
Economic commentary

Introduction

This commentary takes a longer view than usual, setting the latest developments in the context of recent years—broadly, since the first sharp increase in oil prices in late 1973.

The commentary begins with a summary of world economic developments: policies to reduce inflation are meeting a good measure of success, but prospects for recovery of activity are uncertain. This is followed by an account of the main developments in the UK economy: trade flows, influenced by the economic cycle and changes in cost competitiveness; an easing of inflation; industrial costs increasing very modestly; and recession deeper than elsewhere, despite some hesitant recovery. As often in recession, the share of profits in national income was, until recently, falling, in favour of income from employment.

Where possible, the analysis relates financial aspects of personal and company behaviour to developments in the economy. Two complementary notes—on profitability and company finance (page 243) and inflation-adjusted saving and its sectoral composition (page 239)—appear later in this *Bulletin*.

The world economic background

Responses to rises in the price of oil

Over the last three years, the world economy—which was still adjusting to the effects of the first large increase in oil prices—has been seeking to absorb the second increase.

Between September 1973 and January 1974, the price of a barrel of OPEC oil rose from \$2.70 to \$10; and during 1979 and the first half of 1980 it rose steeply again, from around \$13 to \$32. In the first period, when some major non-OPEC producers (especially the United States and Canada) did not raise prices in line with OPEC, the extra cost of oil was equivalent to 2½% of GNP in oil-consuming countries. On the second occasion, when non-OPEC producers moved much more closely with OPEC, the extra cost was equivalent to 4½% of GNP.

An important difference between the two episodes has been in the stance of policy in the main industrial countries. In the mid-1970s, fiscal policy in a number of industrial countries sought to counter the adverse effect on economic activity of the sharp loss of purchasing power, until the oil exporters were able to spend their revenues. But not all countries gave equal priority to offsetting this demand deflationary effect of the oil price increases. In the event, inflation rose to 15% in the OECD as a whole and 20% or more in some countries (including the United Kingdom). Priority was increasingly given to containing inflation through the pursuit of restrictive policies. By 1976, a number of countries had adopted monetary targets; and although the success in meeting them varied—and in some instances a degree of slippage was accepted—the general thrust of monetary policy was maintained.

At the same time, however, activity in most industrial countries remained subdued. In an effort to provide some stimulus, those countries, notably West Germany, which had been relatively successful in curbing inflation, moved to a rather less restrictive fiscal stance.

When oil prices again began to rise steeply in 1979, most governments reinforced their counter-inflationary policies, accommodating at most only partially the increase in costs. In practice, therefore, monetary policy in many countries became increasingly tight and—partly as a result—real interest rates rose steeply. As activity slackened, budget deficits expanded. Discretionary fiscal policy (as conventionally measured, abstracting from the effects of recession on government spending and taxation) seems to have become more restrictive in the major OECD economies—perhaps to the extent of 1% of GNP between 1980 and 1981. With present policies, there could be a further shift towards restriction this year. Nevertheless, it has been widely argued—particularly with regard to the United States—that lower deficits would strengthen economic activity, on the grounds that a large deficit alongside firm monetary control has meant unduly high real interest rates.

The reaction of the private sector has in each episode tended to cushion the effects of policy. After the first oil shock, when policy was relatively unrestrictive, private spending fell by an amount equivalent to some 2% of GNP. Consumer spending was subdued, and company spending fell away sharply as profits deteriorated and growth prospects worsened. Since 1979, when policy has been tighter, private spending in the OECD has been virtually unchanged.

During the last eight years, almost all industrial countries have experienced slower growth and higher inflation than in the previous two decades. Inflation, however, has been considerably reduced since 1980. In the first quarter of this year, consumer prices in the six major industrial economies abroad rose at an annual rate of about 6%, compared with over 10% in the third quarter of 1981. Commodity prices continue to fall: in dollar terms, *The Economist* all-items index in May was almost 30% below its October 1980 peak (in SDR terms the fall was about 17%) and oil prices have also eased. Labour costs in industrial countries rose less steeply than import costs in 1979 and 1980, and have since slowed further.

Prospects for activity, inflation and payments balances

Any early benefit to activity from lower inflation is likely to be small. Indeed, prospects for recovery now look less certain than they did even a few months ago.

In both 1980 and 1981, GNP in the major countries increased by a little over 1%; over half of this rise stemmed from movements in net exports, arising in particular from trade with OPEC. Imports of oil fell sharply, through a combination of weak activity and conservation measures, while exports to OPEC rose rapidly.

