Economic commentary

In the last three months the economy has been subject to abnormal strains. The immediate threat of a serious shortage of supplies of oil has receded; but the United Kingdom, like other oil-importing countries, is now paying much higher prices for oil: this will produce a major change in the pattern of international payments (see below). And output, so far this year, has been heavily restricted by short-time working resulting from the dispute in the coal-mining industry.

The latest statistics – which refer mostly to the last quarter of 1973 – illustrate the position of the economy before it began to be affected seriously by these developments. The deficit on the current account of the balance of payments mounted through 1973, and by the turn of the year it was running at a very high rate (page 4). With continuing shortages of materials and components, and the initial effects of energy restrictions, domestic output fell in the fourth quarter (page 6). Short-time working this year has aggravated the shortages and increased the pressure of demand.

On 17th December the Chancellor of the Exchequer announced reductions of £1,200 million (2% of GNP) in government expenditure previously planned for 1974/75, and took other steps to reduce demand. A new technique of monetary control was also introduced on 17th December, supplementary to existing arrangements (page 13, and separate note on page 37).

In the light of the development of pressures on the liquidity of some deposit-taking institutions on the fringe of the banking system, machinery was set up by the Bank in conjunction with the clearing banks to keep the situation under review and to provide additional support, as necessary and justified, for the institutions concerned (financial review, page 22, and a speech by the Governor, page 54).

International developments

All oil-importing countries have been affected by the quadrupling of the posted price of oil. The impact on their balance of payments will be severe. The value of the exports of the oil-producing countries in 1974 is likely to be some $60 billion more than in 1973; some increase in their imports is also likely, but the oil-producing countries as a group are likely to have a balance of payments surplus on current account of perhaps $60 billion in 1974, as against $13 billion in 1973 (see Table A). The current balance of payments of oil-consuming countries as a group will be worsened to the same extent. The effects on individual countries will differ according to their dependence on imported oil. The United Kingdom is less dependent than many other industrial countries; even so, the import bill may be larger by some $4–4½ billion than it would otherwise have been (see Table B).

Such a transformation in the international balance of payments is unprecedented in scale and speed. For industrial countries as a group, a very large current account deficit with the rest of the world appears an inevitable result of dearer oil. Non-industrial countries will also face a sharp worsening in their current external accounts. At the meeting of ministers and central bank governors of the Committee of Twenty in January it was agreed that offsetting action should be taken through capital accounts, as general action to improve current accounts would be undesirable and self defeating.

Prices in industrial countries rose more rapidly last year (see Table C). Higher oil costs will have a varying impact this year, but are generally expected to raise final prices by perhaps 2%–3% in industrial countries, which might take rates of inflation close to, and in some cases well into, double figures.

Table A

Trade of oil-producing countries[a]

$ billions

	1972	1973	1974[b]
Exports of oil	21	27	85
Estimated surplus on current account	7	13	60

[a] Saudi Arabia, Abu Dhabi, Kuwait, Qatar, Iran, other Gulf States, Iraq, Libya, Algeria, Venezuela, Nigeria, and Indonesia.
[b] Very broad estimates.

Table B

The importance of oil to industrial countries

	Energy from oil as % of total energy used[a]		Rise in costs of oil imports at 1973 volumes ($ billions)[b]
	Total economy	Industry only	
Italy	79	66	4·7
Japan	75	63	8·3
France	69	54	4·6
Western Germany	55	37	5·4
United States	47	25	9·4
United Kingdom	48	42	4·3

[a] Figures for 1972 (except Japan – 1971): from *OECD Economic Outlook*.
[b] At early 1974 prices.

Table C

Increases in retail prices in industrial countries

Percentages

	During[a]	
	1972	1973
Japan	4·5	16·4
Italy	7·2	11·6
United States	3·4	8·4
France	6·9	8·3
Sweden	5·9	7·7
Western Germany	6·5	7·3
United Kingdom	7·7	10·3

[a] Fourth quarter (of preceding year) to fourth quarter.

Table D

World expansion

Percentage increases in volume at annual rates: *seasonally adjusted*

	Average for past decade[a]	2nd half 1971 to 2nd half 1972	2nd half 1972 to 1st half 1973	1st half 1973 to 2nd half 1973[b]
Industrial production				
Europe[c]	5¾	6½	11¼	3½
United States	4	10¼	10¼	4½
Japan	13¾	10	22¼	11¾
All OECD countries	5¼	8½	11½	6
International trade in manufactures[d]	9¼	8½	17¼	9½

[a] From average of 1959 and 1960 to average of 1970 and 1971.

[b] Figures to November for Europe, Japan, and OECD total; to December for United States.

[c] European members of OECD.

[d] Exports of Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, Switzerland, United Kingdom, United States, and Western Germany.

Table E

The current account of the balance of payments

£ millions: *seasonally adjusted*

	1973					1974
	1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	Year	Jan. (quarterly rate)
Visible trade balance	−380	−425	−575	−995	−2,375	−1,150
Net invisibles	+165	+205	+250	+290	+ 905	+ 215
Current balance	−215	−220	−325	−705	−1,470	− 935
1972 4th quarter=100						
Export prices[a]	103·0	106·8	112·5	116·4	109·6	..
Import prices[a]	105·2	113·6	124·1	131·6	118·7	..
Terms of trade[b]	97·9	94·0	90·7	88·4	92·3	..

.. not available.

[a] Indices of average values of goods (subject to revision).

[b] Index of export average values divided by import average values.

Table F

The sources of the visible trade deficit[a]

£ millions: *seasonally adjusted* at quarterly rates

	1972		1973		
	1st half	2nd half	1st half	3rd qtr.	4th qtr.
Deficit	−80	−260	−400	−580	−1,000
Change		−180	−140	−180	−420
of which: volume		*−160*	*+ 30*	*+ 40*	*−230*
price		*− 20*	*−170*	*−220*	*−190*

[a] This table employs the volume indices for exports and imports of goods (as recorded for the balance of payments accounts). Changes in these indices have been applied to the value of trade. The difference between the constructed volume series and the current values is here called the 'price' contribution, and reflects both the general effect of rising prices on the trade balance and the deterioration in the terms of trade.

World economic expansion slowed markedly in the second half of last year (Table D). It had previously been well above the rate that could be sustained; and government policies, notably in the United States, Japan, and Western Germany, had been directed to securing a slower growth of demand. The prospects for oil supplies are still not clear, but it now appears likely that most industrial countries will receive enough oil in 1974 to avoid significant disruption to industrial production. Prospects for demand are, however, affected by the rise in the price of oil, equivalent to a large rise in indirect taxation, which will reduce real purchasing power: the need for compensating expansionary measures will vary from country to country. The result of these various influences may well be a relatively slow growth in world demand.

