Company profitability and finance

This article, which continues an annual series, reviews the performance of UK industrial and commercial companies during 1990. The main points include:

- *Profitability continued to decline during the course of the year, as steeply as in previous recessions, but the level remained above that of both 1974–75 and 1980–81.*
- *Total income rose, albeit modestly, as the fall in gross trading profits was offset by rises in non-trading income and income from overseas.*
- *Investment expenditure began to decline from its high level. In contrast, growth in dividend payments remained exceptionally high.*
- *The financial deficit increased to £27 billion (5% of GDP) compared with £21 billion (4% of GDP) in 1989.*
- *Bank borrowing was considerably reduced during the year, with some switch towards the capital markets.*
- *Company insolvencies, which began to increase in 1989, rose by 44% in 1990.*

Introduction

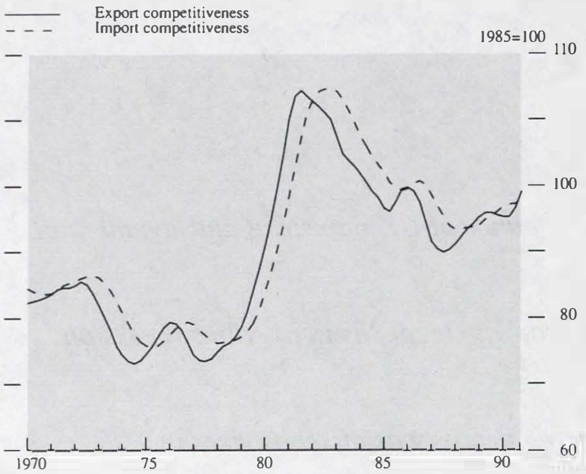
By early 1990, there were signs that industrial and commercial companies (ICCs) were beginning to adjust to the slowdown in domestic demand growth generated by the tightening of monetary policy from the middle of 1988 onwards. Their experience had so far varied considerably, as tight monetary policy had not affected sectors uniformly. In particular, many companies whose activities related to the production and sale of consumer durables, and to the housing market, had suffered most, while those with access to overseas markets had benefited from improved competitiveness during 1989. Nevertheless, high levels of fixed investment, dividend payments, and merger and acquisition activity had caused many companies' financial exposure to rise substantially during 1988 and 1989, and whether or not their income was yet adversely affected by tighter monetary policy, it was expected that companies would attempt to reduce their exposure by curtailing expenditure during 1990.

In the course of 1990, four quarter growth in domestic demand slowed further, and in the second half of the year it was negative. While ICCs' total income was again supported by strong profits from overseas activities, these in part reflected the high earnings (including stock gains) of oil companies in the second half of the year. Having fallen by 2½ percentage points since its peak at the end of 1988, the profitability of production in the United Kingdom fell by a further 2 percentage points in 1990. Adjustment was first evident in destocking and increasingly subdued merger and acquisition activity. Since mid-1990 investment expenditure has also fallen, and most recently wage settlements have begun to decline.

Economic background

Both GDP and domestic demand growth slowed sharply in 1990. However, in contrast to 1989, an improvement in the country's net trade position allowed GDP growth to exceed that of domestic demand. Among the components of domestic demand, annual growth in consumption continued to decline. From a peak rate of 7% in 1988, total consumption growth fell to 4% in 1989 and just 1% in 1990. As in 1989, the slowdown was most pronounced for durable goods expenditure, annual growth in which fell from 12% in 1988 to -6% in 1990. Investment growth was negative in 1990, notwithstanding a 1% rise in total business investment (including public corporations), as residential investment fell by a further 13%. Growth in domestic demand was further reduced by destocking. In the first quarter of 1991 both GDP and domestic demand fell, and the trends evident during 1990 in the components of domestic demand continued. Consumption rose marginally, but this is thought to reflect the temporary rise in retail sales prompted by the announcement of a VAT increase; investment continued to fall; and destocking persisted.

Chart 1
Effective manufacturing competitiveness (a)

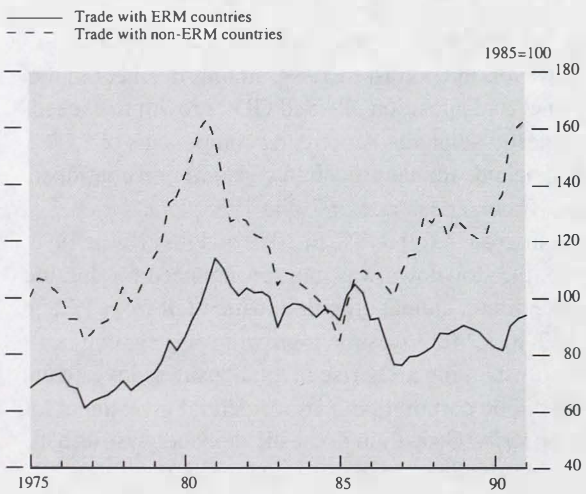


(a) The lower the index the more competitive is UK manufacturing industry.

The trade deficit in manufactures, which rose in 1989, fell by £6 billion to £11 billion in 1990 and to £1½ billion in the first half of 1991. Excluding erratics, the balance has also improved. While growth in *both* manufacturing exports and manufacturing imports slowed in 1990, the former declined least. Declining export growth in part reflected deteriorating effective manufacturing export competitiveness,(1) following an improvement in 1989 (Chart 1). Effective manufacturing import competitiveness also declined, but growth in import volume was nevertheless minimal, owing to the relatively weak state of UK demand.