These various influences are beginning to weaken, so that the major countries will now be relying on domestic demand as the main source of economic growth. A recovery in activity is likely to depend in the first instance on consumer spending. Real incomes have

benefitted from the recent improvement in the industrial countries' terms of trade, thus reversing the earlier trend. This effect on real personal incomes and consumption could be reinforced by some modest growth in employment, albeit no more than the expected growth in the labour force. Altogether, real personal incomes might increase by $2\frac{1}{2}\%$ – 3% in both 1983 and 1984. In addition, destocking is expected to end. Government spending, however, will in most cases grow slowly, and fixed investment is expected to remain weak. Overall, GNP might be rising at an annual rate of up to 3% in the second half of 1982 and through much of 1983.

Wage settlements appear to be moderating and commodity prices (including oil) may remain weak. But there are still risks. As activity recovers, wage settlements may increase again, and companies may be anxious to rebuild profit margins. Marked disparities in inflation rates seem likely to persist.

In contrast to 1974–76, the smaller developed economies have followed much the same course as the major countries. External financing constraints have strengthened their commitment to counter-inflationary policies. Such considerations are also important for the less-developed countries, many of whose export earnings have been adversely affected by weak demand in industrial countries, while the cost of servicing external debt has mounted. As a result, their imports may grow by only about 3% a year, against the 10% recorded in 1978 and 1979.

In the last two years, world trade as a whole has grown only slowly, in part reflecting the large fall in OECD oil imports. Outside the OECD, however, where UK exporters are well established, imports have increased rapidly, so that UK markets have been less depressed than world trade.

Against this background, the oil exporters' current account surplus has contracted sharply. This and other aspects of the world current account are discussed in more detail in the review of international financial developments (page 212).

World trade and UK export markets

Percentage change (volume)

	1980	1981	Bank forecasts	
			1982	1983
World trade	$\frac{3}{4}$	1	3	6
UK export markets	3	$2\frac{1}{2}$	3	6
of which:				
OECD	$\frac{3}{4}$	$-2\frac{1}{4}$	3	6
Other	$7\frac{1}{4}$	12	4	5

The UK economy

Main developments

Now that the United Kingdom is self-sufficient in oil, a rise in the oil price largely represents an internal transfer of income—which is not the case in most other industrial countries. Nevertheless, the recession has been deeper here than elsewhere. Because inflation in the United Kingdom was so high to start with, policy has been strict. In the 1981/82 financial year, the public sector borrowing requirement (PSBR) was equivalent to about $3\frac{1}{2}\%$ of GDP,⁽¹⁾ compared with $5\frac{3}{4}\%$ in the previous year and over 10% in 1975/76. Increases in narrowly-defined money have become modest, and the growth of sterling M_3 has also slowed. Real interest rates are still high, although no higher than in some other countries.

A striking feature in the United Kingdom between 1977 and early 1981 was the loss of industrial competitiveness as measured by labour costs in manufacturing industry. While the exchange rate rose in effective terms, wages increased much faster than abroad;

(1) At £8.4 billion, the PSBR was £1.2 billion lower than expected as recently as March. The reasons for the low outturn are not entirely clear: it seems that central government and local authorities spent less than expected; that tax revenues were more buoyant; and that more council tenants borrowed from banks and building societies to finance the purchase of their houses, so reducing the call on local authorities to extend mortgages.

altogether, after allowance for exchange rate changes, wage costs per unit of output in UK manufacturing industry rose by over 60% in relation to wage costs abroad. Last year, the exchange rate declined somewhat. Wage increases moderated and productivity in industry grew rapidly. As a result, the United Kingdom's labour cost competitiveness has improved by perhaps 15% since the first quarter of 1981.

Trade affected by competitiveness and markets

Gaps in the statistics and changes in the method of compilation make interpretation of recent external trade figures difficult. In the last two years,⁽¹⁾ the volume of UK exports of manufactured goods, excluding the customary erratic items, has fallen by nearly 8%. With due allowance for time lags, changes in competitiveness alone would have been expected (on the basis of past relationships) to have reduced exports by 13% or so in the period; on the other hand, the modest growth in world trade might have increased them by 2%–3%. The fall of 8% is thus fairly close to what the combined effect of these influences would have suggested. Meanwhile, the volume of imports (excluding oil and erratic items) has increased by 6%. Imports have probably been less affected by loss of competitiveness in the two years as a whole, because the improvement in industrial costs last year would, to judge from experience, have affected them quite quickly. Moreover, the rise in imports in the period has to be set against a reduction in total domestic demand, representing further penetration of domestic markets.

Over the same two-year period, the surplus on trade in services (at 1975 prices) has fallen, but trade in oil has moved from deficit into substantial surplus.

The UK balance of payments is discussed further on page 213.