The pattern of international interest rates has broadly reflected the monetary authorities' concern about the development of demand. In the United States, monetary policy has eased a little since October, and short-term interest rates have recently moved downwards. In Western Germany short-term rates have fallen markedly from the very high peaks reached in October; but elsewhere in Europe, and in Japan, rates have tended to rise, and in some countries quite sharply. In the year ahead, less buoyant demand may lead monetary authorities to relax their policies and ease interest rates. International capital markets will also be affected both by the volume of surplus funds which the oil-producing countries will have available for investment, and by the probability that many industrial countries will wish to borrow abroad to offset deficits on current account. International organisations such as the International Monetary Fund and the Bank for International Settlements should be able to play an important rôle in assisting in this process.

The UK balance of payments[1]

The current account worsened sharply in the fourth quarter of 1973, and worsened further in January. The deficit was nevertheless financed with little net loss to the reserves. The effective depreciation of sterling since the Smithsonian realignment, despite fluctuations over the period, was rather less at the end of February than it had been at the end of the third quarter. Dearer oil was responsible for only a small part of the deficit in the fourth quarter; in 1974 its effect may be to add £2,000 million to the import bill, more than the deficit for the whole of 1973.

The current account[2]

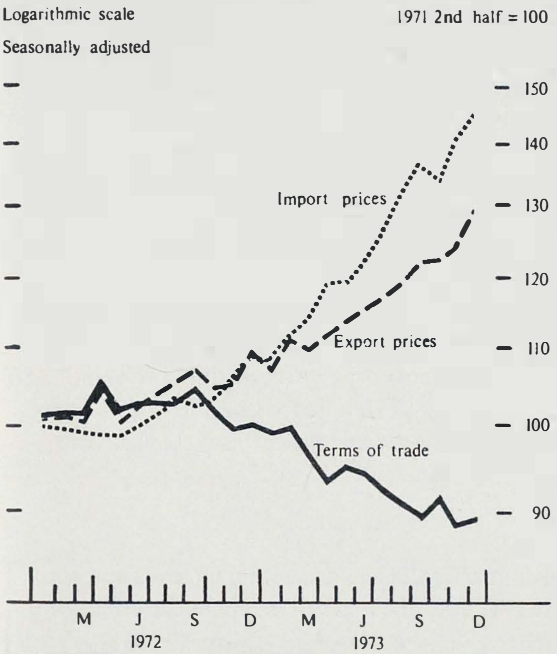
The terms of trade continued to worsen in the fourth quarter and in January. At the same time, the volume of trade moved unfavourably: exports, instead of rising faster than imports as in the first part of the year, fell slightly in the fourth quarter, and imports rose strongly. As a result, the current account deficit in the fourth quarter – some £705 million – was about as big as in the three previous quarters taken together, and brought the total for the year to £1,470 million (see Table E). The deficit in January, which was over £300 million for the month alone, was due in part to dearer oil, and was to some extent aggravated by short-time working in industry.

The worsening balance of visible trade throughout 1973 was largely the result of increasingly adverse terms of trade. In the fourth quarter, but not earlier, changes in volume were also unfavourable (see Table F). Exports of goods then fell in volume by 10% (at an annual rate), the first recorded fall since the second half of 1972; imports of goods rose by as much as 26%, thus more than reversing the downturn which had occurred in the previous quarter. The course of exports in the second half of 1972 was distorted by the dock strike, and the volume of exports may well, as a result, have been artificially inflated in the early part of 1973. The actual changes in volume

[1] It has not been possible to include in Table 20 of the statistical annex the latest balance of payments figures used here, which were released earlier this month by the Central Statistical Office.

[2] This section is written in seasonally-adjusted terms.

Terms of trade[a]



Import prices continued to rise more quickly than export prices, and the terms of trade worsened considerably.

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

Table G

Commodity price changes[a]

Percentage changes at annual rates

	June 1972 to June 1973	June 1973 to Oct. 1973	Oct. 1973 to Feb. 1974	Total June 1972 to Feb. 1974
All items	69	18	120	65
Food	66	−2	142	60
Industrial raw materials	73	54	93	73
of which: fibres	*93*	*27*	*19*	*62*
metals	*56*	*94*	*160*	*80*

[a] The new *Economist* world commodity price indicator, calculated in sterling terms; reproduced with permission.

Table H

Crude oil imports

Seasonally adjusted

	Value (c.i.f.)	Tons	Average value
	£ millions	millions	£/ton
1972 Year	915	103	9
1973 Year	1,293	112	12
1973 1st qtr.	242	25	10
2nd ,,	283	28	10
3rd ,,	330	30	11
4th ,,	438	29	15
Oct.	143	11	13
Nov.	138	9	15
Dec.	142	8	18
1974 Jan.	210	10	21

between the first and second halves of 1973 may therefore give a pessimistic picture of the underlying trend. But it seems unlikely that the recent performance of exports can be entirely explained as arising from such a temporary distortion of the figures.

With the moderating pace of world activity in the second half of last year, a slower expansion of British exports would not have been surprising. It was however clearly disappointing that the volume of exports should have fallen in the fourth quarter even though world trade was still increasing, if less rapidly than earlier, and even though British export prices remained unusually competitive. Since sterling has been floating, British export prices have risen far less than those of competitor countries when expressed in foreign currencies. It would be natural to suppose that shortages of labour and materials in the domestic economy, which continued in the fourth quarter (page 10), helped to retard exports and to swell imports. In January, with general short-time working in industry, these adverse effects became worse. The fall in the volume of exports was however much less than the cutback in industrial output, but so too was the fall in the volume of imports.

Since the beginning of 1972 export prices for manufactured goods have risen only slightly more than the price of manufactures sold on the home market. The depreciation of sterling over this period has, therefore, led primarily to a marked increase, of some 15%, in the competitiveness of British exports. In view of the strength of world demand throughout 1972 and part of 1973, as well as the fact that profit margins on domestic sales have been subject to control during much of this period, it is, perhaps, surprising that exporters have not exploited more the scope for increasing their prices. Whether this scope will continue to exist from now on will depend on world trading conditions.

In the fourth quarter, the worsening of the terms of trade accounted for over two fifths of the deterioration in the visible trade balance. In spite of dearer oil, average import prices increased less rapidly than earlier in the year, by 6%. This easing probably reflected the trend in commodity markets in the second half of the year, when prices rose more slowly. The prices of most commodities other than oil have, however, since then been rising more rapidly.

Following the explosive rise in commodity prices from June 1972 to June last year, the rate of increase for many commodities eased considerably until about October (see Table G). This was particularly so for foodstuffs, where some prices – beef, for example – fell, and for fibres, where the rate of price increase slowed down very sharply. In contrast, metal prices rose faster still. With the exception of fibres, however, the prices of most of the main commodities have been rising faster since October than they were before mid-1973. Fears of inadequate oil supplies and the big increase in oil prices may have delayed the prospect of a fall in the price of commodities, notwithstanding the slower pace of economic expansion in industrialised countries.

