting that skilled labour was a factor limiting output rose to 28% in the April survey, but fell subsequently, and throughout the year was well below the average figure of 37% recorded in 1973. This feature of the current cycle must be viewed as encouraging, given that a rapid increase in labour costs poses a major threat to prospects for non-inflationary growth.

Chart 2
Capacity utilisation in manufacturing [(a)]



(a) The responses to question 4 of the CBI quarterly survey, transformed according to the method described in Driver C, 'Transformation of the CBI capacity utilisation series: theory and evidence', Oxford Bulletin of Enonomics and Statistics (1986).

The rapid expansion in capital expenditure in 1987 and 1988 probably resulted in a significant increase in productive capacity. It is notable that, according to the CBI survey, the proportion of companies citing capacity expansion as a reason for capital expenditure rose rapidly between 1986 and 1988. By 1988, over 40% of companies were purchasing new investment goods in order to expand capacity, compared with a proportion of less than a quarter two years earlier. The extent to which productive capacity has been expanded is difficult to quantify, partly because the rate of scrapping is likely to be sensitive to the pace of output growth. In the two years 1987 and 1988, manufacturing investment totalled £22 billion (at 1985 prices), about 8% of the CSO's estimate of capital stock in the manufacturing sector at the end of 1986. This represents gross investment, however, some of which will have been for replacement purposes. The picture is further complicated by the role of technical progress and because the CSO estimate of the capital stock may well be an overstatement.[(2)] Taking these considerations together, an

(1) For a more detailed treatment, see 'Productivity trends' in the February 1989 *Bulletin*, pages 23–6, where the issue of total factor productivity is discussed.
(2) The work reported by the National Institute suggested that the CSO estimate for the replacement cost of equipment in manufacturing in 1983 overstated the true figure by 37%. See A D Smith, 'A current cost accounting measure of Britain's stock of equipment', *National Institute Economic Review* No 120. Other work suggests the element of overstatement in the CSO's estimate is lower, see S Wadhwani and M Wall, 'The UK capital stock — new estimates of premature scrapping', LSE Centre for Labour Economics Discussion Paper No 245.

estimate of growth in productive capacity in manufacturing of about 4% a year in the last couple of years would be plausible, although the degree of uncertainty associated with such an estimate is large.

Profitability and margins

Given rapid growth and high capacity utilisation, it was perhaps surprising that companies did not widen margins to a significant degree last year. Outside the manufacturing sector, margins appear to have been stable, and even in manufacturing only a modest widening was discernible (see Table A). Several factors appear to have been at work in holding down margins, in particular the appreciating exchange rate and rising labour costs—the latter being associated with a slight acceleration of wage settlements.

Table A
Contributions to output prices in manufacturing[a] from changes in cost components
Percentage points

	Labour productivity (increase -)	Labour costs	Unit labour costs	Input prices	Bought-in services	Margins (residual)	Output prices
	1	*2*	*3=2+1*	*4*	*5*	*7-(3+4+5)*	*7*
1980	1.8	8.0	9.9	3.7	5.2	-3.4	15.4
1981	-2.0	6.3	4.2	2.9	2.7	-2.4	7.4
1982	-3.0	4.3	1.3	2.3	1.1	2.2	6.9
1983	-3.8	3.7	-0.1	2.6	0.9	2.0	5.4
1984	-2.8	3.4	0.6	3.0	0.9	0.6	5.1
1985	-1.4	3.5	2.1	1.0	1.3	1.3	5.7
1986	-1.5	3.1	1.6	-3.4	1.0	4.9	4.1
1987	-3.1	3.3	0.2	1.7	0.9	1.6	4.4
1988	-2.5	3.4	0.9	1.6	1.7	0.6	4.8

(a) Excluding food, drink and tobacco.

