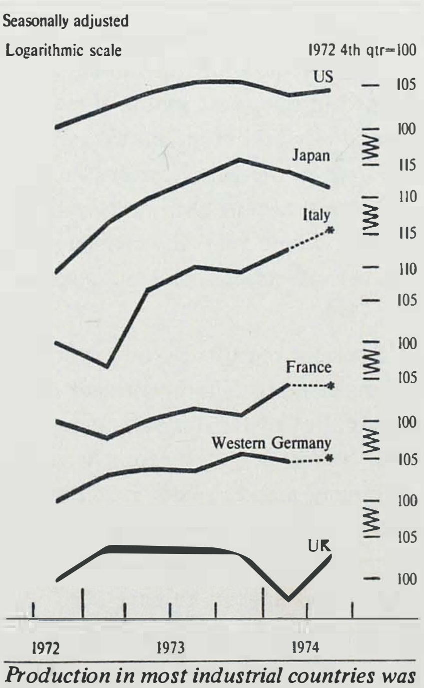
# Economic commentary

Though output recovered quickly from the short-time working at the beginning of the year, the rise in the second quarter barely reversed the reduction in the first. Because of the weaker trend of demand, unemployment has increased; but shortages of materials and components, widespread at the turn of the year, to some extent persist. In other industrial countries, also, the rise in output has been very limited.

The balance of payments on current account remained in large deficit in the second quarter: at slightly over £1,000 million after seasonal adjustment it was about as big as in the first quarter. Good signs were that, while the trade deficit in oil increased, the non-oil balance again improved, both in volume and in value, and that the terms of trade ceased to worsen. Other industrial countries aside from Western Germany also incurred large deficits – though not as big as this country's. These, as here, were largely matched by capital inflows.

The rate of monetary expansion, though subject to largely fortuitous fluctuations, remained relatively restrained; and only a few of the banks, while continuing to lend to manufacturing industry on a substantial scale, ran into the penalty area under the supplementary deposits scheme. Companies may now be entering a period of increasing financial difficulty, stemming not from monetary restraint but from the limited prospects for profits.

**Industrial production**




*Production in most industrial countries was lower in the first half of 1974, partly through the oil crisis, partly through capacity constraints.*
*Bank estimates.

## International developments

The previous rapid upswing in demand in industrialised countries came to a halt around the turn of the year. There was in fact a small fall in the total output of the OECD countries in the first half of the year. This was mainly attributable to the United States, where there was a fall of nearly 1½%; output also fell in Japan, as well as in the United Kingdom; and although increases occurred elsewhere, they were only modest. The statistics for the second quarter point to a slight recovery in industrial production in the United States and production continued to grow in Italy; but in France and Western Germany industrial output appeared to flatten out, and in Japan, where the impact of oil prices has been most severe, it fell further (see chart). Thus, any tendency for demand and output to recover in industrialised countries is undoubtedly weak as yet. Slack continues to develop in most economies, and unemployment is rising.

Price inflation continued at alarming rates in industrialised countries during the second quarter (see Table A). In many of them, however, though not in this country, the rate of increase was slower than in the first quarter, when the big increase in oil prices made its main impact.

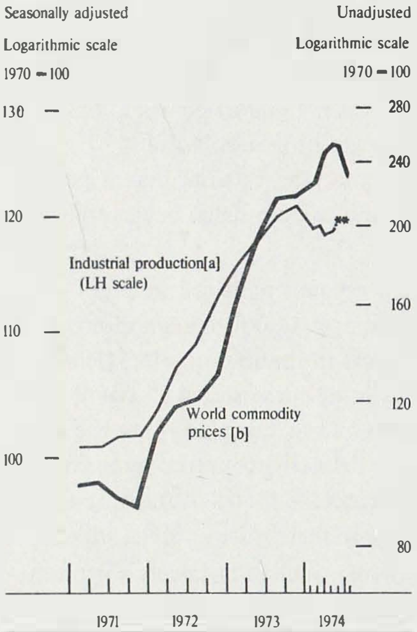
**Table A**
**Consumer prices in industrial countries**
**Percentage increases on three months earlier**

| | 1973 | | | 1974 | |
|---|---|---|---|---|---|
| | June | Sept. | Dec. | Mar. | June |
| Italy | 3·5 | 1·8 | 3·4 | 6·5 | 4·2 |
| France | 2·4 | 2·4 | 2·6 | 4·2 | 4·0 |
| Canada | 2·8 | 2·9 | 1·6 | 2·8 | 3·6 |
| Japan | 3·8 | 4·4 | 4·7 | 8·1 | 3·4 |
| United States | 2·0 | 2·4 | 2·2 | 3·3 | 2·8 |
| Western Germany | 2·3 | 0·3 | 2·9 | 1·9 | 1·6 |
| Sweden | 2·0 | 0·9 | 2·8 | 4·7 | –0·2 |
| United Kingdom | 3·2 | 1·6 | 3·5 | 4·6 | 5·9 |

Source: OECD.

Although reduced demand in industrial countries has scarcely yet affected domestic prices, which have been kept up by the costs of dearer oil, it is apparently influencing world commodity prices, which generally stopped rising in the second quarter after increasing by nearly 50% in the previous twelve months (as measured by *The Economist* dollar index – see chart). The peak appears to have been reached in late April, and the fall since then is attributable to industrial materials, especially metals. Food prices in this period showed no tendency to fall, although the rate of increase on balance slackened considerably:

**Output in industrial countries and commodity prices**




*Commodity prices, other than oil, started falling in April, largely through reduced demand in industrial countries.*

[a] Canada, France, Italy, Japan, the United Kingdom, the United States, and Western Germany.

[b] *The Economist* world commodity price index (excluding oil) in $ terms; reproduced with permission.

*Bank estimates.

**Table B**

**Current accounts of industrial countries**[a]

$ billions: *seasonally adjusted*

| | 1973 | 1974 | |
|---|---|---|---|
| | | 1st qtr | 2nd qtr |
| | | (annual rates: provisional) | |
| Western Germany | 4·7 | 10 | 10½ |
| Canada | −0·4 | − 1 | − 2 |
| United States | 0·7 | – | − 3½ |
| France | −0·2 | − 5 | − 6 |
| Japan | −0·1 | −10½ | − 7 |
| United Kingdom | −3·3 | − 9 | −10 |
| Italy | −2·4 | − 9½ | −10½ |
| Other OECD countries | 3·8 | −10 | −12 |
| All OECD countries | 2·8 | −35 | −40½ |

[a] Including official transfers.

by the end of the first quarter they were over 50% higher than a year earlier; they then changed little in the second quarter, before rising again in July, when the prices of sugar, wheat and cocoa, in particular, increased further.

Now that the cost of dearer oil has been largely absorbed into domestic prices, the falling prices of other industrial materials should help to reinforce the counter-inflationary policies being pursued in most countries, even though for foodstuffs the situation is clouded by uncertainties about harvests, particularly in the United States and Canada.