The fall in UK manufacturing competitiveness between 1989 and 1990 was quite substantial and will have caused a further fall in *effective* competitiveness in the first few months of 1991. However, whereas relative unit labour costs in manufacturing rose by 5% between 1989 and 1990, they rose by 17% and 21% in 1979 and 1980 respectively.(2) The contrast with the last recession is most marked in relation to UK competitiveness against ERM countries. Although, by the end of 1990, competitiveness was much worse against non-ERM countries than in 1985 (and as bad as in the 1980–81 recession), it was little changed against the ERM members (Chart 2). This is of significance, as ERM countries account for more than half of UK exports.

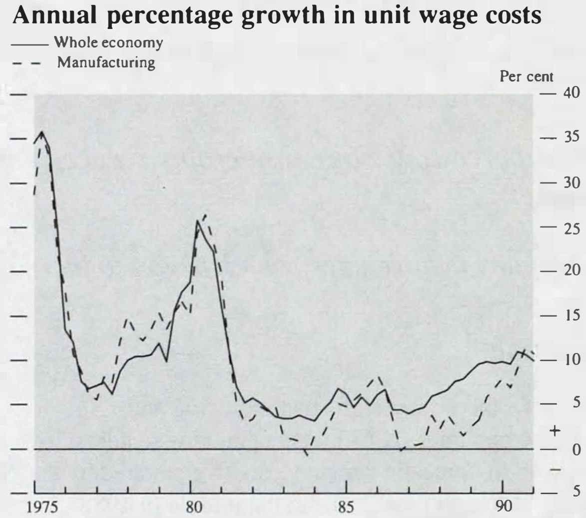
Chart 2
Competitiveness of manufacturing in terms of direction of trade flow (a)



(a) The lower the index the more competitive is UK manufacturing industry.

More recently the competitiveness of UK manufacturing may have recovered somewhat, with consequent benefits for effective competitiveness later this year. The dollar has appreciated significantly against sterling since February, and unit wage cost growth may be being held back by some decline in settlements (Chart 3). At the same time, demand for UK exports is already benefiting from the apparent recovery in the North American economies, although growth in Japan and Germany shows some sign of slowing.

Chart 3
Annual percentage growth in unit wage costs



Profitability and margins

There was little reduction (at least in comparison to the falls that occurred in 1980 and 1981) in figures for manufacturers' domestic margins in 1990. In 1989, lower labour productivity growth led to higher unit labour costs growth, which was not fully offset by lower margins. In 1990, labour productivity was almost unchanged, leading to a substantial rise in unit labour costs. This was offset as much by weaker input prices as by a change in margins (Table A). More recently, domestic margins are likely to have fallen further. In particular, there is some evidence, from the CBI survey, that the price discounting likely to occur at this point in the cycle is indeed occurring, but is not captured fully in the CSO series for manufacturers' output prices.(3) This suggests that prices, and therefore margins, may actually have been been lower in the first half of 1991 than official data suggest.

(1) Throughout this article competitiveness is measured as relative unit labour costs in common currency. The *effective* measure also takes into account the delays with which changes in competitiveness are thought to affect the volume of trade. Lags are derived from equations for manufactured trade volumes in the Bank model.

(2) If the figures are adjusted to take account of the United Kingdom's relative cyclical position (as in the IMF normalised measure of relative unit labour costs), the distinction between this and the previous recession is even greater.

(3) See the May 1991 *Bulletin*, page 194.

Table A
Contributions to year-on-year percentage change in domestic output prices in manufacturing[(a)]
Percentage points

	Labour productivity (increase +)	Labour costs	Unit labour costs(b)	Input prices	Bought-in services(c)	Margins (residual)(b)	Output prices
	1	*2*	*3=2-1*	*4*	*5*	*6=7-(3+4+5)*	*7*
1980	-1.7	7.8	9.9	3.8	5.2	-3.5	15.4
1981	1.9	6.5	4.4	2.9	2.8	-2.7	7.4
1982	3.0	4.4	1.3	2.3	1.1	2.2	6.9
1983	3.7	3.7	0.1	2.6	0.9	1.8	5.4
1984	2.7	3.4	0.7	3.0	1.1	0.4	5.1
1985	1.6	3.5	1.9	1.0	1.1	1.6	5.7
1986	1.7	3.2	1.5	-3.4	0.8	5.2	4.1
1987	3.1	3.4	0.3	1.7	0.9	1.5	4.4
1988	2.8	3.6	0.7	1.6	1.9	0.6	4.8
1989	1.9	3.9	1.9	1.8	2.4	-0.7	5.4
1990	0.2	4.3	4.1	-0.3	2.4	-0.2	6.1

(a) Excluding food, drink and tobacco.
(b) Figures may not add to totals because of rounding.
(c) Proxied by unit labour costs in the service sector.

Manufacturers' export margins, by contrast, fell sharply during 1990, as worsening labour cost competitiveness forced cuts in margins in order to limit the decline in price competitiveness. A subsequent depreciation of sterling, particularly against the dollar, has more recently given companies the opportunity partially to restore export margins.

Unit wage costs outside the manufacturing sector also continued to rise strongly in 1990. As a result of this and falling demand, a number of non-manufacturing sectors are likely to have accepted falling margins. In particular, retail price data suggest that retailers of clothing and household goods engaged in particularly sharp discounting in mid and end of season sales. More recently a number of them have reduced margins still further by choosing to absorb, at least temporarily, part of the rise in the rate of VAT.

