Economic commentary

The first months of this year were clearly an exceptional period for the economy. The shorter working week and general restrictions on the use of energy by industry were in force until early March. Output was seriously curtailed, though less severely than it seemed at the time. It appears since to have made a rapid recovery. Shortages of materials and components, which seemed an impediment to production at the end of last year, were inevitably aggravated by the dislocation of output.

Exports have probably increased in volume since the beginning of the year; and the trade balance in goods other than oil shows an improving trend. The higher price of oil has, however, worsened the deficit on current account, which, in the first four months, was running at an annual rate of nearly £4,000 million.

The deficit has none the less been financed without undue difficulty by capital inflows of various types. The exchange rate, as measured against an average of other countries' currencies, has remained mainly 17%–19% below its Smithsonian level, much as in the fourth quarter of last year; and the reserves at the end of April were higher than at the end of December. No drawings have yet been made on the $2½ billion loan to the Government arranged in March through the clearing banks.

Following the introduction last December of supplementary deposits as a new mechanism of monetary control, domestic monetary developments have generally been more satisfactory. The period of short-time working did not, as earlier feared, result in pressure on the banks for special accommodation. The growth of M_1 has remained small, though rising in April, and that of M_3 has fallen progressively – from a rate of around 7% a quarter in the second half of last year to 2% in the three months to mid-April. The allowable increases under the supplementary deposits scheme for the second half of this year provide for a similar rate of growth of interest-bearing resources as in the first half.

International developments

The pace of expansion in industrialised countries slowed down still further during the first quarter of this year following the marked deceleration which occurred towards the end of last year. In the United States and Japan national output fell; it continued to expand on the Continent, but more slowly than in 1973.

Prices in most industrial countries have been rising at an increasingly rapid rate throughout 1973 and early 1974 (see Table A). In some countries the particularly sharp increases in the first quarter in part reflected dearer oil, but even before then the acceleration was often considerable. In most countries counter-inflationary policies are being pursued, which should in time cut back the rate of price increase. The recent easing in world commodity prices should help too, and may go further because of reduced industrial demand.

The value of world trade in manufactured products has continued to rise fairly fast this year largely, however, because of higher prices. The volume of trade has probably grown more slowly as world demand has slackened, which it began to do in the second half of last year.

Individually, trends in current account surpluses and deficits among industrial countries were accentuated in the first quarter; at the same time, the greater cost of oil must have meant that, as a group, these countries were in deficit with the rest of the world after having been in surplus in 1972 and 1973 (see Table B). For the year 1974, the direct and indirect effects of dearer oil[1] will probably worsen the OECD countries' combined current accounts by $50 billion or more, though they will still have a surplus with other developing countries.

[1] The extra cost of oil and of interest payments on consequent borrowing, partly offset by a smaller demand for oil and some extra exports.

Table A

Consumer prices in industrial countries

Percentage increases on a year earlier

	1973				1974
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Japan	7·1	10·5	12·8	16·4	24·5
Italy	8·8	11·1	11·7	11·6	14·3
France	6·4	7·1	7·6	8·3	11·3
United States	4·1	5·5	6·8	8·4	9·8
Sweden	6·0	6·6	6·5	7·7	9·9
Western Germany	6·4	7·3	6·9	7·3	7·4
United Kingdom	7·9	9·4	9·2	10·3	12·9

Source: OECD.

Table B

Current accounts of industrial countries[a]

$ billions

	1972	1973	1st qtr 1974[b] (annual rate)
Western Germany	1·1	4·7	11½
United States	–8·4	3·0	5
France	0·3	–	– 4
Japan	6·6	–0·1	–10½
Canada	–0·6	–0·3	– 2
Italy[c]	2·6	–2·2	– 8
United Kingdom	0·3	–3·2	– 9
Other OECD countries[c]	3·2	4·6	..
All OECD countries	5·0	6·1	..

.. not available.

[a] Including official transfers.
[b] Provisional seasonally-adjusted estimates.
[c] Partly estimated.

The higher price of oil began to affect the pattern of international trade in the first quarter. During January to April extra payments for oil of perhaps some $15 billion will have been made, of which about $12½ billion will have been paid by industrial countries. The impact of the higher price will however have been partly delayed by the fact that oil is usually paid for a month or two after it has been shipped. Because the imports are recorded in countries' trade accounts at the time of landing, the delay in payment produces a (sometimes unidentified) credit item in their balance of payments accounts (see next page for the effect on the UK account in the first quarter). But by now this transitional financing element must have worked itself out; and industrial countries' borrowing, particularly from the euro-dollar markets, is playing an increasing role. Medium-term foreign and international bank credits announced during the first four months of the year – the majority for industrial countries – amounted to more than $15 billion, almost as much as arranged in the whole of last year (see Table C), some of which, however, will not as yet have been drawn.

For domestic reasons, short-term interest rates in the United States, which eased until February, rose thereafter to new peaks. Euro-dollar rates tended to move in line with short-term rates in the United States: after falling from mid-December to about 8¼% by mid-February, the three-month rate rose to about 11¾% by the end of April. In contrast, short-term interest rates in London have fallen, if only moderately and rather unevenly; some Continental short-term interest rates have also tended to ease a little, particularly in Western Germany, though most remained firm.

During this period sterling was fairly stable, while other currencies, as indicated by the effective changes in exchange rates, varied quite markedly (see chart on page 142). The dollar effectively depreciated by some 4% in the four months to the end of April, the French franc by 10%, and the lira by just over 8%. In contrast, the deutschemark appreciated strongly, by almost 7%, and its effective appreciation at the end of April was almost at its greatest since the Smithsonian realignment. The yen, which weakened sharply in January, recovered in February and March, declining a little thereafter.

Table C

Medium-term foreign and international bank credits[a]

$ billions

	1973	Jan. to Apr. 1974
Borrowers:		
US corporations	0·8	0·3
United Kingdom	2·5	4·7
of which public sector	*2·2*	*3·7*
Other EEC countries	5·2	4·8
of which public sector	*4·7*	*4·6*
Other OECD countries	2·5	1·5
of which public sector	–	*1·0*
Developing countries	6·1	3·3
Rest of the world	1·4	0·6
Total	18·5	15·2

[a] Credits arranged and made public but not necessarily drawn; the figures may be incomplete.

The UK balance of payments

The current account[1]

The current account of the balance of payments worsened further in the first quarter, to nearly £1,000 million. Most of the deterioration of over £300 million occurred in visible trade and can be more than accounted for by the rise in oil prices (see Table D): the deficit on trade in oil increased from £300 million in the fourth quarter, when relatively little effect of higher prices had been felt, to over £700 million. Notwithstanding short-time working throughout most of the quarter and further increases in primary product prices, the 'non-oil' deficit was some £150 million smaller than in the particularly adverse fourth quarter. Net invisible receipts, although still substantial, fell back from the previous high figure, in particular because of a big increase in shipping costs, and also because of the rising cost of financing the deficit.