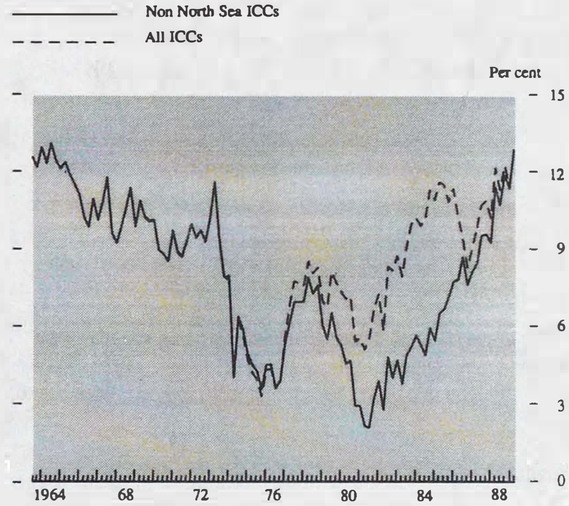
Although margins widened only slightly during 1988, the increase in output was sufficient to ensure that the rate of return on capital employed continued to rise. Profitability now appears to have returned to the levels of the 1960s, with the share of ICCs' and public corporations' profits in total GDP rising by 3½ percentage points since 1981.[1] In 1988, the real rate of return earned by non North Sea companies stood at over 11%, the highest level for over 20 years (see Chart 3). A variety of factors have contributed to this revival in profitability:

- The real rate of return on financial assets has been considerably higher in the 1980s than in the 1970s. This has increased the required rate of return on new investment.

- Movements in productivity and commodity prices have moderated increases in companies' costs and allowed them to increase margins during most of the 1980s. The very strong growth in margins observed in 1985 and 1986, for example, was associated with the weakness of commodity prices (especially oil prices) during that period.

- Scrapping and low investment in the early 1980s probably reduced the level of the capital stock. As a consequence, the subsequent increased pressure of demand has tended to result in shortages of capital rather than of labour.

Chart 3
Profitability[a] of the company sector



(a) Pre-tax real rate of return on capital employed.

- Profitability moves procyclically. With the economy at exceptionally high levels of capacity utilisation in the last two years, profitability has undoubtedly been boosted by the spreading of overhead costs.

Income and appropriations

With margins stable and output continuing to grow rapidly, non North Sea ICCs' gross trading profits (net of stock appreciation) rose by 19¾% in 1988—a slightly larger increase than in the previous year (see Table B). In the North Sea sector, however, the combination of a subdued oil price and supply disruptions in the second half of the year caused profits to fall by 27½%, to little more than one third of their peak level of 1984. By the end of 1988, profitability was at roughly the same level in the North Sea and non North Sea sectors.

Table B
ICCs' income and appropriation accounts
£ billions

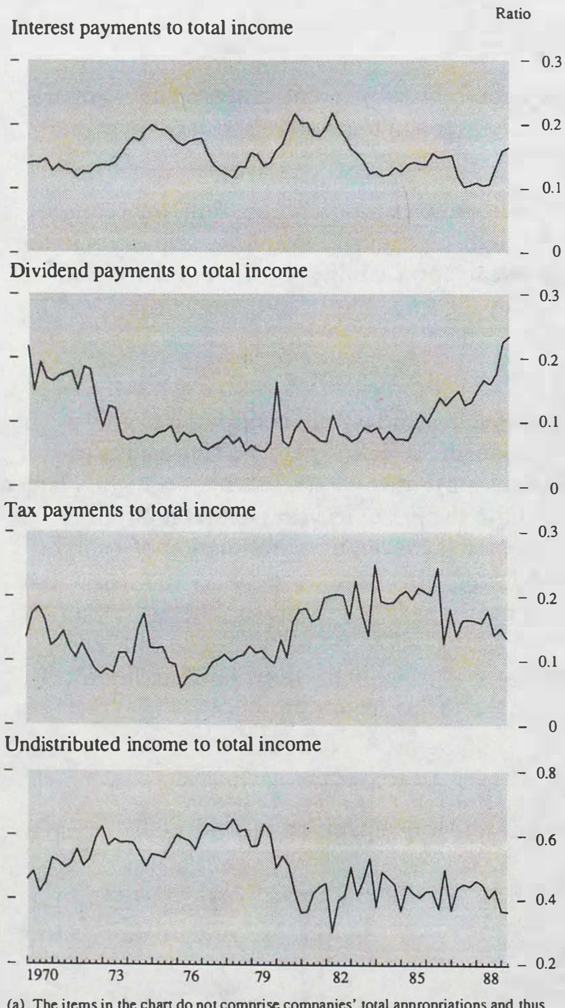
	1986	1987	1988
Income			
Gross trading profits	51.7	61.1	69.0
Non North Sea	43.3	51.6	62.1
North Sea activities	8.4	9.5	6.8
Other income	15.4	19.9	22.2
Total income (a)	**67.1**	**81.0**	**91.2**
Allocation of income			
Dividends on ordinary shares	9.0	11.9	17.6
Interest and other payments	11.3	11.7	14.6
Profits due abroad	4.3	6.3	6.6
UK taxes	12.9	13.5	15.1
Undistributed income (a)	**29.6**	**37.7**	**37.3**
Capital transfers	—	0.4	0.2
Fixed investment	26.4	32.6	37.5
Physical investment in stocks	1.0	1.5	2.3
Financial balance (surplus +)	**2.2**	**3.3**	**-2.7**

