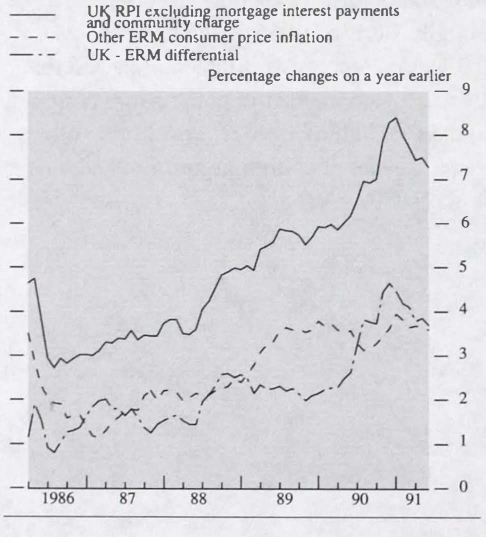
The domestic economy

- *As the economy continues to respond to tight monetary conditions, progress is now being made on reducing retail price inflation, although labour cost pressures remain uncomfortably strong.*
- *Other indicators of actual or potential inflationary pressure are also adjusting; labour demand is continuing to weaken, monetary growth is slowing and the current balance, which had been improving rapidly in the early part of last year, may still be doing so, if now much more slowly.*
- *The fall in output and demand in the second half of 1990 is likely to continue into 1991, but follows a period of rapid growth in the previous five years.*
- *Recovery is expected to be led by consumption, but its strength and timing will depend on how quickly confidence is restored in the face of weaker financial positions in both the personal and corporate sectors than in earlier recessions.*

The differential between **UK and ERM countries' price inflation** *has narrowed*



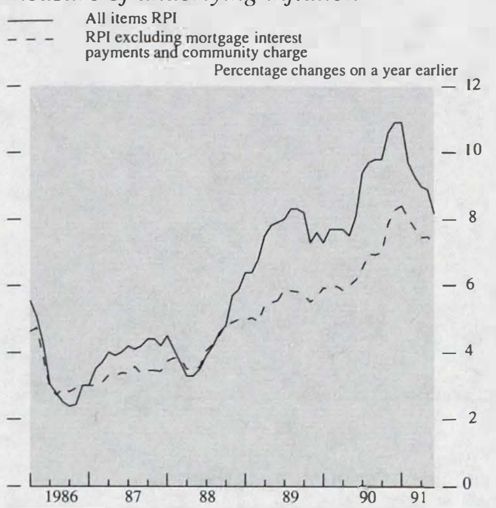
Domestic demand continued to fall in the fourth quarter of last year, and by more than output. Inflation has also started to diminish on most measures of final prices and sharply so on some. Furthermore, on a comparable basis, the differential between consumer prices in the United Kingdom and the average for the rest of the EC is now narrowing. The economy is therefore continuing to respond to the tight monetary policy that has been in place now for more than two years, and the adjustment is sufficiently well established to have allowed some reduction in nominal interest rates. There remains, nevertheless, much further scope for reductions in cost pressures, which are necessary if the economy is to remain competitive within the ERM.

Adjustment is occurring, and needed, in financial markets also. The recession has exposed weaknesses in balance sheet positions of some companies and individuals and this has caused financial intermediaries to reassess the quality of their assets. The period of rapid expansion, when providers of financial services sought to obtain market share following deregulation, may be being replaced by a more sober period in which emphasis is turning from quantity to quality of business. In such a climate, the growth of credit is likely to be slower to resume and more modest in extent than occurred in the mid-1980s.

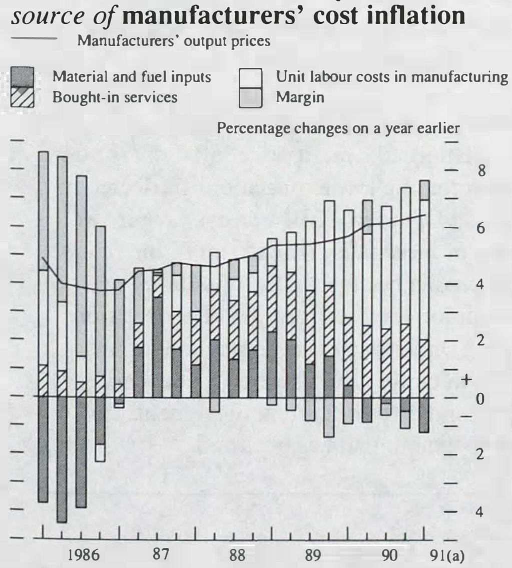
Inflationary pressures *are starting to subside*

The twelve-month growth rate in the headline RPI peaked at just under 11% in September/October last year and has since declined, falling to 8.2% in March. It is expected to continue to decline to around 4% by the end of the year. This measure is understandably the one most influential in wage negotiations, so the fall is particularly welcome if it helps reduce cost pressures. But it is subject to various distortions and its decline does not accurately represent current progress in reducing underlying inflationary pressure now any more than it did last year when some of the

Mortgage interest and the community charge may have distorted the **RPI** *as a measure of underlying inflation*



Unit labour costs *are the major short-term source of* **manufacturers' cost inflation**



(a) 1991Q1 is estimated.

distortions operated in the opposite way. First, the inclusion of mortgage interest payments in the index means that this measure is perversely affected by the main instrument of policy used to counter inflationary pressure; among the industrial countries only Canada, Australia, New Zealand and Ireland include housing costs in this way. There is a danger using this measure that, as interest rates ease, public perceptions of the rate of progress in reducing core inflation will become too sanguine, leading to pressure for premature further interest rate cuts. Second, although in some ways useful in minimising seasonal influences and indicating the extent to which living costs have risen over the typical (twelve-month) life of pay agreements, the twelve-month RPI change is a *lagging* indicator of current inflation. It is also potentially misleading in the more forward looking context that ought more properly to be the focus of labour agreements in the ERM régime where cost structures need to be planned ahead to retain competitiveness.