In spite of short-time working, total exports of goods were nearly £350 million higher in value in the first quarter than in the fourth, an increase of over 11%. In January, the volume of exports was about as low as in December but, although later figures are not available, it seems almost certain to have risen thereafter, probably in response to the competitive advantage resulting from the depreciation of sterling since June 1972. However, with manufacturers' selling prices to the home market 7% higher on average than in the fourth quarter, higher prices must have contributed most of the increase. In April exports continued to grow, with a rise of 5½% in value over March.

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

Table D

Current account of the UK balance of payments

£ millions: *seasonally adjusted*

	1973				1974	
	Year	1st half (quarterly rate)	3rd qtr	4th qtr	1st qtr	Apr. (quarterly rate)
Visible trade balance	–2,375	–375	–605	–1,020	–1,290	–1,175
of which:						
oil[a]	– *945*	*–205*	*–235*	– *300*	– *720*	– *925*
non-oil	*–1,430*	*–170*	*–370*	– *720*	– *570*	– *250*
Net invisibles	+1,090	+210	+315	+ 360	+ 310	..
Current balance	–1,285	–165	–290	– 660	– 980	..

.. not available.

[a] The balance of trade in petroleum and petroleum products *(Standard International Trade Classification).*

Table E

World prices of manufactures and primary products

US dollars: 1950=100

	Export prices of manufactures [a]	Prices of primary products other than oil [b]	Terms of trade
1951–55	118	101	117
1956–60	123	88	140
1961–65	131	90	146
1966–70	142	103	138
1971	161	107	150
1972	174	124	140
1973	202	205	99
1973 4th qtr	213	234	91

[a] Source: UN. Covers the main industrial countries.
[b] *The Economist* world commodity price indicator; reproduced with permission.

Table F

Share of materials in imports of industrial countries

Per cent of total imports, 1972

	Food and raw materials	
	Including oil	Excluding oil
Japan	75	56
Italy	58	45
Western Germany	44	35
France	44	32
United States	34	26
United Kingdom	50	40

Table G

Financing of the UK current account deficit

£ millions

	1973				1974
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Current balance	−370	−190	−240	−490	−1,090
Financed by:					
Public sector foreign currency borrowing under the exchange cover scheme	+ 40	+280	+370	+310	+ 310
Increase (+) in official sterling holdings[a]	+190	+100	−350	+160	+ 260
Increase (+) in UK banks' other net foreign currency borrowing[b]	−190	+ 50	− 60	+ 70	− 150
Other capital flows, including direct investment and the balancing item	+400	+140	+ 20	− 30	+ 630
Decrease (+) in reserves	− 70	−380	+260	− 20	+ 40

[a] Excluding sterling held by international organisations.
[b] Excluding borrowing to finance lending to UK public authorities and for UK private investment overseas.

Further details are in Table 20 of the statistical annex.

Imports of goods, other than oil, rose in value by 4½% between the two quarters. Higher prices probably accounted for much of this increase, particularly for food and industrial materials, reflecting in turn the continuing rise of commodity prices. Indeed, in January UK import prices, as measured by the unit value index, rose by over 4%.[1] The volume of imports may have fallen slightly during the period of restricted production (in January it was 2½% less than in December): imports of food and finished manufactured goods almost certainly fell from the high rate of the end of last year. The effect of reduced demand probably outweighed any tendency to substitute foreign for home-produced goods. In April the value of imports was little changed from March.

Compared with manufactured products in world trade, the prices of primary commodities (excluding oil) are exceptionally high by post-war standards, and Table E shows how the relative terms of trade are unusually unfavourable to manufactured goods. However, the present tendency for prices of most primary products to rise more slowly or to fall and for export prices of manufactured goods to rise more strongly suggests that some reversal is now under way; and this would be reinforced if world economic expansion slows as expected this year.

Any check to the pace at which the prices of commodities are rising will help to alleviate cost-inflationary pressures in this country, as well as contribute to some improvement in the balance of payments. There is, however, no reason to believe that the United Kingdom will on average benefit more than its main competitors (see Table F): maintenance of the present strong competitiveness of British export prices will depend essentially on the course of home costs (see page 128).

The financing of the deficit

The current account deficit in the first quarter was about £1,100 million before seasonal adjustment. It was mainly financed (see Table G) through overseas investment in the UK private sector; foreign currency borrowing by public bodies under the exchange cover scheme; a rise in official sterling balances; and unidentified sources (reflected in a large positive balancing item). As a result, the reserves fell by no more than £40 million, despite the size of the deficit – and in April they rose by about £200 million.

The big balancing item was probably partly accounted for by company cash-flow problems stemming from short-time working: these could have induced recourse to finance from overseas. The recorded rise in inward investment owed much to the oil company account, partly as funds were built up before making heavier payments abroad.

Public sector borrowing of foreign currencies under the exchange cover scheme,[2] including borrowing through UK banks, continued at about the same rate as in the last nine months of 1973, and amounted to almost £310 million. In the first fourteen months (up to and including April) since its reintroduction, the scheme raised over £1,600 million (almost $4,000 million).

The increase in official sterling balances of some £260 million is more than accounted for by the much bigger sterling receipts of the oil-producing countries though, as usual, only some of these receipts were retained in sterling. The continuation of guarantee arrangements for certain sterling holdings was announced on 15th March. These arrangements maintain most of the previous provisions, including the ceiling on the amount eligible for guarantee, but relate the guarantee to the effective change in the sterling exchange rate (see page 143).

Perhaps over a quarter of payments to oil-producing countries for crude oil is made in sterling, and the rise in the price has produced a big increase in sterling transactions. The amounts payable on some days are now very large, and foreign oil companies, which account for nearly half the sterling paid to the producing countries, have had to increase their purchases of sterling and have spread them over a longer period. The exchange rate has

[1] As with exports, no volume and unit value indices are available beyond January at the time of going to press.
[2] June 1973 *Bulletin*, page 136 and December 1973 *Bulletin*, page 423.

benefited, and, because the companies hold more on average than before, private foreign sterling balances in total should also tend to be bigger. Money markets have absorbed these increased flows without noticeable difficulty.

Among remaining capital flows, the banks borrowed about £190 million in foreign currency to finance private investment overseas, but otherwise – and excluding their borrowing to lend to the public sector – their net external liabilities in foreign currencies fell by some £150 million. The supplementary deposits scheme discourages switching into sterling, though it does not discourage the lending of foreign currency to residents.

The Chancellor announced in his Budget speech on 26th March that the Government were to borrow $2·5 billion in the euro-dollar market. The loan is the largest ever raised in the international capital markets. It was arranged by the London clearing banks in conjunction with the Bank of England – the clearing banks also bringing in about thirty associate banks in this country and abroad. The agreement was signed in the Bank on 7th May. No drawings have yet been made.

The loan is for ten years in all, but taken for three, six or twelve months at a time at the option of the borrower, and successively rolled forward. The rate of interest incorporates a margin over the cost on the London inter-bank market of three, six or twelve-month euro-dollars as appropriate, the margin being ⅜% in the first two years, ½% in the next three, ⅝% in the sixth and seventh years, and ¾% in the last three. Repayment will be made in four equal instalments at the end of each of the last four years.

