Economic commentary

In the middle of November there was a further severe tightening of monetary policy. The restrictive monetary measures in July had been undertaken with the effect of relative interest rates on the capital side of the balance of payments primarily in mind. The measures in November were prompted rather more by the general state of the economy and the domestic monetary situation.

After expanding rapidly, the economy entered a new phase with output growing at a more moderate and sustainable rate (see page 402).

The balance of payments on current account has continued to worsen through the year entirely because of the continued deterioration in the terms of trade (see page 409). Changes in the volume of foreign trade have been encouraging, but it will be some time before an improvement in volume can offset the effect of adverse price movements; and the October figures published in November showed a particularly large deficit in value.

In September the banks were asked to restrain lending for personal spending, property development and financial transactions (see page 415). Bank lending (quite largely to other categories) continued however to grow, and there was a sharp rise in advances, and a continued large rise in M_3, in the four weeks to mid-October. Such an expansion was judged inappropriate at a time when the economy was nearing the limits of capacity. On Tuesday, 13th November, a call was therefore made for a further 2% of Special Deposits (which will bring Special Deposits to 6% of banks' eligible liabilities), and at the same time the usual formula for the Bank's minimum lending rate was temporarily suspended and the rate raised from 11¼% to 13%. There was an immediate upward effect on market rates of interest; despite the trade figures for October, the exchange rate for sterling was well maintained.

The world setting

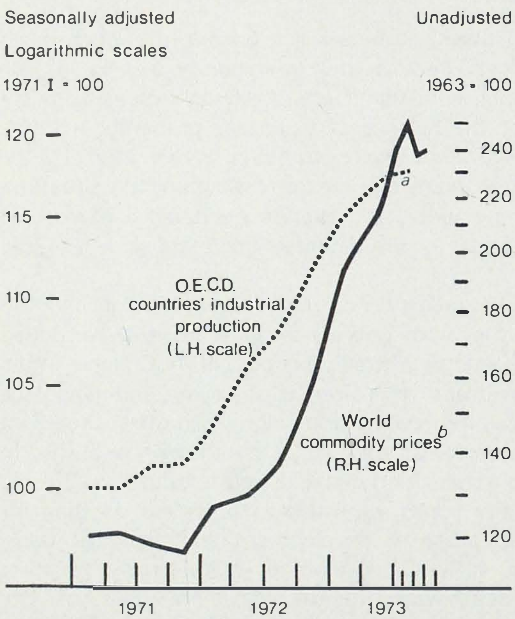
Developments in the United Kingdom have been greatly influenced by the pace of world economic expansion, which, however, is now slowing (see Table A). For some eighteen months

Table A
World expansion
Percentage changes in volume at annual rates: *seasonally adjusted*

	1970 and 1971 / 1959 and 1960	2nd half 1972 / 2nd half 1971	1st half 1973 / 2nd half 1972	3rd qtr. 1973(a) / 1st half 1973
Industrial production				
Europe(b)	5·7	6·8	11·3	–3½/–4
United States	3·9	10·4	9·2	6½
Japan	13·8	10·2	23·2	10½
All O.E.C.D. countries	5·3	8·8	11·1	2½/3
International trade in manufactures(c)	9·3	10·8	22·8(d)	

(a) Provisional: July and August only, except for the United States.
(b) European members of O.E.C.D.
(c) Exports of Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, Switzerland, United Kingdom, United States, and Western Germany.
(d) Provisional.

Commodity prices and output in industrial countries



a Provisional estimate for 3rd quarter 1973.
b *The Economist* world commodity price index. This index is reproduced with permission.

Table B
Retail prices in industrial countries(a)
Percentage changes between 1st qtr. 1972 and 3rd qtr. 1973

	Total	Food
Japan	16·1	16·4
Italy	15·2	17·8
France	11·2	14·8(*b*)
Western Germany	9·7	11·0
Sweden	9·3	9·7
United States	8·8	20·1(*c*)
United Kingdom	13·1	18·7

(*a*) Source: O.E.C.D.
(*b*) Excludes tobacco.
(*c*) Excludes beverages and tobacco.

almost all the main industrial countries experienced rapid growth; world trade increased at a near record rate; commodity prices escalated (see chart) at a pace unseen since the Korean War; and retail prices, especially food prices, rose rapidly (see Table B). The rise in world commodity prices, apart from oil and certain metals, is now showing signs of levelling off; and world trade might grow at a more normal pace — though the effects of oil shortages cannot yet be fully assessed.

The moderating pace of expansion in the United Kingdom[1]
After expanding rapidly between the middle of 1972 and the first quarter of 1973, output in the United Kingdom was checked in the second quarter. In the third quarter expansion appears to have been resumed at a more moderate pace.

Table C
Domestic expansion
Index numbers of volume, *seasonally adjusted,* 2nd half 1971=100

	1972		1973				Percentage change (annual rate)
	1st half	2nd half	1st half	1st qtr.	2nd qtr.	3rd qtr.	3rd qtr. 1973 / 1st half 1973
Gross domestic product:							
Output measure	100·8	103·1	106·6	106·8	106·4	107·6(*a*)	*+2·5*
Expenditure measure	99·4	100·9	106·0	107·1	104·9		
Income measure	100·1	102·7	105·6	105·6	105·5		
Industrial production	99·9	103·5	109·5	109·3	109·8	110·8	*+3·2*
Consumers' expenditure	102·8	106·0	108·9	110·0	107·9	108·8(*a*)	*–0·3*
Retail sales	102·0	107·0	108·5	110·4	106·7	109·3	*+2·0*
Exports of goods	97·8	96·8	107·8	106·2	109·4	110·2	*+6·1*
Imports of goods	109·0	115·3	125·5	125·8	125·2	126·3	*+1·7*

(*a*) Provisional.

The course of consumer spending this year has been strongly affected by the introduction of value added tax. Spending was very heavy in the first quarter and, in reaction, fell off in the second, when, indeed, it was largely responsible for the check to output.

Because of the effects of anticipatory buying on the figures for the first and second quarters, it is helpful to take the two quarters together. Trends so far this year can then be judged by comparing what is known about the third quarter with the first half-year as a

1 The Central Statistical Office have recently rebased all their constant price economic series on 1970 prices (previously 1963). These new series are used throughout this commentary.

whole (see Table C). Industrial production in the third quarter was 1·2% above the first half-year, or 3·3% at an annual rate. As the rise in the second quarter illustrates, this indicator is not necessarily representative of trends in the whole economy; but it suggests that, in the third quarter, the economy may have been growing at somewhere near the underlying rate of growth of capacity. What is known about trends in expenditure might suggest a lower rate of expansion, though it would appear difficult to reconcile this with the trend in unemployment. (Unemployment is discussed below.)

Between the first half of 1972 and the first quarter of this year, total output rose at an annual rate of about 7%, after rising at an average annual rate of about 2½% between 1960 and 1971. The speed of this expansion led to a rapid take-up of slack, and created difficulties of adjustment for industry.

During 1972 rising domestic expenditure other than stockbuilding was responsible for all the increase in total final expenditure (see Table D). Stocks were sharply reduced during the first half of that year but fell more slowly in the second half; the contribution made by exports of goods and services fell slightly. In contrast, the rapid upsurge in expenditure between the second half of 1972 and the first quarter of this year was fairly widely spread. Not only did domestic expenditure in general increase, but there was a sharp turn-round in stockbuilding, and exports of goods and services picked up strongly. The check to expansion in the second quarter can be attributed to a fall in domestic expenditure; exports continued to rise. They rose further still in the third quarter, and domestic expenditure recovered somewhat.