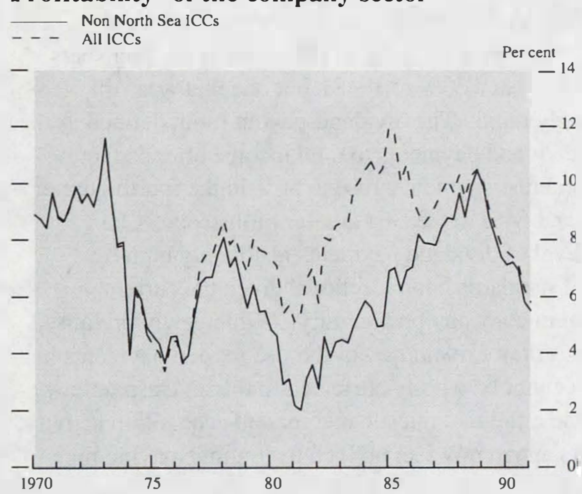
There is also much anecdotal evidence to suggest that, in common with previous cyclical downturns, the impact of the recession on the construction sector has been particularly severe. The volume of construction output rose rapidly from 1986 onwards but, since its peak in the first quarter of 1990, it has fallen by more than the output of any other sector. The value of new orders in construction has fallen even more sharply. Although there has been some recent reduction, earnings growth in this sector remains higher than in manufacturing. High productivity growth throughout much of the 1980s was sufficient to offset increases in earnings, so that unit wage costs were little changed. In the late 1980s this was no longer the case, and annual unit wage cost growth reached 13% by the end of 1989. During 1990 unit wage cost growth slowed, but much reduced increases in the sector's output prices meant that margins fell significantly in 1989 and 1990.

Declining margins in a number of sectors caused gross trading profits of non North Sea ICCs (net of stock appreciation) to fall by 2½ % between 1989 and 1990, compared with an increase of 2½ % in the previous year. The second half of 1990 was worse than the first, with profits falling by 2%. In the first quarter of 1991 they fell by a further 5%, if the newly privatised electricity distribution companies are omitted. Overall profits of oil companies recovered in 1990, rising by 7% on a year earlier. Despite industrial disputes and maintenance work (in part a consequence of the Piper Alpha report), which disrupted production in the third quarter particularly, profits of this sector were higher in the second half of the year than the first, owing to the rise in oil prices. In the first quarter of 1991 oil company profits declined, as oil prices fell on the outbreak of hostilities in the Gulf.

For ICCs as a whole, notwithstanding the recovery of North Sea profits, gross trading profits were 2% lower last year. In particular, they fell by 5% in the fourth quarter, and (once the newly privatised electricity distribution companies are omitted) by a further 5% in the first quarter of 1991.

Profitability for all ICCs fell from its peak of 10½% in the fourth quarter of 1988 to about 6% in the first quarter of 1991. For non North Sea ICCs the ratio fell further, to around 5½%. Although the fall has been as steep as in the last two recessions, profitability currently remains above the level seen in the previous troughs (Chart 4).

Chart 4
Profitability[(a)] of the company sector



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

Income and appropriations

The fall in gross trading profits in 1990 was more than offset by increases in income from other sources (Table B). Rent and non-trading income rose by 20%, as interest rates were on average higher than in 1989 and the stock of liquid assets rose. Despite sterling's appreciation, income from abroad (from companies' overseas branches and subsidiaries) increased by 12% last year, as growth in overseas markets did not slow as rapidly as that at home, and oil companies' overseas earnings (profits and stock gains) rose on account of higher oil prices. Overall, ICCs' total income (net of stock appreciation) therefore rose by 4% in 1990. This was, nevertheless, substantially less than the 10% increase in the previous year. Furthermore, in the first quarter of 1991, total income fell by 9%, as the fall in trading profits was compounded by declining non-trading income, owing to lower interest rates, and sharply reduced income from

Table B
ICCs' income and appropriation accounts
£ billions

	1987	1988	1989	1990
Total income (a)	**77.5**	**88.0**	**96.9**	**100.7**
Gross trading profits	58.2	64.7	65.9	64.8
Non North Sea	48.7	57.9	59.3	57.8
North Sea	9.5	6.9	6.6	7.0
Rent and non-trading income	7.7	9.1	12.8	15.3
Income from abroad	11.6	14.1	18.3	20.5
Allocation of income				
Dividends on ordinary and preference shares	11.2	14.9	19.0	22.1
Interest and other payments	12.1	15.0	23.8	30.3
Profits due abroad	6.7	7.3	8.6	7.8
UK taxes	13.3	15.1	18.8	17.7
Undistributed income (a)	**34.1**	**35.7**	**26.7**	**22.8**
Capital transfers	-0.1	-0.5	0.2	0.4
Fixed investment	32.2	39.7	45.3	50.1
Physical increase in stocks	1.8	4.3	2.4	-1.0
Financial balance (surplus +)	**0.2**	**-7.8**	**-21.3**	**-26.7**

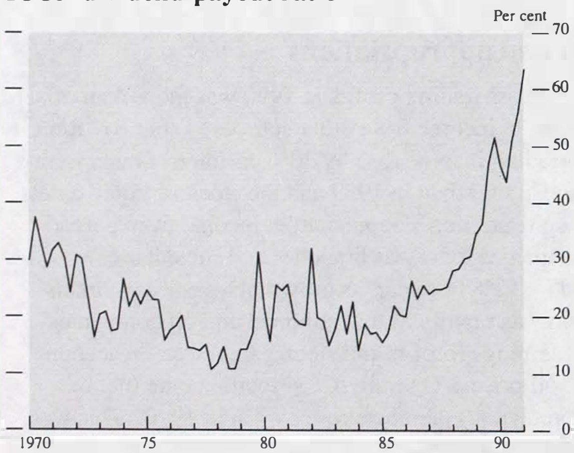
Source: Central Statistical Office.

(a) Net of stock appreciation.

abroad. The latter reflected slowing world growth, the impact of the Gulf war on business confidence, and a fall in oil company overseas earnings (including stock losses) as oil prices fell.