Inflationary pressure is not just a matter of what is happening to retail prices, important though they are as a long-term yardstick of the success of policy. An important intermediate measure is manufacturers' output prices. Here the evidence appears contradictory. On the traditional twelve-month change there appears to have been a pick-up in output price inflation around the turn of the year. But this contrasts starkly with anecdotal and other survey evidence, most particularly the CBI industrial trends survey. That survey shows a balance of firms expecting to raise prices in the next four months fluctuating around 20% for most of last year but falling to a record low of only 4% in March. This augurs well for output price inflation later this year and there is evidence that the CSO measure is a lagging indicator (see the note on page 194).

Moving back a stage to cost pressures, the story is rather clearer. Prices of material and fuel inputs used by manufacturers have been falling for more than a year and the end of the Gulf war removes an uncertainty that had been affecting oil prices. Nor is it likely that there will be substantial renewed pressure from this quarter while world activity looks set to slow further.

Unit labour costs, on the other hand, continue to rise more quickly than other elements of cost, and more quickly than elsewhere in the European Community. They are the major short-term source of domestic cost inflation. In part this is cyclical and can be expected to reverse as output recovers, employment growth lags behind (as unemployment is doing in the downturn) and productivity therefore improves. To that extent it may not be unreasonable for manufacturers to allow margins, which were built up substantially in the mid-1980s, to fall. It may be less necessary, therefore, to worry about wage decisions of the traded goods sectors, which sooner or later will become subject to ERM discipline, than about wage behaviour in the non-traded, and particularly the public sector. There is normally a tendency for relative wage growth of the public sector to move counter-cyclically, and over the past 20 years it has done so about a slowly declining trend. ERM membership strengthens the transmission mechanism of tight monetary policy to the traded goods sector because it is clear to wage bargainers that cost escalation will not be validated by depreciation of the exchange rate. But in the non-traded sector there is much less strengthening in the short term so there is a risk that cost escalation here will feed through, adversely affecting the competitiveness of the traded sector, and be harder and more painful to correct.

Producer output price inflation

There has been an inconsistency this year between output price inflation as measured by the CSO index and responses to pricing questions in the CBI industrial trends survey. The CSO series shows prices in the first quarter 6.3% higher than a year earlier (the seasonally adjusted quarterly change at an annualised rate is rather higher—see table) whereas the April CBI survey shows the balance of firms reporting price rises to have fallen. These CBI balances can be transformed to give an index of output price inflation[1] that tracks the CSO series reasonably well (see charts), although strictly the CBI data refer to four month periods.

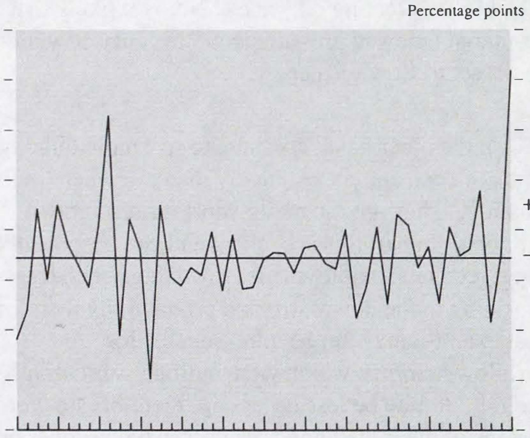
Producer price inflation in CSO and CBI data

Annualised quarterly percentage changes, seasonally adjusted (a)

	CSO	CBI (reported)	CBI (expected)
1980			
Q1	17.0	16.1	18.4
Q2	13.6	13.3	16.8
Q3	10.2	10.4	13.5
Q4	8.5	9.0	10.9
1981			
Q1	8.6	8.0	9.4
Q2	11.0	8.5	10.6
Q3	8.0	9.4	10.2
Q4	10.0	9.4	12.2
1990			
Q1	6.2	6.1	6.7
Q2	7.5	6.3	7.2
Q3	4.3	5.4	6.1
Q4	5.6	5.6	6.9
1991			
Q1	7.9	4.7	6.4
Q2	—	—	4.4

(a) Seasonal adjustment by the Bank.

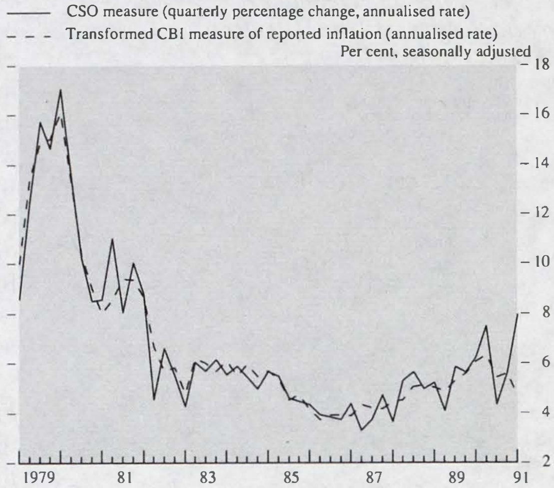
Difference between CSO and CBI measures (a)



(a) Percentage point difference between annualised change in CSO measure (seasonally adjusted) and annualised transformed CBI measure of reported prices (seasonally adjusted).

The CBI survey also gives manufacturers' expectations of future price increases. Normally, suitably lagged, these also broadly track the CSO series of past price changes. In January, the CBI expectations series, like the CSO series, showed evidence of continuing inflationary pressure, possibly in part reflecting the widespread practice of revising price lists at that time of year. In the event these planned increases do not appear to have been fully realised, according to the CBI backward-looking series of reported price changes in April. As a consequence, perhaps, manufacturers' expectations for price changes in the second quarter were sharply reduced.