The import bill in the fourth quarter had begun to reflect the impact of dearer oil. Between the third and fourth quarters the average value of crude oil imports rose by nearly 35% (see Table H), and this accounted for about £100 million of the deterioration of £420 million in the visible trade balance. But most of the effect of dearer oil on the balance of payments had yet to appear. At early 1974 prices, the same volume of oil imports would cost some £2,000 million more than in 1973. British exports to the oil-producing countries can be expected to rise, but this will offset only a small part of the effect of higher prices.

The worsening current account deficit reflected the behaviour of the visible trade balance. Net invisible receipts rose further in the fourth quarter (see Table E), even though the invisibles account was beginning to be adversely affected by the growing cost of financing the current account deficit.

With a heavy 'oil deficit' to be financed in addition to the 'non-oil' component, the total current account deficit will, for some time, impose an even heavier increase in the interest burden.

Table J

The financing of the current balance of payments

£ millions

	1973 1st qtr.	2nd qtr.	3rd qtr.	4th qtr.	Year
Current balance	−363	−185	−326	−594	−1,468
Financed by:					
Public sector borrowing under the exchange cover scheme	+ 44	+282	+371	+306	+1,003
Increase (+) in official sterling holdings[a]	+150	+175	−422	+154	+ 57
Increase (+) in UK banks' other net overseas currency borrowing[b]	−191	+ 47	− 52	+112	− 84
Other capital flows[c]	+429	+ 58	+171	+ 44	+ 702
Increase (−) in reserves	− 69	−377	+258	− 22	− 210
Effective depreciation (*per cent*) of sterling since December 1971[d]	*11·6*	*14·1*	*19·7*	*17·4*	*17·4*

[a] Other countries' exchange reserves in sterling, and other banking and money market liabilities in sterling, excluding sterling held by international organisations.
[b] Excluding borrowing to finance lending to UK public authorities and for UK private investment overseas.
[c] Including the balancing item, and capital transfers under the sterling guarantee arrangements.
[d] End-quarter.

Table K

The variability of exchange rates

Effective changes (*per cent*) in exchange rates[a]

	End-June 1973 to end-Sept. 1973	End-Sept. 1973 to end-Feb. 1974	Average week-to-week change[b] End-Sept. 1973 to end-Feb. 1974
United Kingdom	−6·7	+1·9	0·8
United States	+1·2	+5·5	0·9
Italy	+3·0	−6·6	0·6
France	−2·1	−6·1	0·8
Western Germany	+1·6	−3·0	0·7
Japan	−0·3	−2·8	0·9
Netherlands	+5·0	−1·1	0·6

[a] See additional notes to Table 29 of the statistical annex.
[b] Disregarding direction.

The financing of the deficit

Three main elements contributed to the financing of the current account deficit in the fourth quarter (Table J). Foreign currency borrowing by public bodies under the exchange cover scheme, including borrowing through UK banks, continued at about the same rate as in the two previous quarters, and covered over half the deficit. Otherwise, foreign currency borrowing by the banks increased by some £275 million, of which about £165 million was to finance UK private investment overseas. Official sterling balances rose by some £150 million, after a sharp fall in the previous quarter. Other capital flows were, on balance, small. As a result of these inflows the reserves, despite the current account deficit, rose by just over £20 million in the quarter.

Borrowing under the exchange cover scheme, reintroduced in March of last year, financed about two thirds of the 1973 current account deficit of some £1,470 million. Other inflows over the year amounted to some £680 million, so that the reserves rose by £210 million. In January 1974 they fell by £138 million. Euro-dollar borrowing under the exchange cover scheme amounted to only £6 million.

The exchange rate

In the course of the fourth quarter the exchange rate, on average against other currencies, improved. Thus at the end of December the effective depreciation since December 1971 was 17·4%, as against 19·7% at the end of September. In the early part of the fourth quarter, adverse pressure on sterling continued and some support was given from the reserves; conditions later eased. In January sterling came under renewed pressure and, despite further use of the reserves, the effective depreciation increased to just over 20% before the pressure again fell away. There was again some use of the reserves as sterling came under pressure early in February, but the effective depreciation settled around 18% later in the month.

Between the end of September and the end of February, the dollar effectively appreciated by some 5½%, despite some weakening in the later weeks. Most other major currencies effectively depreciated over this period, especially the Italian lira and the French franc (Table K). In spite of these divergent exchange rate movements, the extent of short-term fluctuation among the various currencies has been remarkably similar, and the variability in the value of sterling has been about average (Table K, last column).

The domestic economy

Output recovered during the second half of last year after the sharp check in the second quarter. The size of this recovery was moderate however, and towards the end of the year output was actually falling slightly. At the beginning of this year short-time working in industry brought a substantial fall in production. Although employment and incomes were both reduced, they did not fall to the same extent as production, and the shortages of goods and materials, already evident in the second half of last year, have been considerably aggravated. In contrast, labour shortages eased as unemployment rose.

Output and demand [1]

Between the first and second halves of 1973, total output appears to have risen at an annual rate of about 1% (see Table L). The expenditure and output indicators of total activity showed some recovery in the third quarter from the low second quarter, and the average estimate suggests that, compared with the first half, the annual rate of growth was 1½%.[2] Industrial production alone rose at an annual rate of 2¼%. For the fourth

[1] This section is written in seasonally-adjusted terms.
[2] The annual rates suggested by the separate indicators ranged from zero by the income measure to 2¼% by the expenditure measure.

Table L

Domestic expansion

Index numbers of volume, *seasonally adjusted*, 2nd half 1972=100

	1973				Percentage change (annual rate)	
	1st half	2nd half	3rd qtr.	4th qtr.	4th qtr. / 3rd qtr.	2nd half / 1st half
Gross domestic product:						
Output measure	103·6	104·0	104·3	103·7	*– 2·3*	*+0·8*
Expenditure measure	105·8	..	106·8	..		
Income measure	103·9	..	104·0	..		
Average estimate	104·4	..	105·0	..		
Industrial production	105·9	106·0	106·7	105·3	*– 5·4*	*+0·2*
Consumers' expenditure	102·8	103·0	102·7	103·3	*+ 2·4*	*+0·4*
Retail sales	101·4	102·8	102·0	103·6	*+ 6·4*	*+2·8*
Exports of goods	107·8	108·7	110·2	107·3	*–10·1*	*+1·7*
Imports of goods	125·5	130·0	126·3	133·7	*+25·6*	*+7·3*

quarter the evidence, more fragmentary, suggests that output as a whole fell by ½%; the index of industrial production declined by 1½%. In October and November the rate of output of the third quarter had been maintained, but the index fell by 3¾% in December, when many companies closed for the week between Christmas and the new year and the miners' overtime ban reduced output of coal substantially. In January, following the introduction of short-time working, industrial output showed a further substantial fall.

The movement of total final expenditure has not matched the slowing down in the growth of output. Between the first and second halves of last year the increase in total demand was about 3% at an annual rate (see Table M) – certainly faster than the rise in output.