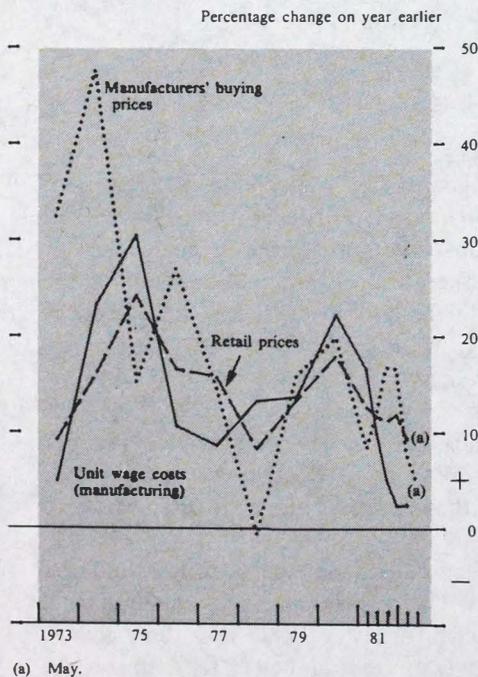
More moderate price and cost increases

Price inflation has recently eased, as it has abroad, and is now lower than for most of the last decade. There has been a sharp reduction in the rate of increase in industrial costs.

The year-on-year increase in retail prices has fallen from 12% at the turn of the year to about 9½% in April and May. The effect of the Budget tax measures was lower than last year; rents and local authority rates went up less this spring; and mortgage interest rates were reduced by 1½%, whereas in April 1981 the cut was 1%. Moreover, nationalised industry charges have risen much less in the past year. With the movement in costs and other factors continuing to exert downward pressure on inflation, the Treasury forecast of a 9% increase in the retail price index between the fourth quarters of 1981 and 1982 may be achieved earlier.

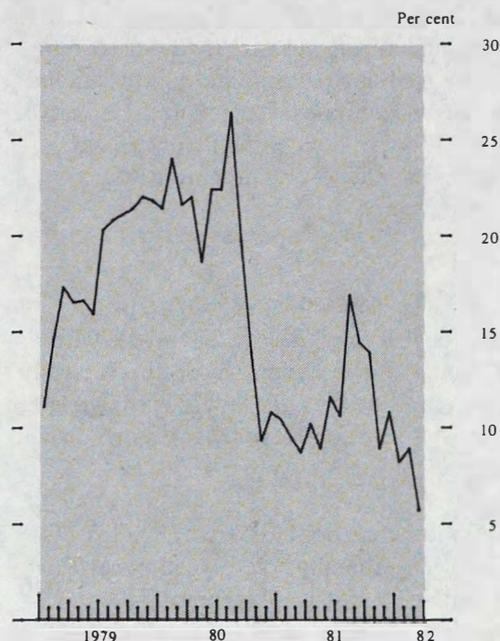
The best available figures of industrial costs relate to manufacturing. In the last year or so, productivity growth has almost kept pace with pay, and wage costs per unit of production in manufacturing industry increased by only 2¾% in the twelve months to the first quarter of 1982. Because of the time involved in the production of manufactured goods (and the way they are priced), slow growth in labour costs in the past year should restrain price increases for some time to come. Whether the growth in labour costs will continue to be so modest is uncertain. The improvement in productivity in

Cost and price inflation has fallen substantially.



(1) 1980 Q1 to 1982 Q1. This comparison avoids most of the change in domestic stockbuilding behaviour (important for imports). Also, the first quarter of 1980 is a useful basis for comparison because trade flows were little affected by special factors.

Increases in earnings are now lower than for some years.^(a)



(a) Averaged monthly increases at an annual rate. Adjusted by the Department of Employment for seasonal and temporary factors.

Adjusted industrial production^(a)

1975 = 100

1981 Q1 89
Q2 89
Q3 91
Q4 91

1982 Q1 91

(a) See text.

manufacturing industry appears to be slowing down (although the figures may have been distorted by interruptions to production in the bad weather), but the growth of earnings is also slowing as more of this year's wage settlements, averaging around 7% in manufacturing, are implemented. Expectations of slower inflation might restrain wage settlements further.

The other major elements in manufacturers' costs—fuel and raw material prices—were unchanged between August 1981 and May 1982, having risen rapidly (partly because of sterling depreciation) in the earlier part of last year. In the first quarter, such costs were 11¼% higher than a year earlier; by May the increase was down to 4¾%. Other costs borne by manufacturing industry (such as rates—see page 243) may have increased faster, but the rise of 8¾% in manufacturers' selling prices in the year to May will probably have been accompanied by some recovery of profit margins.

The GDP deflator is for some purposes a more appropriate measure of inflation than retail prices, because it excludes the impact of indirect tax changes and interest rates and the prices of imported goods and services. This deflator increased by under 9% between the first quarters of 1981 and 1982, a considerable reduction from most recent experience.