Table D

Contributions to the change in total final expenditure

Changes in the components of total final expenditure at constant prices, *seasonally adjusted* at annual rates, expressed as percentages of the total(a)

	1st half 1972 / 2nd half 1971	2nd half 1972 / 1st half 1972	1st qtr. 1973 / 2nd half 1972	2nd qtr. 1973 / 1st qtr. 1973
Domestic expenditure (other than stockbuilding)	3·8	3·8	8·7	−7·4
of which: consumers' expenditure	*2·8*	*3·3*	*5·6*	*−4·1*
Stockbuilding	−1·4	0·4	5·7	−0·7
Exports of goods and services	0·2	−0·2	3·5	2·3
Total final expenditure	2·6	4·1	17·9	−5·8

(a) Changes in components may not sum to the total change because of rounding.

Consumer spending — responding to the tax reductions in the 1972 Budget, to increasing earnings and employment, and to easier credit conditions — led the recovery throughout 1972, rising at an annual rate of some 6%. In the first quarter of 1973, consumers spent at a very high rate — the recorded increase between the second half of 1972 and the first quarter was a little over 10% at an annual rate. Two fifths of this big increase in consumers' spending was matched by a reduction in the rate of personal saving, which became unusually low. This pattern was reversed in the second quarter when consumption fell sharply, notwithstanding an increase of over 2% in real personal disposable income. The resulting high rate of saving may, however, have been short-lived: in the third quarter, the recovery in spending was perhaps greater than the rise in real disposable income. The volume of retail sales is estimated to have risen by 2¼% in the third quarter, and consumers' spending as a whole (provisionally) by almost 1%.

These sharp swings in total personal spending primarily reflect spending on durables, and this in turn goes some way to explain the sharp changes in personal saving. After the Budget last year, people spent heavily on durables: during 1972 and the first quarter of 1973 such purchases were almost a quarter of the whole increase in consumers' spending – cars and motor cycles alone being responsible for a tenth (see Table E). As in past upswings, greater spending went along with a big rise in consumer debt.

Table E

The composition of the change in the volume of consumer spending

Percentages

	Share of **total** consumption in 2nd half 1971	Share of the **rise** between 2nd half 1971 and 1st qtr. 1973	Share of the **fall** between 1st qtr. 1973 and 2nd qtr. 1973
Cars and motor cycles	4·4	10·5	58·0
Other durable goods	4·7	13·2	26·1
Food	19·4	1·7	7·4
Other goods and services	71·5	74·7	8·5
Total consumers' expenditure	100·0	100·0	100·0
Percentage change (annual rate)		*+7·2*	*–8·1*

The check to expansion in the second quarter of this year was also largely the result of reduced demand for durables – this accounted for four fifths of the fall in personal spending (or half the fall in total final spending). In the third quarter, demand appears to have recovered. Retail sales by durable goods shops were up by more than 3½%, and new car registrations by over 5% – which, however, still left spending on both durables and cars at about the same on average as in the first half-year.

For much of the period when output was expanding rapidly, total *fixed investment by private industry* was also increasing, but it fell in the second quarter of this year, recovering a little in the third. The survey of investment intentions conducted by the Department of Trade and Industry in August and September indeed suggested a recovery in the second half of this year and in 1974.

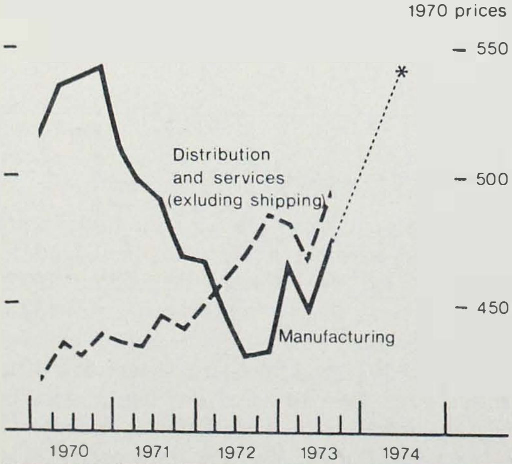
Expenditure on fixed investment in the distributive and service industries rose strongly until the end of 1972, but fell back in the first half of this year (see the chart). Provisional estimates for the third quarter point to a significant recovery – in fact, to a faster rise than that suggested by the investment intentions survey. This indicated a small increase between the first and second halves of this year, and only a modest rise in 1974.[1]

In contrast, investment in manufacturing industry – which accounts for between one third and one half of total private fixed investment – has picked up only since the beginning of this year; it fell throughout 1971 and most of 1972. The recovery appears to have been somewhat erratic:[2] there was a sharp increase in the first quarter, a fall in the second, and a strong recovery in the

Private fixed investment

Seasonally adjusted

£millions
1970 prices



* Forecast value derived from the D.T.I. investment intentions survey taken in August/September.

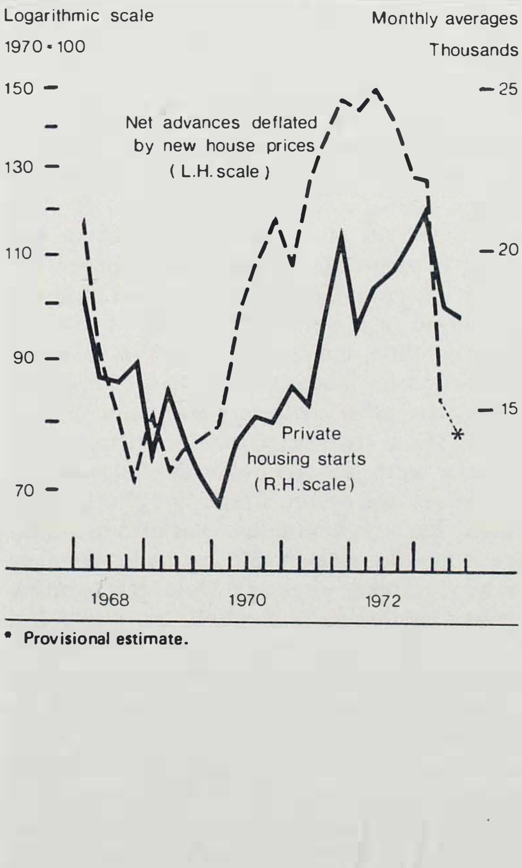
1 Although the investment intentions surveys have proved a reasonable guide to manufacturing industry's investment, the results have been less satisfactory for the distributive and service industries (see *Economic Trends*, September 1970, page lviii). The sample covers only about a quarter of the distributive and service industries' investment and is less representative than that for manufacturing.

2 However, the change in corporation tax and the introduction of value added tax probably distorted the timing of expenditure earlier this year.

third, bringing the average volume of investment in the first three quarters to 4% above the average for 1972. According to the intentions survey, investment in manufacturing industry is expected to be 6% greater in 1973 than in 1972, followed by a rise of 15% in 1974. The recovery is encouraging. However, at the turning point in the second half of 1972, fixed investment in manufacturing industry was almost as low as it had been in the second half of 1967; and even at the end of next year it would still be little higher than the last peak at the end of 1970.

Housebuilding, both private and public, has fallen away since the beginning of this year. The number of houses completed in the first three quarters of the year was almost 6½% less than in the same period of 1972. Most of this fall has occurred in the public sector. In the private sector, the number of houses completed was particularly high in the first quarter of this year, and has since declined. So too has the number being started, clearly reflecting the reduction in advances for house purchase made by the building societies; commitments to lend were also reduced. Since the middle of 1972, the value of net advances has fallen in real terms, to a point little higher than in 1969 (see the chart). It seems to have been some time before this affected the number of new houses being started (as indeed appears to have been the case in the early part of 1969 when advances rose but starts continued to fall for a while). The decline in advances and commitments during recent months reflects the building societies' difficulties in securing sufficient funds. Advances have, however, fallen much less than the inflow of funds to the societies (see the chart on page 428).

Housing finance and housebuilding



* Provisional estimate.

Partly, no doubt, because of the pace at which demand was expanding, *stocks* were fairly steadily reduced during 1972, particularly by manufacturers. It was not until the first quarter of this year that stocks began to rise again, but they then rose sharply. This change alone accounted for about a third of the increase in total final expenditure in the first quarter (see Table D). In both the second and third quarters, stocks continued to be built up, though at a decelerating rate. Much of the increase in the second quarter was in retailers' stocks, and may well, in part, have been unintended — a reaction to the sharp fall in consumer spending. In the third quarter, retailers added much less to their stocks, though they continued to build them up quite fast historically. By the early part of this year manufacturers' stocks were unusually low in relation to output; despite the large increase in the first quarter and smaller increases in the second and third, the ratio still remained low.