CSO and implied CBI price inflation

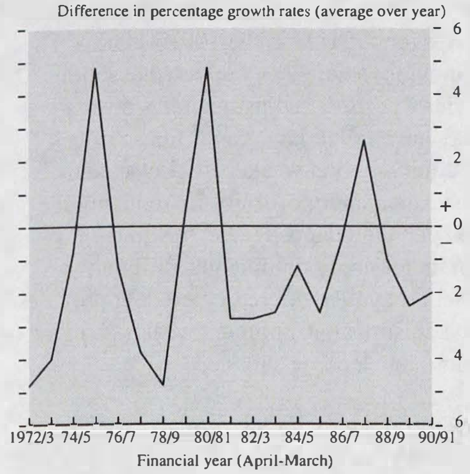


This was true also in early 1981 when, as now, the CBI expected changes series tracked the CSO series better than either tracked the CBI reported changes series. It would appear that, as the economy moves into recession, market conditions lead to price discounting and that such discounting is not fully captured in the CSO series, despite that enquiry specifically asking manufacturers to report changes in ex-works prices *actually charged* rather than list prices.[2] Further evidence that price discounting was significant in the first quarter is provided by the percentage of firms reporting actual price falls which rose 5 percentage points to 19% in the first quarter; comparably high figures have not been observed since the second half of 1980 and the first quarter of 1981.

If this explanation is correct, it would suggest that producer price inflation, like retail price inflation, is now falling, and the continuing low expectations (reflected in both the monthly and quarterly CBI surveys) augurs well for a continuation of these falls. The extent of the fall is more difficult to predict because of the possibility of continuing discounting (or over-reaction of expectations to past discounting) and it may take some time for the CSO measure, particularly the change on a year earlier which is a lagging indicator of current movements, to reflect the scale of the fall that has occurred.

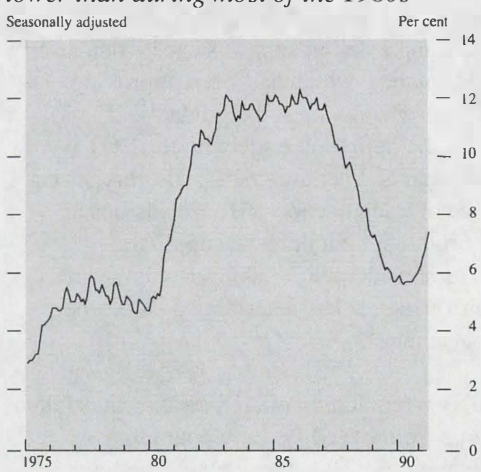
(1) See B Pesaran and C B Wright, 'Using and Assessing CBI Data at the Bank of England' Bank of England *Discussion paper* (Technical Series), No 37, January 1991.
(2) See 'Wholesale Price Index: Principles and Procedures', CSO, 1980 for details of the construction of the CSO measure.

Public services pay relative to private sector earnings(a) *has tended to move counter-cyclically*

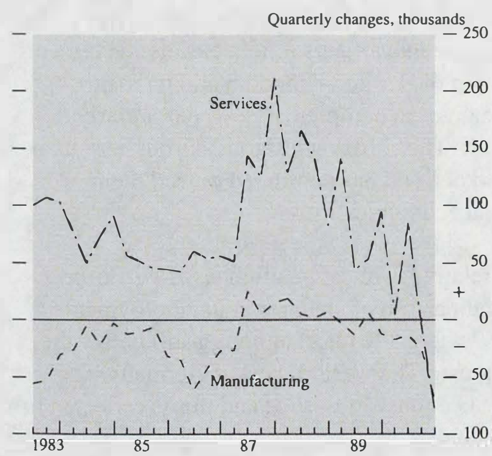


(a) Source: C Trinder, 1990, 'Trends and cycles in public sector pay', *Public Sector Pay Paper*, No 3, Public Finance Foundation.

The **unemployment rate** *is rising but is still lower than during most of the 1980s*



Relative to trend, **employment in services** *has fallen more sharply than* **in manufacturing**



It is notable that the main evidence of pay restraint in the form of settlements below the rate of increase of the headline RPI, deferred settlements and nil awards is in the traded goods sector. In terms of earnings, also, it is the cyclical elements—overtime and short-time working—most associated with manufacturing that are weakest. Public sector awards, on the other hand, are tending to occur in the upper part of the distribution of settlements.

Labour market conditions *continue to ease . . .*

Reducing pressure in the labour market is evident from the rise in unemployment, which has continued to accelerate. In the first three months of this year unemployment grew by an average of 83,500 per month, well above the average rate of increase last year or in 1980. The unemployment rate of 7.4% is, however, still lower than it was for almost the entire period 1981–88 and lower (on a comparable basis) than in the major European countries except the former West Germany, although it is increasing faster here than elsewhere in the Community. Other indicators of easing include overtime working which is continuing its downward trend, and hours lost through short-time working which remains high. Unfilled vacancies are currently less informative because of the temporary increase in recruitment of enumerators for the population census.

It is harder to pin down where within the labour market pressure is easing most but there is some evidence that the service sector, which employs now some two thirds of the workforce in employment, is more affected relative to manufacturing than was the case in either the early 1980s or the mid-1970s. The most up-to-date figures show that employment fell by 163,000 in the fourth quarter, and of this 72,000 was in manufacturing and 82,000 in services. With the level of employment in manufacturing only one third that in services this might suggest that manufacturing is still relatively worse affected. Nevertheless, the trend growth in manufacturing employment is negative and the deterioration relative to this trend is less than that relative to the positive trend growth for services. The geographical incidence of the unemployment rises supports this inference, being concentrated in the southern part of the country where the service industries are more (and manufacturing industries less) concentrated.