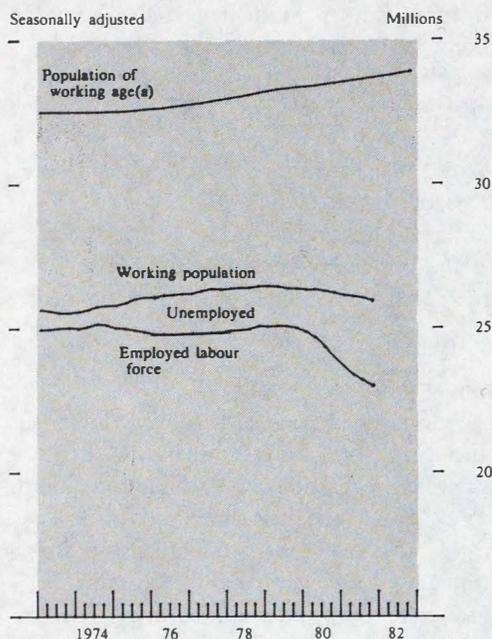
Hesitant recovery of output

The course of output suggests a slow and hesitant recovery. After six quarters of decline, the output measure of GDP rose by about ¾% during the second half of last year. Industrial production (about 40% of GDP) rose by over 1½% between the second and third quarters, with a rather larger increase in the manufacturing sector (which is about 70% of industry). In November and December, however, industrial production in total, and manufacturing, fell back, partly because of strikes and unusually severe weather. There was some recovery subsequently, but GDP in the first quarter fell by ¼%, though it was still higher than at the trough of the recession in the second quarter of 1981.

To form a better view of the underlying position, some adjustments to the basic statistics are needed. First, North Sea oil and gas should be disregarded, because extraction rates are largely determined by technical considerations. Second, industrial production figures include some sales data, and need to be adjusted to measure output. (Both these adjustments are made by the CSO.) Third, in order to avoid distortions caused by bad weather and industrial disputes, the categories of production most affected may be excluded from the index. (Strikes in the motor industry reduced production last May and November. The CSO estimate that unusually severe weather reduced construction work by up to 5% in the fourth quarter of 1981 and the first quarter of 1982, which is equivalent to a fall of almost 1% in industrial production; on the other hand, net output of the gas and electricity industries was unusually high for the same reason.) The index in the table accordingly measures industrial production, excluding North Sea oil and gas, construction, motor vehicles and public utilities (altogether about 30% of the total industrial production index) and adjusted for sales out of stock. The picture is clear—recovery from last spring but no further growth since the autumn.

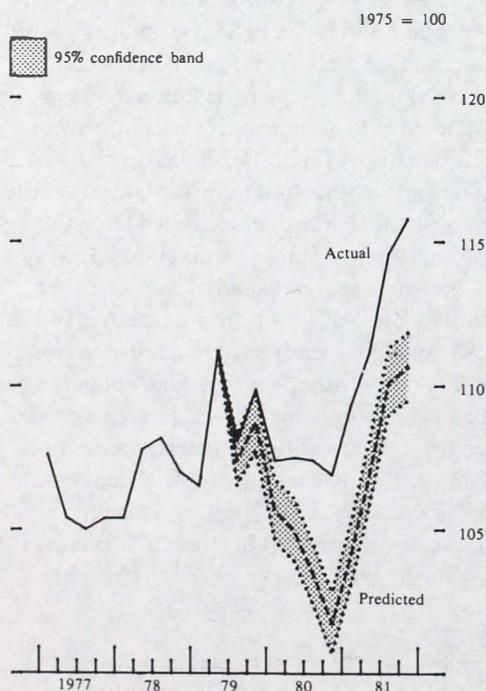
Non-industrial output—almost 60% of GDP—fell only very slightly between 1979 and the third quarter of last year. In the fourth quarter there was some increase in the output of service industries.

The number of jobs declined steeply last year.



(a) Based on official projections published in 1981.

Productivity in manufacturing was some 5% higher at end-1981 than would have been predicted on the basis of experience.



(a) The range of likely outcomes in the absence of structural change.

Despite possible help from lower inflation (for reasons explored below) and better competitiveness, prospects for output remain uncertain. Surveys and reports from industry suggest a slow improvement in business confidence. Replies to a question in CBI surveys about output in manufacturing industry in the succeeding four months have barely changed since the middle of last year, and about two thirds of respondents continue to expect production to be unchanged. In April, over 90% of respondents still mentioned demand as the factor limiting production; no other potential constraints were seen as important.

The labour market

The number of people with jobs fell by a further 200,000 in the fourth quarter of last year, to 9% below the level in mid-1979, the recent high point. (In the mid-1970s recession, the decline was only 1½%.) Since the end of last year, however, the falls in employment in manufacturing—where the sharpest contraction has occurred—and in other industrial sectors have slowed.