Both the fall in output in the second quarter, and the rise in the third, clearly reflect the check to, and subsequent resumption of, the expansion of demand. But there is increasing evidence that output is to some extent being impeded by shortages of labour and materials. The moderating pace of growth of output may not, therefore, unambiguously reflect a parallel moderation in the pace of growth of demand.

The pressure of demand and the labour market

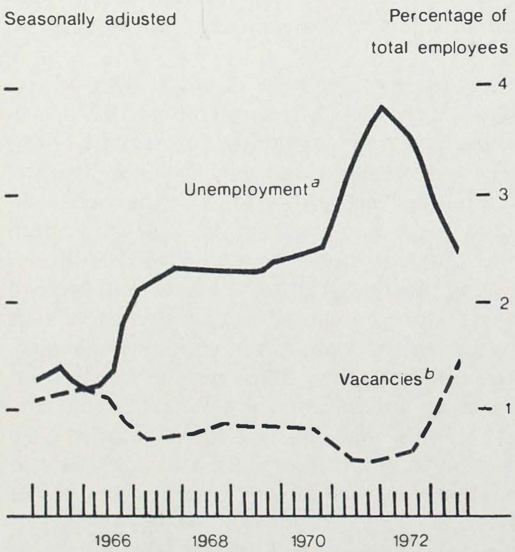
Unemployment has continued to fall and unfilled vacancies to rise, and in November there were 2·2% and 1·6% respectively on the registers. The monthly falls in unemployment between September and November were much bigger than they had been during the previous six months, partly because fewer than usual school-leavers entered the labour market as a result of the raising of the school-leaving age (see Table F).

Table F
Indicators of the pressure of demand on resources

	Previous 'high' pressure of demand	1972 1st qtr.	1973 1st qtr.	1973 2nd qtr.	1973 November
Unemployment (percentage)(a)	1·2 (1st qtr. 1966)	3·8	2·9	2·6	2·2
Unfilled vacancies (percentage)(b)	1·2 (1st qtr. 1966)	0·5	1·0	1·3	1·6
Overtime (1970=100)(c)	107·6 (4th qtr. 1965)(d)	72·6	94·3	98·3	101·5 (September)
Percentage of firms reporting below capacity working(e)	38 (February 1965)	67 (April)	47 (April)	39 (July)	44 (October)

(a) Seasonally adjusted, Great Britain, excluding school-leavers and, after 1970, adult students.
(b) Seasonally adjusted, Great Britain.
(c) Per week per employee in manufacturing in Great Britain, seasonally adjusted.
(d) In the second quarter of 1969 this index reached 107·7. However following the argument outlined in the September *Bulletin*, page 280, the earlier figure has been taken as representing the higher pressure of demand.
(e) C.B.I. survey: percentage of firms who reported working "below a satisfactorily full rate of operation". (The C.B.I. index was briefly described, and its limitations explained, in the September *Bulletin*, page 280.)

Unemployment and vacancies



a Excluding school-leavers and adult students.
b Adults.

With the rapid expansion of demand and output last year and in the early part of this, unemployment had fallen and unfilled vacancies risen, each substantially. By the first quarter of 1973 neither of these two indicators of the demand for labour had reached the 'high point' of early 1966 (see the chart). Since then, the demand for labour has continued to increase: and although the percentage unemployed in November had still not fallen to the previous low point in 1966, the extent of unfilled vacancies suggests a very high demand for labour.[1] The extent of overtime working (see the table) and other indicators also point to tight conditions of demand. There have been widespread reports of shortages of skilled labour; in the surveys by the Confederation of British Industry the percentage of firms reporting shortages of skilled labour as a factor likely to limit output has risen dramatically over the last twelve months, reaching 50% in the latest survey (taken in the first two or three weeks of October). In many regions, particularly the south east of England, the number of reported vacancies for skilled engineers and skilled construction workers was greater than the number registered as unemployed — though in none was the proportion of skilled vacancies to registered unemployed as high as at previous peaks.

There have been similarly widespread reports of shortages of materials and components, and finished goods. Some shortages — of steel, for example — have been world-wide. The extent of shortages probably owes much to the initial speed of the expansion, but, although some have eased now that the pace of expansion is more moderate, the general position does not appear to have greatly eased.

The results of the C.B.I. survey in October show that the percentage of reporting firms working below a 'satisfactory level' of capacity had risen since the July survey. At that time the results suggested that capacity was almost as fully utilised as at the earlier peak in this series, in the first quarter of 1965 (see Table F).

1 In recent years the interpretation of these series as indicators of the pressure of demand, by comparison with previous peaks, has become more doubtful. In particular, present rates of unemployment do not seem to represent the same degree of slack in the economy as in earlier cycles.

The slight fall in reported utilisation in October — together with large order books, especially in the engineering industry — strengthens the belief that supply constraints may have contributed to the less rapid pace of expansion.[1]

Imports continued to rise more rapidly than output up to the first half of this year. Between 1966 and 1971 — when output was growing only slowly — the volume of imports had increased almost three times as fast; and during the period of rapid expansion of demand up to the early part of this year it rose three and a half times as fast (at an annual rate of almost 16%). In part, the recent rise was associated with heavy stockbuilding — imports of basic materials rose particularly quickly up to the first half of this year; in part it must also have reflected shortages of home supplies, for the rise in imports of manufactured goods and semi-manufactures was also particularly rapid (see Table G). With the moderation in the pace of expansion since the first half-year, the rise in imports has tended to slow down. The volume of imports barely changed in the second quarter; however, imports of fuels and of manufactures increased quite substantially in the third.

Table G
Changes in output and imports
Percentage changes in volume at annual rates: *seasonally adjusted*

	1st half 1973 / 2nd half 1971	3rd qtr. 1973 / 1st half 1973
Gross domestic product	4·4	2·5
Imports of goods(a)	15·7	9·1
of which: finished manufactures	*29·6*	*27·9*
semi-manufactures	*16·4*	*2·0*
basic materials	*12·5*	*0·1*
fuel	*2·1*	*29·5*
food, drink and tobacco	*5·5*	*−13·7*

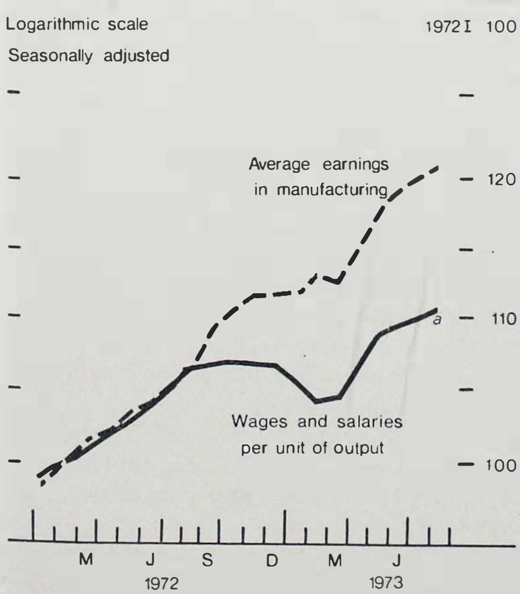
(a) C.i.f. Source: *Overseas Trade Statistics.*

Costs and prices

Average earnings in the third quarter were over 14½% higher than a year earlier. (The figure includes the effect of sharply increased overtime.) During the standstill on prices and incomes, earnings rose only slowly — between the fourth quarter of 1972 and the first quarter of this year by 1¼%. The transition to the second stage of the Government's counter-inflation policy allowed wage settlements previously held in abeyance to take effect, and earnings rose by nearly 4% in the second quarter. The pace then slackened somewhat, to a little over 3½% in the third quarter (before the introduction of the third stage).