During January and early February, and in early March, sterling came under spasmodic pressure, and at one time its effective depreciation since the Smithsonian realignment increased to just over 20%. But mostly, and with only occasional intervention in the foreign exchange market, it remained around 17%–19%. The cost of intervention was financed by the public sector's borrowing in foreign currencies. At the end of April the effective depreciation was 17%, compared with 17½% at the end of last year.

The domestic economy

The fall in output for the first quarter that resulted from the industrial crisis[1] was less than expected beforehand or than it seemed at the time. Aggregate demand (excluding stockbuilding) still exceeded current output. But the scale on which stocks were run down – and will eventually need to be reconstituted – appears less than expected, if still substantial. Output and employment, while still impeded by shortages, have recovered fairly rapidly since the resumption of full-time working.

Output and demand[2]

The limited evidence available for the first quarter indicates that, compared with the previous quarter, industrial production fell by 6½% and national output as a whole by 3½% (see Table H). About one half of the index of industrial production is based on deliveries rather than on actual production, and so includes an element of delivery out of stock. Even so, the actual fall in total output in the first quarter may still have been not much more than 4%.[3] Industrial production as recorded fell by 6% in January, with the output of the manufacturing sector down by slightly more. As companies gained experience in reorganising their activities, and certain relaxations were announced in the use of power, industrial production rose in February by about 2%, with manufacturing output increasing by 4½%.

[1] Coal output began to be affected in November and virtually ceased between 10th February and 11th March. Limitations on industrial use of energy and a shorter working week were in force from 17th December to 9th March. The general election was announced on 7th February, the new Government took office on 5th March; and the Budget followed on 26th March.

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

[3] In January, those series based upon deliveries fell, on average, by only half as much as those based upon production. By March it is likely that the published figures were back in line with actual production. If the deliveries-based figures for January and February are reduced in line with the production-based series, the fall in industrial output appears to have been of the order of 8%.

Table H

Domestic activity

Percentage changes in volume: *seasonally adjusted*

	1st half 1973 to 2nd half 1973 (annual rate)	3rd qtr 1973 to 4th qtr 1973	4th qtr 1973 to 1st qtr 1974 (provisional)
Gross domestic product (output measure)	+ 0·8	–0·5	–3½
including industrial production	*– 0·4*	*–1·4*	*–6½*
Consumers' expenditure	–	–	–1
including retail sales	*+ 2·7*	*+1·6*	*–2*
Exports of goods	+ 3·9	–1·8	..
Imports of goods	+11·6	+3·0	..

.. not available.

Table J

Changes in total final expenditure

Percentages, *seasonally adjusted*, constant prices

	2nd half 1972 to 1st half 1973 (annual rate)	1st half 1973 to 2nd half 1973 (annual rate)	3rd qtr 1973 to 4th qtr 1973	4th qtr 1973 to 1st qtr 1974 (estimated)
Change in total final expenditure	+11·7	+0·7	−0·3	−3 to −3½
Accounted for by:				
Domestic expenditure (other than stockbuilding)	+ 4·7	+1·3	+0·4	−1½
of which: consumers' expenditure	*+ 3·1*	*–*	*–*	*– ½*
public spending[a]	*+ 1·1*	*+1·0*	*+0·1*	*−½ to −1*
private fixed investment	*+ 0·5*	*+0·3*	*+0·2*	*small fall*
Stockbuilding	+ 3·9	−1·3	−0·2	−2
Exports of goods and services	+ 3·2	+0·8	−0·4	small rise

[a] Total spending on final goods and services by the public sector (including British Steel).

After the removal in early March of the restrictions on the use of energy, output recovered fairly quickly, and in the month as a whole industrial production was 3½% higher than in February. By the end of March coal production had almost returned to normal, and stocks had begun to rise. The recovery was not uniform, however, throughout the economy, and steel production is still quite low. The excess of demand over domestic production in the first quarter appears to have been met partly by running down stocks of finished goods and components, and in certain sectors recovery has therefore been hampered by shortages.

As was to be expected, total final expenditure dropped sharply in the first quarter, but domestic expenditure other than stockbuilding fell less than national output (see Table J). The rundown of stocks was fairly substantial. In spite of short-time working, exports, as noted earlier, appear to have risen in volume.

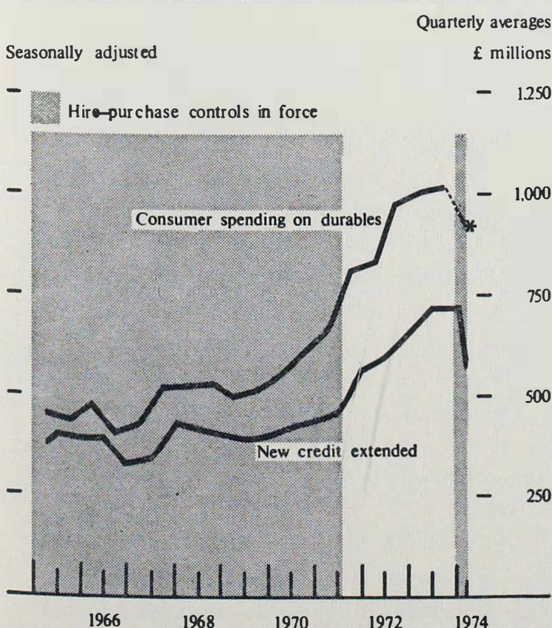
Consumer spending is estimated to have fallen by 1% in the first quarter this year, having changed little in volume between the last two quarters and indeed between the two halves of 1973. An even sharper decline might have been expected: spending before Christmas was given a temporary boost by the pensioners' bonus; while consumption in the first quarter must have been adversely affected by a fall in incomes during short-time working and by the first effects of the credit controls introduced in December.

Wages and salaries as measured by the index of average earnings were 1% less in the first quarter than in the previous quarter. They fell by 4½% between December and January but then rose by 1¾% in February and by 4¾% in March. They were supplemented by social security benefits and income tax rebates. Other personal incomes were probably less affected. But, with prices rising rapidly, real disposable incomes must have fallen significantly more than consumer spending – implying a reduction in the historically high savings ratio of the previous quarter.

Consumers may also have anticipated further restrictive measures in the Budget; the monthly statistics of retail sales (about half of consumer spending) point in this direction. After declining sharply in January, the first full month of short-time working, retail sales were somewhat higher in both February and March, despite the start of the coal miners' strike early in February. Moreover, in April they then fell back again.

Consumer spending was also affected by the imposition of controls on instalment credit in December. The full impact of such measures, though difficult to quantify, is probably felt quickly and then lessens as prospective buyers are able to meet the larger deposits. Such a pattern appears in the figures for instalment credit in the first quarter (see chart). There was a sharp fall on the fourth quarter in the amount of new credit extended by finance houses and retailers. The amount of debt outstanding also fell, for the first time in a quarter since 1969, but the rate of decline was sharpest in January and became slower in February and still more so in March. Sales of durable goods, one of the categories most affected by restrictive measures in the past, fell by nearly 10% between the fourth quarter average and January, but then recovered by over 6%. New car registrations followed a similar pattern – falling by 22%, but then rising by an average of over 15% in February and March.