(a) Net of stock appreciation.

(1) Taking ICCs alone, the rise in profits as a proportion of GDP since 1981 is 5½ percentage points. This rise is however boosted by privatisations.

Towards the end of last year, ICCs' interest payments were boosted as a result of the combination of rising interest rates and rapidly increasing exposure to interest rate changes (see Chart 4). During the year, the total amount of sterling bank lending to ICCs rose by a third, and by the fourth quarter interest payments were almost 50% higher than they had been two quarters earlier. Outflows from the company sector were further swollen by buoyant dividends and, to a lesser extent, by growth in corporation tax payments. Dividends on ordinary shares rose by nearly 50% in the year, the largest annual rise recorded. This exceptional growth is partly accounted for by very large increases in dividend payments by companies which have been recently privatised and by a lagged response to profits growth. In addition, the 1988 Budget resulted in a rise in the capital gains tax rate faced by many high income earners, while the top rate of income tax was cut from 60% to 40%. These changes may have stimulated some increase in dividend payments, by reducing the attractiveness of capital gains as against income for shareholders facing the top marginal rate of income tax.

Chart 4
Income and appropriations[(a)]



(a) The items in the chart do not comprise companies' total appropriations and thus do not sum to unity.

Nevertheless, it is unlikely that this factor is the main cause for the recent burst of dividend growth, given that institutional shareholders—who own more than two thirds of all UK equity—were unaffected by the tax changes. It may be that companies have been boosting dividend payments as a defensive measure during a period when acquisitions activity is at an all-time high.

Tax payments by ICCs rose by 12% in 1988, a slower rate of increase than that of profits. Although buoyant profits boosted tax payments, two factors were operating in the opposite direction—reduced payments of petroleum revenue tax, and the rapid increase in capital expenditure, which reduced companies' taxable income. Payments of petroleum tax now constitute about 10% of ICCs' tax payments, compared with about 50% in 1983 and 1984. It is difficult to evaluate the precise effect of increases in capital expenditure on ICCs' tax liability, because of the 1984 tax changes and differences in tax treatment of different types of capital goods. Nevertheless, it is certain that capital allowances increased quite quickly in 1987,[(1)] on account of both the reaccumulation of capital allowances after the abolition of first year allowances, and the growth of capital expenditure during that year.

Capital expenditure

In the aftermath of the stock market collapse, it was clear that many companies were reviewing investment intentions. Nevertheless, in almost every respect, the situation of the company sector at the beginning of 1988 suggested that a large increase in investment was likely: profitability and capacity utilisation were at unusually high levels, output growth had been strong in the previous year and long-term interest rates remained stable and below 10%. In the event, the investment performance comfortably surpassed the projection made in the DTI's December 1987 survey of investment intentions. Manufacturing investment rose by over 14% and investment by construction, distribution and selected service industries by 18%, as compared with the projections of 11% and 6% respectively made by the DTI. Taken together, investment by these industries represented some 9% of domestic demand in 1988, its largest-ever contribution.

This exceptional result is all the more remarkable for having followed so closely upon the fall in equity prices. Evidence from individual company accounts suggests that a sharp reduction in company valuations, such as occurred in October 1987, may lead to depressed capital expenditure in the following two years.[(2)] The obvious strength of investment spending can therefore be interpreted as further confirmation that the equity price fall represented a correction to the rapid rise in prices earlier in the year. It was never very clear that the rise or subsequent fall had substantially altered industrialists'

(1) For the majority of companies there is a twelve-month lag between the earning of profits and the payment of tax on them. After March 1990, this interval will be reduced to nine months.
(2) See 'Does Q matter for investment? Some evidence from a panel of UK companies' by Richard Blundell, Stephen Bond, Michael Devereux and Fabio Schiantarelli, IFS Discussion paper W87/12A, 1988.

expectations or real expenditures. By contrast, conditions in the equity market did influence financial decisions.