Labour costs per unit of output in manufacturing rose much less, but followed a similar pattern (see the chart). During 1972, in spite of the rise in output, unit labour costs rose steadily. But in the first quarter of this year production rose more sharply than earnings, and unit labour costs fell. The check to the expansion of output in the second quarter led to a sharp increase in unit costs: but in the third quarter, to judge from partial evidence, they again appear to have risen more slowly, perhaps by about 1½%–2%. Thus, in the first nine months of the counter-inflation

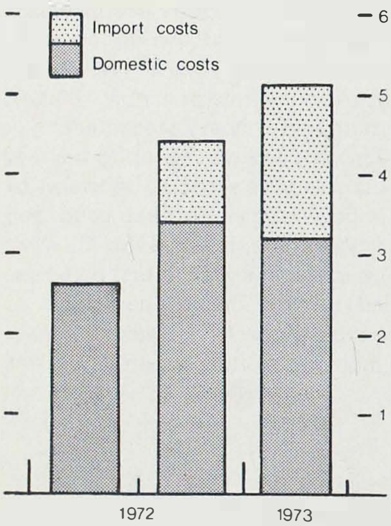
Unit labour costs in manufacturing



a Provisional estimate for August.

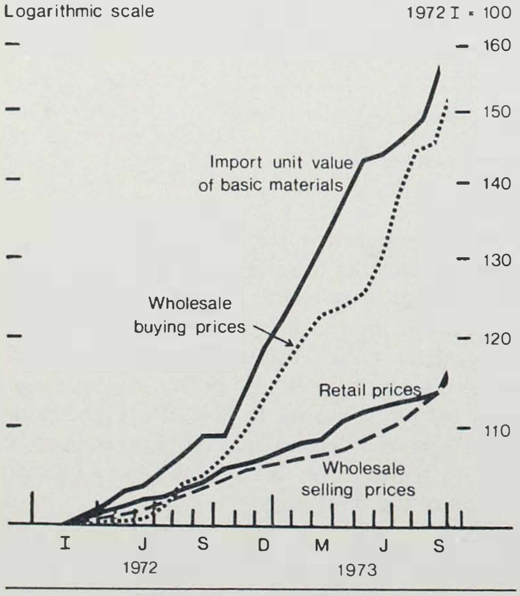
[1] The Bank's capital utilisation index is being rebased on 1970; it should be available for the next issue of the *Bulletin*.

Import contribution to the increase in total costs[a]



a The increase in import costs shown as a proportion of the rise in the price of total final output.

Retail, wholesale and import prices



policy, they rose at an annual rate of about 4%–4½% – a significant and welcome reduction from the rate of just over 9% in the twelve months before the standstill.

Retail prices continued to rise quickly during the first and second stages of the policy; as in most other industrial countries (see Table B), rising food prices contributed heavily. Largely as a result of soaring world prices, retail food prices have risen nearly 19% in the United Kingdom during the twelve months to October – which alone accounts for nearly half the total increase of almost 10% in the retail price index.

The impact of higher import prices on domestic prices is illustrated in the chart. While total home costs rose by 10% between the first half of 1972 and the first half of this year, import costs rose by 15%, accounting for almost a third of the increase in the prices of total final output; and still more in the case of the increase in retail prices. In the fifteen months from July last year to October this year, the cost of imported goods rose by as much as 33% and the wholesale prices of basic materials and fuel purchased by manufacturing industry by almost 49%. Basic materials and fuel, which are mostly imported, represent about one quarter of total costs in manufacturing industry;[1] it is thus not surprising that manufacturers' output prices (see "wholesale selling prices" in the chart) rose by 13¼% over the fifteen months, notwithstanding the slower rise in unit labour costs. Some of the past increases in import costs remain to come through and will affect output prices for some months yet. However, apart from oil and certain metals, some levelling off in world commodity prices has been apparent, and this should be confirmed by the slower pace of the world economic activity that is now emerging. Clearly this should significantly relieve the strong upward pressures on domestic prices next year, though what effect the oil shortage will have remains to be seen.

The increases in crude oil prices announced in October will offset some of this gain. They may add substantially to U.K. import prices and may raise further, though possibly only fractionally, the retail price index.

The greatly accelerated rise in the price of materials has massively increased the value of stocks which firms have to hold. Gross trading profits, when corrected for this element of stock appreciation, do not appear to have risen disproportionately: they must have increased in real terms, but their share in total domestic income in the first half of this year was no higher than at the end of 1971.

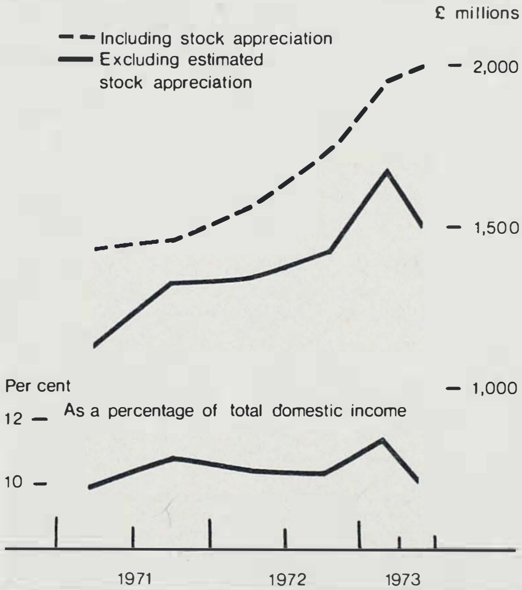
Taking together the first two stages of the counter-inflation policy, average earnings have grown faster than retail prices (see the chart on earnings and prices), though this may not be true for all groups of workers, and some groups will have gained more in real terms than others. The particularly sharp increase in food prices may well have drawn more attention to the rise in living costs than to the rise in earnings.

With a slower expansion of output following the recent rapid growth, the future course of labour costs will depend heavily on the success of the third stage, which came into effect at the beginning of November and is to apply for one year. It was clearly desirable to seek to secure not only a rate of increase in

1 This estimate was mainly derived from the input-output matrix for 1968 constructed by the C.S.O., and from information from other sources about the detailed composition of imports.

Gross trading profits: all companies

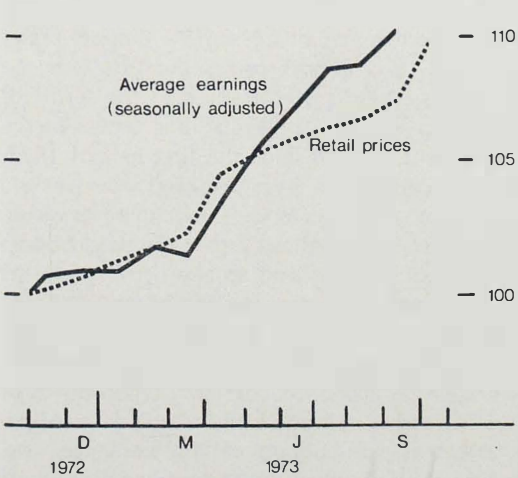
Seasonally adjusted | Quarterly averages



a **Estimates based on annual national income data.**

Earnings and prices

Logarithmic scale | Average Oct./Nov. 1972 = 100



wages and salaries compatible with the maintenance of rising real incomes, but also a significant deceleration in the rate of price increase. Besides the permissible increase in pay of 7% (or £2·25 a week if so preferred), the revised code provides flexibility aimed at removing many of the anomalies which have become apparent during the course of the first two stages; genuine efficiency schemes are encouraged; and some groups will benefit from the permitted removal, within limits, of anomalies, and from the use of premium payments for working 'unsocial hours'. The across-the-board provisions, together with the margins of flexibility, could raise average earnings by some 8%–9%; the other provisions, together with increased overtime, could add perhaps 2%. The threshold arrangements — whereby earnings may increase by up to 40p per week for a rise in the retail price index of 7%, and again for every full percentage point increase beyond that during the twelve months running from October this year[1] — provide further reassurance against the erosion of real incomes. The process of containing the rate of cost and price inflation must inevitably take time. As the third stage progresses, the rate of price inflation should become less rapid, provided that the upward pressure of commodity prices on domestic prices falls away.