World trade in manufactured products has remained remarkably buoyant despite the reduction in demand in industrial countries. Much of the increase has been due to higher prices; even so, the volume appears to have risen at an annual rate of some 9% in the first half of the year, after a record increase of nearly 15% in 1973. Import demand was strong and strengthening in the oil-producing countries. Also, other primary-producing countries, whose reserves had doubled during 1972 and 1973 with the rapid increase in commodity prices, appear to have maintained their demand for manufactured goods despite having to pay much more for their imports of oil.

In the second quarter, the pattern of current account surpluses and deficits among the main industrial countries was very much as in the first (see Table B). Western Germany continued in large surplus, and all other countries ran deficits, which, except for those of the United States and Japan, were broadly unchanged in size. As a group, these countries were in deficit with the rest of the world at an annual rate of some $40 billion, a slightly higher rate than in the first quarter. Within the total, they appear to have been running a surplus with developing countries other than oil producers. For the whole year, the estimate of the worsening from the direct and indirect effects of dearer oil is some $50 billion.

From January to July the surplus of current receipts by oil-exporting countries will have been some $25 billion or more. The investment of the surplus can be identified only roughly, but so far it would seem that up to one eighth of it corresponds to increased sterling exchange reserves or privately held banking and money market assets in sterling. There has also been some buying of other assets in this country such as equities and real estate, and some increase in euro-sterling deposits held elsewhere. Most of the rest of the surplus appears to have been held in dollars, either direct in the United States or as euro-dollar deposits, mainly in London.

Some two thirds of the industrial countries' combined current deficit in the first half-year was financed by capital inflows (see Table C). Reserves fell only slightly in the first quarter, but in the second a slightly larger deficit coupled with a somewhat smaller capital inflow led to a fall of around $6 billion. The statistics for the second quarter, which are far from complete, show some changes in the pattern of capital flows. Most significantly, the United States' balance on official settlements moved into large deficit. But some part of the capital outflow of $3½ billion included in the balance represented a recycling of funds by the American banking system. An increase in liabilities mainly stemming from larger placements of oil-producing countries' official balances in New York was accompanied by an increase in foreign lending by American banks, particularly – as in the first quarter – to Japanese banks.[1] In Italy the reserves were drawn on in

[1] For the balance on official settlements, recycling by US banks is treated as an outflow; but any inflows from central monetary institutions are not treated as reducing it.

**Table C**

**Summary balances of payments of industrial countries**

$ billions: *not seasonally adjusted*

| 1973 | Current account[a] | Total capital[b] | Official reserves |
|---|---|---|---|
| United States | 0·7 | −6·0 | −5·3[c] |
| Western Germany | 4·7 | 4·7 | 9·4 |
| Canada | −0·4 | 0·1 | −0·3 |
| France | −0·2 | −1·3 | −1·5 |
| United Kingdom | −3·3 | 3·8 | 0·5 |
| Italy | −2·4 | 2·8 | 0·4 |
| Japan | −0·1 | −6·0 | −6·1 |
| Other OECD countries | 3·8 | 5·1 | 8·9 |
| All OECD countries | 2·8 | 3·2 | 6·0 |
| **Jan.–June 1974** | | | |
| United States | ½ | − 3 | − 2½[c] |
| Western Germany | 5 | − 4 | 1 |
| Canada | − 1 | 1½ | ½ |
| France | − 3 | 2½ | − ½ |
| United Kingdom | − 5 | 5 | – |
| Italy | − 6 | 4½ | − 1½ |
| Japan | − 6 | 7 | 1 |
| Other OECD countries | − 6 | 1½ | − 4½ |
| All OECD countries | −22 | 15 | − 7 |

[a] Including official transfers.
[b] Including errors and omissions.
[c] Balance on official settlements.

the second quarter, and they fell by $1½ billion, whereas in the first quarter, when nearly $2 billion had been made available under the short-term support arrangement of the European Monetary Co-operation Fund and when public sector borrowing had been heavier, they had risen slightly. A net capital outflow from Western Germany was much smaller than in the first quarter, and the reserves increased. Elsewhere capital inflows were broadly similar in both quarters. The United Kingdom continued to make substantial use of public sector borrowing.

The large and rapid deterioration in industrial countries' current accounts was met by borrowing considerably more in the international capital markets, especially the euro-dollar markets. In particular, medium-term foreign and international bank credits announced in the first seven months of the year, though not necessarily drawn yet, were well above the amounts arranged in the whole of last year; and out of an identified total of $21½ billion some $15½ billion – mostly public sector credits – were for industrial countries. There was, however, a distinct decline in new arrangements during the second quarter.

In general, despite the changes noted above in the pattern of flows, and except possibly for the smaller OECD countries, capital flows during the first half of the year followed individual countries' financing needs fairly closely, and changes in official reserves were modest. Nor did the strains created by the abrupt increase in oil prices lead to particularly marked fluctuations in exchange rates. For each of the main currencies, the average week-to-week effective change in its exchange rate from last September to the end of July was under 1%, and variations were not noticeably larger than in the immediately preceding period.

Continued monetary restraint in the United States and strong domestic demand for loans kept short-term interest rates there high and rising. In other countries, mostly also pursuing counter-inflationary policies, interest rates generally remained firm or rose. The rise in interest rates in the international markets also reflected a growing uncertainty about the ability of the markets to absorb the considerable increase in euro-currency business. Euro-dollar rates reached new records in June – 13½% for three-month money, for example – and towards the end of the month were at times above comparable sterling rates in London. Rates went higher still in July.

Towards the end of the second quarter signs of tension were appearing in financial centres and some banks were expressing concern about the volume of business being undertaken. The Herstatt failure in Western Germany and the announcements of heavy losses in foreign exchange dealings by the Franklin National Bank of New York increased the anxieties. These spilt over into the euro-currency markets. The expansion of new credit slowed markedly and terms hardened: maturities tended to shorten, and, in some instances, the margin over the inter-bank rate charged to borrowers widened. Amid the resulting uncertainty, some smaller banks found it difficult for a time to obtain funds in the inter-bank market; and this was reflected in the emergence of a multi-tiered interest-rate structure.

Following these events the markets have adopted more prudent and realistic attitudes; lines of credit have been reviewed, and turnover in foreign exchange has fallen sharply. At the same time there have been a growing number of direct arrangements by the oil-producing countries for investing their surplus funds, such as the medium-term credit lines the Iranian Government have made available to nationalised industries in the United Kingdom, and the recent Iranian investment in Krupps in Western Germany.

In London the regular surveys of euro-currency business are being made more frequently;[1] and in other countries regulations affecting banks' foreign exchange positions have been introduced or tightened. These developments are part of a general move towards closer surveillance of these markets and a wider sharing of the responsibility for their health and stability.

## The UK balance of payments

### The current account[2]

In the second quarter the current account deficit grew by £65 million to £1,050 million. The worsening was in visible trade – net invisible receipts increased a little to £310 million (see Table D). The growth in the visible trade deficit to £1,360 million was, as in the first quarter, more than accounted for by trade in oil, where the deficit increased from £720 million to £915 million.[3]

Besides higher tax and royalty payments to producing countries based on the new posted prices – these were introduced in January but did not affect all the oil imported during the first quarter – the extra cost of oil in the second quarter reflected revised participation terms so far settled between oil companies and exporting countries. In total, imports of oil cost about 30% more than in the first quarter, and over four times as much as in the third quarter of last year before prices went up.