Stockbuilding

Last year witnessed the largest increase in the level of stocks, almost £2 billion (in 1985 prices), in any one year since the beginning of the decade. Despite this, the rapidity of output growth ensured that the stock/output ratio continued to fall. Most of the accumulation of stocks occurred in the final quarter of the year, and may have been related to the tightening of monetary policy and the unexpected weakness of demand. In the manufacturing sector, firms accumulated £¾ billion of stocks in the six months to the first quarter of 1989, and some of this increase is likely to have been involuntary; there was a steady rise in the balance of respondents to the CBI survey reporting their holdings of stocks as excessive.

Financial transactions

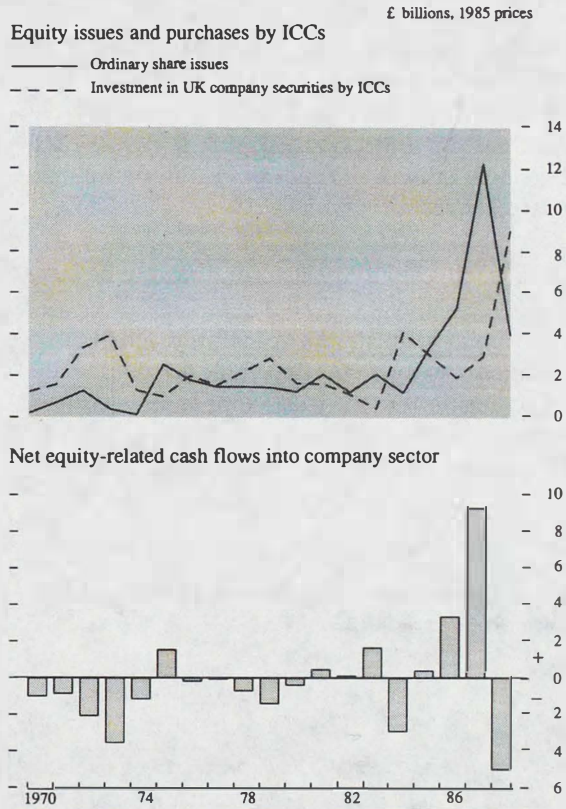
The financial position of the sector continues to be obscured, in the official statistics, by the presence of a large balancing item. In the 1988 company sector accounts, this item represented an unidentified outflow of funds of £13½ billion. It is likely that this unidentified outflow represents some overrecording of profits and some underrecording of investment expenditure—initial estimates of these items are subject to considerable uncertainty and both have recently been revised substantially. The degree of confidence associated with other items in company accounts varies. Estimates of dividend and tax payments and flows between the company sector and banks are regarded as relatively reliable, but there is much greater uncertainty concerning some other items, such as trade credit and cross-border investment flows.

Notwithstanding the large balancing item, it is clear that in 1988 as a whole the company sector moved into financial deficit for the first year since 1979. The deficit reflects the rapid growth of most of the expenditure items in the company sector accounts, but is primarily attributable to the surge in investment.

Acquisitions

There was a record level of takeover activity in 1988, judged both from the point of view of the number of transactions undertaken and the value of expenditure involved. Almost a quarter of total domestic expenditure on acquisitions was accounted for by two very large takeovers—those of Britoil by British Petroleum (for £2.3 billion) and of Rowntree by Nestlé (for £2.7 billion)—both of which were cash-financed. This reflected a marked change in emphasis in financing patterns from the previous year; in 1988 cash accounted for almost 70% of total expenditure, as compared with around 30% in 1987. This shift was partly a consequence of the stock market crash; after the autumn of 1987, ordinary shares were less widely perceived as

Chart 5
Equity creation by ICCs



overvalued and equity was therefore viewed as a more expensive means of financing a takeover. Moreover, in the period prior to the crash, many companies had accumulated large cash holdings and were strategically well placed to take advantage of the lower prices which prevailed in 1988.