Among appropriations, dividend payments rose by 17% in 1990, a lower growth rate than in the two preceding years (27% in 1989 and 33% in 1988), but one that was still surprisingly rapid. The dividend-payout ratio, defined as the ratio of dividend payments to total income after deducting tax and interest payments, rose to 56% in the fourth quarter of 1990 and 64% in the first quarter of this year (Chart 5). Such a level of dividend payments is not only high by historical standards but exceptional given the current downturn in company profitability. While newly privatised companies may explain part of the rise in total payments in 1990, it cannot be wholly attributed to them. Despite lower profits and a fall in domestic merger and acquisition activity, managers apparently feel obliged to continue paying high

Chart 5
ICCs' dividend-payout ratio(a)



(a) Dividend payments on ordinary shares as percentage of income after tax and interest payments.

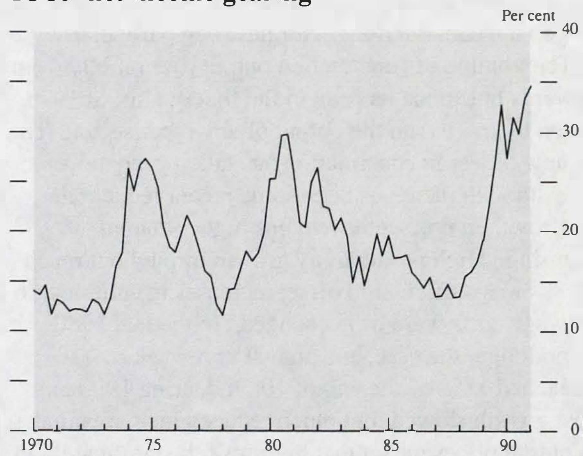
dividends, as shareholders wish to receive a continual income stream and the threat of cross-border takeovers remains.

Tax payments in the United Kingdom, which rose sharply in 1989, fell by 6% in 1990. This partly reflects a once and for all acceleration of some payments from the first quarter of 1990 into the fourth quarter of 1989 as a result of a legislative provision. However, these figures also reflect the falls in trading profits during 1989, as mainstream corporation tax is paid with an average lag of fifteen months. Payments fell again in the first quarter of 1991, and can be expected to fall further this year, in line with declining trading profits during 1990.

The main rate of corporation tax was reduced in the 1991 Budget from 35% to 34%, for profits earned in the 1990/91 financial year. The Treasury estimate[1] that this will be worth around £380 million to companies in the current financial year and a further £480 million in 1992/93. A further cut to 33% has been announced for profits earned in the 1991/92 financial year. The period for which trading losses can be carried back to set against past profits has been extended from one to three years. The benefit of these latter two measures to companies is estimated to be around £600 million in 1992/93. A number of measures were also introduced to aid small businesses, including the raising of the profits limit for the small companies tax rate (at 25%) from £200,000 to £250,000.

Interest payments continued to rise rapidly in 1990, as interest rates were higher on average in 1990 than in the previous year, and ICCs' net indebtedness increased. As a consequence, net income gearing rose during the year,

Chart 6
ICCs' net income gearing(a)



(a) Net interest payments as percentage of post-tax income.

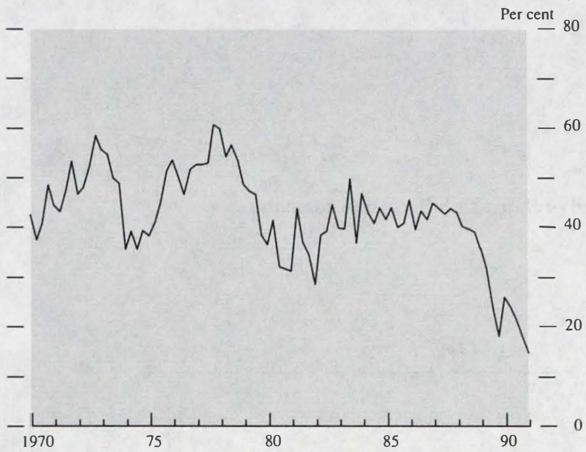
reaching 33% in the fourth quarter, a level in excess of that seen in either of the previous two recessions (Chart 6). Furthermore, despite a fall in interest payments, net income gearing continued to rise in the first quarter of 1991, as the

(1) *Financial Statement and Budget Report 1991/92*. Figures are calculated from an indexed base—that is, by increasing allowances, thresholds and rates of duty in line with actual and forecast movements in the RPI.

benefits of lower interest rates were offset by the sharp fall in income in the quarter.

Undistributed income fell sharply in 1990 for the second consecutive year, as growth in distributions exceeded growth in total income. It fell again in the first quarter of 1991. As a proportion of total income, it was significantly less in 1990 than in either of the previous two recessions (Chart 7).

Chart 7
ICCs' undistributed income to total income[(a)]

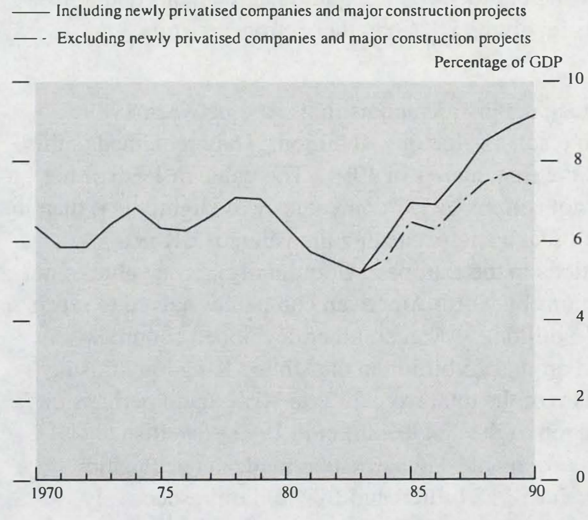


(a) Net of stock appreciation.