All this has masked an improvement in the remainder of the visible trade balance, which has come entirely from the volume of trade (see Table E) and re-establishes a tendency which had begun early in 1973 but which had been interrupted at the end of the year when the pressure of demand on domestic resources was particularly high.[4] Both imports and exports have contributed. In the second quarter the volume of imports was over 3% smaller than two quarters earlier. Not surprisingly, there had been a fall in the first quarter when industry had been working short time; but there was a similar drop in the second despite the recovery in production. On the same comparison exports rose by 7%, but much of the increase occurred in February, since when the monthly volume has been little changed, partly, perhaps, because world markets have been growing more slowly. Many firms report full export order books, and with the reduction in the pressure of domestic demand these orders should, perhaps, be more easily met. But firms appear less confident than earlier of winning new orders.

Until about April these gains from the volume improvement in trade had been outweighed by the worsening terms of trade associated first with the fast rise in commodity prices generally and then with that in oil prices. But during the second quarter the terms of trade improved, if only just, reflecting a rapid increase in export prices and a slower rise in import prices (see chart). In March the terms of trade had been over 25% worse than in the middle of 1972, nearly two thirds of which could be attributed to the exceptional increase in commodity prices (including oil).[5] But between February and mid-August, according to

**Table D**

**Current account of the UK balance of payments**

£ millions: *seasonally adjusted*

| | 1973 | | 1974 | | |
|---|---|---|---|---|---|
| | 3rd qtr | 4th qtr | 1st qtr | 2nd qtr | July (estimated) |
| Visible trade balance | −605 | −1,020 | −1,285 | −1,360 | −480 |
| *of which:* | | | | | |
| *oil*[a] | *−235* | *− 300* | *− 720* | *− 915* | *−345* |
| *non-oil* | *−370* | *− 720* | *− 565* | *− 445* | *−135* |
| Net invisibles | +330 | + 460 | + 300 | + 310 | +105 |
| Current balance | −275 | − 560 | − 985 | −1,050 | −375 |

[a] The balance of trade in petroleum and petroleum products (Standard International Trade Classification 33).

**Table E**

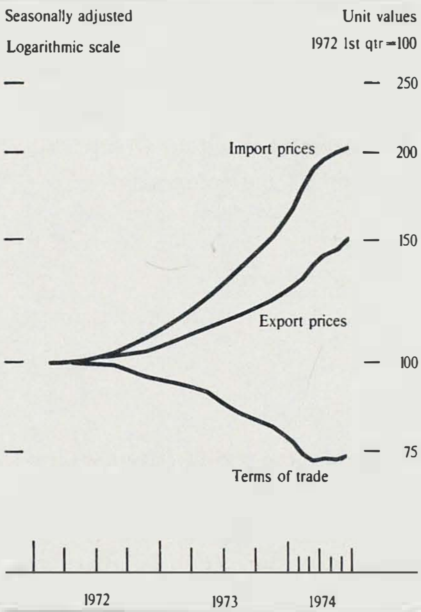
**Estimated sources of changes in the visible trade deficit**

£ millions: *seasonally adjusted*

| | 1973 | | 1974 | |
|---|---|---|---|---|
| | 3rd qtr | 4th qtr | 1st qtr | 2nd qtr |
| Deficit | −605 | −1,020 | −1,285 | −1,360 |
| Change | | −415 | −265 | − 75 |
| *of which:* | | | | |
| *oil* | | *− 65* | *−420* | *−195* |
| *non-oil* | | *−350* | *+155* | *+120* |
| Volume | | −155 | +180 | +130 |
| Price | | −195 | − 25 | − 10 |

[1] See page 306.
[2] This section is written in seasonally-adjusted terms.
[3] Trade in petroleum and petroleum products (Standard International Trade Classification 33). This provides only a partial measure of the effect of dearer oil on the balance of payments, for the cost of oil will have affected the prices of and the demand for goods and services generally, both imports and exports, besides effects on other flows such as interest payments.
[4] March *Bulletin*, page 4.
[5] If world prices of traded commodities and manufactures had risen at the same rate, the deterioration in the UK terms of trade might have been some 10% – accounted for by the depreciation of sterling, partly offset by UK inflation being greater than in competitor countries. The remainder is therefore attributed to the exceptional rise in oil and other commodity prices.

## Prices of exports and imports




*With a slower increase in import prices but faster rising export prices, the terms of trade improved during the second quarter for the first time since mid-1972.*

**Table F**

**Financing of the current account deficit**

£ millions: *not seasonally adjusted*

| | 1973 | | | 1974 | |
|---|---|---|---|---|---|
| | 2nd qtr | 3rd qtr | 4th qtr | 1st qtr | 2nd qtr |
| Current balance | –190 | –230 | –410 | –1,080 | –1,020 |
| Capital transfers | – 20 | – | – | – | – 30 |
| | –210 | –230 | –410 | –1,080 | –1,050 |
| Financed by: | | | | | |
| Public sector foreign currency borrowing | +280 | +360 | +360 | + 340 | + 500 |
| Increase (+) in sterling holdings (official and private)[a] | +180 | –420 | +160 | + 190 | + 360 |
| *of which, from oil-exporting countries* | *+ 60* | *– 60* | *+260* | *+ 270* | *+ 600* |
| Increase (+) in UK banks' other net foreign currency borrowing[b] | + 50 | – 60 | + 70 | – 160 | – 50 |
| Other capital flows[c] | + 80 | + 90 | –160 | + 670 | + 350 |
| *of which, net investment – 'oil and miscellaneous'* | *+110* | *+250* | *– 40* | *+ 420* | *+ 400* |
| Decrease (+) in reserves | –380 | +260 | – 20 | + 40 | – 110 |

[a] Excluding sterling held by international organisations.
[b] Excludes borrowing to finance lending to UK public bodies and for UK private investment overseas.
[c] Includes direct and portfolio investment and the balancing item.

Further detail is shown in Table 20 of the statistical annex. Oil-exporting countries are listed under Table 24.

*The Economist* sterling indicator, commodity prices (other than oil) fell by some 5% on balance. As changes in commodity prices tend to be reflected in the cost of imports only after a lag, the fall should continue to contribute towards an improvement in the terms of trade for some time. Meanwhile British export prices rose by almost 10% in the second quarter. This increase has undoubtedly helped the balance of payments in the short run and may well have improved the profitability of exports. But it was almost certainly greater than the rise in export prices of other industrial countries, and so implies some reduction in the competitiveness of British exports in world markets at a time, as noted earlier, when these markets are likely to be growing more slowly.

In July imports and exports were little changed, and the trade deficit was much the same by value for the third month running.

The surplus on invisible transactions increased slightly in the second quarter. Most of the improvement was in shipping and other services. There was a smaller total of net earnings of interest, profits, and dividends, which had been temporarily inflated over the turn of the year by an exceptional amount of realised stock appreciation by oil companies.