Instalment credit and spending on durables

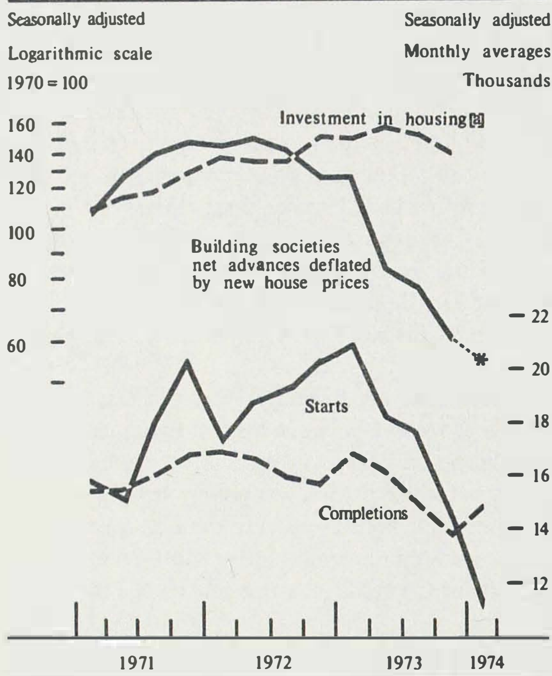


The fall in instalment credit and spending on durables in the first quarter stemmed from the reimposition of controls and short-time working.

*Bank estimate.

The rise in *private fixed investment* which had been getting under way last year – in the fourth quarter it was about 8% up (excluding dwellings) on a year earlier – was checked in the first quarter. Even so, apart from expenditure on shipping, which is often erratic, it held up fairly well. Manufacturing investment was in fact a little greater than in the previous quarter, and over 8% more than a year earlier. For the future, investment intentions, as measured by the CBI survey, suggest a significant slowing down. The results of the January survey, which indicated a sharp decline in the amount of capital expenditure that would be authorised in the following year, were, of course, affected by the industrial conditions prevailing then. However, the survey taken in April, after the Budget and when normal working conditions had been restored, still pointed to a decline, though not such a sharp one.

Housing finance and housebuilding in the private sector



Owing partly to the further decline in building society finance, private housebuilding remained depressed in the first quarter.

[a] At constant prices.

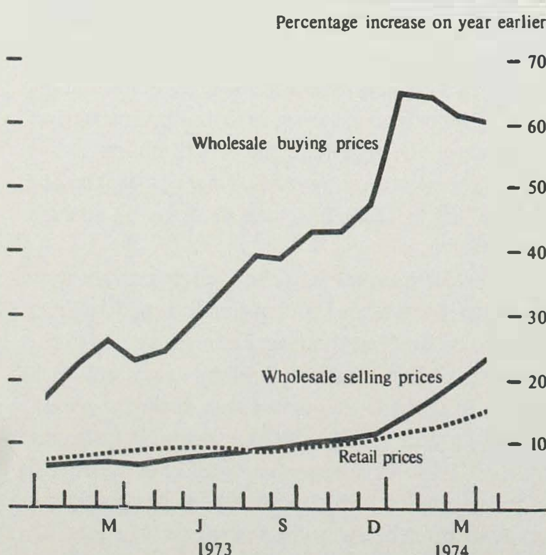
*Bank estimate.

Table K
Retail prices
Percentage increases on a year earlier

	1973				1974
	Mar.	June	Sept.	Dec.	Mar.
Total index	8·2	9·3	9·3	10·6	13·5
of which: food	*3·2*	*3·7*	*3·8*	*4·7*	*4·6*
housing and nationalised industries' prices	*2·1*	*1·8*	*1·8*	*1·7*	*2·0*
other goods and services[a]	*2·9*	*3·8*	*3·7*	*4·2*	*6·9*

[a] Including drink and tobacco, clothing and durable goods, transport, and miscellaneous services.

Retail and wholesale prices



In the first four months of this year, the rate of increase of manufacturers' buying prices abated, whereas for their selling prices it accelerated. For retail prices it continued more steadily upward.

Housebuilding rose slightly in the first quarter, but trends were very different in the public and private sectors. Activity in the public sector increased, with the number of new houses started 37% up on the previous three months, and running at the highest rate in any quarter for two years. Completions also rose, but only half as fast. A number of authorities may have been pushing ahead with new programmes before the reorganisation of local government came into effect on 1st April, and some builders may have switched available resources into the public sector from the more depressed private market. Whatever the explanation, it would seem that any shortages of building materials resulting from the industrial crisis were not so serious as effectively to exhaust existing stocks.

In contrast, the number of new houses started in the private sector in the first quarter fell to the lowest for many years, and was 22% less than in the previous quarter (see chart). Shortages of materials may have had some effect, but most probably builders were attempting to reduce their stocks of unfinished private houses, which, as noted in the last *Bulletin*, were higher at the end of 1973 than at any time since the Second World War; during the quarter, the number fell by 12,000, to just under a quarter of a million, and the number completed was 12% greater than in the previous quarter. Estimates of demand must have been revised downwards in recent months because of the shortage of mortgage funds, while, on the supply side, a heavy volume of work in progress had become increasingly expensive to finance.

Since the Budget, loans have been made available to the building societies by the Bank and the Government to help them continue to provide mortgages while they are experiencing difficulty in attracting resources (see page 140), and this should help to sustain housebuilding.

Stocks held by private industry are estimated to have fallen by about £200 million (1970 prices) in the first quarter. With deliveries being maintained out of stock, the reduction was mainly in finished goods held by manufacturers and retailers. Manufacturers continued to build up their holdings of materials and fuels, partly no doubt because they were using less in production. The overall fall in stocks reversed about a third of the increase that had occurred during 1973, when manufacturers, wholesalers and retailers had all rebuilt stocks to sustain the general increase in activity. With the exception of retailers' stocks, the rise during 1973 was not sufficient, however, to prevent stock/output ratios remaining historically low.

Price and cost developments

The rate of price increase has accelerated sharply this year, and in March retail prices were over 13% higher than a year earlier (see Table K). In April they were over 15% higher. The impact of dearer oil began to be reflected in retail prices, although not all the effects had come through. Food prices, which had made the biggest contribution to the rise in the cost of living during 1973, continued to rise fast; but by the first quarter other prices had begun to rise faster as well. Between March and April, after big increases in indirect taxes, the retail price index rose by 3½%, triggering the threshold pay agreements.[1]

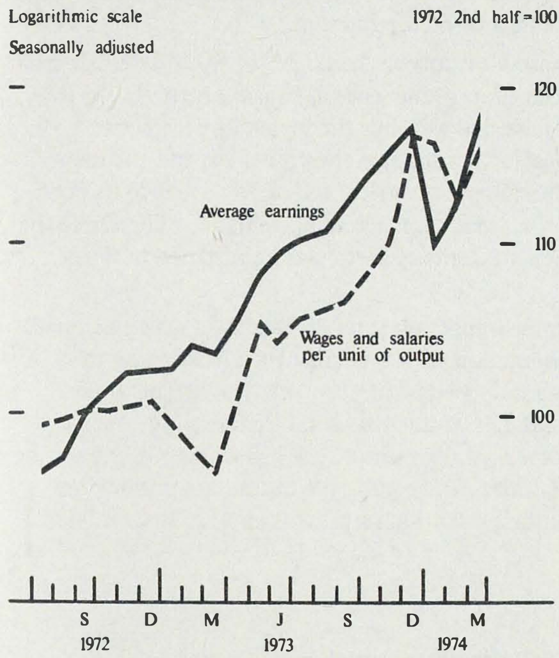
On the other hand, pressure from increasing raw material prices probably began to ease (see chart). Wholesale prices of basic materials and fuels purchased by manufacturing industry rose by less than 3% between January and April, the lowest three-monthly increase for nearly two years. Nevertheless, manufacturers' wholesale selling prices on the home market went up by nearly 10% between January and April, reflecting earlier increases in costs, notably dearer oil and other commodities.