Capital expenditure

Following two years of substantial growth, ICCs' investment expenditure rose by a further 11% in 1990. However, it fell by 7% between the first and second halves of the year, and was unchanged in the first quarter of 1991, if the newly privatised electricity distribution companies are omitted. Furthermore the figures for 1990 are distorted by the inclusion in the accounts of the newly privatised water companies from December 1989. In common with a number of other recently privatised companies, the water companies have continued to invest heavily at a time when other sectors have reduced expenditure. Whereas the volume of investment in energy and water supply industries rose in 1990 by 12%, other non-manufacturing investment was broadly unchanged and there was a 4% fall in the volume of manufacturing investment. When newly privatised companies and major construction projects are excluded, Bank estimates suggest that ICCs' investment expenditure fell as a proportion of GDP in 1990 (Chart 8).

Chart 8
Industrial and commercial companies' gross domestic fixed capital formation

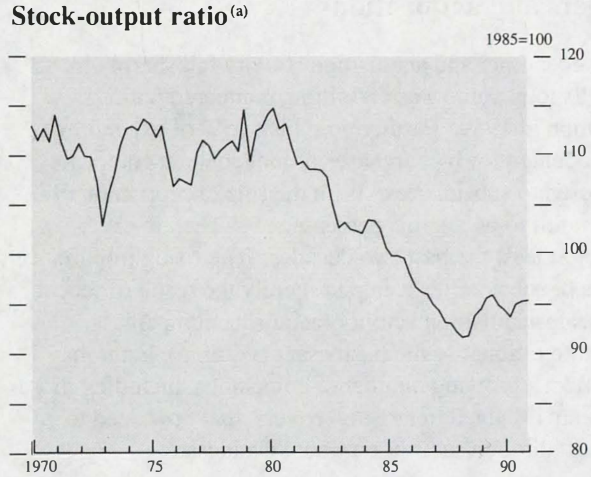


The decline in manufacturing investment accelerated towards the end of 1990: it fell by 8% between the first and second halves of 1990 and by 6% in the first quarter of 1991. The fall was concentrated in direct investment, as a tight cash flow, high indebtedness and increased risk of tax exhaustion (tax allowances exceeding chargeable profits) encouraged manufacturing companies to engage in relatively more finance leasing.

Stockbuilding

ICCs' stocks (including the national accounts statistical adjustment) are estimated to have fallen by £1 billion in 1990. This follows increases of £4 billion and £2 billion in 1988 and 1989 respectively. The stock-output ratio (Chart 9), which fell throughout much of the last decade, was broadly unchanged in 1990, having risen quite steeply in 1988–89. However, stockbuilding prior to the current recession has been significantly less than in 1980–81, and destocking on the scale seen then (it alone caused GDP to fall by almost 2½ percentage points in 1980), is not expected.

Chart 9
Stock-output ratio[(a)]



(a) Including national accounts statistical adjustment.

Financial transactions

Largely as a result of lower undistributed income and higher investment than in 1989, ICCs' financial deficit continued to increase in 1990. It reached £27 billion (Table C). Furthermore, the continued fall in undistributed income in the first quarter of 1991 meant that the deficit continued to rise, reaching £8 billion.

Interpretation of the financial deficit is complicated by the existence of a large balancing item, of £7 billion in 1990 (amounting to around 11% of gross trading profits) compared with £11 billion (or 17% of gross trading profits)

Table C
ICCs' financial transactions
£ billions

	1987	1988	1989	1990
Financial balance (surplus +)	**0.2**	**-7.8**	**-21.3**	**-26.7**
Identified financial transactions (outflow/acquisition of assets -)				
Investment in UK company securities	-5.1	-11.8	-18.7	-1.3
Investment abroad	-15.2	-14.8	-19.2	-5.2
Balance of import and export credit received/given	-0.3	-0.8	0.9	-0.8
Bank borrowing	12.2	31.8	33.1	18.9
Ordinary share issues	13.1	4.1	1.4	2.6
Other capital market issues (a)	3.6	3.6	5.6	3.5
Other capital issues	2.2	2.5	7.7	5.7
Overseas investment (other)	1.6	4.2	7.0	3.8
Other loans and mortgages	2.0	3.0	3.2	2.2
Financial assets: liquid	-7.9	-3.9	-12.5	-10.7
other	-3.4	0.7	6.9	4.2
Changes in tax balances and other accruals adjustments, including net unremitted profits	-3.4	-5.4	-5.7	-3.2
Balancing item (b)	**0.5**	**-5.4**	**11.4**	**7.1**

Source: Bank of England.

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

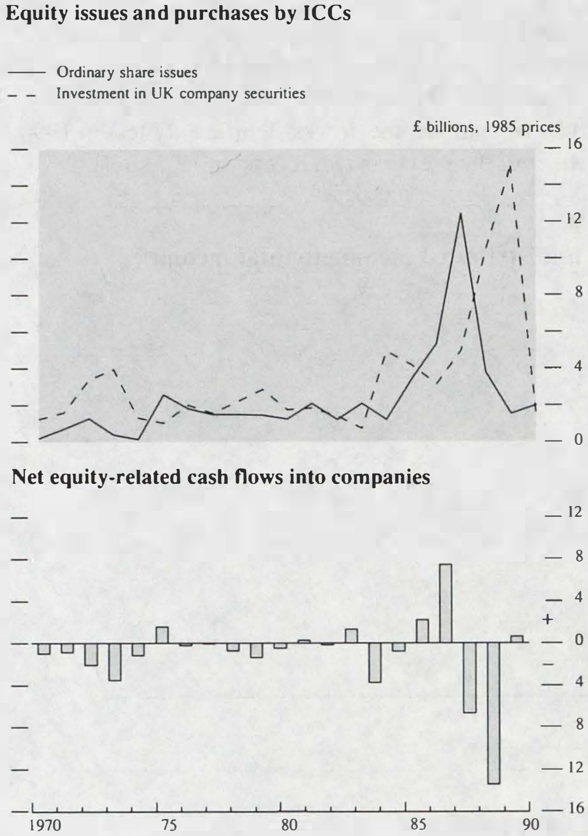
in 1989. As in the preceding year the balancing item was positive, indicating that recorded outflows exceeded recorded inflows. It is thought that the discrepancy is largely accounted for by overrecording of financial outflows rather than misrecording of items in the income and appropriation or capital accounts. Therefore the existence of a sizable financial deficit is not in doubt.