### The financing of the deficit

The current account deficit in the second quarter was £1,020 million before seasonal adjustment. Payments to certain official overseas holders of sterling under the guarantee arrangements which ran from last September until March amounted to nearly £30 million. This brought the financing requirement to £1,050 million (see Table F).

The financing was achieved, as in the first quarter, without difficulty, even though uncovered short-term interest-rate differentials in favour of sterling narrowed considerably and at times disappeared (see the financial review, page 265). The official reserves rose by £110 million – and fell by £16 million in July – with little effective change in the exchange rate. The euro-dollar facility of \$2·5 billion, arranged for the Government in March,[1] was not drawn upon. On 22nd July, the Chancellor announced that the Iranian Government was to extend a line of credit for \$1·2 billion to be drawn as three separate loans by public sector bodies within the next three years.

The largest source of finance during the second quarter was foreign currency borrowing by public sector bodies. They borrowed £500 million, mainly in April, of which £435 million was under the exchange cover scheme.

An increase in overseas sterling holdings also contributed significantly. They rose by £360 million of which £165 million was on official account. The increase was more than accounted for by oil-exporting countries,[2] whose holdings rose by about £600 million, thus continuing the movement which began in the first quarter. In the first six months of the year these countries received over £3,500 million as oil revenues paid in sterling, and of this they retained some £860 million in sterling balances. In July their holdings of sterling rose further still.

Other inflows in the second quarter contributed some £300 million. As in the first quarter a substantial amount came from oil company transactions, but unrecorded flows this time made little difference. Also as in the first quarter, the banks reduced their net external liabilities in foreign currencies, apart from their borrowing to lend to the public

[1] June *Bulletin*, page 126.
[2] Those listed under Table 24 of the statistical annex.

**Table G**

**Domestic activity**

Percentage changes in volume: *seasonally adjusted*, quarterly rates

| | 1st half 1973 to 2nd half 1973 | 2nd half 1973 to 1st half 1974 | 4th qtr 1973 to 1st qtr 1974 | 1st qtr 1974 to 2nd qtr 1974 |
|---|---|---|---|---|
| Gross domestic product (output measure) | +0·2 | −1·1 | −2·9 | +2·1 |
| *including industrial production* | *−0·1* | *−1·8* | *−5·7* | *+5·4* |
| Consumers' expenditure | − | −1·0 | −0·6 | −1·1 |
| *including retail sales* | *+0·7* | *−1·2* | *−2·0* | *−2·6* |
| Exports of goods | +1·0 | +2·1 | +3·5 | +3·4 |
| Imports of goods | +2·8 | −0·5 | −1·7 | −1·5 |

**Table H**

**Changes in total final expenditure** [a]

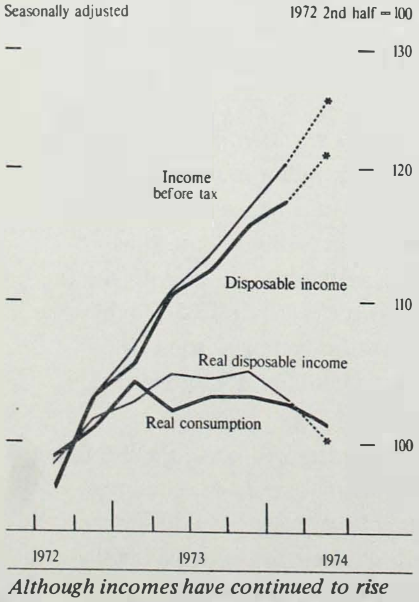
Percentages: *seasonally adjusted*, constant prices, quarterly rates

| | 1st half 1973 to 2nd half 1973 | 2nd half 1973 to 1st half 1974 (estimated) | 4th qtr 1973 to 1st qtr 1974 | 1st qtr 1974 to 2nd qtr 1974 (estimated) |
|---|---|---|---|---|
| Total final expenditure | +0·2 | −0·3 | −1·3 | +2·1 |
| Accounted for by: | | | | |
| Domestic expenditure (other than stockbuilding) | +0·3 | −0·4 | −0·3 | −1·1 |
| *of which:* | | | | |
| *consumers' expenditure* | − | *−0·3* | *−0·3* | *−0·6* |
| *public spending* [b] | *+0·2* | *+0·1* | *+0·3* | *−0·4* |
| *private fixed investment* | *+0·1* | *−0·2* | *−0·3* | *−0·1* |
| Stockbuilding | −0·3 | −0·3 | −1·8 | +2·4 |
| Exports of goods and services | +0·2 | +0·4 | +0·8 | +0·6 |

[a] Changes in the components of total final expenditure expressed as percentages of the total in the previous period.

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

**Personal incomes and consumption**




*Although incomes have continued to rise strongly, in real terms they have fallen, as has personal consumption.*

*Bank estimates.

sector and to finance private investment abroad. The reduction was again associated with a large increase in the foreign currency deposits of domestic customers, notably oil companies.

During the quarter the exchange rate was generally steady, fluctuating narrowly with only occasional intervention in the market. At the end of August the effective depreciation of the pound since the Smithsonian realignment was 18%. It has remained within a range of 16% to 20% since the big increase in oil prices and consequent worsening of the current deficit.

## The domestic economy

### Output and demand [1]

To judge from the limited evidence available, the rise in output in the second quarter did not entirely reverse the reduction which occurred in the first. Industrial production increased by 5½% and total domestic output by 2% (see Table G). Having picked up sharply in February and with the return to normal working in March, industrial production rose by less than ¼% between April and June.

The rise in total final expenditure in the second quarter was, as expected, largely accounted for by renewed stockbuilding (see Table H). The fall in domestic expenditure excluding stockbuilding was probably larger than in the first quarter, owing mainly to the continuing decline in consumer spending, and also to a further small reduction in private fixed investment. In contrast, exports of goods and services again rose strongly in volume. There was thus a marked change in the composition of expenditure and, in conjunction with a fall in imports, a pronounced shift of resources into the balance of payments in the first half of the year. However, the volume of exports decreased slightly within the second quarter.

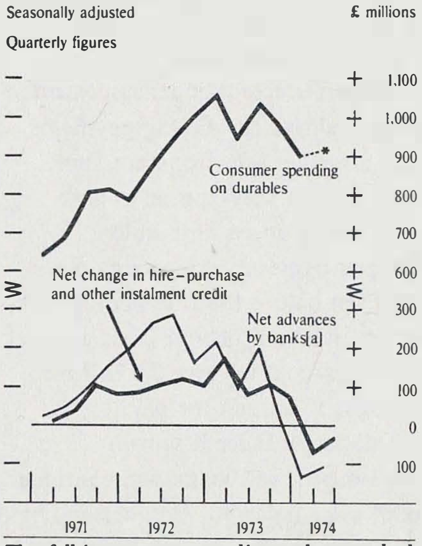
*Consumer spending* is provisionally estimated to have fallen in volume by 1% in the second quarter to the lowest total since late 1972 (see chart).