In the third quarter, total final expenditure rose substantially, but the sharp fall recorded in the second quarter was not fully offset by the recovery in the third. In the fourth quarter it continued to rise – albeit more slowly than in the third – despite the fall in output. Personal consumption, public spending, and private fixed investment made positive contributions, whereas, as already noted, exports declined. (The figures shown in the table are based on rough and provisional indications.)

Table M

The pattern of changes 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

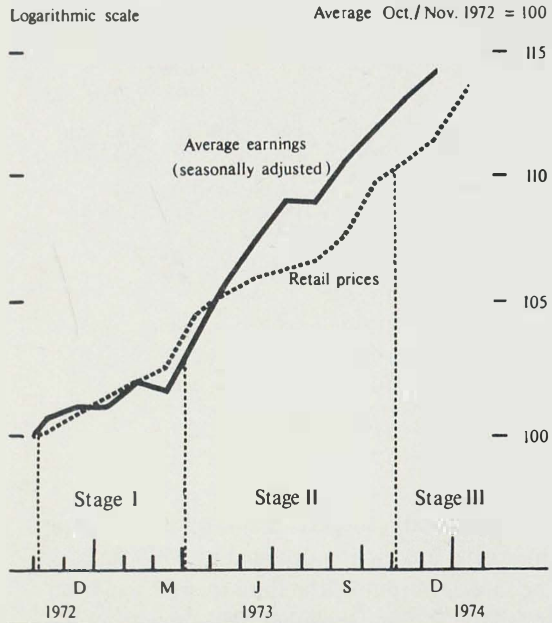
	2nd half 1972 to 1st half 1973	1st half 1973 to 3rd qtr. 1973	2nd qtr. 1973 to 3rd qtr. 1973	3rd qtr. 1973 to 4th qtr. 1973 (provisional)
Domestic expenditure (other than stockbuilding)	4·7	1·7	5·8	3¼
of which: consumers' expenditure	*3·0*	*0·0*	*1·7*	*1¼*
public spending[a]	*0·3*	*1·5*	*3·0*	*1½*
private fixed investment	*1·4*	*0·3*	*1·2*	*½*
Stockbuilding	4·0	–1·5	–1·8	0
Exports of goods and services	3·2	1·0	0·4	–1¼
Total final expenditure	11·9	1·2	4·5	2

[a] Total public spending on final goods and services.

Consumer spending rose at an annual rate of just over 3% in the third quarter and by 2½% in the fourth. In the second half of the year taken as a whole, however, the volume of consumers' purchases was only a little greater than in the first half.

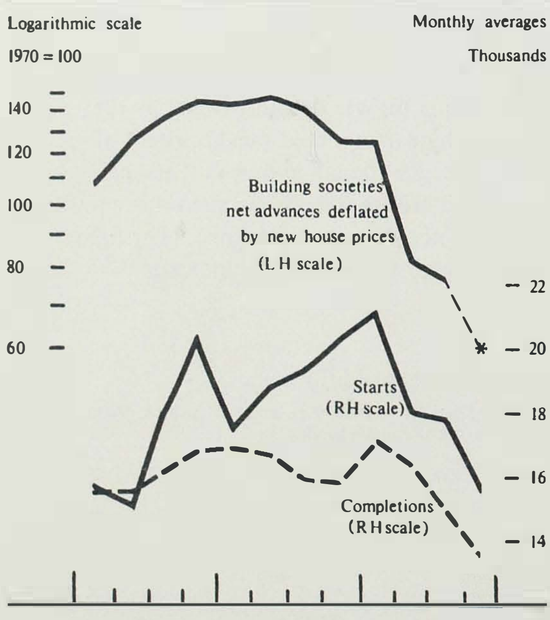
Perhaps one half of the increase in consumer spending during the fourth quarter stemmed from the special Christmas bonus to old-age pensioners;

Earnings and prices



Earnings have risen more than prices since the start of the counter-inflation policy.

Housebuilding and housing finance in the private sector



The small number of starts will tend to keep activity in the private housing sector depressed for some time.

* Estimated.

this is reflected in the heavier sales of food towards the end of the year. The remainder appears to have been at the expense of a fall in the rate of personal saving, which had been unusually high in the second quarter and, to a lesser extent, in the third quarter. Such an adjustment towards a more normal rate of saving is suggested by the behaviour of wages and prices in the fourth quarter. Average earnings continued to rise rapidly, and in the fourth quarter were 12½% higher than a year earlier while retail prices were 10¼% higher. On this comparison, the increase in real earnings was much smaller than it had been earlier in the year.

Private fixed investment rose by 1½% in the fourth quarter. About two fifths of this increase was in manufacturing industry, where investment rose by almost 1% – much less than in the third quarter – to bring it 13% above the low point reached in the second half of 1972. In contrast, fixed investment fell by 2¾% in the distributive and service industries; and the biggest increase was in investment in shipping, which changes erratically.

The decline in *housebuilding,* both public and private, which started at the beginning of last year, continued into the fourth quarter. In the public sector the fall in activity was modest, although in the fourth quarter the number of houses started was some 12% down on a year earlier and the number completed was some 6% down. In the private sector the fall in activity was more pronounced: housing starts and completions in the fourth quarter were running at annual rates of around 175,000 and 165,000 respectively, compared with rates of 245,000 and 190,000 in the fourth quarter of 1972 (see chart). In due course, the declining trend in the numbers started that was evident throughout last year will show up in the figures for completions. However, their initial impact is likely to fall most heavily on the stock of houses under construction.

The low rate of housebuilding in the private sector partly reflects the reduction in advances made by the building societies for house purchase; and behind that, the small inflow of funds to the societies (see page 12). Higher mortgage rates, coupled with high house prices and the uncertain economic outlook, seem also to have restrained the demand for advances, particularly from prospective first-time purchasers. There is evidence that the rapid increase in house prices has come to an end, and potential buyers may well be holding back for a time in the hope of lower prices. At the end of last year, the number of unsold houses, including those under construction, reached more than a quarter of a million, 13% more than a year earlier, and the largest number since the war.

Stockbuilding in private industry was some £175 million (at 1970 prices) in the fourth quarter; information is not available for the nationalised industries, but it seems almost certain that their stocks fell. Most of the increase in stocks was in manufacturing industry, at a rate almost twice as fast as in the previous quarter. The composition of stockbuilding probably reflected in part the presence and expectations of shortages, for stocks of finished goods rose only slightly. There were sizable increases in stocks of materials and fuels and in work in progress. In the distributive trades stocks were further but modestly increased.

The balance of the economy and the labour market [1]

The slower rate of expansion in the second half of last year brought with it a rather slower growth in the volume of imports – at an annual rate of 12½% compared with almost 16% in the first half-year (see Table N). In the fourth quarter alone, although there was a fall in output, imports rose very sharply indeed, at an annual rate of 26%. The increase was almost entirely in semi-manufactures and finished goods; the volume of fuel imports fell, while other categories were little changed.