The steadying of basic material prices reflected a moderation in commodity prices: between late February, when they reached at least a temporary peak, and late May they fell by 9%, compared with a rise of about 30% in the previous five months.[2]

[1] December 1973 *Bulletin*, page 409.

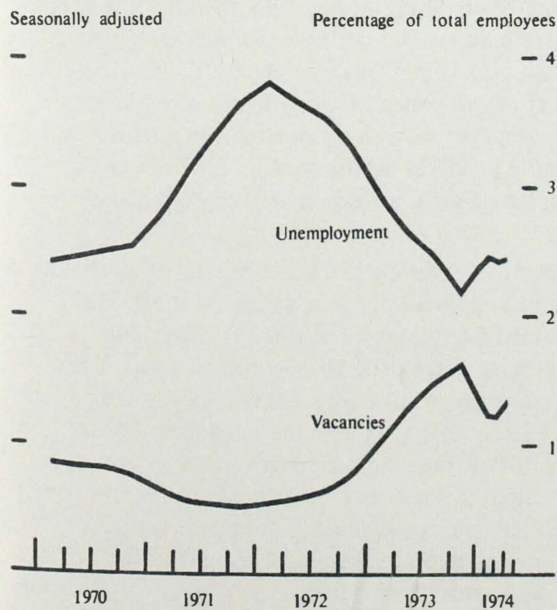
[2] As measured by *The Economist* sterling indicator (provisional for May).

Unit labour costs in manufacturing



The published series for unit labour costs uses three-month moving averages to smooth the figures. The series used above is based upon monthly data (estimated for March), and illustrates more clearly the distortions caused by short-time working.

Unemployment and vacancies



After the turn-round in January, unemployment remained around 2·4%. Unfilled vacancies, however, began to rise again when normal working was resumed.

By contrast, unit labour costs in manufacturing were becoming an important source of inflationary pressure (see chart). Short-time working exacerbated the situation temporarily. Output fell much faster in December than earnings, causing a sharp rise in unit labour costs, and despite falling in February they were some 3% higher on average in the first quarter than in the fourth.

The balance of the economy and the labour market

The shortages of components and materials, which appeared widespread in the last quarter of 1973, inevitably worsened in some cases during short-time working. Steel, plastics, and packaging materials were all reported to be short, although steel output in fact remained higher than had been feared. When short-time working ended, production rapidly recovered in many industries. However, shortages continued to restrict output, with electrical motors said to be a particularly serious problem; and 58% of respondents to the CBI survey in April mentioned material or component shortages as a factor likely to limit output in the following four months. Some 50% of reporting firms were then working below a satisfactorily full rate of operation, as compared with 71% in January and 44% in October.

The labour market grew progressively tighter throughout last year. The imposition of short-time working interrupted this trend. Unemployment rose by around 65,000 (seasonally adjusted) at the count in early January and unfilled vacancies dropped sharply (see chart). Companies were, however, reluctant to lay off workers, and, after the first month, unemployment virtually stabilised, at 2·4%. Unfilled vacancies behaved rather differently: from a recorded high point of 368,000 in November 1973 they had fallen sharply by over 60,000 at the January count, and they fell by another 30,000 in the next two months. Then in April and May, as the recovery from short-time working continued, they rose again, in all by 40,000, while unemployment still scarcely changed. As in previous CBI surveys, many firms cited skilled labour as a constraint on output; two mentioned this in April for every three that reported shortages of materials or components.

The Budget

The Budget was introduced shortly after full-time working was resumed. As already noted domestic demand had been high in the latter part of the last year and shortages had emerged, with the result that resources were probably tending to be diverted from the balance of payments at a time when the announcement of massive increases in oil prices underlined the need for improvement. There was, therefore, clearly a need to keep demand under restraint, a need which had been recognised by the previous Government's decision in December to make substantial cuts in public expenditure and to reintroduce consumer credit controls. The restraint on output during the period of short-time working had exacerbated the tendency for demand to exceed domestic supply, and further shortages had developed. In the meantime the rate of price increase was higher, and cost pressures suggested a continuing inflation of prices. The prospects for demand appeared however to be less buoyant than last year.

In his Budget speech the Chancellor introduced a wide range of measures; the changes both in taxation and in expenditure were large (see Table L on the next page). The yield of the tax increases is expected to be some £1,400 million (about 2% of national income) during this fiscal year, besides the increase in national insurance contributions (not conventionally regarded as a Budget change) of just over £500 million. The main changes in expenditure stemmed from the introduction of food subsidies and (again not classified as a Budget change) the increase in pensions and other social security benefits. The balance between the changes in revenue and expenditure included in the Budget should reduce the prospective public sector borrowing requirement by some £700 million,

Table L

Estimated changes in revenue and government expenditure for 1974/75

£ millions

Increases in revenue	
Income tax and surtax	300
Corporation tax and capital gains tax	420
Stamp duties	80
Value added tax	210
Revenue duties (tobacco, alcohol) and betting duty	380
Total conventional Budget changes	1,390
National insurance contributions	520
Total increase in revenue	1,910
Increases in expenditure	
Food subsidies	500
Housing	210
Public spending cuts; retention of the regional employment premium	- 30
Total conventional Budget changes	680
Pensions and other benefits	860
Subsidies to nationalised industries	-300[a]
Housing subsidies (rent freeze)	70
Total increase in expenditure	1,310
Net increase in public sector borrowing requirement	
Budget measures as conventionally defined	710
All measures covered in the Budget speech	600

[a] Assuming that the total subsidy in 1974/75 would otherwise have equalled that in 1973/74.