The pattern of predominantly cash-financed takeovers in 1988 led to a substantial cash outflow from the company sector in that year. Altogether, companies spent £15½ billion of cash in the course of completing acquisitions. Not all of these funds went out of the sector,

Table C
Industrial and commercial companies' financial transactions

£ billions

	1986	1987	1988
Financial balance (surplus+)	**2.2**	**3.3**	**-2.7**
Identified financial transactions (outflow/acquisition of assets -)			
Investment in UK company securities	-2.0	-3.2	-10.3
Investment abroad	-5.2	-15.4	-10.8
Balance of import and export credit received/given	-0.6	-0.8	-1.5
Bank borrowing	9.4	13.0	29.6
Ordinary share issues	5.4	13.2	4.6
Debt issues (a)	2.0	4.4	7.7
Overseas investment	2.9	2.8	3.5
Other loans and mortgages	1.5	2.8	3.8
Financial assets : liquid	-11.1	-9.8	-5.4
other	0.7	-2.7	2.1
Changes in tax balances and other accruals adjustments, including net unremitted profits	-2.8	-4.0	-3.2
Balancing item (b)	**-2.4**	**-3.7**	**-14.0**

(a) Debentures, preference shares and capital issues overseas (including eurosterling).
(b) Figures may not add because of rounding.

however; about a quarter of the transactions were sales of subsidiaries and vendors were often themselves part of the corporate sector. Nevertheless, it is estimated that around £11½ billion did flow out of the sector on account of purchases of UK company securities—a substantial sum, and significantly larger than the £4 billion raised in ordinary share issues during the year (see Table C). The net equity-related outflow of funds of £7½ billion was easily the largest ever witnessed.

The boom in takeover activity also continued to be in evidence in ICCs' acquisitions abroad in 1988. The volume of overseas acquisitions expenditure fell back slightly from the previous year (see Table D), but the number of acquisitions of overseas companies was up sharply, largely, it appears, on account of the prospect of the single European market. The number of acquisitions by UK companies in EC countries rose by 50% in 1988.

Table D
Domestic and cross-border acquisitions affecting ICCs
£ billions, *numbers of transactions in italics*

	1986		1987		1988	
Domestic	14.9	*696*	15.4	*1,125*	22.1	*1,224*
Cross-border						
Outward acquisitions(a)	4.7	*21*	6.0	*282*	5.5	*444*
Outward disposals(b)	0.9	*93*	1.2	*89*	2.4	*94*
Net outward acquisitions	3.8		4.7		3.2	
Inward acquisitions(c)	0.6	*27*	1.2	*42*	2.5	*76*
Inward disposals(d)	0.3	*12*	1.1	*14*	0.5	*13*
Net inward acquisitions	0.3		0.1		2.0	

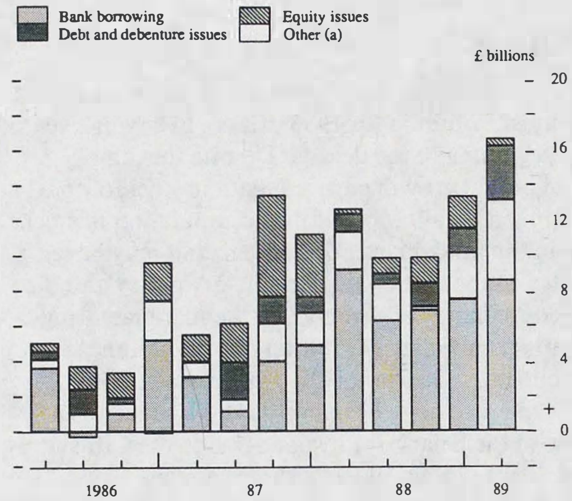
(a) Acquisitions by UK ICCs of overseas companies.
(b) Disposals by UK ICCs of overseas companies.
(c) Acquisitions of UK ICCs by overseas companies.
(d) Disposals of UK ICCs by overseas companies.

Nevertheless, the United States remains the most popular area for overseas expansion by UK companies.[1] Notwithstanding the takeover of Rowntree—which constituted one half of total inward acquisitions expenditure in 1988—outward acquisitions expenditure by UK companies was more than twice as large as inward expenditure by foreign companies.