Mergers and acquisitions

Domestic merger and acquisition activity fell sharply in 1990. Its total value was £8 billion, compared with £27 billion in 1989. Furthermore, just 65% of expenditure was accounted for by purchases of independent companies as opposed to subsidiaries. With the sole exception of 1982 (when it fell to 64%), this percentage has been in excess of 75% for at least the past two decades. The rising importance of sales of subsidiaries is in part merely the result of recent large-scale acquisition activity (acquiring companies planned to rationalise the businesses acquired), but it may also reflect a growing number of companies, including those previously involved in large takeovers, that now need to raise cash through sales of non-core businesses.

Of total expenditure on independent companies, 70% was in the form of cash, almost all the remainder being financed by issues of ordinary shares. The proportion of cash finance fell in 1990 (from 79% in 1989), as companies became reluctant to incur further debts. Furthermore, the flow of funds out of the sector was partially offset by significant trade disinvestments, again perhaps a reflection of companies' need to raise cash. As a result, ICCs' investment in UK company securities fell to just over £1 billion from £19 billion in 1989. It was just £0.2 billion in the first quarter of 1991. In 1990 ICCs' net equity creation (net ordinary share issues minus investment in UK company securities) was positive for the first time since 1987 (Chart 10).

Chart 10
Equity creation by ICCs



Cross-border acquisitions by UK companies (including financial companies) were also relatively subdued in 1990 and the first quarter of 1991. Net acquisitions abroad fell in value from £19 billion in 1989 to just £7 billion in 1990. It is notable that UK companies chose to direct their limited resources to EC countries rather than to the United States. This was probably in part due to the relatively depressed state of the US economy, but may also have been in anticipation of completion of the EC single market. Net acquisitions in the European Community rose marginally to £2½ billion while, despite depreciation of the dollar, net acquisitions in the United States fell sharply, from £16 billion in 1989 to just £3 billion in 1990. Furthermore the figures for the European Community do not capture fully the growing number of participation agreements and joint ventures involving UK and other European firms.

In contrast, net inward acquisitions rose between 1989 and 1990, to reach a value of £10 billion. They remained at this level in the first quarter of 1991. The value in 1990 of net inward aquisitions by EC companies was slightly less than in 1989 (although still exceeding the value of UK net acquisitions in the European Community). The value of net acquisitions by North American companies halved to reach just £1½ billion. However, other developed countries invested around £5 billion in the United Kingdom, raising their share of the total from 27% to 50%, again perhaps in anticipation of the single market in 1992. Swedish and Japanese companies, in particular, made net acquisitions with a value of £2 billion and £1½ billion respectively.

Capital issues and capital markets

Net issues of ordinary shares rose in 1990 by 80%, a substantial recovery over the previous year. However, the figure for 1989 was distorted by the BP buyback in the first quarter. If gross issues are compared to get around this problem, there was a slight fall between the two years. Furthermore, relatively low share prices, particularly in the second half of 1990, caused net issues to decline through the year.

Having increased significantly in 1989, corporate debt issues (including preference shares) were reduced in 1990. They did, however, increase somewhat towards the end of the year, as a number of food retailers and newly privatised companies, in particular, issued securities to finance expansion.

In 1990, capital issues other than those made in markets were also lower than in the previous year, but still considerably higher than in 1988. While issues were reduced on account of a lower volume of management buyout activity, they were sustained relative to the level of 1988 by continued overseas acquisitions of subsidiaries of UK companies.

More recently, equity issues in particular have risen sharply, as rising share prices combined with somewhat wider margins on some new bank borrowing (see below) have increased the relative attractiveness of the capital markets as a source of finance. The value of ICCs' ordinary share issues in the second quarter of 1991 was £3½ billion compared with £3 billion in total in 1990. A number of companies are using the funds raised from rights issues to restructure their balance sheets and, in particular, to reduce debts.

Bank borrowing and company liquidity

In 1990, ICCs' external borrowing declined to £37 billion from £58 billion in the previous year. While the financial deficit continued to be very large, the sharp fall in cash expenditure on mergers and acquisitions ensured that the need for external funding was less than in 1989. Some move towards increased funding from the capital markets (which accounted for 32% as opposed to 25% of external funds), plus a broadly unchanged contribution from other loans and mortgages (including commercial paper issues) and other overseas investment, also helped to reduce recourse to the banking sector.

Such lower recourse was evident from the second quarter of 1990 onwards. Until the third quarter of the year this coincided with continued increases in ICCs' liquid asset holdings. The latter rose for much of the late 1980s, occasionally to almost the same extent as bank borrowing. A simultaneous rise in the sector's bank deposits and bank borrowing can in part be accounted for by the existence of two distinct sets of companies. However, an individual company may both make deposits and borrow if it is prefunding an acquisition or if it can take advantage of a differential between the rate at which it borrows and the return available on liquid assets. Alternatively large companies, particularly those with overseas subsidiaries, may hold financial assets and liabilities in distinct parts of the organisation, for administrative, risk management or tax reasons. During periods of greater uncertainty all companies may also desire to increase their liquid holdings.