Income from employment rose sharply. Earnings recovered with the end of short-time working and were supplemented by threshold payments from the end of May; and in all, average earnings covered by the official index rose by about 7½% in the quarter. Other personal incomes, mainly of self-employed and professional people, probably rose less in total; and dividend payments may well have been lower than in the first quarter, when they appear to have been unusually high. But, as in the first quarter, prices absorbed all, or almost all, of the rise in pre-tax incomes. Accordingly, after taking into account income tax and other deductions, real personal disposable income fell — as it had done in the first quarter — by perhaps 1½%. Despite a further probable fall in the rate of personal saving (although it was still somewhat above the average over the last few years), consumer spending fell significantly.

The hire-purchase controls announced in December have also checked consumer demand, as has continued restraint exerted by banks on lending to persons. As past experience would suggest, the effect of the hire-purchase restrictions seems to have diminished somewhat after three or four months. Sales of consumer durable goods, including cars, were unchanged in volume in the second quarter, compared with a drop of nearly 12% in the first immediately after the introduction of

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

## Consumer credit and spending on durables

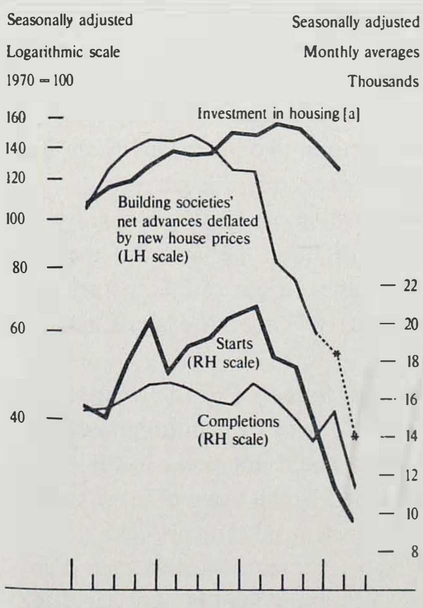



*The fall in consumer credit was less marked in the second quarter: spending on durables picked up slightly in money terms.*

[a] Net advances, excluding those for house purchase, by all banks to persons.

*Bank estimate.

## Housing finance and housebuilding in the private sector




*Private housebuilding was very depressed in the second quarter.*

[a] Gross fixed investment in dwellings at constant prices.

*Bank estimates.

the controls. Net hire-purchase debt incurred by consumers fell in the second quarter – as indeed it had, for the first time in four years, in the first quarter. The rate at which indebtedness is falling has, however, slowed down since December, and the pattern has been very much the same for bank lending to persons (see chart).

After a slight recovery in March, retail sales – which amount to about one half of consumer spending – fell sharply in volume in April and again in May, but picked up in June and July, partly no doubt because of the boost to incomes given by threshold agreements in May and June.

*Private fixed investment* fell further in the second quarter. The decrease was especially marked for investment in the distributive and service industries; but manufacturing investment too, which rose by 4½% in the first quarter, fell in the second, by 1½%. The recovery in investment which began early in 1973, particularly in manufacturing industry, therefore appears to have been checked. This is consistent with the results of the Department of Industry's investment intentions survey carried out in April and early May, which, given the rate already reached in the first quarter, implied less investment in the rest of the year. Further indications of a cutback are given by replies to the CBI survey conducted in July, which showed an increased balance of firms expecting to reduce capital authorisations in the next twelve months compared with the last. The prospect of weakening demand was the principal explanation given, but a higher proportion of firms cited shortages of finance as a constraint on future spending.

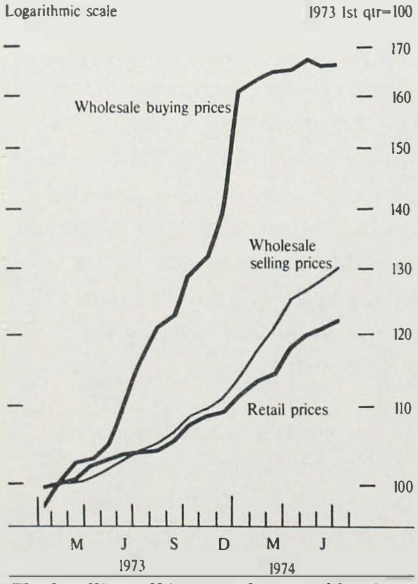
In the second quarter, as in the first, trends in *housebuilding* were very different in the public and private sectors. The number of new houses started in the public sector increased, though by under 2% – compared with as much as 37% in the previous quarter, which had been heavily affected by the acceleration of new programmes before the end of the financial year and the reorganisation of local government.[1] The number completed also rose slightly but remained appreciably below starts, no doubt reflecting the fairly low rate of starts during most of 1972 and 1973. In contrast, activity continued to fall steeply in the private sector, where the number of new houses started declined by 15% and completions by 27%. As completions still exceeded starts, it appears that builders were further reducing their historically large stocks of uncompleted houses.

The severe reduction in private housing starts has been associated with a steep fall in net advances by building societies, which provide some 80% of all lending to finance private housing. In the second quarter net advances were unusually low, particularly in real terms (see chart). The immediate prospects for housing finance seem somewhat more encouraging. In the second quarter the societies' net receipts of funds from the public picked up strongly; and they also drew the first £200 million of the loans extended to them by the Bank and the Government.[2] Since then, the societies have drawn most of the remaining three tranches of £100 million each. These developments together have permitted an appreciable improvement in the societies' liquidity position and a sizable increase in their new commitments (see chart on page 272).

*Stockbuilding* in private industry in the second quarter broadly reversed the fall in stocks in the first.

[1] June *Bulletin*, page 128.
[2] June *Bulletin*, page 140.

**Retail and wholesale prices**




*The levelling off in manufacturers' buying prices is yet to be fully reflected in their selling prices or in retail prices.*

### Wages and prices

The Pay Board was disbanded on 25th July; and with it went the provisions governing wages and salaries under the third stage of the counter-inflation policy. By the end of June, the board had been notified of threshold pay agreements covering some eight million workers, although more in fact may have been affected. Under agreements negotiated before 21st June employees qualified for weekly payments of up to £1·20 a week from late May, a further 80p from late June, and 40p in each of July and August. Although they appear to have been granted to less than half the total labour force, threshold payments clearly contributed to a sharp increase in labour costs per unit of output in the second quarter. Even before the first became due, wage costs were rising sharply. Manufacturers' unit labour costs are estimated to have risen by about 5% in May and by over 3% in June. Although the third stage has been brought to an end for pay settlements, threshold arrangements negotiated under it remain operative unless subsumed in later settlements, and many will continue until late in November, when the retail price index for October will be published. However, not all eligible workers receive the full payments because, for example, some employers are unable to afford them all.

In anticipation of the resumption of collective bargaining without statutory controls the TUC has offered guidelines to member unions in accordance with its understanding of the 'social contract'. These recognise that there is little scope at present for real increases in consumption and suggest that a central objective of negotiators should be the maintenance of real incomes.

