

## Economic commentary

The present prospects are for rather slow growth in world trade, but prospects will change if, and when, policies abroad become more expansionary. Domestic demand in this country has recovered from the set-back earlier in the year, but output is no higher than a year ago; and shortages, though persisting, have eased.

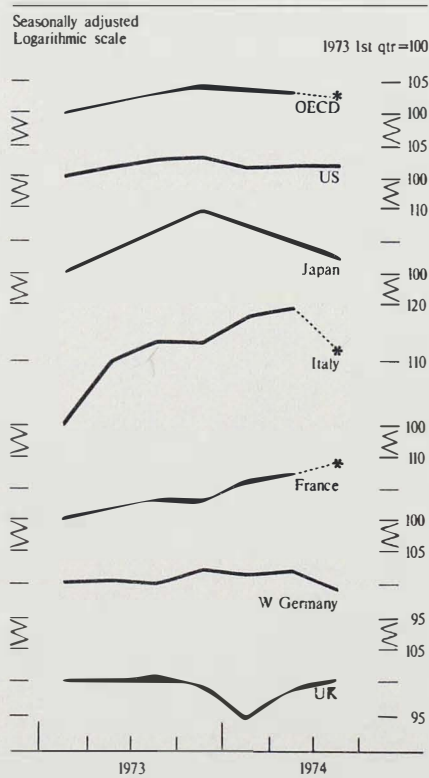
Despite comparatively stable import prices, domestic costs and prices have continued to increase fairly rapidly. This diverse trend is reflected in the terms of trade. The rise in export prices and stability of import prices have recently been the main influences in the continuation of the trend towards a reduced deficit this year in trade apart from oil.

The rise in commodity prices has greatly inflated the value of stocks and working capital. Company finances have also been adversely affected by other developments, including the working of price controls, and by the autumn, financial restraints were leading companies to prune investment plans. The measures taken in the Budget in November will alleviate this situation.

The tax relief granted to companies in the Budget will further enlarge the public sector borrowing requirement, which was already running at a rate of £5,500 million in the financial year. Since the beginning of the year the rate of monetary expansion has nevertheless remained moderate. The arrangements for the supplementary deposits scheme have been continued substantially unchanged for a further period to the middle of 1975.

### Industrial production

Production in the OECD countries as a whole fell slightly in the third quarter, and was no higher than a year earlier.



\* Estimated.

Table A

### Consumer prices in industrial countries

Quarterly averages: percentage change on previous quarter

	1973		1974		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Italy	2.3	2.7	5.3	5.2	6.2
Japan	2.9	4.5	9.9	4.7	3.7
France	2.4	2.7	6.3	4.1	3.3
Canada	2.8	1.8	2.4	3.3	3.1
United States	2.2	2.4	2.8	3.0	3.1
Sweden	1.6	2.3	3.9	0.9	1.5
Western Germany	0.9	2.0	2.4	1.6	0.9
United Kingdom	1.5	3.4	4.2	5.9	2.5

Source: OECD.

### International developments

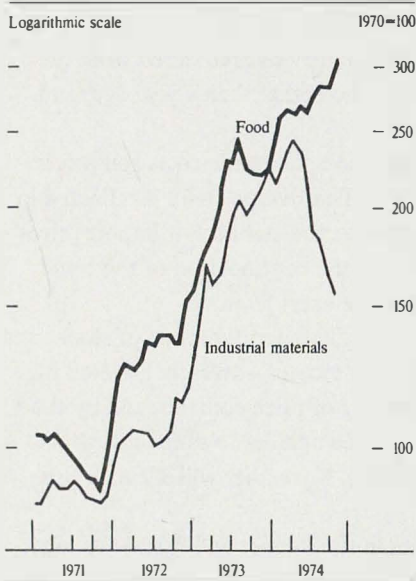
There is little sign yet of any general revival in demand in the industrialised countries. After the fall in the first half of the year, output fell further during the third quarter in the OECD countries as a whole and was no higher than a year earlier (see chart). Unemployment has continued to rise in most industrialised countries. Demand has been restrained by the contractionary effect of last year's increase in oil prices, together with the restrictive policies adopted by several countries. The first signs of a shift in policy have begun to appear in some countries but, without further changes, it seems unlikely that world industrial activity will make any significant recovery.