Registered unemployment more than doubled between mid-1979 and the end of last year, and exceptionally severe weather caused a further large increase in January. Subsequent increases have been smaller, but in June adult unemployment (seasonally adjusted) rose by 39,000.

The decline in the working population—the total of employees with jobs, HM Forces, the self-employed and registered unemployed—continued throughout last year. By December, the working population was 500,000 smaller than in mid-1979, although the population of working age probably increased by a similar amount.

Productivity

The course of manufacturing production, employment and average hours worked in recent months has brought a slowing in the rapid rate of growth in productivity (output per man-hour) to perhaps 1% a quarter from 2% a quarter or more during 1981, though this is still fast by the standard of recent years.

Whether productivity growth will slow further or revive is unclear. Until 1979, productivity seemed to be dominated by the behaviour of output with a tendency to rise over time, possibly reflecting advances in technology and growth of the capital stock.

In the present recession, productivity has been higher than statistical relationships (which worked well between 1974 and 1979) would have predicted. Earlier experience would have indicated a much sharper fall in productivity when output declined in 1980 than in fact occurred. Because it takes time for employers to adjust their work force fully to changes in output, the continued fall in hours worked last year was partly a delayed response to the steep fall in production in 1980—as the chart shows, last year's rise in productivity was not unexpected.

Some aspects of sectoral income and finance

Between 1977 and 1980, employees' income rose rapidly in real terms, with large wage increases and a rising exchange rate—the latter restricting the ability of companies to raise prices but seemingly doing little to restrain wage settlements. By contrast, the profits of industrial and commercial companies (excluding profits

Shares in factor incomes

Per cent

	Income from employment	Gross trading profits (a)	Gross trading profits, excluding North sea operations
1973	67	14	13
1975	73	10	10
1977	68	14	13
1979	68	14	11
1980	70	13	9
1981 H1	71	12	8
H2	69	14	9

(a) Profits of industrial and commercial companies, net of stock appreciation.

arising from North Sea operations) fell steeply in real terms.⁽¹⁾ Employment income and profits both fell in the first half of last year, but the redistribution away from profits continued. In the second half, however, there was some reversal of this trend.

Personal sector

Real personal disposable income (RPDI)—which includes social security benefits and other sources of personal income, after tax—fell between 1973 and 1977; grew rapidly between then and 1980; and eased back last year. Consumer spending⁽²⁾ followed the same course until 1980, since when it has been broadly unchanged. Personal saving (the difference between income and consumers' expenditure) was well sustained in 1975, fell from then to 1977, but rose strongly to 1980 before falling again last year.

The high recorded saving in recent years (and the high figures for RPDI) is, however, somewhat misleading. An alternative measure of income and saving might exclude amounts needed to preserve the real value of persons' net assets fixed in money terms. In 1975, for example, inflation reduced the real value of the personal sector's net monetary assets by £13 $\frac{3}{4}$ billion.⁽³⁾ If allowance is made for this, the picture is changed: instead of adding £9 billion to their savings, persons reduced them by over £4 $\frac{1}{2}$ billion.

The point may be developed in terms of the possible effect of slower inflation on consumer spending. (The effect discussed here is separate from any associated change in wages.) In mid-1981, the personal sector held about £120 billion of monetary assets (net of liabilities). Thus the sector would need to save over £4 billion less over the next year to preserve the real value of its net monetary assets if the rate of inflation dropped to 7 $\frac{1}{2}$ % than it would have to save if prices were to rise by 11%. But the effect on consumption may depend on the interest paid on these assets. Some monetary assets pay interest (and much personal sector debt carries interest costs), the rate tending to vary with inflation. Lower inflation would reduce the amount of saving needed to maintain the real value of these assets (net of debt), but would also reduce interest income, possibly leaving consumer spending unaffected. Other monetary assets pay no interest. As inflation slowed, the real income (as usually defined) of holders would be unaffected, but the amount of saving required to maintain the real value of such holdings would fall and consumer spending would tend to be higher than otherwise. A consideration tending to reduce consumption, however, would be the lower cost of holding such non-interest-bearing assets as inflation fell.

Altogether, therefore, lower inflation might encourage consumer spending, but by less than the reduction in the amount of saving needed to preserve the real value of net monetary assets.

Lower inflation might in principle affect consumer spending through its effect on the price of equities, property, and also unindexed gilt-edged securities (which count as monetary assets). In practice, no such wealth effect has so far been identified in Bank research.