By July, the rate of increase in retail prices over the previous twelve months had risen to over 17% (see chart); and between March and July alone they rose by almost 7%, partly as a result of some of the measures announced with the Budget, including the rises in fuel prices. Some respite was gained from the Chancellor's measures of 22nd July (see page 259). More lasting relief will result from the easing of commodity prices, which, after soaring during the second half of 1972 and throughout 1973, have fallen on the whole in recent months; by the middle of August, *The Economist* sterling index of commodity prices (excluding oil) was 5% below its peak in February. Manufacturers' buying prices (including oil) have already begun to reflect this reduction. Their rate of increase diminished sharply after January, in June they fell for the first time in two years, and there was virtually no change in July. As would be expected, this was not immediately reflected in manufacturers' selling prices, which rose by 7½% in the second quarter, compared with 7% in the first. But there was a marked deceleration during the quarter: a rise of 3% in April was followed by increases of 1¾% in May and 1½% in each of June and July.

It will be several months before the full influence of the changes in wholesale prices affects retail prices, and to help contain inflation it is vital that a sharp acceleration in earnings should not occur in the meantime. Some pay settlements concluded in the wake of stage three have clearly been well above the earlier growth of earnings, and a continuation of settlements at these high rates would generate an even faster increase in labour costs per unit of output than in May and June, offsetting the relief from more stable raw material prices.

### The balance of the economy and the labour market

Since the end of last year the pressure of demand on resources has eased somewhat. Total final demand and total output in the second quarter were slightly lower than in the fourth quarter of last year, as were imports. But firms have had to adjust to an unusual set of developments this year: the problems associated with short-time working followed by the return to normal conditions and the need to rebuild stocks have, as noted earlier, been compounded by marked changes in the pattern of demand. Consequently, shortages of materials and components have persisted despite the easing in activity. Some 54% of firms responding to the July CBI survey reported working below a satisfactorily full rate of operation, as compared with 44% in October (see Table J); but the survey also showed the proportion of firms reporting output as hampered by shortages of materials and components to be virtually the same as in October. Steel, paper and petrochemicals, as well as components such as electric motors and bearings, appear to be among the more important items which are scarce.

Unemployment rose again in August, by 24,000 – the third appreciable monthly increase since May, after having previously remained fairly steady since February. This brought the total to 2·7%, compared with 2·2% in the fourth quarter of last year (see Table J). Other indicators also suggest a slackening of the labour market, if to varying degrees. Unfilled vacancies, for example, although they rose between March and July, did so without regaining their late 1973 peak and with shortages of skilled industrial labour remaining as usual widely reported – and they fell in August. Overtime working has understandably risen since the first quarter, but in the second it was still considerably lower than in the fourth quarter of 1973.

**Table J**

**Indicators of the pressure of demand on resources**

*Seasonally adjusted:* Great Britain

| | Previous 'high' pressure of demand | 1973 | 1974 | | |
|---|---|---|---|---|---|
| | | 4th qtr | 1st qtr | 2nd qtr | Aug. |
| Unemployment (percentage) | 1·2 (1st qtr 1966) | 2·2 | 2·4 | 2·4 | 2·7 |
| Unfilled vacancies (percentage) | 1·2 (1st qtr 1966) | 1·6 | 1·2 | 1·4 | 1·3 |
| Overtime (1970=100)[a] | 107·0 (1st qtr 1966) [b] | 104·8 | 76·1 | 95·8 | |
| Percentage of firms reporting below capacity working[c] | 38 (Feb. 1965) | 44 (Oct.) | 71 (Jan.) | 50 (Apr.) | 54 (July) |

[a] Per employee in manufacturing.

[b] 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.

[c] CBI survey, UK, not seasonally adjusted: firms working 'below a satisfactorily full rate of operation'.

The Chancellor's July measures were designed mainly to secure an easing in the rate of increase of the retail price index while at the same time applying a modest stimulus to demand. To avoid some further threshold payments – six having been made by then – the rate of value added tax was reduced from 10% to 8%. Extra domestic rate relief was also announced, as well as a further allocation of the sum provided for food subsidies in the March Budget. The Chancellor also announced that the regional employment premium – unchanged since it was introduced in 1967 – was to be doubled with effect from the first week of August, and that the ceiling under the price code for the annual rate of increase of company dividend payments was to be raised from 5% to 12½%.

It was estimated that the direct effect of these measures would be to change the balance of revenue and expenditure by some £390 million in the rest of this financial year and, after allowing for secondary effects, to raise the public sector borrowing requirement by about £340 million. The Chancellor expected that the increase of retail prices would be reduced by rather more than 1½% by October of this year, so obviating one or two further threshold payments. The increase in demand resulting from the measures directly affecting retail prices might largely have occurred in any case because of the threshold agreements, but taking into account the remaining measures the total demand effect is mildly expansionary.

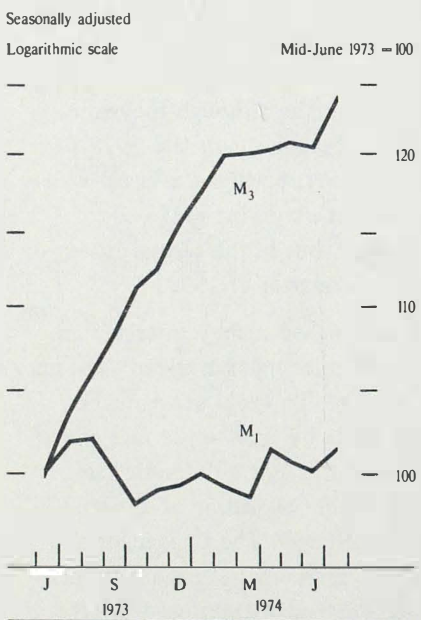
## Financial and monetary developments

### Company finance[1]

The financial pressures on industrial and commercial companies arising from short-time working in the first part of the year turned out to be

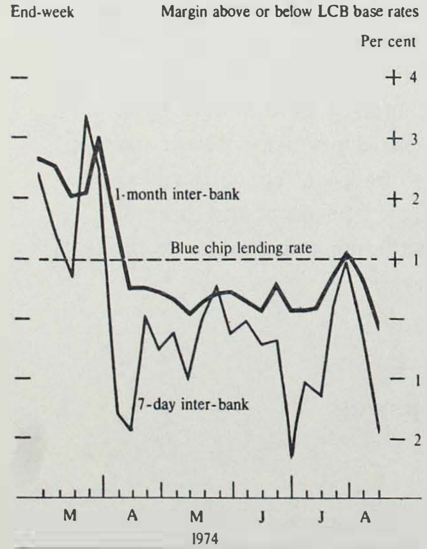
[1] Further detail of the company sector's finances appears in the financial review, page 270.

### Money stock




*$M_3$ rose in July but the rise over the latest five months was still much slower than earlier; $M_1$ continued to change little on balance.*

### Arbitrage margins




*The pattern of interest rates, with inter-bank rates below the blue chip lending rate, left no incentive for arbitrage.*

less severe than expected. Nevertheless, companies had to rely heavily on the banking sector for funds: their borrowing increased substantially, while there was little offsetting increase in their bank deposits.