On the prices side too, the third stage allows for more flexibility. As far as can be judged, profit margins for the company sector at large have remained relatively constant over the first nine months of the counter-inflation policy. The revised code will keep control of profit margins and in certain respects strengthen it. The code also contains a number of changes, such as the admission of depreciation charges as an allowable cost against price increases, designed to encourage investment.

When interest rates are high the banks are able to earn high profits: consequently, for the duration of the third stage no interest will be paid on a proportion of the banks' Special Deposits. The amount to be forgone is calculated by reference to the proportion of each bank's eligible liabilities which is not bearing interest.

Balance of payments

The current account has tended to move further into deficit during the year: in October it was some £230 million (seasonally adjusted)[2] compared with about £320 million in the third quarter, £210 million in the second quarter, and £190 million in the first. The deterioration was entirely in visible trade: net earnings on invisible account have continued to rise — from about £200 million a quarter at the beginning of the year to over £230 million in the third quarter.

The increase in the trade deficit principally reflects the very large deterioration in the terms of trade resulting from the extremely rapid rise in commodity prices and the effective depreciation of the exchange rate. Nevertheless, the depreciation of sterling has improved U.K. competitiveness in overseas markets — an influence, perhaps, only just now beginning to come through in the balance of payments. To illustrate these influences, Table H distinguishes between the contribution from volume and the contribution from prices to the change in the current balance.

1 The index was 185·4 (January 1962 = 100) in October.

2 Excluding imports not recorded in October because of a strike by computer operators at Heathrow airport.

Table H
The sources of the balance of payments deficit (a)
£ millions: *seasonally adjusted* at a quarterly rate

	1st half 1972	3rd qtr. 1973	Change between 1st half 1972 and 3rd qtr. 1973
Current balance	+ 100	– 320	– 420
Visible trade balance	– 80	– 550	– 470
of which: volume	*– 80*	*– 170*	*– 90*
price	–	*– 380*	*– 380*
Exports of goods	2,250	2,990	+ 740
of which: volume	*2,250*	*2,530*	*+ 280*
price	–	*460*	*+ 460*
Imports of goods	2,330	3,540	+1,210
of which: volume	*2,330*	*2,700*	*+ 370*
price	–	*840*	*+ 840*

(*a*) This table employs the volume indices (1970=100) for exports and imports of goods (as recorded for the balance of payments accounts) calculated by the Department of Trade and Industry. Changes in these indices since the first half of 1972 have been applied to the value of trade series. The difference between the constructed volume series and the available current value series has been called the 'price' contribution, and reflects the influence of both inflation and the terms of trade.

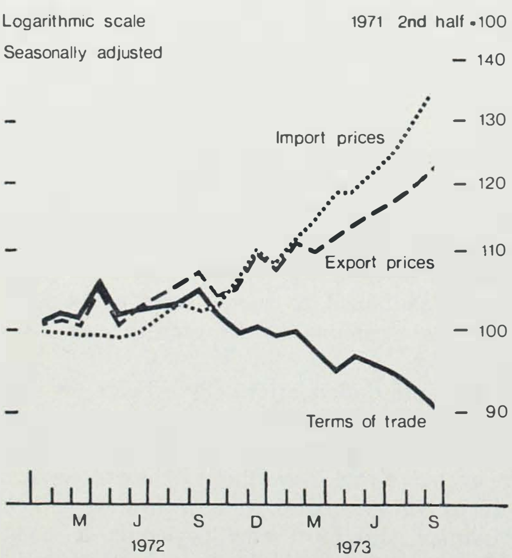
Since the first half of 1972, when it was in surplus at a quarterly rate of about £100 million, the current account has moved progressively into deficit — as noted above, the deficit had grown to £320 million in the third quarter of this year — which has more than been accounted for by the deterioration in the trade balance. During this period the terms of trade moved against the United Kingdom by as much as 10%, import prices increasing by nearly 31% and export prices by 18% (see the chart). On a broad calculation, the worsening in the terms of trade can be estimated to account for about nine tenths of the deterioration in the current balance since the first half of 1972. The changes in volume, could they have occurred alone, would have kept the current account in balance — but exports would certainly not have done so well without either the world boom (which drove up commodity prices and so the earnings of the primary producing countries) or the depreciation of sterling.

To judge from the relative increase in the import prices of manufactured goods and of non-manufactured goods, the rise in commodity prices may have accounted for about two thirds of the deterioration in the terms of trade.[7] The remainder resulted mainly from the effective depreciation of the exchange rate, which by the end of the third quarter had increased to over 19½% since the Smithsonian realignment in December 1971.

Recent changes in the volume of exports and imports are shown in the chart, and Table J illustrates their impact on the visible trade balance since the first half of 1972. It was not until the first half of 1973 that the increase in the volume of exports exceeded that of imports, so partially offsetting the effect of the continued deterioration in the terms of trade. In the third quarter

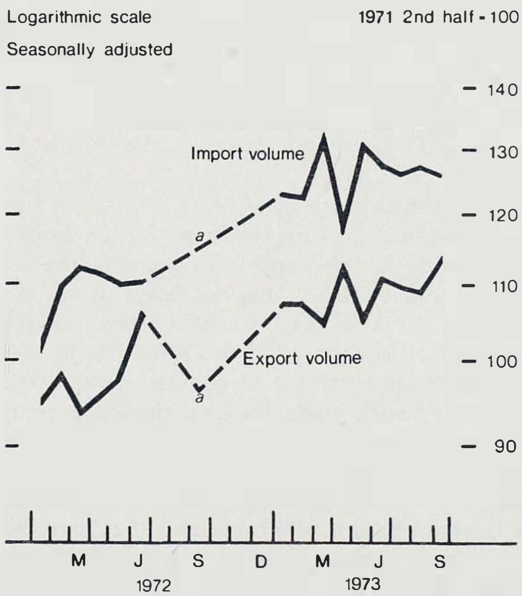
7 The contribution of the rise in commodity prices to the deterioration in the terms of trade may be estimated as the difference between the rise in prices of commodities and of manufactured imports, multiplied by the weight of commodities in total imports. Between the first half of 1972 and the third quarter of 1973 the average value of commodity imports rose by 39%, and of manufactured imports by 22%. In all, the contribution of the commodity price boom to the deterioration in the terms of trade is estimated at about 6% out of 10%.

Terms of trade [a]



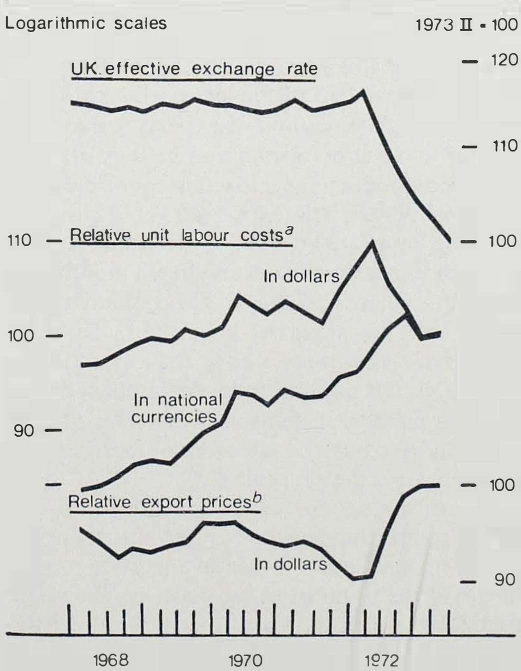
a Average values. Estimated by dividing imports and exports at current prices by the official volume series (1970 = 100).

Volume of U.K. trade



a 2nd half 1972 average to allow for dock strike.