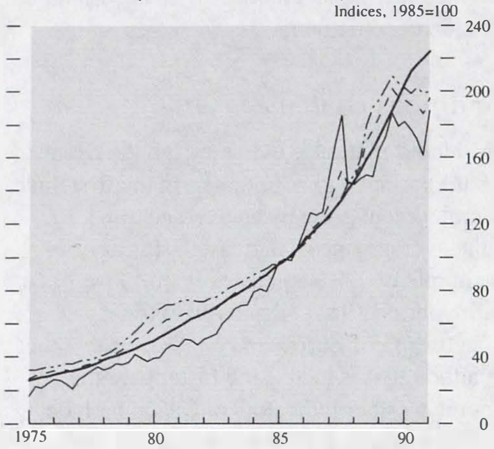
. . . and the **housing market** *remains subdued*

This geographical pattern is reflected also in the housing market where the lowest rates of price increase, and the biggest falls, have been mainly in the southern parts of the country. Despite the overall fall, therefore, in the house price/earnings ratio, this ratio remains historically high and concerns about job (and income) security may be a factor moderating any revival in the housing market. Indicators of turnover, for example the number of particulars delivered for stamp duty, confirm this continued weakness. Furthermore, there has been a substantial rise in mortgage arrears, with the number of mortgages at least six months in arrears doubling to about 160,000 in the past year.

Monetary growth *is also slowing*

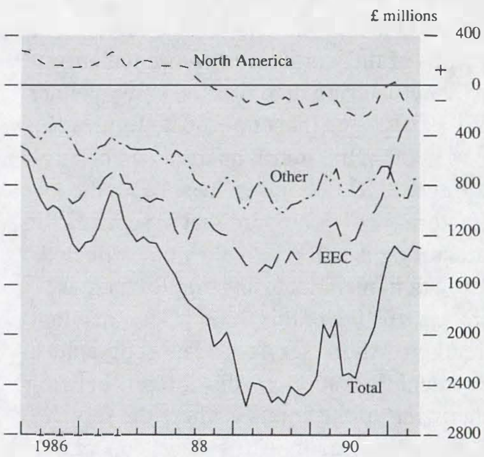
Subsiding growth in nominal activity in the latter part of last year has been associated with a slowdown of monetary growth. Again, the twelve-month growth rate provides a lagging indicator of current developments. The three-month and six-month annualised growth rates show progressively lower figures, particularly for M4.

M4 *growth has slowed as falling asset prices have prompted* **portfolio adjustment**



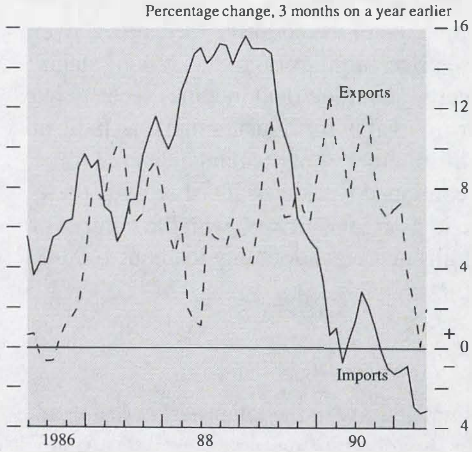
(a) Weighted average of share and house prices reflecting their importance in personal wealth.

The main improvement in the **visible trade balance**[(a)] *has been in trade with the EC*



(a) Three-month moving average at monthly rate.

The **volume of exports** *has ceased growing but the* **volume of imports** *is falling*



The slowdown in M0's growth in the second half of 1990 reflected declining growth in the value of retail sales. (Sales volume was falling, as was shop price inflation.) M0 has remained within the target range set in the 1990 MTFS since last August. (That target range was reduced to 0%–4% for 1991/92 in the 1991 MTFS.) The growth rate of M4, which includes savings as well as transactions balances, has also fallen. Here, portfolio adjustment has been a factor. Personal wealth may have fallen last year as house prices remained subdued and the equity market weakened. Individuals have therefore sought to rebalance their portfolios by reducing the growth of nominally valued debt and deposits which would otherwise have assumed an increasingly dominant position in personal balance sheets. Net repayment of credit card debt provides some evidence of portfolio adjustment. Continued weakness in the housing market has kept mortgage lending subdued.

Portfolio adjustment by the corporate sector also appears to have been responsible for the reduction in both borrowing and deposits.

The **balance of trade** *has been improving*

The trade balance is another indicator of the presence of inflationary potential.[(1)] It is the difference between domestic demand and domestic supply (or output), and a deficit suggests excess demand pressure. The visible trade balance, which had been improving rapidly last summer, may still be showing some gradual improvement. In particular, the deficit on trade with the EC has fallen sharply over the past year and is now small. The very strong improvement in the balance of trade in cars reflects decisions of manufacturers to use UK production facilities to supply the European market (as well as considerable weakness in domestic demand). Trade with North America has deteriorated somewhat, reducing the overall improvement.

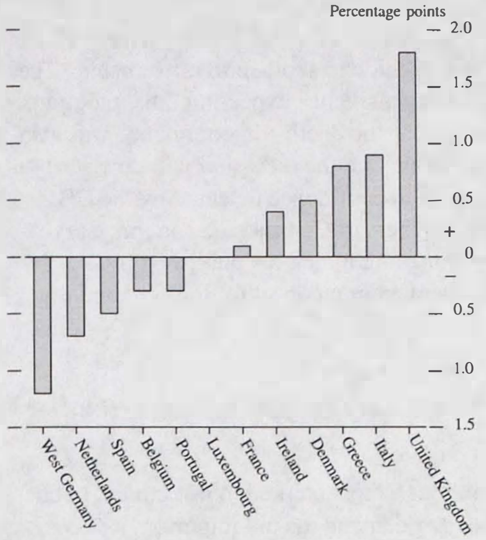
The volume growth of imports (excluding oil and erratics) has fallen sharply in the past two years from over 14% per annum to a negative rate in the last six months. This mirrors the slowdown in consumption here as the tight monetary policy took effect. As the rapid growth of domestic demand was reined back, export volumes (excluding oil and erratics) started to grow again, at an increasing rate, until the middle of last year. Export growth has since ceased but as import volumes have been falling the trade balance has continued to improve. These movements reflect closely movements in relative demand between the United Kingdom and its main trading partners—and changes in competitiveness, particularly exchange rate movements. The slowdown started earlier here than in most of our major markets, and has continued to lead them (particularly the European economies).