In the second quarter, companies continued to rely very heavily on the banks for borrowed funds, and their bank deposits again changed little. Their holdings of liquid assets measured in proportion to turnover consequently declined further. Net liquidity (calculated from liquid assets net of bank borrowing) tightened too – see the chart on page 271 in the financial review. Resumed stockbuilding at higher prices and sharply rising labour costs not fully recovered through increases in selling prices must have impaired cash flow; and, with the capital market providing no new money, substantial recourse to the banks was inevitable.

This situation is likely to continue, with companies having to rely mainly on the banks for whatever external funds they need (though some could call on overseas sources). Any diminution in the availability of such funds does not yet appear to have been a serious constraint. The greater anxiety of companies is that low profit margins and diminished cash flow will prevent the generation of sufficient internal funds to sustain their investment; and that this in turn will continue to restrict their access to new capital funds on acceptable terms and will also make it increasingly difficult for them to borrow further from the banks.

**Money and bank lending**

The slower growth this year of the broadly-defined money stock, $M_3$, (see chart) no doubt reflects in part the unwinding of some of the special developments which helped to cause the rapid increase in 1973. The rise in $M_3$ was then exaggerated by interest arbitrage – causing both sides of the banking sector balance sheet to be inflated – and also, towards the end of the year, by the extra use made of bank facilities by companies and other customers fearing new credit restrictions. The more recent pattern of short-term rates in the money markets has removed the incentive for arbitrage (see chart); and, as fears of new restrictions have abated, these earlier transactions have now probably been largely closed out, reducing the rise in both bank deposits and bank lending. Thus, just as the rise in $M_3$ in 1973 gave an exaggerated picture of the growth of the money supply, the small rise in the more recent period almost certainly understates the trend.

There was a particularly sharp check to the growth of $M_3$ in the three months to mid-June, when it rose by no more than ¼% after seasonal adjustment, compared with an increase of 4% in the previous three months. Apart from the influences just mentioned, there were also large official sales of gilt-edged stocks to the general public, a greater contractionary influence arising from the balance of payments deficit, and, in particular, a further decline in the underlying rate of growth of lending to the private sector (see Table K).[1]

In the month to mid-July $M_3$ increased much more strongly, by 3%. This can be partly explained by a change in sentiment in the gilt-edged market, which led to a sharp drop in buying by the general public; but the rise was also exaggerated by the uneven timing of the Government's borrowing needs, for there was an unusually large government deficit during the month. $M_3$ also seems to have been swollen on the make-up day by an exceptionally large increase in British oil companies' foreign

[1] The pattern of the authorities' market operations was such that the decline in lending to the private sector shows up more as a run-down of official holdings of commercial bills – compared with the build-up in the previous quarter – than as a fall in bank lending.

**Table K**

**Influences on the money stock ($M_3$)**

£ millions: *seasonally adjusted*

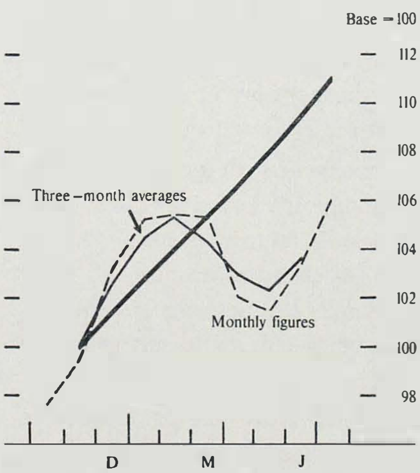
| | 1973 | | | 1974 | |
|---|---|---|---|---|---|
| | Mid-Mar. to mid-June | Mid-June to mid-Sept. | Mid-Sept. to mid-Dec. | Mid-Dec. to mid-Mar. | Mid-Mar. to mid-June |
| Central government borrowing requirement | + 570 | + 570 | + 180 | + 540 | + 560 |
| Purchases (–) of central government debt by private sector other than banks | – 550 | – 290 | – 210 | – 490 | – 740 |
| Other public sector[a] | + 30 | + 630 | + 460 | + 50 | + 40 |
| Issue Department commercial bills[b] | – 60 | – 40 | + 120 | + 240 | – 360 |
| Bank lending to private sector | +1,180 | +2,030 | +2,250 | +1,440 | +1,380 |
| External items | – 50 | – 420 | – 640 | – 380 | – 670 |
| Other | – 30 | – 70 | – 260 | – 120 | – 170 |
| Money stock ($M_3$) | +1,090 | +2,410 | +1,900 | +1,280 | + 40 |
| *Percentage increase* | *+ 4* | *+ 8¾* | *+ 6¼* | *+ 4* | *+ ¼* |

[a] 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).

[b] Net purchases (+) of commercial bills by the Issue Department in the course of market operations.

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.

**Supplementary deposits scheme**




*The heavy line shows the penalty-free limit for individual banks. The other lines show that on average the growth of interest-bearing eligible liabilities for all banks remained well within the limit.*

currency deposits, which can fluctuate widely from day to day as a result of overseas receipts and payments. Despite this, $M_3$ has risen during the latest three months by only 3¼%, compared with a three-monthly rate of over 6% throughout the second half of 1973.

The narrowly-defined money stock, $M_1$, after falling slightly for two months, rose by 1½% in the month to mid-July. $M_1$ is less affected by the influences distorting the trend of $M_3$, and its rate of growth might be expected to increase this year as inflation increases the money value of current transactions; however, because of the size of monthly fluctuations it is as yet difficult to assess the extent to which this has happened.

Although total demands made on the banks for credit were fairly subdued in the spring and early summer, there seems to have been some upturn in June and July. Companies' needs for working capital must have risen sharply, particularly for restocking at higher prices; there seems to have been very little borrowing to finance new projects. Throughout the period, bank advances to manufacturing industry have continued to rise strongly – by £630 million (after seasonal adjustment) in the three months to mid-May, the latest period for which a full analysis is available. Lending for other production has also increased markedly. During the same period advances to property companies also continued to rise (by £70 million), but by much less than in the previous three months (£260 million); and advances outstanding to other financial bodies and to persons fell substantially. The direction of bank lending, therefore, has generally been consistent with the guidance given last September and December.

The introduction of the supplementary deposits scheme in December obliged banks to take a more cautious attitude towards requests for new loans; but, with no very strong demand for credit in total, most of the banks had little difficulty in staying within the unpenalised limit of 8% growth in their eligible liabilities in the first six months. When the first supplementary deposits became payable in July, only fourteen banks (out of some three hundred) were liable for payments, which amounted in aggregate to less than £6 million. For the banking system as a whole, the total growth averaged over the previous three months was only 2¼% above the October/December 1973 base (see chart). In August the number of banks liable for payments, for growth in the three months to July beyond 9½% from the base, was reduced to seven, the amount payable was only £1 million, and the three-monthly average for the banks as a whole increased to 3½%. The growth in interest-bearing liabilities was however being heavily concentrated in the clearing banks; in the three months to July the London clearers as a group were 6¾% above the base, while the average for the rest showed virtually no change.