After allowance for the effect of inflation on net monetary holdings, personal sector saving in real terms has been tending to grow. Nevertheless, capital spending by the personal sector (mainly housing and spending on fixed investment and stocks by

Personal income and financial transactions

£ billions, 1975 prices

	1973	1975	1977	1979	1980	1981
Disposable income	75.3	73.9	72.4	83.6	84.5	82.8
Saving	8.9	9.1	7.8	12.1	13.0	11.4
Borrowing	6.2	3.4	4.6	6.7	5.8	6.9
Capital spending	4.2	3.4	3.9	4.5	3.8	3.7
Acquisition of financial assets	12.5	10.5	10.6	15.1	14.3	13.5
Notional 'real' loss on net monetary assets	6.7	13.7	6.9	9.7	7.5	6.3

(1) If capital consumption at replacement cost as well as stock appreciation is deducted, the share of profits in (net) national income fell to 3 $\frac{1}{2}$ % in the first half of 1981—see 'Profitability and company finance', page 243.

(2) Consumers' expenditure includes spending on durable goods but excludes the purchase of homes, which is recorded as capital spending by the personal sector.

(3) See the article on page 239.

Industrial and commercial companies' income, expenditure and financial transactions

£ billions, 1975 prices

	1973	1975	1979	1980	1981
Income(a)	17.5	12.3	19.2	16.8	16.6
	<i>13.1</i>	<i>9.5</i>	<i>11.3</i>	<i>9.2</i>	<i>8.2</i>
Undistributed income	8.6	5.4	7.9	5.3	5.6
Borrowing(b)	9.8	3.5	5.2	5.2	5.9
Fixed investment and stocks	9.2	5.2	9.8	6.3	5.3
Acquisition of financial assets(c)	7.9	3.4	4.5	4.4	6.0
Notional inflation gain(d)	2½	5½	2½	2½	1½

(a) Gross trading profits, net of stock appreciation, plus other sources of income. Figures in *italics* are gross trading profits (excluding stock appreciation) of non-North Sea companies.

(b) Including trade credit received.

(c) Including investment abroad and trade credit extended.

(d) Rough estimates.

unincorporated businesses) has fallen as much in real terms in the recent period as it did in the mid-1970s, with low spending on new houses. More marked is the course of borrowing, which at constant prices almost halved between 1973 and 1975 (partly a consequence of the abolition of tax relief on interest paid on most forms of loan) but more recently has on balance continued to grow faster than inflation.

A consequence of these developments has been a much larger acquisition of financial assets by the personal sector (both as conventionally measured and after allowance for the effect of inflation on net asset holdings). In the mid-1970s, the real value of acquisitions fell; up to the middle of last year, they grew, although they fell back quite sharply in the second half.

Company sector

Company income⁽¹⁾ in total has been better maintained in the latest recession than in the mid-1970s, falling (in constant prices) by less than 20% between 1979 and the first half of last year, as against 30% between 1973 and 1975. Profits from North Sea operations were building up in the late 1970s; without them, the real decline in profits on this measure between 1979 and mid-1981 was, at 34%, more marked than in the previous recession. (The decrease between 1978 and mid-1981 was 45%.) With or without North Sea operations, there was a recovery in the second half of last year.

For all industrial and commercial companies (North Sea operations cannot be separately distinguished), real undistributed income (net of stock appreciation) fell by a third between 1979 and the first half of last year, declining considerably faster than total company income.

Among the appropriations of income, interest payments, although very variable, have not on the whole been higher in relation to company income than they were in the mid-1970s (so income gearing has not been consistently higher). On the other hand, taxes and profits due abroad have risen, largely because of growing income from North Sea operations. Dividend cover has fallen—indeed, it seems that a substantial minority of companies have been paying uncovered dividends if profits are computed on a current cost basis.

Industrial and commercial companies' monetary liabilities usually exceed their assets, so that—in contrast to the personal sector—inflation tends to benefit their net monetary position (so tending to offset the cost of higher interest rates). But the development of company borrowing, investment and financial transactions has in some ways resembled behaviour in the personal sector. In 1975, companies borrowed in real terms barely a third as much as in 1973, and reduced their spending on stocks and fixed assets (despite growing investment in the North Sea) and also their acquisition of financial assets. Between 1979 and last year, by contrast, companies maintained or increased their borrowing in real terms and increased their acquisition of financial assets;⁽²⁾ they cut investment spending (mainly stocks) by considerably more than they had done in the earlier period.

To judge from the position of about 200 large companies sampled by the Department of Industry, liquidity—the ratio of current assets to current liabilities—has improved, though unevenly, in recent quarters, and is considerably stronger than it was at times in 1974

(1) Industrial and commercial companies' gross trading profits (net of stock appreciation) plus their income from other sources. 'Profits' alone means gross trading profits net of stock appreciation. Capital consumption is not deducted from these figures. See also the note on page 243.

(2) The Civil Service dispute obscured the underlying position in the two halves of last year.

and 1975. The April CBI survey (covering a much larger number of companies of various sizes in manufacturing industry, and relating to different periods) gave much the same picture.