Table M

Industrial and commercial companies: sources and uses of capital funds

	1968 to 1970 (annual average)	1971	1972	1973 1st half[a]	1973 2nd half[a]
Total increase in funds (£ millions)	5,710	6,380	9,570	10,770	16,120
Comprising (per cent):					
Undistributed income	*55*	*54*	*48*	*54*	*41*
Capital transfers	*9*	*9*	*4*	*4*	*2*
Bank borrowing	*14*	*11*	*31*	*21*	*40*
Other loans and mortgages	*4*	*5*	*2*	*7*	*6*
Capital issues (UK)	*7*	*6*	*6*	*2*	*1*
Overseas sources	*11*	*15*	*9*	*12*	*10*
Total *identified* use of funds (£ millions)	5,150	6,020	8,160	9,120	14,840
Comprising (per cent):					
Gross domestic fixed capital formation	*57*	*56*	*45*	*44*	*34*
Increase in stocks	*18*	*11*	*6*	*21*	*24*
Liquid financial assets	*2*	*19*	*29*	*16*	*26*
Overseas financial assets	*13*	*7*	*9*	*9*	*10*
Subsidiaries and trade investments	*8*	*10*	*9*	*7*	*8*
Other	*2*	*- 3*	*2*	*3*	*- 2*

[a] At annual rates; seasonally adjusted.

or by £600 million when the extra-Budgetary measures are included. By comparison with the outturn of £4,200 million in 1973/74, the post-Budget estimate for the public sector borrowing requirement in 1974/75 of £2,700 million represents a marked reduction.

The total impact of these measures on demand is likely to be small and was described by the Chancellor in this sense as broadly neutral. The increase in pensions will raise demand, but the increases in direct and indirect taxation and in national insurance contributions, and the reduced financial support for nationalised industries, will serve to reduce it. Food subsidies and the rent freeze, although increasing demand, will restrain the rate of price increase for some items of particular importance to many families.

Although, on balance, the impact on total demand is likely to be small, it needs to be seen in conjunction with the cuts of £1,200 million in government expenditure announced last December. The official forecast suggests that by the second half of this year total final expenditure and national output may be no more than some 2½% higher than in the second half of 1973. The uncertainties surrounding the immediate outlook are recognised in the Chancellor's intention to present another Budget later this year.

Financial and monetary developments

Company finance

The impact of short-time working on industrial and commercial companies' financial positions appears to have been less serious than was originally feared. Perhaps because previous deliveries and a reduction in stocks allowed sales revenue to be maintained in the face of lower output, industrial demand for credit did not increase significantly during the period of restricted production. The return to normal working is likely to be associated with efforts by firms to replenish their stocks to some extent, and at higher prices, which in turn will make claims on their diminished cash flow. As yet, however, this situation does not appear to have had a significant effect on the demand for bank credit, and companies in general have a large cushion of liquid assets to help them.

In the last two years companies have relied more heavily on the banks as a source of funds, partly to build up liquid assets (see Table M). The proportion of funds obtained from retained profits has fallen; and, in the last year or so, companies have raised little by new capital issues. With continuing pressures on company profitability, these trends in the pattern of company financing are likely to continue in the immediate future. During the years 1967 to 1971, when bank lending was subject to continuous official restriction, the volume of outstanding bank borrowing by industrial and commercial companies roughly kept pace with the expansion of gross trading profits. Since then indebtedness to the banks has more than doubled, while gross profits have expanded at only half this rate. Another source of finance which companies have turned to during periods of greater financial tightness, as in 1970/71, is borrowing in one form or another from overseas, and they may do so again.

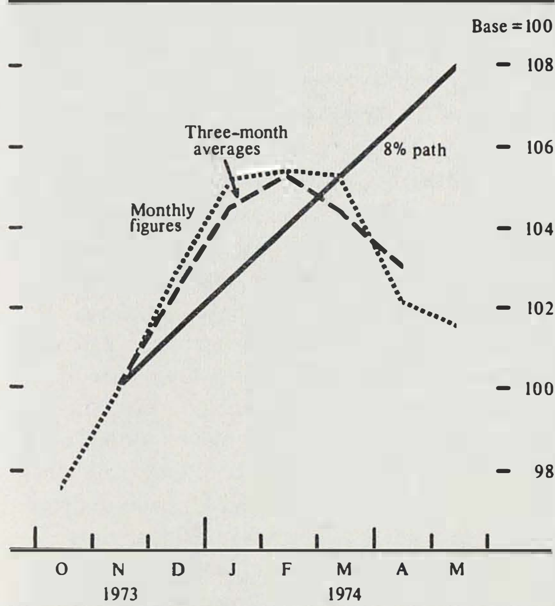
In 1973 stockbuilding made a large claim on company funds; and, as noted above, may now make another. In the last two years, companies allocated a considerable proportion of their funds to the acquisition of liquid financial assets, primarily bank deposits. This increase in their gross liquidity has been associated with the sharp rise in their borrowing from banks — partly as a result of arbitrage transactions, and in fact there has been a fall in their 'net' liquidity (see the chart on the opposite page). Companies might, for a time, wish to overcome a reduced availability of funds by ceasing to build up their liquid assets. This indeed appears to have happened in the first quarter. But some companies may not be in a position to continue to do so.

Supplementary deposits

To allow the banks some time to adjust to the supplementary deposits scheme introduced in December,[1] no deposits are to be paid until July, when the scheme will have been running for six months. The banks as a whole have appeared to be making good progress in restricting the growth in their interest-bearing resources to conform to the guideline (see chart).[2] The average amount of these resources in March to May was 3% above the base figure, well below the 8% path. The banks have been more selective in their lending to the private sector; and have taken steps, as was intended, to tailor their future lending commitments – which had expanded very rapidly in the previous two years – so as to bring them into line with more reasonable expectations of the likely growth in their resources.

In the absence of evidence that companies in general were running into difficulties as a result of the existing restraints on credit, and taking account of the likely pattern of public sector financing and external flows, it seemed appropriate at the end of April to continue the guideline broadly as before. On 30th April the Bank announced that in the six months after April/June the three-monthly average of banks' interest-bearing resources would be allowed to rise above the previous 8% by a further 1½ points a month before liability was incurred to make supplementary deposits. The increase allowed without penalty by next October/December will thus be 17% above the base a year earlier. After any first payments in July (relating to the position in April/June), supplementary deposits will be adjusted each month, like other special deposits. The rates of call of supplementary deposits, and the proportions of 'excess' resources on which they are levied, remain as before, rising to 50% where interest-bearing resources are more than 3% above the guideline.

Interest-bearing eligible liabilities (all banks)



The banks, as a whole, made good progress in keeping within the guideline announced last December.

Money and bank lending

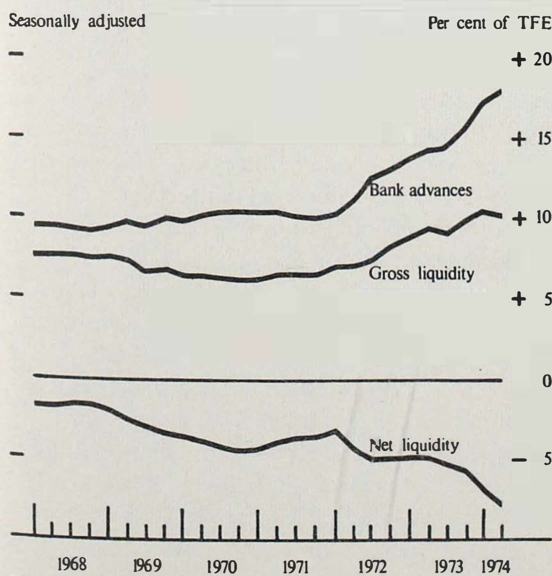
The check to the growth in the banks' interest-bearing resources has been reflected in a slower rate of growth in the broadly-defined money stock (M_3) since the turn of the year. During the three months to mid-March, M_3 rose after seasonal adjustment by no more than 4%, compared with a rise of 6½% in the previous three months. At the same time, M_1, the narrow version of money, actually declined after seasonal adjustment by about ½%. As the chart on the next page shows, in the twelve months to mid-March, M_3 grew by over 25% while M_1 grew only by 2½%. The contrast illustrates the extent to which, at a time of relatively high interest rates, bank customers limited their (mostly) non-interest-bearing current accounts in favour of interest-bearing assets like deposit accounts or certificates of deposit. Such interest-bearing assets were also, of course, swollen at times by arbitrage, as described in earlier issues of the *Bulletin*; and had generally come to play a more important rôle as a home for short-term funds.