The United Kingdom's relative cyclical position *vis-à-vis* Europe can be illustrated by a comparison of changes in unemployment rates over the past year—where UK rates, although still below the EC average, have risen most. The western part of Germany has proved the most buoyant economy in Europe and this is reflected in UK export performance there.

The relative demand effect on trade with Europe has been offset to a moderate extent by worsening competitiveness against ERM

(1) There are, of course, circumstances in which a trade deficit that is the counterpart of inward long-term investment will add to supply in due course.

Within the EC, UK unemployment rates
have risen fastest over the past year



countries, particularly as sterling strengthened last summer. Against dollar-based trade, on the other hand, the competitiveness loss has been worse (partly a reflection of the dollar's weakness until recently) and, for the United States, the relative cyclical position has been less favourable to UK trade. Thus, within the overall account, the non-EC trade balance has weakened somewhat.

The improvement in the current account in 1990, especially in the second half, also owes much to a significant upturn in the balance on invisibles, which is now again estimated to be in sizable surplus. The recent improvement here is concentrated in interest, profits and dividends and reflects most importantly higher net direct investment earnings, particularly of oil companies; it also in part reflects improved banking margins as banks, mindful of capital requirements and bad debt experiences, have focused more on profitability than volume.

Falls in **demand** *and* **output** *represent a correction to excessive* **past growth . . .**

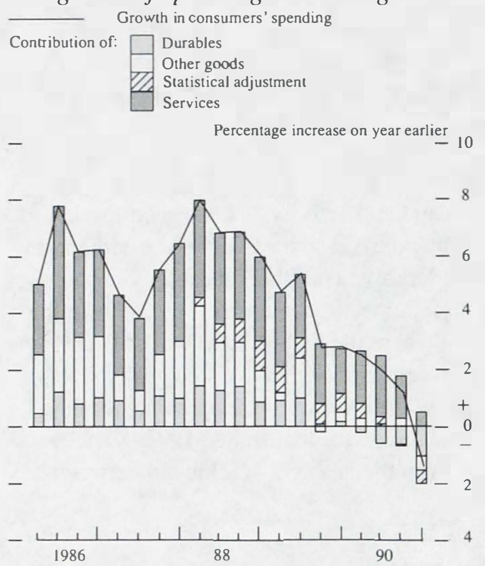
Progress in the fight to reduce inflation has, of course, involved a reduction in the level of demand and activity. This is a correction to what is now seen to have been an excessive expansion in demand in the mid-1980s, growth considerably faster than the supply capacity of the economy. Even though domestic demand fell by 3¼% in the second half of last year, the level at the end of 1990 was still 18% higher than five years earlier, representing an average growth rate of over 3¼% per year over that period—which compares favourably with less than 2% a year on average for the decade 1975–85, 2¼% between 1965 and 1975, or even the nearly 3% achieved between 1955 and 1965.

The fall in output has been rather less than the fall in demand—only 2¼% in the second half of last year and only 1¾% if North Sea oil activity, disrupted by maintenance and safety work, is excluded. Over the five years to the fourth quarter of 1990, output rose by 13¼% or 2½% per annum (16% and 3% per annum excluding North Sea oil), again comparing favourably with the 2% per annum average growth over the previous 20 years. Although it is probable that there will be a further fall in activity in the first part of this year, this recession is not expected to approach the severity of that in the early 1980s, when output fell by 6% between the fourth quarters of 1979 and 1980. Reasons why circumstances now are less unfavourable than then were discussed in the February *Bulletin* and include a more favourable world trade background, much less loss of competitiveness and a very much reduced stock cycle. Since the February *Bulletin* was published the world trade outlook may have weakened somewhat but is still a reason to expect this recession to be less severe.

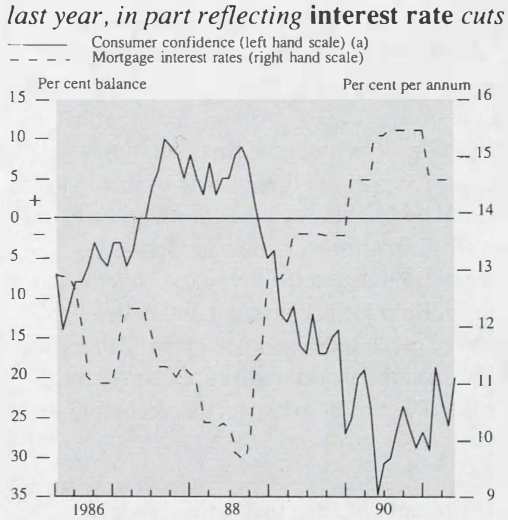
There are, of course, risks present this time that were absent last, most particularly on the financial side where debt levels of both the corporate and personal sectors are now much higher than then. It is also the case that the industrial shape of this recession is different from the last one. Manufacturing production fell only 4½% between the second and fourth quarters of last year; in a comparable period last time it fell 7% and went on to fall by 15½% in total. Output of the service sector then fell by 2% between the fourth quarters of 1979 and 1980 and accounted for a fifth of the overall fall in output, whereas so far this time it has fallen by 1%, a comparable quarterly rate to last time but has accounted this time for a third of the overall fall in non North Sea output.

The CBI survey of industrial trends measures expected trends in output and has proved a useful guide to short-term movements. The April survey was still indicating a balance expecting falls in output, though at a sharply slowing rate; the decline in confidence was also considerably reduced, suggesting that the recession will now start to bottom out. The improvement in confidence detected by the CBI echoes that in the British Chambers of Commerce economic survey for the first quarter. Longer leading indicators published by the CSO also suggest an improvement in prospect for the economy by the end of the year.