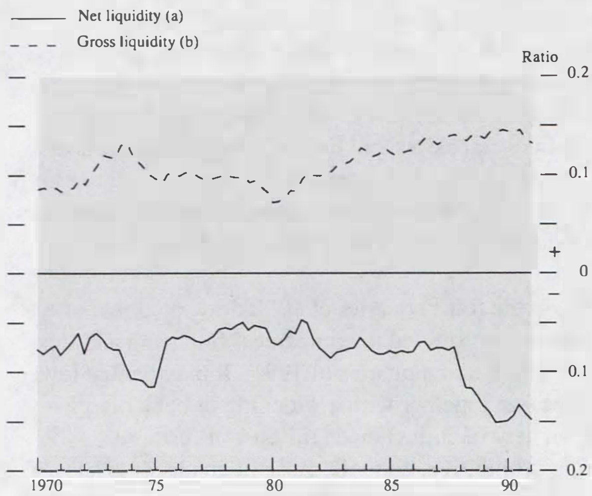
However, in the fourth quarter of 1990 drawing down of bank deposits contributed to companies' financing and this continued into the first quarter of 1991. It may be that lower profit forecasts, together with a widening of bank margins (at least on new facilities) made the cost of further borrowing prohibitive, either because of an absolute lack of available funds with which to make the interest payments, or because income gearing had reached some target level. In such conditions firms with deposits may have chosen to run them down instead. Alternatively firms may have wished to use cash rather than borrow at higher margins, for fear of the precedent set. Some commentators have also suggested that the banking sector may have rationed funds by quantity rather than price. The Bank of England has found no evidence to support this hypothesis.[1]

Concern has recently been expressed regarding the financial position of small businesses, and in particular it was suggested that reductions in base rates had not been passed on to them. An informal Bank of England survey, carried out earlier this year,[2] found that, for companies in general, while many had seen their borrrowing rates decline in line with base rates, there had been a general rise in bank margins. More recently, a joint investigation by the Bank of England and the Treasury has looked at the position of small businesses in particular. Overall, the findings suggest that the vast majority of small businesses did enjoy at least a 3 percentage point reduction in interest rates with many receiving all, or almost all, of the 3½ percentage point reduction in base rates which occurred between October 1990 and June 1991.[3] In addition, for those companies that had experienced an increase in margins of, in the main, ½ percentage point, this was due largely to renegotiation of facilities .

ICCs' net liquidity increased slightly in early 1990. However, it remained lower than at any time since at least 1970 and the rundown in deposits at the end of the year meant that it deteriorated once more (Chart 11). Similarly, the result of ICCs' financing decisions was a slight fall in net capital gearing at the beginning of the year, but a renewed rise in the fourth quarter and in the first quarter of 1991 (Chart 12). Much of the rise in ICCs' indebtedness in 1988 and 1989 was apparently voluntary, as it coincided with rapid increases in dividend payments, fixed investment and

(1) See the May 1991 *Bulletin*, pages 256–59.
(2) See the May 1991 *Bulletin*, page 176.
(3) The report was completed before the further 1/2 percentage point reduction in base rates on 12 July.

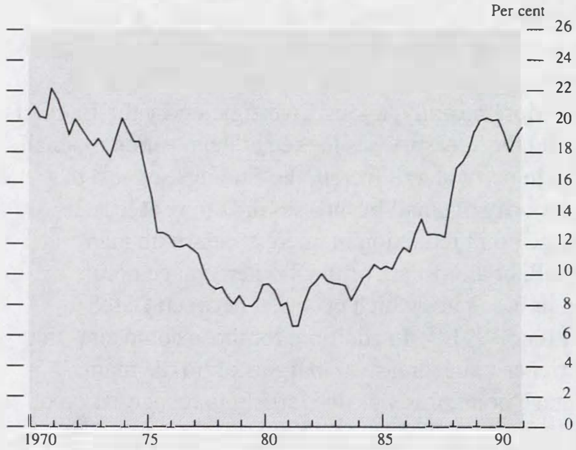
Chart 11
ICCs' liquidity



(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.

merger and acquisition activity. However, notwithstanding the increased use of capital market instruments made by larger companies, the change in financing has not in many cases been accompanied by a significant improvement in a firm's ability to manage the resultant risk.(1) As a result, as demand has fallen, a number of companies have found themselves in a difficult financial position.

Chart 12
ICCs' capital gearing(a)

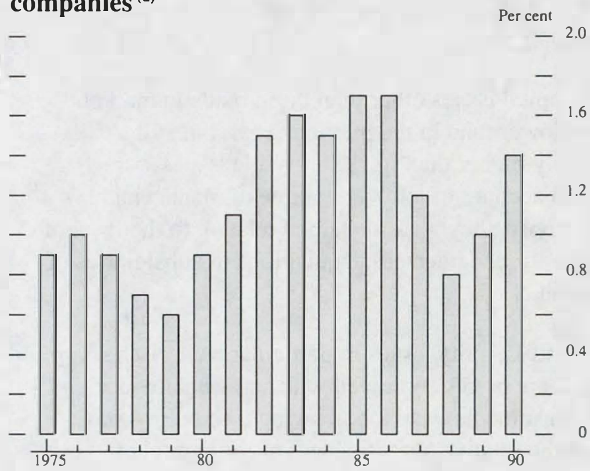


(a) Net debt at book value as a percentage of replacement cost capital stock.

Company insolvencies

Net income gearing has risen to historically high levels. Furthermore, analysis of individual company accounts suggests a wide dispersion of company performance around this mean. The consequent increase in the financial fragility of a number of UK companies is likely to have contributed to the recent increase in company insolvencies, which began in the fourth quarter of 1989. Total insolvencies (including financial and agricultural companies) were, in the first quarter of 1991, more than double the level reached in the trough of the third quarter of 1989. Although as a proportion of the number of active companies the number of insolvencies remains modest, the ratio has already risen significantly (Chart 13). As in the last recession, the number of insolvencies can be expected to continue rising for some time after the trough in output, as rising working capital requirements often make companies most vulnerable during the upturn.(2)

Chart 13
Company insolvencies as a percentage of active companies(a)



(a) Insolvency data are for England and Wales only. Both series include financial and agricultural companies.