Capital issues and capital markets

Although it was difficult to detect any significant impact of the crash on many aspects of company behaviour in 1988, the effects on the capital markets were very clear. ICCs' issues of ordinary shares were extremely subdued in the first half of the year, at just over £1 billion. In the second half, equity issues began to recover, but remained well below the levels observed in the corresponding period of 1987. In contrast, issues of fixed-interest debt have been at above their pre-crash volumes, and in the year as a whole companies raised roughly similar amounts through equity and bond issues (see Chart 6). The strength of

Chart 6
ICCs' external borrowing



(a) Overseas investment and other loans and mortgages.

private bond issues was not surprising, in view of the stability of long-term interest rates at around 9½% and the relative unattractiveness of equity finance. In the first quarter of 1989 the volume of bond issues was particularly large, and ICCs raised almost £3 billion of funds in this way.

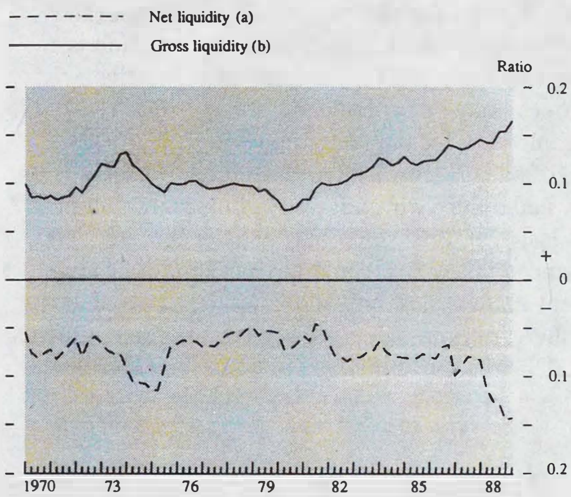
The movement of the public sector into financial surplus in the last couple of years and the associated contraction of the stock of outstanding gilts has also been an important factor stimulating companies' use of bond finance. The surplus is probably tending to reduce long-term interest rates, and it is certainly reducing the share of sterling bonds in the portfolio of large investing institutions, many of which have long-term sterling-denominated obligations. It is likely, therefore, that these institutions will increase their demand for corporate debt, and indeed they have been doing so. Nevertheless, corporate bonds and gilts cannot be viewed as perfect substitutes, for several reasons: corporate debt is more heterogeneous, is usually issued in smaller tranches than are gilts (and is as a consequence less liquid) and has a higher default risk.

Bank borrowing and company liquidity

The movement of the company sector into financial deficit, the substantial outflow of funds on account of domestic and overseas takeover activity and the limited extent to which the capital markets were used all led to a large upsurge in bank borrowing by ICCs in 1988. As a result, net liquidity deteriorated very rapidly indeed (see Chart 7). This trend was also evident from the DTI survey of company liquidity. Respondents to the survey, which are all large industrial companies, were in an exceptionally liquid position in the immediate aftermath of the crash, when their liquidity ratio—the ratio of short-term assets to short-term liabilities—stood at 116%.

(1) The pattern of cross-border activity, and the reasons for the emphasis on the United States, were analysed in more detail in 'Takeover activity in the 1980s' in the February 1989 *Bulletin*, pages 83–5.

Chart 7
ICCs' liquidity



(a) Net liquid assets (liquid assets less bank lending) as a proportion of replacement cost capital base.
(b) Liquid assets as a proportion of replacement cost capital base.

The ratio had fallen to 75% by the end of 1988, indicating that large companies had moved from a position in which a rise in interest rates increased their income(1) to one in which a rise would reduce it. A similar trend was discernible for the company sector as a whole. In the twelve months to December 1988, ICCs' exposure to short-term interest rate changes almost doubled (see Table E), with their net interest-bearing liabilities rising to almost £50 billion.