This rapid rise in imports in the fourth quarter may, in part, have been a response to increasing shortages of finished goods and components. It may also reflect an attempt by manufacturers to anticipate shortages expected in the early part of 1974; this seems to be supported by the substantial rebuilding of stocks in the fourth quarter.

[1] This section is written in seasonally-adjusted terms.

Table N

Changes in output and imports

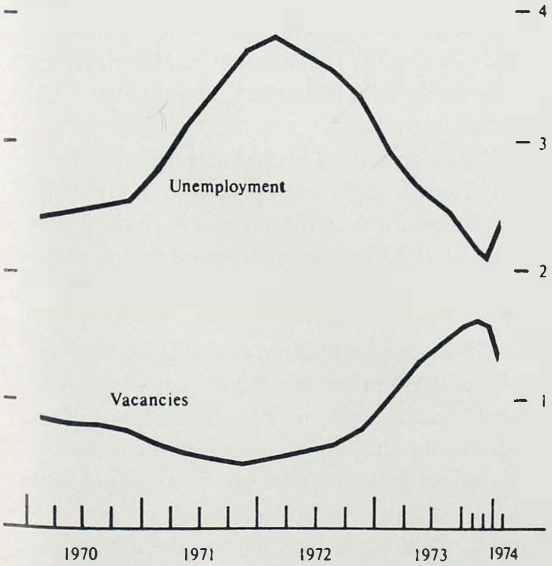
Percentage changes in volume at annual rates: *seasonally adjusted*

	2nd half 1971 to 1st half 1973	1st half 1973 to 2nd half 1973	1st half 1973 to 3rd qtr. 1973	3rd qtr. 1973 to 4th qtr. 1973
Gross domestic product	+ 4	+ 1	+ 2	− 2
Imports of goods (f.o.b.)[a]	+16	+ 7	+ 2	+26
main components (c.i.f.):				
finished manufactures	*+30*	*+26*	*+28*	*+21*
semi-manufactures	*+16*	*+11*	*+ 2*	*+44*
basic materials	*+12*	–	–	–
fuel	*+ 2*	*+ 5*	*+30*	*−21*
food, drink and tobacco	*+ 5*	*−10*	*−14*	*+ 2*

[a] Total imports are as in the balance of payments accounts. Components, however, are only available from *Overseas Trade Statistics,* including the cost of carriage, insurance and freight.

Unemployment and vacancies

Seasonally adjusted — Percentage of total employees



The labour market changed sharply in January. Total unemployment excludes the temporarily stopped (including those on a three-day week), school-leavers and adult students.

Unemployment continued to fall during the fourth quarter and, until November, unfilled vacancies continued to rise (see Table P). With output expanding much more slowly during the second half of last year, it was not, perhaps, surprising that unemployment was falling less rapidly and unfilled vacancies rising slowly – in December, indeed, vacancies fell, if only slightly (see chart). In general, therefore, the demand for labour, still largely reflecting the attempts of employers to adjust their requirements to the earlier burst of rapid expansion, continued to rise until the end of 1973, though at a somewhat slower rate than earlier in the year. The figures for overtime worked in October, November and the first half of December confirm however that the demand for labour continued at that time to be high.

Table P

Indicators of the pressure of demand on resources

	Previous 'high' pressure of demand	1973 3rd qtr.	1973 4th qtr.	1974 February
Unemployment (percentage)[a]	1·2 (1st qtr. 1966)	2·5	2·2	2·4
Unfilled vacancies (percentage)[b]	1·2 (1st qtr. 1966)	1·4	1·6	1·2
Overtime (1970=100)[c]	106·9 (1st qtr. 1966)[d]	101·4	103·8 (November)	
Percentage of firms reporting below capacity working[e]	38 (February 1965)	39 (July)	44 (October)	71 (January)

[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 1973 *Bulletin,* page 280, the earlier figure has been taken as representing the higher pressure of demand.

[e] CBI survey: percentage of firms who reported working 'below a satisfactory full rate of operation'. (The CBI index was briefly described, and its limitations explained, in the September 1973 *Bulletin*, page 280.)

In January, after three-day working began, the labour market changed sharply. At the count early in the month, unemployment had risen by about 60,000 to reach a total of 535,000 (2·4%), and it then went to 548,000 (2·4%) early in February, while unfilled vacancies fell in January and February to 278,000 (1·2%). The number of workers registered as temporarily stopped rose by 906,000 in January but fell by 170,000 in February.[1]

Price and cost developments

Retail prices rose strongly during the fourth quarter and were, on average, 10¼% higher than a year earlier; some acceleration has taken place since

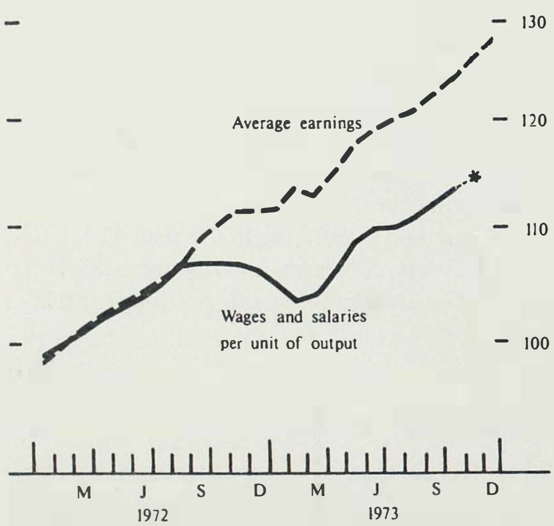
[1] As the unemployment counts, as always, were taken on a Monday, they may understate by as much as one half the total number of temporarily stopped for part of any week because of the way three-day working was divided within the week. There was also a large number of workers temporarily stopped who did not register, because their basic wages were guaranteed under company agreements.

Table Q
Retail prices
Percentage increases on a year earlier

	1973			
	1st qtr.	2nd qtr.	3rd qtr.	4th qtr.
Total index	7·9	9·3	9·2	10·3
of which:				
*food**	*2·8*	*3·8*	*3·6*	*4·7*
housing	*1·7*	*1·5*	*1·5*	*1·2*
nationalised industries' prices	*0·5*	*0·3*	*0·3*	*0·3*
other goods and services	*2·9*	*3·7*	*3·8*	*4·1*

Unit labour costs in manufacturing

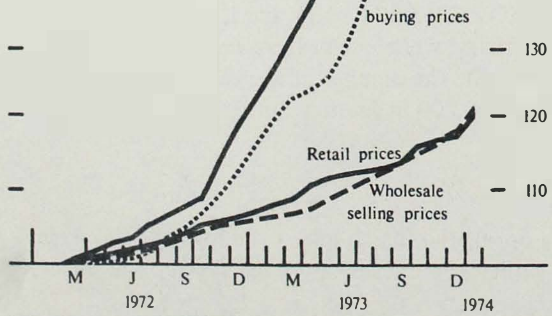
Logarithmic scale
Seasonally adjusted



With output slowing, the continued increase in earnings led to a sharp rise in labour costs per unit of output.
* Estimated.