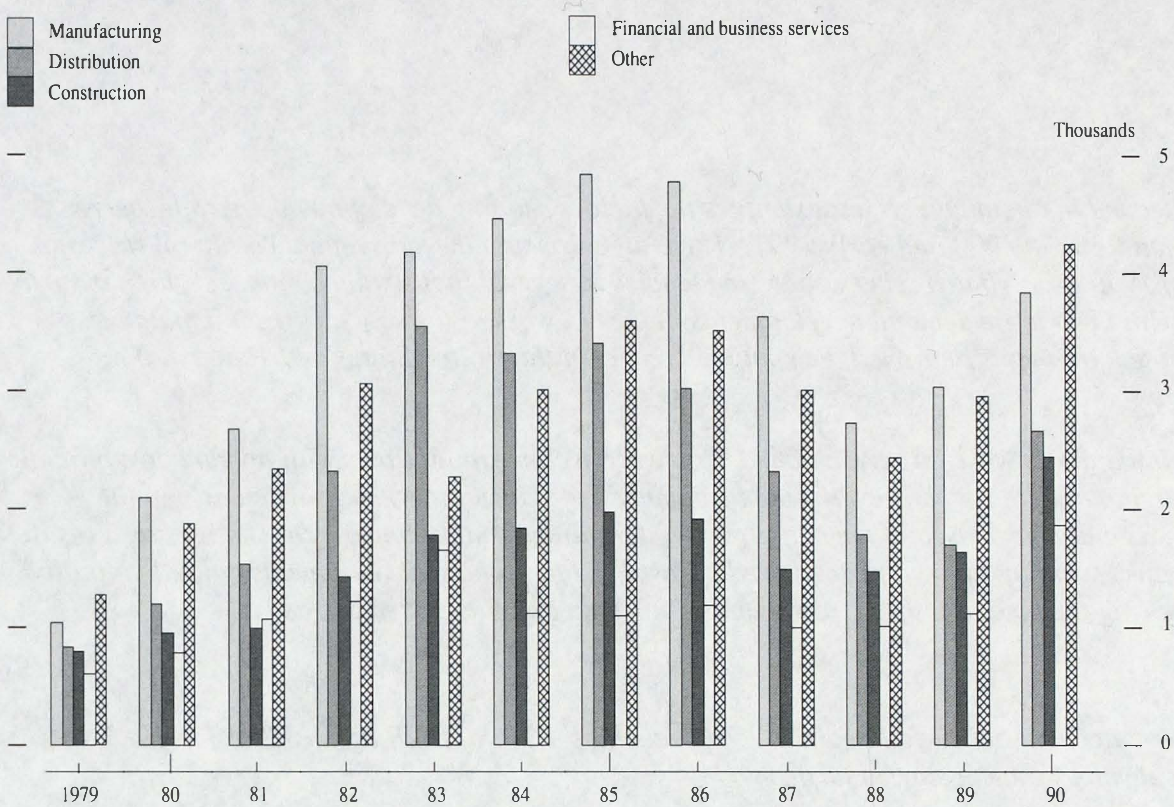
An industrial breakdown of company insolvencies shows that manufacturing industry has survived somewhat better than the average in the current recession (Chart 14). Whereas insolvencies in this sector more than doubled between 1979 and 1980, they rose by just 26% between 1989 and 1990. The highest increases in the number of insolvencies in 1990 have been among business services (including financial companies) and distribution. The relatively favourable position of the manufacturing sector is supported by figures on capacity utilisation. Although manufacturing capacity utilisation has shown a fall comparable to that in previous recessions, it fell from a higher peak and remains above the low levels reached in the previous two recessions.

Prospects

As the profitability of ICCs on average fell further in 1990, and net income gearing continued to rise, an increasing number of companies found themselves in a difficult financial position. Notwithstanding a decline in effective manufacturing competitiveness during the year, it remained the case that manufacturing companies were less adversely affected by the fall in domestic demand growth than those in

(1) For further discussion see 'Industrial and commercial companies' gearing' in the May 1991 *Bulletin*, pages 228–33.
(2) The insolvency figures have to be treated with some caution for two reasons. First, they do not provide an indication of the size of the company failure. (It may be that the proportion of failures among small and medium-sized companies is greater on this occasion, as the rapid growth in the number of companies in the 1980s means that there are many companies with little experience in dealing with the downswing in the economic cycle.) Second, there is a break in the series in 1986 on account of the introduction of the Insolvency Act of that year.

Chart 14
Company insolvencies by sector



the non-manufacturing sector, owing to the former's access to export markets. In the first half of 1991 pressure on profitability has been maintained and is likely to have become more widespread, as margins have been squeezed further.

Although a fall in merger and acquisition activity has enabled companies to limit their net borrowing requirement, and hence contain the rise in their gearing, other forms of adjustment have not yet occurred as fast as the slowdown in income growth. As a result the sector's financial deficit remains very large. Further substantial adjustment seems likely: it would be preferable that this should occur through wage restraint, rather than through cuts in employment and investment. Although investment grew strongly in the late 1980s, and less capacity is likely to have been lost in this recession than in the last one (due to more mothballing rather than scrapping), it remains a priority in terms of improving the supply side of the economy over the longer term. Recent evidence of wage restraint, most notable in the more competitive sectors of the economy, is therefore welcome.

Once output recovers, companies should benefit from a cyclical upturn in productivity, enabling profitability to increase and the sector's financial position to improve. Both the stock market and the banks will, however, be asked to provide significant volumes of finance, as companies continue to restructure their balance sheets, and as working capital requirements rise once orders start to recover.