U.K. competitiveness



a Ratio of manufacturing labour costs per unit of output in the United Kingdom as compared with competitor countries.

b Ratio of export prices (unit values) of manufactures in competitor countries as compared with the United Kingdom.

compared with the first half there was a bigger improvement in the volume of trade, though the terms of trade again worsened further.

Table J

The sources of the visible trade deficit(*a*)

£ millions: *seasonally adjusted* at a quarterly rate

	1972 1st half	1972 2nd half	1973 1st half	1973 3rd qtr.	Total change 1st half 1972 to 3rd qtr. 1973
Visible trade deficit	–80	–260	–390	–550	–470
Change in trade balance		–180	–130	–160	–470
of which: volume		*–160*	*+ 30*	*+ 40*	*– 90*
price		*– 20*	*–160*	*–200*	*–380*

(*a*) See footnote to Table H.

In fact, the volume of exports — after still more rapid increases previously — increased by 6% at an annual rate in the third quarter over the average for the first half of the year; meanwhile, imports increased by little more than 1½%. (By contrast, between the two halves of 1972, the volume of exports had fallen slightly while imports had increased by 12% at an annual rate.) Slower growth of imports is to be expected with the moderating pace of output. Stockbuilding, which must have contributed to the recent growth of imports, may remain high — as noted earlier, stocks are still low in relation to output — but it seems unlikely to accelerate much.

Although in the short run the impact of sterling depreciation has tended to exert a perverse influence on the balance of payments by raising the sterling cost of British imports (see Table K), it was a necessary corrective for a loss in the price competitiveness of British exports in overseas markets. For some time, the rising trend of costs and prices has been more pronounced in this country than abroad. Thus, since the end of 1971, unit labour costs in national currencies have risen faster in U.K. manufacturing than in competitor countries (see the chart).

Table K

Import prices and exchange rates in industrial countries 4th qtr. 1971–2nd qtr. 1973

Percentage changes

	Increase in import prices(*a*)	Effective change in exchange rate(*b*)
Japan	+ 1	+12
France	+ 2	+ 7½
Western Germany	+ 5	+18
Sweden	+11	+ ½
Italy	+19	–13
United States	+22½	–13½
United Kingdom	+19½	–13

(*a*) Average values in national currencies. Source: O.E.C.D.

(*b*) End-quarter to end-quarter. See Table 29 of the statistical annex, and its additional notes.

Similarly, prices of exported U.K. manufactured goods have also been rising faster than the export prices of these countries:

measured in national currencies, up to the third quarter of this year, U.K. export prices had risen relatively by 5½% since the end of 1971 and by 9% since the end of 1970. The main depreciation of sterling has come since June 1972, and to judge from the relative export prices of manufactured goods — this time expressed in terms of U.S. dollars — it has corrected the earlier and current underlying loss of competitiveness and at the same time has helped to establish a good competitive position (see the chart).

The gain in competitiveness since June last year has not had time to be fully reflected in export performance. By the second half of 1972 the share of British exports of manufactures in overseas markets was about 10½%, having fallen from the previous peak of 12% in the latter part of 1969.[1] Some recovery occurred in the first half of this year, and this should go further in response to the recent improvement in competitiveness. The share of British exports in world trade has, over the longer term, tended to decline, a trend which was only sustainable because the growth of the economy has been slower than in most other industrial countries, so that the growth of imports has been less. Correction of the current account deficit requires that the U.K. share in overseas markets is maintained or enlarged. With the volume of world trade growing by, say, 9% a year, an improvement of one percentage point of the British share over the next eighteen months would mean an increase in the volume of exports of 16% a year during that period. Much will also depend therefore upon the demand for imports.

The shift of resources to the balance of payments has been a significant element of total demand. Between the second half of 1972 and the third quarter of this year, the swing into net export surplus may have absorbed some 15% of the increase in real G.D.P. If, for the sake of argument, the volume of exports were to continue to grow ahead of imports by as much as in the first three quarters of the year, it would reduce the current account deficit by about one half in eighteen months. But with a less rapid growth of G.D.P., it would entail a larger relative shift of resources: were G.D.P. to grow at 3½% a year over the next eighteen months, the same improvement in the volume of trade would claim a share close to one quarter of the increase in output. Domestic expenditure is expected to grow more slowly than over the last eighteen months, which should provide room for a major adjustment of this sort to the pattern of demand. The terms of trade can be expected to improve, but a shift of resources, even on this scale, would seem no more than is needed.

Though the terms of trade have so far continued to turn against the United Kingdom, the development of the volume of trade has begun to be encouraging. The rise in the price of oil in October has further tilted the terms of trade; however, the effects of oil shortages, particularly with regard to the volume of trade, cannot yet be assessed. To the extent that they depress world activity and commodity prices, the terms of trade would be improved.

The external capital account

The heavy deficit on current account this year has been more than matched by capital inflows, which have, however, been

1 The share of overseas markets is based on volume not on value. Allowance is made for the difference between the rate of growth of U.K. markets and the growth of world trade as a whole.

sensitive to the level of U.K. interest rates relative to those overseas. The uncovered interest rate differential against sterling (on the three-month inter-bank/euro-dollar comparison), which had appeared in June, became very unfavourable in July. However, the comparison became favourable again later in that month, after domestic interest rates had been raised, and it continued to improve during much of August.

Table L distinguishes capital flows of a 'structural' nature, most of which may be regarded as comparatively insensitive to monetary conditions; other — mainly short-term — capital flows, here including the balancing item, which are more sensitive to both monetary conditions and confidence; and euro-dollar borrowing by public bodies under the exchange cover scheme reactivated in the last Budget.[1]

Table L

The external capital account *(a)*

£ millions

	1973 1st qtr.	2nd qtr.	3rd qtr.	Total to end-September
Current balance (seasonally adjusted in brackets)	−349 (−187)	−183 (−208)	−335 (−317)	−867 (−712)
Capital transfers *(b)*	− 38	− 19	− 1	− 58
Capital flows of a 'structural' nature *(c)*	+ 22	+154	+138	+314
Total to be financed	−365	− 48	−198	−611
Changes in other sterling holdings	+148	+175	−426	−103
U.K. banks' other net overseas currency borrowing	−188	+ 54	− 40	−174
Other short-term flows (including the balancing item)	+428	− 84	+ 35	+379
Public sector borrowing under the exchange cover scheme	+ 46	+280	+371	+697
Change in reserves (increase +)	+ 69	+377	−258	+188
Effective changes in the exchange rate *(per cent)*				
Depreciation since December 1971 *(d)*	*11·6*	*14·1*	*19·7*	*19·7*
Average weekly change *(e)*	*0·6*	*0·4*	*1·3*	*0·8*

(a) Further detail in Table 20 of the statistical annex.

(b) Under the sterling guarantee arrangements.

(c) Comprising official long-term capital, overseas investment in the U.K. public sector (excluding public sector borrowing abroad under the exchange cover scheme), private investment (net), overseas currency borrowing by U.K. banks to finance U.K. private investment overseas, trade credit, and sterling holdings of international organisations.

(d) End-quarter.

(e) Disregarding direction.

The experience of the third quarter was in marked contrast to the first half of the year. In the first half, the current deficit, taken together with the net flow of 'structural' capital, was smaller than the increase in the overseas sterling holdings taken together with a large, mainly unidentified, inflow of short-term capital (which occurred in the first quarter). High domestic interest rates contributed to this result. Despite some switching out of sterling by the banks, the reserves rose by almost £450 million after some £380 million of foreign currency borrowing by the public sector, mainly under the exchange cover scheme.

1 The arrangement was extended in October to include other currencies (see page 423).

Between the end of February and the middle of May the effective depreciation of the exchange rate was reduced.

In the third quarter, not only was the current account deficit a good deal larger than in the second, but there was also a reduction of over £420 million in the sterling balances, in part reflecting uncertainties at that stage about the future of the sterling agreements. The downward pressure on the exchange rate was at times contained by use of the foreign exchange reserves; but as a result of further borrowing in euro-dollars by public bodies, the reserves were still some £190 million higher at the end of September than at the end of 1972.