Consumers' expenditure *fell sharply in the fourth quarter of 1990, with all main categories of spending weakening*



Consumer confidence *has recovered since last year, in part reflecting* **interest rate** *cuts*



(a) The EC/Gallup measure is the weighted average of positive and negative responses to five questions concerned with households' finance and their assessment of economic conditions.

. . . *and most forecasters expect* **consumption** *to lead the recovery*

Falls in output last year, although most marked in investment goods, also reflected falls in consumer demand (as did imports); it was weakness in consumption that most took forecasters by surprise. Real income growth slowed to 0.3% in the fourth quarter, compared with an average of around 1% in each of the three previous quarters. This reflected a deceleration in average earnings, and rising unemployment, which combined to constrain nominal wages and salaries growth to just 1.4% in the fourth quarter, the lowest quarterly rate since the beginning of 1987. Consumer spending contracted in volume in the fourth quarter with spending on both durable and non-durable goods falling. Only spending on services showed any significant growth in the year to the fourth quarter and even here there was a fall of 2½% between the first and second halves of the year.

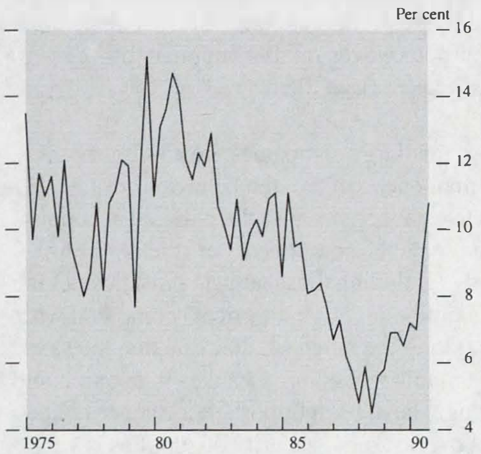
The pattern of the spending slowdown has reflected the fact that purchases of household durable goods have responded to the housing market recession, which in turn was precipitated by high interest rates at an earlier stage. The contraction in spending on vehicles, on the other hand, is rather more recent and appears to have been more severe in this recession. New car registrations were 12.7% lower in 1990 than 1989 and in March 1991 were 19% lower than a year earlier.

Consumer confidence this year has shown some gradual recovery over the last year but remains below the level in most of 1989 when consumption growth was being sharply reduced. That confidence should have improved is not surprising given the past strong (negative) correlation with interest rates. In this country, unlike the United States, there does not seem to have been any detectable effect on consumer confidence, in either direction, associated with the Gulf crisis and war.

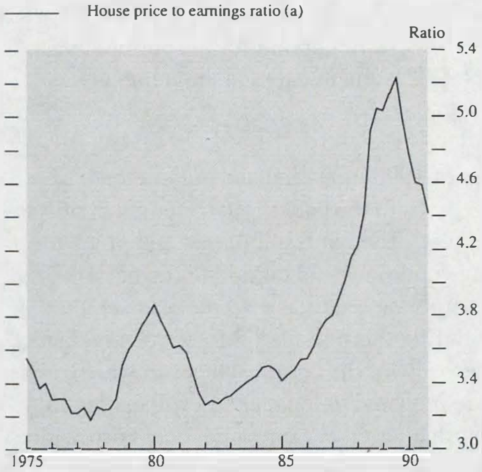
Real incomes (as conventionally calculated using a twelve-month inflation measure) are expected to grow faster this year than in the second half of last as inflation falls faster than nominal incomes, notwithstanding rising unemployment.[1] This would normally be sufficient to prompt an upturn in consumption and is the basis of forecasters' views that recovery in the economy will take place later this year. Reductions in interest rates, made possible by the success

(1) Since the twelve-month inflation measure lags behind current inflation, the growth in real incomes may actually occur earlier than this calculation suggests, but on the other hand consumption probably responds to real income growth also with a lag.

The **personal sector saving ratio** *has returned to a level comparable with the average for the late 1970s and early 1980s*



The **ratio of house prices to earnings** *has fallen but remains historically high*



(a) Calculated using the mix-adjusted Department of the Environment house price index and whole-economy annual earnings.

of counterinflation policy, will contribute to the rise in uncommitted real income and may also be expected to help rekindle the housing market; if that were to happen, associated demand for household durable goods would provide an impetus to consumption. The main uncertainty, however, concerns whether consumer confidence will improve sufficiently to bring this about. At issue here is whether the prospect and incidence of a continuing rise in unemployment and the highly geared financial position of the personal sector will pose constraints on the recovery of confidence and the housing market, and whether an upturn in consumption would come about in the absence of a housing market revival.

Put another way, the period since mid-1988 (when interest rates started to rise) has seen a sharp recovery in the saving ratio as consumption growth has slowed.[1] This ratio reached 10.8% in the fourth quarter of 1990. That is comparable to the level of the saving ratio for much of the period between 1973 and 1984, although still well below the peak of over 15% in the fourth quarter of 1979. The sharp reduction in the saving ratio in the mid-1980s coincided with a rapid expansion of personal borrowing and a rise in income gearing resulting in part from deregulation and competition in financial services. It also reflected the restoration of consumer confidence in the wake of strong and sustained growth of real personal disposable income and a marked improvement in job security. Although it may still happen, there is an element of uncertainty this time, therefore, as to whether the response of the personal sector to rising real incomes will be to allow the saving ratio to fall again. The main portfolio adjustment to deregulation has already occurred and the exposure of the sector to variable interest rates that has been highlighted by experience of the last two years may also encourage caution. Likewise, fiscal changes that erode the relative advantages of investment in housing, such as the restriction in this year's Budget of mortgage tax relief to the basic rate of income tax, may also moderate the rate of housing market revival and with it the likelihood and extent of any fall in the saving ratio. On the other hand, there is evidence that saving rises to restore the real value of wealth eroded by inflation, so as inflation falls the need to save for this purpose reduces.