In the month to mid-April, the growth of M_3 slowed further, to only ½%. In contrast, M_1 rose by as much as 2½%. So sharp a break with the trend is unlikely to be permanent and, as so often, one month's figures may provide an exaggerated picture. Nevertheless some increase in the rate of growth of M_1 does not seem unlikely if surplus short-term funds resulting from earlier arbitrage and precautionary borrowing are brought into more active use.

As can be seen in Table N (next page), the slower growth in M_3 this year has been associated mainly with a much smaller rise in bank lending to the private sector. Although still large, the increase in such lending after seasonal adjustment was a little under £1,400 million (over 5%) in the three months to mid-March, as against well over £2,000 million (nearly 10%) in each of the two previous three-month periods – when arbitrage, and fears of fresh credit restrictions, inflated the demand for advances.

Sterling advances are much the largest single component of bank lending to the private sector, and their monthly path since June 1973 is shown in

Company liquidity: gross and net[a]



In the last two years gross company liquidity has improved, largely through increased borrowing from banks.

[a] Ratio of company liquid assets, and advances, to total final expenditure in the previous twelve months, which is taken as a proxy for turnover. Gross liquid assets comprise bank deposits, Treasury bills, tax reserve certificates, tax deposit accounts, local authority temporary debt, and deposits with building societies and finance houses. Net liquid assets comprise gross assets less bank advances.

[1] See the March *Bulletin*, page 37.

[2] Details of the banks' interest-bearing eligible liabilities are now included in Table 9 of the statistical annex.

Table N

Influences on the money stock (M_3)

£ millions: *seasonally adjusted*

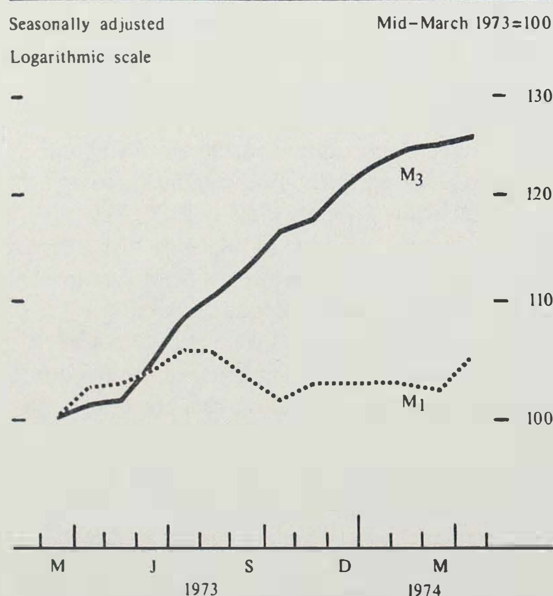
	1973				1974
	Mid-Dec. to mid-Mar.	Mid-Mar. to mid-June	Mid-June to mid-Sept.	Mid-Sept. to mid-Dec.	Mid-Dec. to mid-Mar.
Central government borrowing requirement	+ 570	+ 480	+ 560	+ 270	+ 620
Purchases (–) of central government debt by private sector other than banks[a]	+ 110	– 530	– 360	– 130	– 200
Issue Department offset	*+ 210*	*– 60*	*– 40*	*+ 120*	*+ 240*
Other public sector[b]	+ 10	+ 60	+ 660	+ 430	+ 10
Bank lending to private sector	+1,630	+1,150	+2,100	+2,250	+1,360
External items	– 350	+ 20	– 470	– 600	– 430
Other	– 220	– 40	– 60	– 240	– 110
Money stock (M_3)	+1,750	+1,140	+2,430	+1,980	+1,250
Percentage increase	*+ 7*	*+ 4¼*	*+ 8¾*	*+ 6½*	*+ 4*

[a] Net purchases of commercial bills by the Issue Department in the course of market operations (shown in italics) are included as an offset.

[b] The borrowing requirement of local authorities and public corporations less purchases of local authority and public corporation debt by the private sector (other than banks).

The table follows the general format of Table 12 / 3 of the statistical annex, which was discussed in an article in the December 1972 *Bulletin*, page 512.

Money stock



M_3 rose more slowly from December, while M_1 continued to change little on balance.

the chart on the opposite page. The respective contributions made by the clearing banks and by other banks are also illustrated: bank customers have concentrated upon clearing bank advances whenever these, which are mostly provided at rates related to base rates, have appeared cheap in relation to loans from other banks, which are generally made at rates more nearly related to money market rates. This occurred most noticeably last August and October, and again in March this year. Such shifts of business to the clearing banks have often been wholly or partly reversed in subsequent months, and have usually been accompanied by corresponding shifts of deposits from one part of the banking system to another through the inter-bank market.

The first line in Table N shows that the central government's borrowing requirement (after seasonal adjustment) had a greater expansionary influence on the money stock during the three months to mid-March than in the previous three-month period. It was, however, very largely matched by net purchases of more than £500 million of gilt-edged by the general public (included within the second line), although the effect of these was partly offset by official purchases of commercial bills in the course of market operations (shown separately) and by some encashment of national savings and tax reserve certificates. The rest of the public sector had a broadly neutral effect on the money stock in this period. External items again had a contractionary effect: this entry in the table broadly reflects that part of the balance of payments deficit which is not financed by inflows of capital to the private sector, namely, that financed by running down the foreign currency reserves, or by overseas borrowing by the public sector or by the banking system.