Retail, wholesale and import prices

Logarithmic scale



Retail prices and manufacturers' selling prices continued to rise a good deal more slowly than import prices and manufacturers' buying prices.

the earlier part of the year (see Table Q). Although comprising only a quarter of the index, food accounted for nearly half the increase over the year. The prices charged by nationalised industries, on the other hand, rose very little. In January retail prices again rose strongly, and were 12% higher than a year earlier; the increase of ~~20%~~ in the month reflected 2% mainly further increases in food prices, and dearer petrol and oil.

Following some slackening of the rise in unit labour costs after the introduction of the Government's counter-inflation policy in November 1972, the slower expansion of output towards the end of last year brought the re-emergence of rapidly rising labour costs per unit of output (see chart). In the last quarter of 1973, average earnings, including the effect of increased overtime working, rose by about 3¼%, virtually unchanged from the third quarter. With manufacturing output falling there was a sharp lift in labour costs per unit of output, which rose by perhaps 5¼%. Between the two halves of last year they rose at an annual rate of some 14%; between the two halves of 1972 they had risen at a rate of 9¼%. The fall in production in December, January and February must have been associated with a large, but temporary, increase in labour costs per unit of output, as employers retained the bulk of their labour force at weekly rates of pay or, in some cases, at bonus rates for Saturday shifts under three-day working.

Import costs continued to rise strongly in the fourth quarter, though less rapidly than in the third. The average cost of imported goods rose by 6%, and the wholesale price of basic materials and fuels bought by manufacturing industry increased by nearly 11% – compared with increases in the third quarter of 9% and 12¾% respectively. The slackening of the rise in import costs was probably temporary: prices in commodity markets were still rising strongly during the fourth quarter. Manufacturers' wholesale buying prices rose by nearly 17% in January, about three quarters of the increase reflecting dearer oil.

Despite the much more moderate growth of economic activity in industrialised countries and of international trade during the second half of last year, commodity prices, as described earlier, have yet to show any clear signs of falling. By the end of 1973, and apart from oil prices, they had more than doubled since they had first begun to rise significantly around June 1972.

Manufacturers' wholesale selling prices continued to rise markedly (see chart). Although the big increases in oil prices exerted little direct pressure on domestic prices in the fourth quarter they will add still further to that already exerted by the growth of other import costs and by the more recent acceleration in unit labour costs. Some relief can be expected as the slower pace of world activity comes to be felt in commodity prices, but the uncertainties as to when this might occur have been underlined by the experience of the second half of last year.

The present state of the economy

As already indicated, output has been severely reduced in the early months of this year as the result of restricted working. The Confederation of British Industry's recent special survey of industrial trends[1] – and reports gathered by the Bank's branches – suggests that short-time working reduced the output of firms by some 20%. Later reports suggest that industrial output may not have fallen much further in February.

The effects of short-time working have varied widely within industry, and scarcities of materials and components have contributed to this unevenness. Shortages of steel and finished steel products, already causing difficulty towards the end of last year, have continued, if less severely than expected. Shortages are also widely reported of a growing list of materials and components including plastics, packaging materials, cement, glass, electric motors, and many other items. Bottlenecks in important supplies and components could retard the recovery of output when energy supplies are restored in full.

[1] The survey was made during the period 7th to 23rd January.

Within the company sector, financial difficulties had not become widespread up to the end of February. Such as they were their incidence was uneven, being more apparent in construction and engineering, and in general affecting small firms more seriously than large ones. The company sector as a whole held an unusually large balance of liquid assets before the move to restricted working; and in January and February cash flow was anyway not widely depressed because receipts from earlier sales, and from sales out of stock, in many cases offset the increase in average operating costs. When supplies of energy return to normal, the resumption of full-time working may in many cases entail, for a short while, a phase of increased or continued difficulty as regards cash flow.

The increase in operating costs experienced by firms reflects the fact that largely because of guaranteed weekly wage agreements and, for some, Saturday working at bonus rates, wages and salary bills were cut less than output. In other cases the cut in personal incomes was partly offset by social security benefits. For these reasons, the fall in total personal incomes was probably significantly less than the cut in production. As a rough order of magnitude, the consequent excess of demand over domestic supply might in January have amounted to 5%–10% of national output,[1] even though spending on durable goods will have been checked by the restrictions on consumer credit introduced in December. In the event, excess demand appears to have been largely met by sales out of stock, and by imports, which scarcely fell in volume. Some demand may, however, have been frustrated by shortages.

The measures taken by the Chancellor of the Exchequer on 17th December, before the three-day working week began, will be operating to reduce spending, particularly in the second half of the year. With some of the frustrated demand during the period of short-time working merely being postponed until supplies are available, however, demand pressures will be carried forward into the months ahead.

Monetary conditions

Monetary policy since the autumn has been dominated by two aims. The first, essential in view of the balance of payments situation, was to maintain interest rates fully competitive with those in other financial centres. The second, which became increasingly relevant as the broadly defined version of the money stock continued to expand rapidly, was to place monetary expansion under effective restraint without raising the leading interest rates higher than required by the external situation. These aims are being pursued flexibly in the light of a rapidly changing economic background.

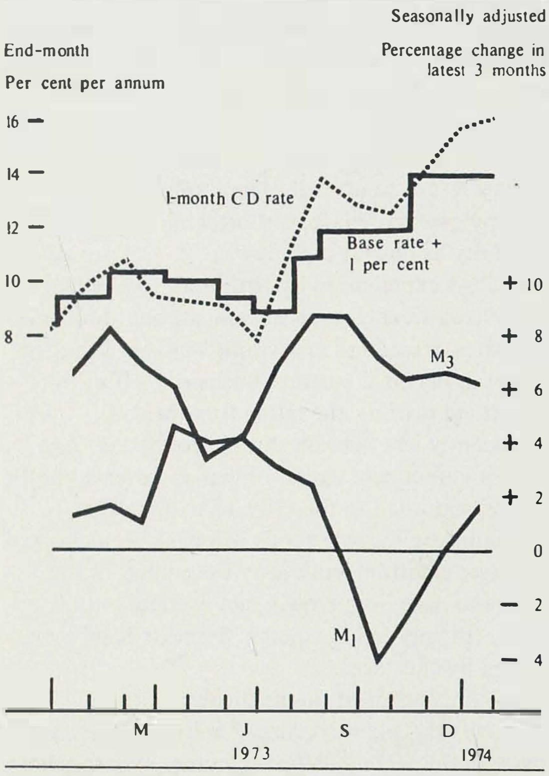
In November – when further calls were made for special deposits – continued rapid monetary expansion appeared inappropriate in a situation where the economy was nearing the limits of capacity and demand appeared in need of restraint. In December – when the supplementary deposits scheme was introduced – moderation in the pace of monetary expansion appeared no less desirable as a general aim. But at a time when industry was about to begin short-time working, with disturbance to firms' finances, it seemed also that the banks might need temporarily to provide support, and that monetary policy might need to be adapted to meet this contingency.