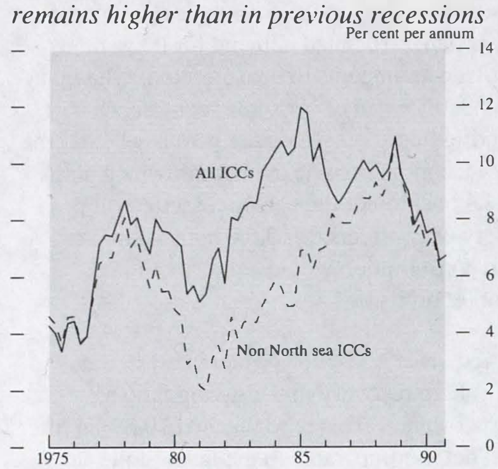
If the saving ratio were not to fall, then recovery in consumption resulting from rising real incomes would be a more muted affair. The extent to which the structure of personal sector assets and liabilities might influence this has always been an uncertainty underlying this recession that did not apply in earlier ones when financial regulation probably limited portfolio choice.

Financial constraints *may also affect recovery in the* **corporate sector**

In the company sector also, the financial position carries risks that recovery could be delayed that were not present in the early 1980s. The financial deficit of industrial and commercial companies, which has risen rapidly over the last three years and resulted in a substantial increase in the stock of corporate debt, appeared at least to have stopped rising in the fourth quarter of last year, though at a level that it is difficult to envisage being sustained. Adjustment has occurred in various forms to help halt the deterioration in companies' finances. Rising unemployment is one evidence of the

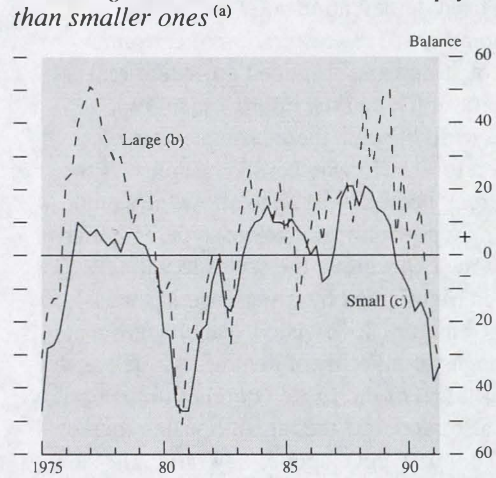
(1) A different treatment of personal pensions accounts for about half a percentage point of the rise in the saving ratio.

Profitability of non North Sea companies[a]
remains higher than in previous recessions



(a) Pre-tax real rate of return.

Larger **manufacturing companies** *appear to be cutting back* **investment** *more sharply than smaller ones*[(a)]



(a) Source: CBI surveys. The balance is the percentage expecting more expenditure on plant and machinery minus the percentage expecting less.
(b) Large = > 5,000 employers.
(c) Small = < 200 employees.

ICCs' bank borrowing and capital market issues

£ millions; *seasonally adjusted*

	Bank borrowing	Capital market issues: Ordinary shares	Capital market issues: Preference shares, bonds and notes	Liquid financial assets(a)	Net borrowing requirement
1987	12,131	13,410	4,170	-8,709	23,633
1988	31,015	4,351	5,039	-5,687	45,018
1989	33,279	1,881	7,023	-15,231	49,089
1990	19,150	2,641	4,586	-13,395	26,724
1990					
Q1	6,380	1,266	927	-7,226	7,674
Q2	4,719	563	413	-4,970	4,144
Q3	4,408	482	1,858	-4,603	5,338
Q4	3,643	330	1,389	3,404	9,568
1991					
Q1	—	672	1,760	—	—

Sources: Table 8.3 Financial Statistics; Bank of England Capital Issues Press Notice.

(a) Largely bank deposits; negative figure = increase.

acknowledged need to contain costs: another evidence is that gross trading profits of non North Sea companies rose by 3% in the fourth quarter and profitability was broadly unchanged at 6%, still comfortably above the level to which it was allowed to fall in the last two recessions. The rapid rise in net income gearing also seems to have been halted, though the level is significantly higher this time.

Much of the adjustment to spending has been in fixed investment, with business investment falling by 3% between the third and fourth quarters (and by 8% between the first and fourth quarters) of 1990. Nevertheless, business investment remains historically high in relation to GDP. Survey evidence suggests that although firms of all sizes are trimming spending, it is the largest that are cutting back most severely. In some cases, but not all, these may be companies most heavily encumbered by debt. Larger companies are most often accused of exploiting their power over smaller suppliers by lengthening the trade credit taken from them.

It is less evident, however, that large companies are cutting stocks more aggressively than small ones. In fact the behaviour of stockbuilding is difficult to establish because the national accounts statistical adjustments dominate the components of stockbuilding that are directly measured. Excluding these adjustments, destocking in 1990 amounted to £1.5 billion (at constant prices) compared with £3.4 billion in 1980, illustrating the much smaller role that the stock cycle seems to be playing in this recession. Changes in taxation and stock control technology may have been important influences but also—a factor sometimes overlooked—security of supplies is very much better now. Stock levels in 1980 no doubt reflected the fact that in 1979 29.5 million working days were lost because of strikes. By 1981 this had fallen to 4.3 million, allowing lower precautionary inventories to be held.[1] The total of days lost to strikes in 1981 was just slightly more than the 1989 starting point for the current cycle, and in the second half of 1990, at an annual rate, the number was down to 0.6 million.