Though sterling has been floating, official policy has sought to moderate in various ways the extent of the depreciation that the state of the current account might otherwise have produced. One important step was the arrangement made to promote further borrowing in euro-dollars by the nationalised industries and local authorities, which, in the event, would alone have financed the greater part of the current account deficit in the first three quarters of this year. As important as the use, from time to time, of reserves — which were augmented by such borrowing — was the shift in monetary policy resulting in the steep rise in domestic interest rates since the middle of July.

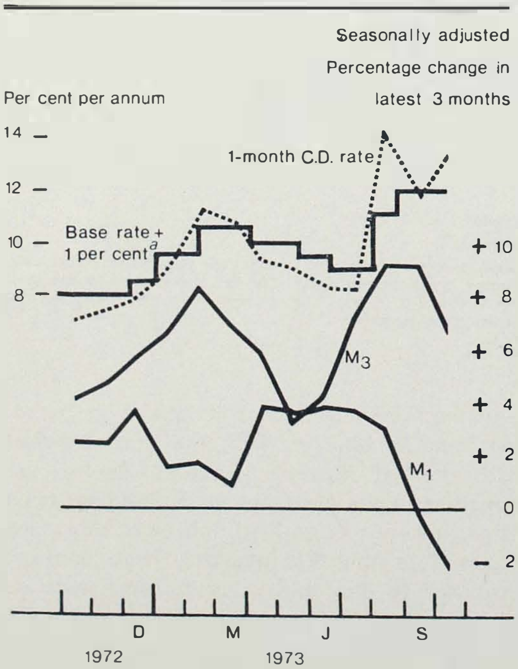
Monetary conditions

After the sharp increase brought about at the end of July, domestic interest rates remained high, though easing somewhat in late October and early November. The continued rapid growth of M_3, and the upward trend of bank lending which underlay it, gave increasing concern. Further restrictive monetary measures were therefore taken on 13th November.

Domestic interest rates had risen sharply in July following the call for a further 1% Special Deposits and the other monetary measures announced on 19th July. Minimum lending rate went from 7½% to 11½% by 27th July, and bank base rates from 8% to 10% early in August and to 11% three weeks later. Rates in the wholesale money markets went higher still during August as banks bid strongly for deposits. This re-created — at a higher level — the pattern of rates seen earlier in the year; bank overdrafts, at rates related to base rate, became very attractive, and companies were able to draw on unused overdraft facilities and to employ the funds short term at a profit, in certificates of deposit or on deposit account, at the market rates for large deposits.

The Bank sought to relieve some of the tightness in the parallel markets; and rates there declined during September, from the peak of nearly 15% for three-month money in August to around 13%. Reserve ratios, which had fallen steadily up to August, eased somewhat in September, the clearing banks' ratio rising from 13·0% to 13·7% and the ratio for all banks from 13·3% to 13·8%. This brought a better pattern of rates, with rates for wholesale money nearer to, though still significantly higher than, base rates and the associated bank lending rates. On wider grounds, the Bank were at this period content to see a slight easing of rates, in line with the movement in rates abroad. Although market conditions remained tight, particularly through the end of September into October when manufacturers made substantial payments of value added tax and official sales of gilt-edged stocks were heavy, there was a slow easing of most rates, leading eventually to a

Arbitrage and the money stock



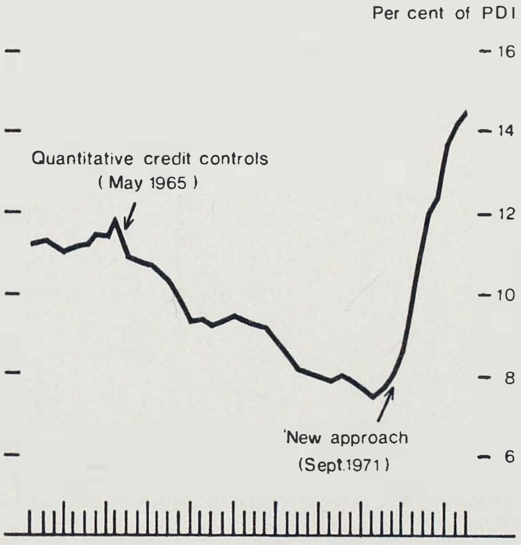
a The overdraft rate for 'blue chip' customers is generally base rate plus 1%.

small downward step in minimum lending rate from 11½% to 11¼% on 19th October.

Rates for small deposits had moved up during August, and had begun to look much more attractive to small savers relative to the rates then offered by building societies. The inflow of funds to the building societies fell away sharply between July, when it had been a record, and September, when the flow was insufficient to sustain the rate of lending to which the societies were committed (see the chart on page 428).

Bank lending to property companies and to other financial companies had been under some restraint since August 1972, but had nevertheless continued to expand throughout most of 1973. Facilities arranged earlier were still being drawn on. However, a substantial part of the lending was no doubt in foreign currencies lent for operations abroad. Lending to persons also continued to rise strongly until the late summer, when it appeared to be levelling off. Lending to manufacturing industry had shown very little growth, except under the influence of arbitrage transactions, during the first half of the year; in the three months to August, when arbitrage operations were again heavy, advances to this group rose by £475 million (seasonally adjusted). Since August arbitrage and other special factors, which are discussed later, perhaps now joined by increased borrowing by business for investment, have brought a further rapid increase in lending to industry.

Personal indebtedness[a]



a Personal borrowing outstanding as a percentage of personal disposable income in the previous twelve months.

With banks' advances still rising substantially, the Governor wrote to the banks on 11th September asking for significant restraint in their lending to persons (other than for house purchase), and further restraint in lending for property development and financial transactions.[1] The banks were also asked not to pay more than 9½% on deposits of under £10,000: the possibility that it might become necessary to limit their competition with the building societies for funds had been foreseen and provided for in the new arrangements for credit control announced in 1971.[2] The Building Societies Association then raised its recommended rates to 11% for new mortgages and to 7·5% (equivalent to 10·7% grossed up at the basic rate of income tax) for share accounts, after which the inflow of funds to the societies recovered substantially. The societies' lending for house purchase remained little changed, if slightly subdued throughout the summer, but was lower in October. This was reflected in the fall in private housebuilding from its high point in the early part of the year, and in the more moderate rise in house prices.

Bank lending in sterling to the private sector rose by about £980 million in the month to mid-October, after such seasonal adjustment as can be made — which almost certainly, however, leaves the figure overstated. This continued growth of bank lending, even when seen in the light of inevitable difficulties in judging the trends, appeared unduly expansionary.

On 13th November, therefore, a call was made for a further 2% of Special Deposits, making 6% in all; minimum lending rate was raised immediately from 11¼% to 13%, the formula by which it is normally calculated being temporarily suspended; and with encouragement from the Bank, the main banks' base rates were raised from 11% to 13%.

1 The letter is reproduced on page 445.
2 June 1971 *Bulletin*, page 192, paragraph 15.

Throughout the year the figures of bank advances as well as those of money supply have been strongly influenced by a number of special factors. Some of these have been transient; but the reflux of business to the banking system since 1971, the change-over to value added tax, and the arbitrage operations between bank overdrafts and the wholesale money markets have together brought exceptional increases in both sides of the banks' balance sheets, affecting the monthly figures very irregularly. More generally, the relative cheapness of bank credit must have encouraged borrowing from the banks and discouraged the repayment of overdrafts; and in this way it will have encouraged still further increases in bank deposits, and in M_3.