Table E
ICCs' exposure to interest rate changes
£ billions, not seasonally adjusted

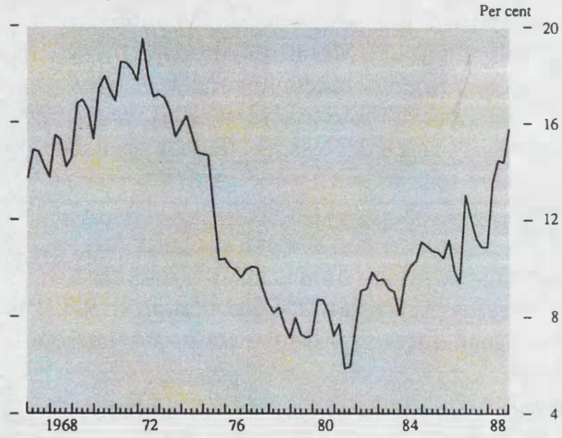
	1987 Q4	1988 Q1	Q2	Q3	Q4
Short-term sterling interest-bearing assets(a)	47.3	45.7	45.7	50.7	50.0
Floating-rate sterling-denominated liabilities(b)	75.2	84.3	88.4	92.7	99.4
Net assets	**-27.9**	**-38.6**	**-42.7**	**-42.0**	**-49.4**

(a) Interest-bearing sight deposits, sterling time deposits, building society deposits, tax instruments and Treasury bills.
(b) Bank lending in sterling and Issue Department holdings of commercial bills.

Given the extent to which companies' net liquidity deteriorated, it was perhaps surprising that a sharper response was not detectable in other aspects of their behaviour. It was notable, however, that ICCs' gross liquidity did not change much during the year, indicating that for most companies the problem of a shortage of liquid funds remained very much in the background. Moreover, with gearing only rising in the second half of the year, and from very low levels (see Chart 8), there appeared to be little concern about companies' ability to meet the increased debt servicing costs that the rapid expansion of bank borrowing and higher interest rates entailed.

The emphasis on debt finance has resulted in a large rise in ICCs' capital gearing since the end of 1987. By the end of 1988, the capital gearing ratio (net debt as a proportion of replacement cost capital stock) stood at around 16%, having been at or below 10% for most of the 1980s (see Chart 8). The current level appears to be in line with the position of companies in the late 1960s, although still below that witnessed in the early 1970s.

Chart 8
ICCs' capital gearing(a)



(a) Net debt as a proportion of replacement cost capital stock.

Prospects for the company sector

Despite evidence of slower output growth this year, company performance has continued to be robust, with few signs that last autumn's policy tightening is causing excessive discomfort. Profits grew strongly in the first quarter—perhaps surprisingly so given pressure on margins—so that even with further strong growth in dividend and interest payments, undistributed income was sharply higher. By contrast, fixed investment appears to have been rather modest—implying some reduction in the financial deficit compared with the fourth quarter. However, this may prove to be temporary. The June DTI survey of investment intentions indicated that industrial investment would continue to rise rapidly in the year as a whole and, while investment prospects beyond 1989 appear less sanguine—a view confirmed by the latest CBI industrial trends survey—such an outturn would be sufficient to leave the company sector in financial deficit for a second consecutive year.

While it is not unusual for the company sector to move into financial deficit at this stage in the economic cycle, when investment growth is particularly rapid, a second year of deficit would be exceptional. The last two years in which substantial deficits were recorded were 1974 and 1979, and in both cases a period of rapid adjustment ensued, in which company sector expenditure was curtailed in real terms. However, while future pressures on companies are likely to bring about a reduction, and eventual elimination, of the deficit the similarities between the position of the company sector in 1989 and in the years immediately following previous deficits should not be overemphasized, for several reasons. First, the

(1) This depends, however, on the size of large companies' longer-term floating-rate liabilities.

macroeconomic conjuncture is still quite favourable for companies at present. It is widely expected that there will be reasonable growth this year, whereas in contrast in 1975 and 1980 output fell. Moreover, although the rate of inflation has risen recently, it remains well below that experienced in either of those two years. High rates of inflation not only exert a depressing effect on aggregate demand, but also tend to worsen companies' financial situation in other ways, for example, by boosting their payments of corporation tax. Second, the corporate sector's financial position remains healthy in other respects at present. Apart from the fact that profitability is exceptionally high, income gearing remains at relatively low levels and there has been no widespread evidence, so far, to suggest that companies are finding it difficult to service their debt after the recent rises in interest rates. The deterioration of companies' liquidity position is striking—and some individual companies, particularly smaller ones, may be experiencing some difficulty—but it is noticeable that, for the sector as a whole, companies' holdings of bank deposits have continued to rise. If liquidity had severely impinged on companies' financial position last year, this would hardly have occurred; and cash-financed takeovers would have begun to die away. The recent spate of new bids indicates, however, that the current merger boom still possesses considerable impetus.