The rate of price inflation appears to have moderated a little since the early months of this year, but it is doubtful how far there has been a clear change of trend (see Table A). Consumer prices in the main OECD countries rose on average by about 3% in the third quarter – slower than the increases of 4½% and 3½% in the first and second quarters. But much of the increase in the first quarter reflected the impact of dearer oil, the effect of which was expected to moderate as the year went on. Many other commodity prices have fallen, and seasonal factors were also working to slow the growth in prices during the summer months.

Although the growth of world trade slowed down in the third quarter, it probably did better than the development of output in the industrialised countries might have suggested. The dollar value of the main OECD countries' imports is estimated to have increased by 3%, and exports by 4% (seasonally adjusted). In volume, however, their imports probably fell, though their exports may have continued to rise. In the first half of the year, there was a rapid expansion in sales to the oil-exporting countries – their capacity to absorb additional imports quickly thus proving to be considerable. At the same time, the imports of the other developing

### World commodity prices[a]

Prices of industrial materials have fallen sharply from their April peak, but prices of foodstuffs have continued to rise.



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

countries from industrialised countries were well maintained. While the demand by industrial countries for the exports of these developing countries had begun to slacken, the latter were able to finance a growing volume of imports with earnings accumulated from the rise in commodity prices over the previous two years or so. However, imports by these countries are now likely to be growing more slowly.

The sluggishness of world output during the last twelve months has been reflected in some – but not all – commodity prices. Oil apart, they generally reached their peak in late April, having risen by nearly 90%, measured in dollars, since the beginning of 1973; between May and October they fell on average by some 8½%. Whereas prices of industrial materials – metals, textiles, and rubber – fell by 40% from their peak, those of foodstuffs continued to rise (see chart).

The combined current deficit on the balance of payments of OECD countries in the third quarter seems to have been about \$12 billion (see Table B), a little heavier than in the second quarter, and is likely to continue at about this rate during the remainder of the year. There was a sharp, partly seasonal deterioration in the US current account into heavy deficit, as well as a substantial, also partly seasonal fall in the West German surplus. Against this, deficits were reduced in several countries, notably Japan and Italy, as well as the United Kingdom.

As in the first half year, capital inflows financed the bulk of the current account deficits of the industrial countries in the third quarter; indeed, for the first time this year, the combined reserve position of OECD countries

**Table B**  
Summary balances of payments of industrial countries  
\$ billions: not seasonally adjusted

	1st quarter			1974			3rd quarter[c]		
	Current account[a]	Total capital[b]	Official reserves	Current account[a]	Total capital[b]	Official reserves	Current account[a]	Total capital[b]	Official reserves
United States	1.1	0.4	1.5[d]	-1.8	-2.3	-4.1[d]	-4%	3%	-1½[d]
Canada	-0.7	1.1	0.4	-0.3	0.3	-	-¼	-	-¼
Japan	-3.3	3.5	0.2	-2.5	3.5	1.0	-	-¼	-¼
Western Germany	2.9	-3.1	-0.2	2.6	-1.3	1.3	1	-2½	-1½
France	-1.6[c]	0.8	-0.8	-1.9[c]	2.3	0.4	-2	2½	½
Italy	-2.0	0.5	-1.5	-2.5	2.9	0.4	-1½	3%	2%
United Kingdom	-2.5	1.8	-0.7	-2.5	3.4	0.9	-2	2½	½
Other OECD	-3.0[c]	0.5	-2.5	-2.2[c]	0.1	-2.1	-2½	4	1½
All OECD countries	-9.1	5.5	-3.6	-11.1	8.9	-2.2	-12	13%	1%

[a] Including official transfers.

[b] Including errors and omissions.

[c] Estimated.

[d] Balance on official reserve transactions.

rose, by \$1¼ billion. France, like the United Kingdom, had some increase in reserves; and Italy's gross reserve position, after drawings from the International Monetary Fund and borrowing from Western Germany, improved by more than \$2 billion. In the United States, after a sharp decline during the first half of the year, the balance on official reserve transactions improved; a large turn-round on the capital account, which reflected a marked reduction in foreign lending by US banks, more than offset the deterioration in the current balance. Western Germany's gross reserves fell by about \$1½ billion through short-term outflows, including some reversal of earlier speculative inflows, movements reflecting interest-rate differentials, and movements attributable to uneasiness arising from the Herstatt failure.

Up to the middle of this year the reserves of developing countries (excluding oil exporters) continued to increase – by some \$3¼ billion – despite dearer oil and the levelling off in the prices of many of their own commodities. Since then the experience of these countries has varied

widely. Some have benefited from further sharp rises in the prices of their principal exports, while a number have received substantial grants and loans from the oil exporters. Some have borrowed actively on euro-dollar markets to supplement capital inflows. As well, by the end of October twenty-six developing countries had arranged drawings of \$730 million on the International Monetary Fund's oil facility, of which about \$300 million was in the third quarter. Nevertheless, some African and Asian countries were forced to run down reserves during the first nine months of the year.