Table M

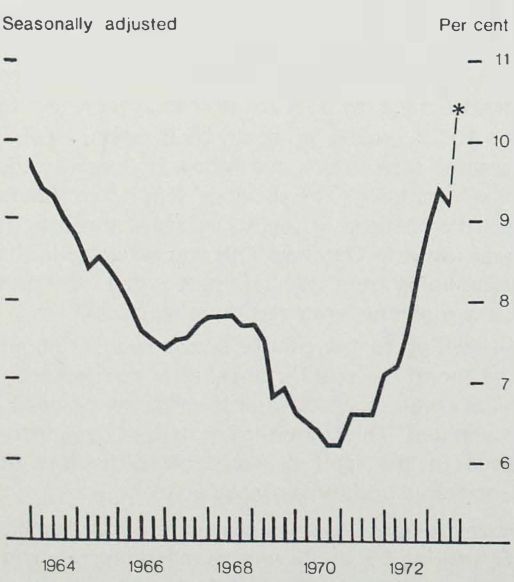
Changes in the money stock (M_3)

£ millions: *seasonally adjusted*

	1972	1973		
	Quarterly average	1st qtr.	2nd qtr.	3rd qtr.
Bank credit to the private sector	1,609	1,509	996	2,173
Credit to the public sector(a)	258	448	312	702
less:				
External finance of the public sector	−391	47	299	−137
Banks' net external liabilities	2	−204	−420	−160
Increase (−) in banks non-deposit liabilities	−153	−297	104	−132
Money stock (M_3)	1,325	1,503	1,291	2,446
Percentage change (quarterly rates)	*5·9*	*5·8*	*4·7*	*8·5*

(a) From banks and overseas, and from the increase in notes and coin in circulation. Further detail in Tables 12(2) and 12(3) of the statistical annex.

Company liquidity[a]



* Estimated.

a Ratio of company liquid assets to total final expenditure in the previous twelve months. Liquid assets comprise bank deposits, Treasury bills, tax reserve certificates, tax deposit accounts, local authority temporary debt, and deposits with both building societies and finance houses. Total final expenditure is a proxy for the turnover of industrial and commercial companies.

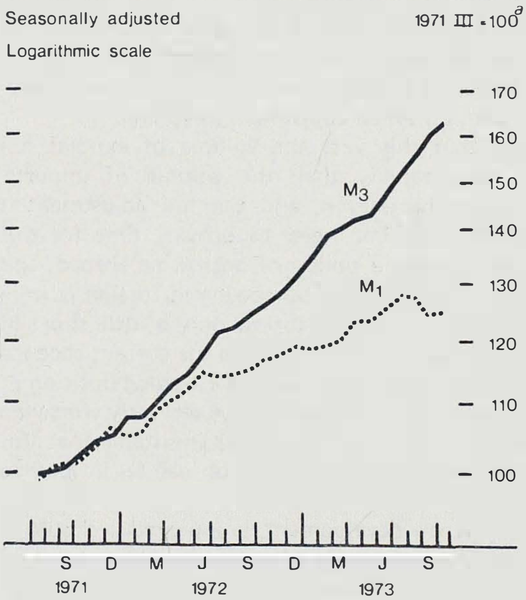
The considerable extension of bank credit to the private sector over the year has been reflected in the rapid increase in the money stock (M_3). The central government's borrowing on the other hand has been less than expected at the time of the Budget, and the general public have provided much of what was needed by purchases of gilt-edged stocks.

The policy of expansion, which by the end of 1972 had barely begun to work through into new investment, called for monetary conditions, at the start of 1973, that would accommodate rising investment while continuing to sustain consumer spending.

The rapid expansion of bank lending to the private sector (see Table M) has led to a marked increase in liquidity, notably of industrial and commercial companies, which have now rebuilt their liquidity. As may be seen from the chart, for some years before September 1971 liquid assets, mainly bank deposits, held by these companies had been rising more slowly than total final expenditure at current prices; but the ratio has risen sharply since 1971, and by the third quarter of this year was probably higher than in 1964.

Largely as a result of the rise in bank lending to the private sector, M_3 has grown more rapidly this year. By contrast M_1, though continuing the upward trend during the first half of the year, has since turned down or been steady. The divergence may, in this period, owe much to the rises in interest rates, which have reduced the attraction of current accounts compared with deposit accounts and increased the attraction of the latter as compared with some other assets. In the three months to mid-October, M_1 fell by 2¼%, while M_3, after incomplete seasonal adjustment, rose by 6½%.

Money stock



a Average of three months to mid-September.

The high and still rising liquidity in the private sector is partly a short-term financial response to temporary opportunities created by abnormal differentials between lending and borrowing rates, but partly also a more widespread response by companies at large to the relative cheapness of bank credit. Against this background, and with the increasing concern for the balance of payments, further rapid monetary expansion appeared increasingly inappropriate.

Conclusion

Policy has been successful in promoting rapid economic expansion, which has raised the amount of employment and created conditions in which a continuing rise in industrial investment could be expected. Despite these successes, the economy was still clearly faced with a number of serious problems. Prices and costs had been rising rapidly; the balance of payments on current account was in heavy deficit; and, in the monetary field, there had been unduly rapid growth of bank credit and, on the wider definition, of the money stock.

In seeking to deal with these problems, it remained important to preserve the benefits which had been achieved. The tightening of monetary policy in November followed other adjustments of policy undertaken in the light of the needs of the economy at that stage. In view of the fact that the economy was nearing the limits of capacity, it was made clear that the aim of government policy, after the earlier phase of rapid expansion, was to secure continuing expansion at a more moderate and sustainable rate. Government expenditure plans were reviewed to ensure that public spending expands more slowly than total output, in order to provide room not only for a rise in domestic investment, but also for the continuing expansion of exports. The further large call for Special Deposits should help to moderate monetary expansion and an unduly rapid growth of bank lending.

The economy of this country, and of many others, is now faced both with the effects of the rise in the price of oil, and with the possibility of significant shortfalls in its supply. This creates new uncertainties for policy, but does not diminish the need for continued efforts to deal with the problems with which the economy would anyhow have been faced in the absence of these developments.

The problem of rising prices was greatly exacerbated by the world commodity boom. In this and other industrial countries, the effects of steeply rising commodity costs were superimposed on a situation where costs and prices were already threatening to continue rising at well above the historical rate. The effects of this acceleration on domestic costs and prices cannot be quickly contained. Nevertheless, as world economic expansion slows down, there are reasons to hope that commodity prices in general will level off. They should therefore cease to exert upward pressure on domestic prices. Although the recent rise in the price of oil is now likely to add further to the rise in the general level of prices, there are still grounds for expecting the retail price index to start to rise more slowly next year.

The problem of the balance of payments also has arisen, as to the larger part, because of the rise in world commodity prices; and, to a lesser extent, reflects too the normal result of exchange depreciation, first to worsen the terms of trade, and subsequently to lead to a more favourable balance in the volume of overseas trade. Although the rise in oil prices may delay the process, it is still reasonable to expect that world commodity prices will level off, and the terms of trade improve again. The improvement is, however, likely to reverse only part of the adverse movement of the last eighteen months; and it would be prudent to assume that a large part of the necessary improvement in the balance of payments will need to come from an adjustment in volume.

It is encouraging that this year the volume of exports has started to grow more rapidly than the volume of imports. Progress will no doubt be uneven, and the full adjustment is bound to take more time. The need to provide time for this justifies at the present stage a policy of borrowing abroad; and the encouragement of public sector borrowing in foreign currencies has to date resulted in a capital inflow only a little short of the deficit on current account. The deficit on the current account of the United Kingdom, in common with the trading position of all other industrial countries, now stands to be seriously worsened by the rise in the price of oil; and it appears inevitable that this country, like others, should depend more on capital inflows to balance its accounts.

Even apart from this new development, it appeared desirable to hasten as far as possible the process of correcting the balance of payments on current account and thus to reduce reliance on heavy overseas borrowing: the adverse effect of higher oil prices increases that desirability. In many respects, conditions for exporting are highly favourable: the present exchange rate is unusually competitive; and though the growth of world trade could be impeded by the effect of oil shortages on the production of exports, world demand for them is likely to remain high.

As against these favourable aspects, it is not at present clear how serious is the risk that continuing shortages of oil and also coal might impede the growth of domestic output. Such a development could create many imbalances in demand, and complicate the task of keeping the economy in balance.