Interest rates

At the beginning of the fourth quarter last year domestic interest rates were tending to drift down; but on 13th November minimum lending rate was raised from 11¼% to 13%; and a call was announced for a further 2% of special deposits (payable in four instalments of ½% – on 28th November, 12th December, 27th December, and 2nd January). With the

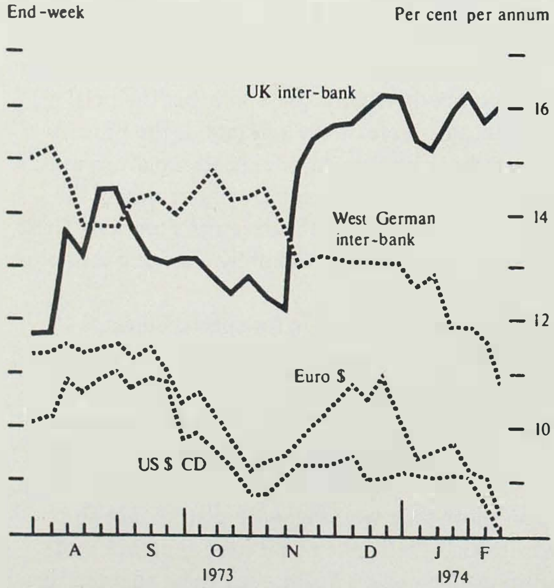
[1] Most surveys and reports taken in the course of January suggest that output in productive industry may have been something of the order of 20% below what it might otherwise have been, and wages and salaries about 10% below. Activity in the services sector has however been less restricted.

Arbitrage and the money stock



The scope for interest arbitrage again increased in the latest period, but M_3 did not rise any faster, and little arbitrage seems to have taken place.

Three-month interest rates at home and abroad



After rising in November, UK rates have generally remained high; some foreign rates have tended to fall.

economy nearing full capacity, these steps were prompted by the continued rapid rate of credit expansion (see below), and also by the general balance of payments situation. The first impact was to produce a sharp rise in domestic interest rates. A more delayed result was to put pressure on the banks' reserve ratios, which led to continuing upward pressures on interest rates.

The combined reserve ratios of the banks fell from 14·3% at mid-November to 13·7% at mid-December, and were almost unchanged at 13·9% at mid-January. But meanwhile, on 17th December – when the supplementary deposits scheme was introduced – the remaining 1% of the November call for special deposits was revoked.

Throughout much of the period from mid-November, the pattern of some short-term interest rates continued to favour borrowing at the best rates from the banks to take advantage of arbitrage (see chart). However, in the uncertain circumstances, deposits for a month or more were less attractive than deposits for very short terms, and rates on these offered much less scope for arbitrage. For the future, the clearing banks announced in December that they were taking action to discourage such activity (page 21).

The rise in domestic interest rates tended for most of this period to keep rates in this country fairly fully competitive with those abroad. In the new year, as short-time working in industry began, and as some foreign rates eased somewhat, the Bank acted to offset any further significant tightening in the money markets, and on occasion during January placed funds in the local authority money market to ease pressure on reserve ratios. But in the latter part of January, tax payments, especially of value added tax and corporation tax, contributed to a larger central government surplus than was foreseen, so creating an additional tendency for interest rates to rise as the banks' reserve ratios came under further pressure. Accordingly a repayment of ½% of special deposits was announced on 31st January, which added about £150 million to reserve assets. Despite the tight conditions, there was competition for Treasury bills throughout the month; minimum lending rate was reduced by ¼% following the tender on 4th January, and by a further ¼% to 12½% following the tender on 1st February.

Financial flows

To help the flow of funds to the building societies, the banks were requested on 11th September to limit to 9½% the rate paid on deposits of less than £10,000; and on 14th September the Building Societies Association recommended an increase in the rate paid on share accounts with the societies to 7·5% (equivalent to 10·7% grossed up at the basic rate of income tax), and an increase to 11% in the rate for new mortgages. This temporarily halted the decline in receipts which had set in earlier: in October the net inflow of funds was £150 million (seasonally adjusted). By mid-November, however, other short-term rates had risen further still, and the receipt of funds by the building societies began to fall away, to no more than £75 million (seasonally adjusted) in December. Mortgage advances and commitments fell in the fourth quarter (see above, page 8). In January receipts by the building societies fell further to some £50 million.

So far this financial year the central government borrowing requirement has been less than foreseen in the Budget last April. In part, this is because the needs of some public sector bodies have been met by foreign currency borrowing under exchange guarantee rather than by drawing on the National Loans Fund, but this leaves the Government's need to borrow from domestic sources unaffected, and the financing needs of the public sector as a whole have evolved broadly as expected. Sales of gilt-edged stocks to the general public had been strong in October, but after the sharp lift in interest rates in mid-November there was little public demand as prices fell further. It was not until the period just before the announcement of 17th December measures that demand revived. In the fourth quarter, net purchases by the general public amounted to £475 million.

Demand for gilt-edged remained firm until early January, but weakened as the industrial situation worsened.

After taking into account sales of debt to the general public, the financing of the public sector borrowing requirement led to a marked increase from mid-October to mid-January of some £850 million (seasonally adjusted) in credit extended to the public sector (see Table R). Bank lending, mainly to the central government, accounted for rather more than one third of the increase, as did the external financing of the public sector.

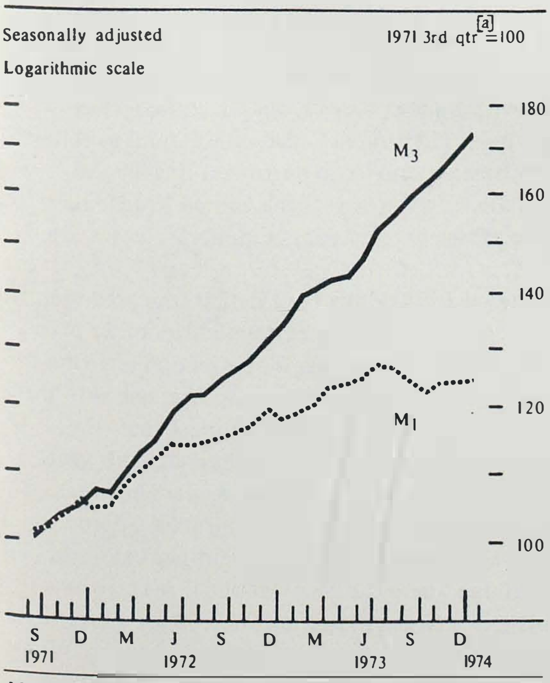
Table R
Changes in the money stock (M_3)
£ millions: *seasonally adjusted*