From 1988 to the first part of 1990 industrial and commercial companies borrowed heavily from the banking system, much of it to fund acquisitions and mergers. The net result of this and of a wide variety of different trading conditions and corporate financial strategies meant that the corporate sector as a whole also acquired substantial bank deposits during this period.[2] More recently, banks have been taking a tougher view of the circumstances in which, and the price at which, they are prepared to lend, and new bank lending has eased back. In the fourth quarter, as companies' net borrowing requirement continued to grow with the deepening recession, net recourse to the banking system rose sharply (to 74% of the net borrowing requirement). In the tougher lending climate, half of this was found from running down deposits rather than increasing borrowing. This contraction of both lending and deposits has contributed to the declining growth of the broad monetary aggregates, which has continued into the first quarter of this year when companies have turned also to the capital markets. Net sterling capital issues rose by nearly £0.5 billion (to £1.4 billion) and net foreign currency issues by £0.3 billion (to £1.0 billion). More strikingly, and reflecting the pick-up in the equity market in

(1) Although working days lost rose again to over 27 million in 1984, this was due to the miners' strike and was concentrated in that industry whereas over two-thirds of the 1979 total was in the metals, engineering and vehicles industries where components supplies are crucial to the production process.
(2) The statistics include the residual of unidentified holdings of sterling CDs which may not be accurately allocated to the industrial and commercial company sector.

March, announcements of new sterling issues jumped to £2.2 billion in March, giving a first quarter total of £3.5 billion compared with £1.5 billion in the previous quarter.

Banks' increasingly discriminating lending policies represent a return to more normal competitive conditions after a period, following deregulation, in which balance sheet size rather than profitability or quality seemed to dictate the policies of too many banks. There is little evidence, however, of a 'credit crunch' in the sense that lenders are unable to lend because they are unable to raise funds (see the Bank's evidence to the Treasury and Civil Service Committee reprinted on pages 256–9). Default experience and the economic prospects for their customers are factors that will cause changes in the cost and availability of credit from banks as a normal feature of the economic cycle. Company finances have certainly become more fragile and liquidations last year rose by 43% to a level of 1.3% of registered companies, compared with a previous peak of 1.5% in 1985. As a result banks have increased their domestic provisions and raised their lending margins. This improvement in margins has, in turn, been made possible by a reduction in competition from the major foreign banks (particularly the US and Japanese ones) who have needed to consolidate for their own domestic reasons.

Companies may be unwilling to borrow at increased margins, not just because of the increased cost but because of the signal it might give about their status. To the extent that the equity and bond markets remain active, and attractive, or that companies have liquidity to continue to draw upon, the amount of further adjustment forced upon them may be limited and recovery from the recession could therefore be quicker. If these conditions were to cease, however, the weakened corporate financial position could give a further downward twist to companies' expenditure adjustment that could offset any recovery in consumption.

Cyclical stabilisers *will aid recovery*

At the time of the 1991 Budget the latest estimate of the PSDR in 1990–91 was £0.8 billion, compared with a forecast of £6.9 billion in the 1990 Budget, and £3.0 billion in the 1990 Autumn Statement. The outturn for the PSDR in 1990–91 was £0.4 billion, half the 1991 Budget estimate, and although a detailed breakdown consistent with that outturn is not yet available, comparisons between the 1990 and 1991 Budget figures give a broad indication of areas where differences have arisen in the course of the year. General government receipts were estimated to be £2.0 billion less than expected at the time of the 1990 Budget. Higher than forecast income tax and corporation tax receipts were expected to be more than offset by lower Customs and Excise, social security and community charge receipts. General government expenditure was estimated to be £3.3 billion higher than forecast in the 1990 Budget. Central government support for local authorities and local authority self-financed expenditure were both expected to be higher than previously anticipated. The financing requirements of nationalised industries were also expected to be higher. Public corporations' debt repayment was expected to be lower than projected.

The Budget for 1991/92 was broadly neutral in cyclically adjusted terms and consistent with the Government's objective of budget balance over the medium term. A PSBR of £7.9 billion is forecast for 1991/92 reflecting the operation of automatic stabilisers. Central

Estimated outturn of the PSBR in 1990–91 and forecast for 1991–92

	Estimated outturn 1990–91	Forecast 1991–92	Percentage increase
Receipts			
Income tax	55.5	59.6	7.4
Corporation tax	21.6	19.5	-9.7
Customs and Excise receipts	55.3	62.2	12.5
Rates and community charge receipts	22.6	22.0	-2.7
Social security receipts	34.9	36.7	5.2
Other receipts	26.7	26.6	-0.4
General government receipts	**216.6**	**226.5**	**4.6**
Expenditure			
Central government expenditure	140.6	152.1	8.2
of which:			
Social security	*51.8*	*58.2*	*12.4*
Defence	*22.1*	*22.8*	*3.2*
Central government support for local authorities	42.6	52.5	23.2
Financing requirements of nationalised industries	2.5	2.3	-8.0
Privatisation proceeds	-5.3	-5.5	3.8
Reserve	—	3.5	—
Planning total	**180.4**	**205.0**	**13.6**
Local authority self financed expenditure	14.7	9.1	-38.1
Central government debt interest	17.6	16.7	-5.1
Accounting adjustment	3.4	3.9	14.7
General government expenditure	**216.0**	**234.8**	**8.7**
General government borrowing requirement	**-0.5**	**8.3**	—
Public corporations market and overseas borrowing	-0.3	-0.4	—
Public sector borrowing requirement as estimated in the 1991 Budget	**-0.8** (a)	**7.9**	**—**

Source: Financial Statement and Budget Report 1991–92.

(a) The estimated outturn for 1990–91 was subsequently revised to -£0.4 billion but a detailed breakdown of this total consistent with the FSBR is not available.

government support for local authorities will increase (by 23.2%), although this will be offset in part by a reduction in local authority self-financed spending. The reduction in the community charge of £140 will be financed by an increase in the standard rate of VAT (Customs and Excise receipts being projected to rise by 12.5%).