Direction of bank lending

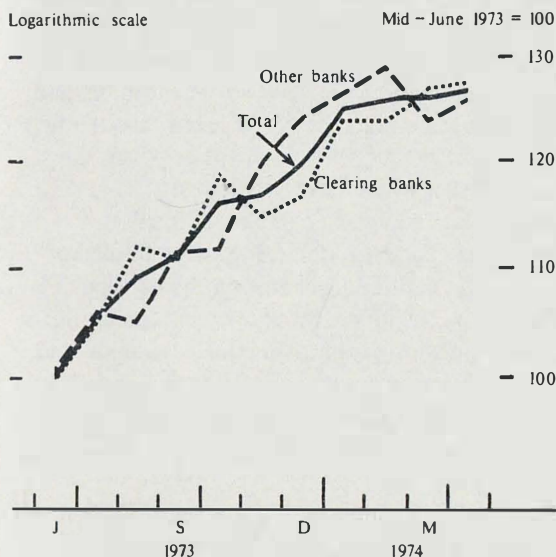
In September 1973 the Governor of the Bank asked the commercial banks to ensure that credit was available for exports, industrial investment, and other essential purposes, and consequently to limit the provision of credit to persons (other than for house purchase), to property companies, and for purely financial purposes. In December they were asked to reinforce this restraint. The direction of lending this year has been in accord with this request, apart from advances to property companies. The bulk of the increase in lending has gone to trade and industry. The most recently available analysis of bank advances (Table 10 of the statistical annex), which is for the three months to mid-February, shows that lending to persons actually fell, by some £130 million (and credit extended by finance houses also fell in this period). Although lending to the 'other financial' category rose by £230 million in the three months, the rise was more than accounted for by lending in foreign currency for investment abroad and support for fringe financial institutions arranged under the Bank's auspices since last December.[1] Apart from the latter, sterling lending to 'other financial' institutions was, in fact, also reduced. Lending to property companies, however, showed an apparently unsatisfactory trend. It continued to rise even though (by £260 million) less sharply than in the previous period (£340 million). To an important degree, full restraint was made impracticable by developments in the property market itself, in that demand for completed properties fell away sharply, so breaking the normal chain of realisations and repayments, while existing commitments had still to be met. The resultant inflation of interest costs, combined with sharp movements in capital values, have created financing problems for property companies, some of which have suffered heavy losses.

Interest rates

With the new arrangements for supplementary deposits providing a more direct influence on the rate of monetary expansion, it has been possible to use general calls for special deposits more flexibly than before. In the months under review a number of repayments were made when tight

[1] See the March *Bulletin*, pages 22 and 54.

Sterling advances to UK residents



Sterling advances rose strongly until the supplementary deposits scheme was announced in December. Relative interest rates have accounted for switches between clearing bank funds and other bank sources.

conditions in the money markets seemed likely to raise short-term interest rates.

Thus, when domestic short-term rates rose in January as the banks' reserve ratios came under pressure following unexpectedly large Exchequer surpluses, a release of ½% of special deposits was made on 4th February. Thereafter money market rates drifted downwards for a time. Heavy tax payments caused a further sharp rise in rates towards the end of February: this time pressure was relieved by official operations and later by the Exchequer's move into deficit. Owing to the shortage of Treasury bills, substantial official help in these months was given by the purchase of commercial and local authority bills, or, to a much lesser extent, by placing funds in the local authority temporary money market. Pressures again built up at the end of March, but the announcement on 4th April of two more releases of special deposits of ½% each, on 8th and 16th April, produced a sharp drop in rates. A further ½% was repaid on 22nd April.

Interest rates remained competitive with those in foreign centres, though they were falling as US rates rose; and there was also a big reduction in differentials over euro-dollar rates – for three-month inter-bank money the differential was 7½% at the end of January and only 2% at the end of April.

In contrast to the rise in most market rates in January, the Treasury bill rate eased, and by 1st February minimum lending rate had fallen from 13% to 12½%. It had fallen further, to 12%, by 11th April, and on the same day the clearing banks reduced their base rates from 13% to 12½%. A more detailed account of recent developments in the financial markets appears later, in the financial review. They included a large drop in asset values, particularly of securities – whether gilt-edged, debentures, or equities – but also of property. In some two years to the low point at the beginning of April, prices of both ordinary shares and long-dated government stocks fell by about 50%. The fall in equity values was comparable to those in 1929–31 and 1937–40.

Conclusion

Despite the uncertainties which have beset the economy, developments so far this year have been in certain respects satisfactory. The period of short-time working imposed less damage on output than might have been feared; and the restoration of normal conditions of production, though no doubt still incomplete, appears to have been fairly rapid. The disruption to firms' finances did not create much demand for additional bank credit. The rate of growth of money on the wider definition (M_3) has been progressively reduced, while on the narrower definition (M_1) it has on balance continued to be small. The value of British exports has continued to grow; their volume was certainly well maintained, and probably increased, despite the dislocation of short-time working; and the trade deficit, abstracting from trade in oil, has shown a substantial decline. As a result of dearer oil, the total balance of payments deficit on current account is running at a rate much higher than last year's. It has, however, been broadly matched by capital inflows; and the exchange rate has been well maintained.

The general situation of the economy clearly remains, nevertheless, one of great difficulty, which will take several years to overcome, and which will require a firm and balanced combination of policies. The problems, though in some respects not unfamiliar, are on a scale which goes beyond previous experience. The direction of policy this year needs to be seen in this perspective.

The United Kingdom is, of course, not alone in facing a worse balance of payments because of the rise in oil prices; and many other countries also will need an inflow of capital to offset a worsening of their external current accounts. It is too early to foresee how smooth this process will be. The full flow of increased revenues has only recently begun to reach the oil-producing countries, and to require to be invested by them on the

world's capital markets. While the development of the markets in the new conditions has been smooth, experience so far has been of a transitional nature. The continued ability of any one country to attract funds on the large scale required will depend in part on the nature of its own policies.

In the longer term this country is favourably placed, in that it has a good prospect of becoming in a number of years self-sufficient in oil, and later of becoming a net exporter. More immediately, it is less favourably placed: even without the effects of the increases in the price of oil, the balance of payments deficit this year would have been on an unprecedented scale. While this deficit is being eliminated, it will be necessary to secure correspondingly large capital inflows. The burden of servicing such debt will be a heavy, continuing charge on the balance of payments – the heavier the burden the longer reliance on external inflows continues. The current account position cannot be remedied quickly; but there is a strong argument for correcting it with as little delay as possible. At the least, progress should be clear and steady. This implies that as national output rises a significant proportion of the increase in resources will have to be devoted to that end.

The least satisfactory aspect of developments this year has been the acceleration of the rate of increase of prices, and the prospect that an unduly rapid rise may continue for some time. Long continuation of this process would jeopardise efforts to improve the balance of payments and weaken the country's international standing. Even apart from the important domestic repercussions, it remains of major importance that price inflation in this country should not outstrip that in its competitor countries.

At the end of last year, there was evidence that shortages of materials and components were increasing, and impeding output generally and production for export. Shortages worsened further during the period of short-time working; and steel, in particular, is still very short. The pressure of demand could, however, begin to ease: this, if confirmed, would provide a sound basis for continued expansion. Prospects for exports appear good: world trade is likely to continue to expand, and British industry is well placed to sell abroad. As part of the pattern of expanding demand, it will be necessary to provide room for the continued strong growth of exports.

The posture of monetary policy needs to be viewed in this general context. So far this year the growth of the monetary aggregates has been contained within acceptable limits, without, however, imposing on the domestic economy conditions of undue financial stringency. Interest rates, although high, are not higher than required to remain competitive with rates abroad. The banks have had room to lend to industry on a substantial scale; and, faced with the need to finance increased investment and dearer stocks, firms have ceased to add to their considerable stock of liquid assets. Development along the present lines should enable monetary expansion to continue to be kept under control.