The current cash payments surpluses of the oil-exporting countries are expected to amount to about \$50 billion in 1974.[1] Some \$33 billion of this is thought to have accrued during the first three quarters, of which about \$15 billion was held in the United Kingdom (including euro-dollar deposits, but excluding some equities and property holdings). About \$8 billion was invested in the United States, in both government securities and bank deposits. The rest, some \$10 billion, would be accounted for by intergovernmental loans, and liquid assets, securities, or real estate in various countries. (Oil money movements are further described in a note on page 405.)

Thus, during the first nine months of the year, the bulk of the borrowing from oil-exporting countries has taken place through the financial markets. The markets will undoubtedly continue to play a very important role, but it must be expected that the proportion of the total oil funds handled by the international banking system will decline in the months ahead. Increasing attention is therefore being given to alternative lending mechanisms to relieve the strain on the commercial banking system.

## The UK balance of payments

### The current account [2]

The current account deficit of £780 million in the third quarter was decidedly smaller than in the second and represented the first improvement for six consecutive quarters. Virtually all the improvement took place in visible trade; the surplus on invisible transactions was little changed (see Table C).

Trade in crude oil and oil products again produced a very large deficit, of £920 million, much the same as in the second quarter. There is, however, some evidence that higher prices have reduced domestic consumption; and, despite a substantial rise in stocks since the beginning of the year, there has been some easing in the volume of imported crude oil. The balance of trade in oil products moved from a small surplus in the second quarter to a small deficit in the third.

The further progress in the third quarter towards balance on trade other than oil came entirely from better terms of trade. There was in fact a small worsening on the volume side, whereas in the first and second quarters it had improved (see Table D). The volume of exports remained at much the same rate first reached in February; even so, this was almost 5% more than in the third quarter of last year. The failure of exports to grow further despite the improvement in price competitiveness between 1972 and early this year owes most to the slowdown in world trade. Supply constraints may also have contributed: there were continued reports of delivery delays caused by shortages of components and of skilled labour (see page 392). Meanwhile, the volume of non-oil imports was little changed in the third quarter, and was only slightly larger than a year earlier. This is largely

[1] Their current balance of payments surpluses, recording transactions and not payments for them, will be some \$65 billion.

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

**Table C**  
Current account of the UK balance of payments  
£ millions: seasonally adjusted

	1973		1974			Oct. (provi- sional)
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr	
Visible trade balance	-600	-1,005	-1,280	-1,365	-1,160	-440
of which:						
oil [a]	-235	-300	-730	-930	-915	-330
non-oil	-365	-705	-550	-435	-245	-110
Net invisibles	+330	+465	+315	+375	+380	+125
Current balance	-270	-540	-965	-990	-780	-315

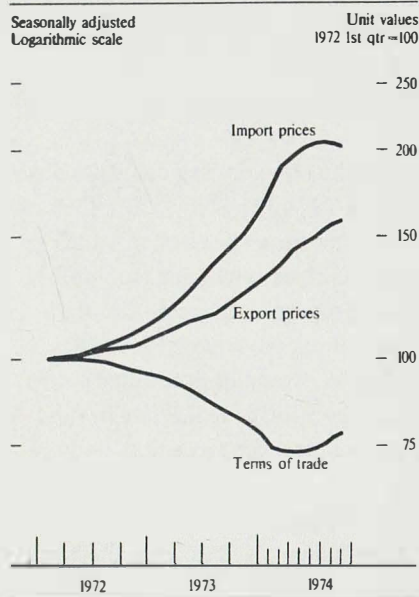
[a] The balance of trade in petroleum and petroleum products (Standard International Trade Classification: division 33).