The much slower rate of destocking was the main reason for companies' return to financial deficit in the second half of last year. Figures for manufacturers and distributors suggest a small increase in stocks (and a rise in fixed investment) in the first quarter of this year. Despite a further recovery in profits, companies may remain in financial deficit if their spending continues to increase, although the deficit seems unlikely to be very large.

Recent improvement in company profitability

In the first half of last year, real company profitability⁽¹⁾ before tax was about $2\frac{1}{4}\%$ —the lowest recorded. In the second half, however, it rose to over $3\frac{1}{4}\%$. Profits have clearly benefited from improvements in productivity, lower wage increases, and the consequent recovery of cost competitiveness. This improvement occurred without a sizable recovery of output. But the real rate of return exceeded 10% for most of the 1960s and remained above 5% even in the recession of the mid-1970s.

Real profitability of existing assets nevertheless remains well below the real cost of finance. The incentive to invest depends on the expected return in the widest sense from a new project in relation to the cost of financing it—for which the return on existing assets may not be a good proxy. Moreover, for reasons set out in the note on page 243—the treatment of redundancy payments and the possible overstatement of capital employed⁽²⁾—estimates of profitability in recent years may be somewhat too low in relation to earlier figures. Even so, the strength of industrial investment in recent years, and the plans to increase it indicated by surveys of investment intentions, are somewhat surprising.

Private sector borrowing and monetary control

Growth in borrowing by the private sector (at constant prices), at least from the rate of the mid-1970s, has already been noted. The proportion of industrial and commercial companies' borrowing supplied by the banks⁽³⁾ has been very variable, and it has recently been high. As noted in previous *Bulletins*, the banks' share in lending to the personal sector has been growing, both for housing and consumer finance.

In order to prevent the whole of sterling bank lending to the private sector from feeding through to bank deposits and thus to the money supply, official sales of public sector debt to the non-bank private sector exceeded the public sector borrowing requirement by $\pounds 2\frac{1}{2}$ billion in 1981/82. (Details of the funding programme and its market implications can be found in the review of the operation of monetary policy.)

Financial position of public and private sectors, after allowing for inflation

The difference between each sector's income and spending is its financial surplus or deficit (or its net acquisition of financial assets).

(1) Profits of industrial and commercial companies, net of stock appreciation and excluding North Sea profits, divided by trading assets valued at replacement cost. The note on page 243 presents annual figures for profitability and the cost of finance since 1970, and explains the concepts used.

(2) The effect of the treatment of rates, also mentioned on page 243, is to reduce estimated profitability by a roughly constant amount throughout the period.

(3) Bank lending to companies includes commercial bills discounted by the banks, including those subsequently purchased by the Bank of England.

In recent years, this measure for industrial and commercial companies has fluctuated around balance; last year they were in small surplus, having taken energetic measures (reducing stocks and their labour force) to correct their financial position. The personal sector has—on conventional definitions—been in large and, until 1981, growing financial surplus; and the public sector has been in continuous deficit, although its deficit shrank appreciably in relation to GDP last year. Domestic oil production and the recession largely explain the surplus on the current account of the balance of payments, to which the financial deficit of the overseas sector corresponds.

Sector balances adjusted for the effect of inflation on monetary assets and liabilities^(a)

Per cent of GDP

	Public	Industrial and commercial companies	Persons	Overseas ^(b)
1973	+1.9	+2.6	-2.5	+1.1
1974	+6.2	+2.9	-8.7	+2.4
1975	+4.4	+6.2	-8.8	—
1979	+3.8	+0.9	-2.0	-0.7
1980	+1.3	+1.4	+1.8	-2.4
1981	+2.1	+2.2	+1.4	-4.0

(a) Excludes financial companies and the residual.

(b) Equal to the UK current account surplus with sign reversed: in 1981, the UK current account surplus is very roughly estimated to have been £8 billion.

Financial positions as conventionally measured in the national accounts take no account of the effect of inflation on the real value of assets and liabilities fixed in monetary terms. The table shows these balances adjusted for inflation in this manner, as a percentage of GDP.⁽¹⁾ On this measure, the public sector has been in continuous surplus. But because the reduction of inflation has been an important aim of policy throughout, the Government would not have been expected to spend more, or tax less, merely because inflation had reduced the real value of public sector debt. Industrial and commercial companies also appear to have been in continuous surplus on this measure. The personal sector's position has improved as a result of lower inflation and growing (nominal) saving. Whether private spending shows some spontaneous increase may depend in part on how companies and individuals view their financial position (and not only on such factors as RPDI, the relationship between profitability and the cost of finance, and expectations about the course of production and sales); their views may in turn be influenced by the effect of inflation on their finances.