	1972	1973			
	Quarterly average[a]	Mid-Jan. to mid-Apr.	Mid-Apr. to mid-July	Mid-July to mid-Oct.	Mid-Oct. to mid-Jan.
Bank lending to the private sector	1,597	+1,195	+1,846	+2,075	+2,079
Credit extended to the public sector[b]	219	+ 722	+ 33	+ 807	+ 851
Less:					
External finance of the public sector	– 349	– 68	+ 364	– 63	– 295
Banks' net external liabilities	– 29	– 140	– 348	– 529	– 450
Banks' non-deposit liabilities (net)	– 152	– 150	– 31	– 186	– 261
Money stock (M_3)	1,286	+1,559	+1,864	+2,104	+1,924
Percentage change	*+ 5·8*	*+ 6·1*	*+ 6·9*	*+ 7·3*	*+ 6·2*

[a] Average of the three-month periods to mid-April, mid-July, mid-October, and mid-January.
[b] From banks and overseas, and from the increase in notes and coin in circulation.
See also Table 12 of the statistical annex.

Bank lending to the private sector was by far the larger element of domestic credit extended during this period; as indeed it was throughout 1973. In the three months to mid-January, about a quarter of the increase was in lending in foreign currencies; in the second half of last year foreign currency lending to the private sector rose by almost £800 million (in part, however, reflecting the revaluation of amounts outstanding in consequence of the depreciation of sterling). On 17th December the banks were reminded of the need to restrain lending to persons, as well as to property companies and for purely financial transactions. The pattern of advances of the London clearing banks shows personal borrowing on a declining trend during this period. In the month to mid-January, bank lending in sterling to the private sector (after seasonal adjustment) rose by some £510 million, which was somewhat less than in the previous months, despite an amount of special lending to some deposit-taking institutions outside the banking sector whose liquidity was under pressure (page 22).

Money stock



M_3 continued to rise strongly throughout the period, but the amount of money more narrowly defined, M_1, has scarcely changed on balance since the middle of 1973.

[a] Average of three months to mid-September 1971.

Monetary aggregates

The persistently large rise in bank lending to the private sector was associated once again with a rapid increase in the money stock (M_3). In the three months to mid-January it rose by 6¼% after seasonal adjustment, somewhat more slowly than in the previous three months, when arbitrage activity led to a particularly sharp increase, but more quickly than earlier in the year. Much of the rise took the form of increased time deposits; M_1 – the narrower version of the money supply – rose by only 1½%.

In the light of the continuing rapid increase in the money stock, notably in time deposits, the Bank introduced on 17th December a supplementary scheme to reinforce the established instruments of monetary policy. This scheme[1] provides for the placing of non-interest-bearing supplementary deposits with the Bank by all banks and deposit-taking finance houses if their interest-bearing eligible liabilities expand at more than a specified

[1] A fuller description is given on page 37.

rate over a specified period. The allowable rate of increase in the first six months (between the average amount of October–December 1973 and that of April–June 1974) was set at 8%; and, on the growth of each institution's interest-bearing sterling deposits in excess of that rate, the proportion of supplementary deposit required was made progressive, up to a maximum rate of 50%. With the introduction of these arrangements, the remaining 1% of the call made in November for 2% of special deposits became unnecessary, and was accordingly revoked.

The immediate situation in industry may produce liquidity problems for particular companies; and the Bank have accordingly maintained close contact with industry and with the banks in order to keep the situation under review and to be able to adapt monetary policy appropriately if the need arises.

Conclusion

In the first months of the year the economy has been heavily affected by short-time working imposed in the light of the dispute in the coal-mining industry and the consequent need to economise on the use of power. Though the effect on output has not been as severe as might have been feared, it may take some time after the settlement of the dispute for the normal balance of production to be restored. It is nevertheless to be expected that in the rest of the year part of the production lost will be made good.

Economic policy has to take account of the difficulties arising from the immediate situation. It also has to have regard to the longer-term problems of the economy, of which the two most pressing are the balance of payments, and inflation. With neither can success be obtained overnight; but it is highly important in each case that progress be made, and that there is promise of a clearly improving trend. While all industrial countries, especially in Europe, face a severe problem of inflation, that facing the United Kingdom may be more acute than most countries. The success of other countries in bringing inflation under control will both constitute a challenge and at the same time ease the task.

There will inevitably be a large deficit this year on balance of payments current account, which can conceptually be divided into two components. The United Kingdom, like other industrial countries, is having to pay much more for imports of oil. The oil-producing countries will run very large surpluses on balance of payments current account; industrial countries, taken as a group, will correspondingly be bound to have a large deficit on current account with these countries, and, in consequence, with the rest of the world as a whole. The United Kingdom is bound to follow this pattern, and like many other countries to borrow to finance this component of its current deficit. In the case of the United Kingdom, however, this should be progressively reduced, as supplies of North Sea oil become available.

The United Kingdom entered 1974 with a large deficit, the predominant cause of which was the large rise in the price of commodities other than oil. It is agreed that this part of the deficit calls for correction as soon as possible. Commodity prices have, to date, continued to rise; but with the weakening trend of world demand there remains a prospect that the average price of commodities other than oil will stabilise later this year. The export prices of manufactures, here and elsewhere, seem however bound to continue rising. There could therefore well be some improvement in the terms of trade of the United Kingdom and other industrial countries. But, despite this hope, there can be no doubt that correction of the United Kingdom's balance of payments deficit will call for a diversion of domestic resources into greater exports or into saving of imports, which will involve the devotion to this purpose of an important share of the increase in output in prospect.

The obverse of the current account deficit is a need for substantial borrowing abroad in order to finance the deficit. Many other industrial countries will be in a similar situation, but the accretion of funds in the hands of the oil-producing countries and available for investment will also be very large. Conditions regarding international flows of capital have thus been greatly modified; and, at the cost of relatively high interest rates in this country, the financing of the large current account deficit in the latter part of last year did not result in undue pressures on the reserves. The cost of such financing is, however, heavy, and this consideration emphasises the need for an early rectification of the underlying situation.

Advance along this path has been retarded by the abnormal industrial situation, which has also created an unbalanced demand situation. By the end of last year the economy was facing supply limitations, which have probably now become more acute. Incomes have not been reduced as much as output has been curtailed, and stocks of goods have been drawn down. The economy therefore faces the recovery period with a build-up of demand pressures – though these should in time be reduced by various factors already at work in the economy: in particular, the demand reducing impact of higher oil prices, and decisions last year with respect to government expenditure and hire-purchase credit.

The financial position of industry does not appear to have been as seriously worsened by short-time working as might have been feared. Difficulties could nevertheless occur in the recovery phase, when there may be pressure to reconstitute stocks at a time when normal cash flows have not been fully restored. Monetary policy will need to take account of these difficulties if they arise, but there will also continue to be need to keep the growth of bank credit and of the money supply under due restraint.