**Interest rates[1]**

Aided by the release in April of, in all, 1½% of special deposits, short-term rates in the domestic money markets eased sharply; and during May the clearing banks cut their base rates by ½%. Overseas rates, however, were continuing to rise (notably in the United States), thereby eroding the uncovered differentials in favour of sterling; and during June small adverse differentials developed. Nevertheless, the covered differentials against sterling narrowed at first, and were little changed over the whole period.

The gilt-edged market, encouraged by lower domestic short-term interest rates, was steady in May and strong in early June, when

[1] A more detailed account of recent developments in financial markets appears in the financial review, page 265.

substantial official sales of stock were made. In the latter part of June sentiment changed quite sharply, particularly because of rising interest rates abroad. Yields on long and undated stocks rose rapidly to new peaks; but the market rallied later, and further official sales were made towards the end of July. The equity market was continuously depressed, with prices and turnover falling sharply in the second half of June; the measures announced in July gave little respite. Generally, asset values have declined drastically throughout the year.

On 6th August the Government announced their intention to introduce within the next year two new national savings schemes, both offering investment with the capital linked to the general index of retail prices. One facility, limited to old-age pensioners, would offer a lump sum investment; the other a contractual scheme with contributions spread over five years. In each there would be limits on individual holdings.

**Banking supervision**

As announced on 20th August, in pursuit of a closer supervision of banking activities, the Bank have reviewed the information made available to them by banks and have concluded that, as well as the monthly and quarterly returns designed primarily for the production of statistics or for credit control, there is a need for more regular information for supervisory purposes.

During August they therefore wrote individually to most banks registered in this country, apart from the clearing banks, to ask them to complete supplementary returns as appendices to their regular statistical returns as at 30th September; the banks will also be asked to complete these supplementary returns at least quarterly in future until the information given in them has been incorporated into a new series of banking returns due to be introduced in stages starting in 1975. For the moment, returns are not required from branches of overseas banks. Separate discussions are being held with the clearing banks.

The information requested in the supplementary returns covers such items as the maturity pattern of sterling deposits and claims (on lines similar to those already used for the periodic returns on euro-currencies); details of transactions with associated companies; provisions; and standby facilities. The Bank's requirements are not uniform for all groups of banks but are being tailored to suit particular cases.

As well as writing to the banks mentioned above, the Bank invited a number of other deposit-taking companies, most of which possess certificates under Section 123 of the Companies Act 1967, to submit similar returns.

It is intended that the Banking Supervision Division of the Cashier's Department (which has succeeded the Discount Office) will discuss the information so submitted with the management of reporting banks and deposit-taking companies soon after each submission is made.

## Conclusion

The most noteworthy feature of experience so far this year has been the smoothness with which the external deficit has been financed.

Last year's rise in oil prices has changed the external position of industrial countries as a whole from substantial surplus on current account into very much more substantial deficit. The inevitable involvement of the United Kingdom in that financial revolution has greatly worsened the balance of payments. Even before the rise in oil prices, this country was heading for a record deficit on current account. As a result, the United Kingdom deficit in the first half of this year was, along with those of Italy and Japan, among the worst hit by recent developments, and amounted to 6% of GNP.

Large though it was, the deficit was nevertheless completely offset by capital inflows. The reserves rose slightly; and sterling remained relatively stable — its effective depreciation since the Smithsonian realignment remaining within the range 16% to 20%.

In the new international financial environment in which countries now have to live, it is important that the problems of this country be seen in their international setting. The vast volume of international capital seeking investment outlets might seem at first sight to have created a new ease in the financing of deficit positions. Such an impression needs to be qualified.

The large international banks, which have so far been the main financial channel, have successfully facilitated the transfer of a volume of funds hitherto unprecedented, and are likely to continue this function. Nevertheless, such exclusive reliance on the banks as financial intermediaries may not continue to be possible, and there is likely to be a growing need for alternative financial channels to supplement the banking system. Such channels are indeed already being developed. But the situation in which this new type of massive international investment has to occur may last for most of the decade, and there will no doubt be many problems.

A second question concerns the geographical destination of the flow of funds. So far, most individual industrial countries have obtained the capital inflows they each needed to offset their current deficits, as has the United Kingdom. Such overall balances may, generally, not always be so easy to achieve as in the last half-year. And experience has already shown that a country's access to international finance is not unaffected by its success in dealing with domestic problems, and by market evaluations of creditworthiness.

In this context the importance for this country of containing inflation is clear. The hopeful signs are, first, that commodity prices in general have now for some time been stable; and, second, that there is wide recognition of the need for restraint in pay increases, and of the need to accept, for a period, pay increases no larger than the rise in prices. The latter may be the minimum formula that would give hope of eventually restoring a fair degree of price stability. Nevertheless, it may prove difficult to achieve. Its achievement will depend in the last resort on general acceptance that this is in fact essential for our society, not merely in an international context, but for domestic reasons.

A second crucial area is the continued expansion of exports. To maintain the country's international credibility it would seem essential to make a major improvement in the current balance of payments over the period of years immediately ahead — that is, in advance of the assistance to be looked for later from North Sea oil. At the end of last year, exports were being thwarted by the pressure of demand on resources. Slow growth and slacker demand this year may have eased the bottlenecks and shortages; but the period of short-time working earlier in the year appears to have left industry's stocks in a highly unbalanced state. It is therefore not clear how fast a rate of expansion the economy can yet sustain; and it will in any case be important that room for a continued expansion of exports be preserved. Much of the growth of demand to be looked for must indeed come from exports.

The less buoyant conditions of world demand will make this more difficult to achieve: the example of other countries shows that it is possible.

A third area which is crucial to the health of the economy is the continued expansion of investment. This may, however, prove vulnerable among other factors to the continuing erosion of the financial position of companies. The profitability of industrial and commercial companies has been declining for some years, and their reduced resort to the capital market has led to increased dependence on the banks for outside finance. In the last two years however, the deterioration in such companies' financial position has been seriously aggravated by the effect of inflation on the cost of financing stocks and re-equipment; and by price controls, which have squeezed profit margins further. The generation of internal funds may now be insufficient to sustain investment, and may in some cases fail to provide a satisfactory basis for companies to seek further funds from the banks or elsewhere. Certainly the rise in private investment appears to have been checked; and it seems likely that these financial factors have played an important role. The longer they continue, the greater will be the adverse effect on investment.

Though the rate of monetary expansion was low in the second quarter, this was probably in part fortuitous or due to special factors; the figures show a faster expansion in the month to July. It may perhaps be concluded for the present that monetary expansion has continued at a reasonable rate, which has been consistent with some easing of short-term interest rates despite the generally rising trend abroad. It has also been such as to allow a strong rise in bank advances to manufacturing industry, which has appeared all the more desirable in view of the present dependence of companies on bank finance. The banks have been able to continue lending in this way without, for the most part, running into the penalty area under the supplementary deposits scheme. In the period ahead, as already suggested, bank lending to companies may in some cases be restricted by prudential considerations rather than by the impact of monetary controls; but their needs for bank finance will need to be kept under close and sympathetic review.