Contributions to the change in GDP

Percentages; annual rates

	1975-1979	1979-1981 Q1	1981 Q1-Q4
Consumers' expenditure	+1.7	+0.4	-1.0
Government current expenditure on goods and services	+0.2	+0.3	-0.3
Gross fixed investment	+0.1	-1.1	+0.6
Exports (goods and services)	+1.5	-0.9	+2.7
Total (final expenditure excluding stockbuilding)	+3.5	-1.4	+2.0
Stockbuilding	+0.8	-3.0	+4.3
Imports (goods and services) (increase-)	-1.7	+2.7	-6.8
Adjustment to factor cost (increase-)	-0.5	-0.3	+0.3
GDP (expenditure measure)	+2.2	-1.9	-0.2
GDP (average measure)	+2.5	-2.8	+0.6

Final expenditure and components of demand⁽²⁾

After rising at an average of 3½% a year between 1975 and 1979, final expenditure (excluding stockbuilding) fell during 1980 and in the first quarter of last year, the declines being in fixed investment—especially housing—and exports.

But the largest change as activity fell was in the behaviour of stocks—from an increase of £1.4 billion in 1979 to a decline at an annual rate of £3.6 billion in the first quarter of 1981 (a turn-round equivalent to 5% of GDP, or 3% at an annual rate). The volume of business investment spending⁽³⁾ fell by 40%, a reflection of the pressures exerted by a strong exchange rate and, in 1980, steeply rising wage costs. (The fall in employment was another manifestation of the pressure on companies.) The decline in stocks contributed to a 13% fall in imports of goods and services over the same period, and the effect on GDP was therefore to a considerable extent offset. Notwithstanding the depth of the recession and the pessimism revealed in surveys of business opinion, industrial fixed investment was resilient. The weak components of fixed investment were housing (down 30% in total between 1979 and early 1981) and non-residential public investment. In each case recent declines continued a development begun in the mid 1970s.⁽⁴⁾ In contrast to business spending, consumers' expenditure rose slightly between 1979 and early 1981—reflecting the behaviour of RPDI and, possibly, the improvement in the personal sector's financial

(1) The adjustments are those set out in the note on page 239. Figures for industrial and commercial companies are rough estimates.

(2) At 1975 prices.

(3) Stockbuilding, and private fixed investment, excluding housing.

(4) See the March *Bulletin*, page 12.

position discussed earlier. Government current spending on goods and services also grew.

On the evidence of the first and fourth quarters—full information for the intervening period is lacking—there was a rise in final spending in the course of last year, which was more than accounted for by exports. As in the downturn, however, the largest change was in spending on stocks. Indeed, business fixed investment and spending on stocks taken together grew by 50% between the first and fourth quarters (mostly because destocking was greatly reduced); imports, no doubt affected by the behaviour of stocks, grew rapidly; consumer spending eased back.

Components of fixed investment

	Percentage shares in fixed investment in 1979	1975–	1979–	1981
		1979	1981 Q1	Q1–Q4
		Percentage changes; annual rates		
Housing	17	–3.3	–19.9	–14.9
Non-housing:				
Public	25	–7.2	–5.8	–15.1
Private	58	+6.9	–2.0	+13.6

Consumer spending fell slightly again in the first quarter of this year. Industrial fixed investment, however, increased by nearly 4½%, returning to the average level of 1980. If leased assets are included, there was a fall in fixed investment by manufacturing industry; all the growth was in distribution and service industries. The survey of investment intentions carried out by the Department of Industry in May indicates an increase of 2% in the volume of industrial fixed investment this year—implying some fall from the rate in the first quarter. Manufacturers added about £100 million to stocks in the first quarter, mostly in the form of finished goods; some of this stockbuilding may have been involuntary, since replies to CBI surveys indicate that manufacturers still regard their stocks of finished goods as too high. Altogether, however, stocks fell slightly. A very large increase (from a low level) in housing starts—up 45% on the fourth quarter, and 33% higher than in the first quarter of last year—may signal some revival in housebuilding. (Housing finance is discussed on page 198.) Both exports and imports (of goods and services) fell.

With little change in output and lower inflation, GDP at current prices grew by about 10% between the first quarters of 1981 and 1982. Over a slightly longer period—mid-February 1981 to mid-April 1982, the last target period—sterling M_3 increased at an annual rate of 13%, while M_1 grew by 7¼% and PSL_2 by 12%. The ratio of money or liquid assets to GDP consequently rose slightly on the wider definitions; but M_1 fell in relation to GDP, as it has tended to do for a number of years. Changing payments habits may be part of the reason. Even on the wider definitions, liquidity ratios remained much lower than they had been for most of the 1970s. Total M_3 (which includes foreign currency deposits) rose by 16½%. In the three months to mid-May, sterling M_3 and PSL_2 rose at an annual rate of about 10%, but M_1 was barely changed.

Monetary and interest rate developments are discussed in detail in the next section.