**Table D**  
Estimated sources of changes in the visible trade deficit  
£ millions: seasonally adjusted

	1973		1974		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Deficit	-600	-1,005	-1,280	-1,365	-1,160
Change		-405	-275	-85	+205
of which:					
oil	-65	-430	-200	+10	+195
non-oil	-340	+155	+115	+195	+195
volume	-160	+190	+130	-45	-45
price	-180	-35	-15	+240	+240

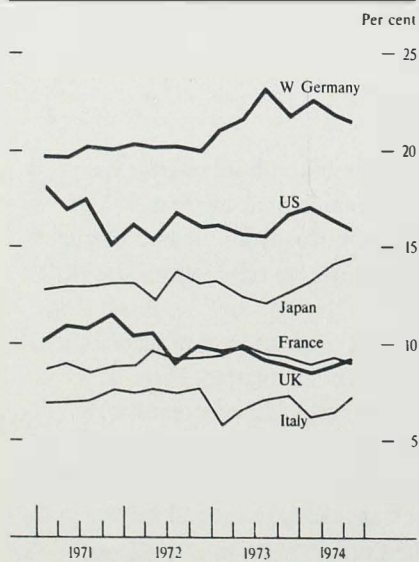
## Prices of exports and imports

With rapidly rising export prices and a fall in import prices during the third quarter, the terms of trade improved further.



## Shares in the value of world exports of manufactures

Since the first quarter, sharply rising export prices have increased the UK share of the value of world exports of manufactured goods.<sup>[a]</sup>



[a] Provisional figures from National Institute of Economic and Social Research; reproduced with permission.

explained by the sluggishness of domestic demand — particularly the lack of any substantial rebuilding of stocks beyond those needed to make good the effects of short-time working.

The terms of trade improved by 7% between March and September, having worsened by over 25% in the preceding two years (see chart). After commodity prices had passed their peak, the unit value of imports rose less rapidly, and between July and September actually fell by 1%. Comparing the third quarter with the second, the terms of trade improved by 4½%: the unit value of imports rose by 1½% and of exports by over 6%. The sharp increase in export prices reflects mounting costs as well, perhaps, as the influence of the price code, which, by curbing domestic price increases, may have encouraged companies to raise export prices and so improve their total profits. The comparatively rapid growth of export prices has allowed a slight increase since the first quarter in the UK share in the value of world trade (see chart). Meanwhile, revised royalty and tax rates imposed by oil exporters will have increased the cost of oil imports arriving in this country, beginning from about mid-November; in due course this will raise the general index of import prices by perhaps 1½%.

The volume improvement in external trade during the first half of the year, which occurred despite short-time working and its aftermath, seems to have been partly due to the sluggish domestic economy and partly a delayed response to the economy's improved competitive position following the depreciation of sterling during 1972 and 1973. Although some of this competitive advantage has been lost in 1974, the UK position remains better than some two and a half years ago.

In October there was a marked widening in the visible deficit, principally reflecting a sharp drop in exports.

The surplus on invisibles increased a little to £380 million in the third quarter, some £90 million more than the quarterly average for 1973. One feature of the second and third quarters was the emergence of a significant surplus on travel account. As well, net earnings from other services were well sustained; and those from interest, profits, and dividends remained very substantial despite the growing cost of financing the current deficit. The deficit on government services and transfers was running a little higher than in 1973 entirely because of the effect of inflation on expenditure on services abroad; net transfers to the EEC were at a lower rate.

## The financing of the deficit

The current account deficit in the third quarter was £850 million before seasonal adjustment; including capital transfers of £40 million arising from implementation of the 1973 sterling guarantee arrangements, the amount to be financed was a little under £900 million. The requirement was met without difficulty. Sterling's effective depreciation fluctuated during the quarter between 16.7% and 18.3% below its Smithsonian settlement rate; and some £180 million was added to the reserves.

Sterling holdings made a big contribution to the requirement, rising by £630 million, much more than in previous quarters. As Table E shows, the rise was more than accounted for by oil-exporting countries, whose holdings increased by almost £1,800 million in the first nine months of the year. Increases in holdings since September 1973 have not been covered by the sterling guarantee, and it was announced with the Budget in November that the arrangements would not be further extended at the end of the year (see page 404).

Public sector foreign currency borrowing, at £220 million, was under half as much as in the second quarter. With other inflows so large, the authorities did not encourage public bodies to borrow.

Oil companies' transactions once again provided a considerable inflow, reflecting investment by foreign oil companies in North Sea operations and

Table E

## Financing of the current account deficit

£ millions: not seasonally adjusted

	1973		1974		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Current balance	-230	-390	-1,050	-950	-850
Capital transfers	-	-	-	-30	-40
	-230	-390	-1,050	-980	-890
Financed by:					
Public sector foreign currency borrowing	+360	+350	+340	+500	+220
Increase (+) in sterling holdings (official and private)[a]	-420	+190	+190	+390	+630
of which, from oil-exporting countries	-60	+280	+270	+590	+920
Increase (+) in UK banks' net foreign currency borrowing[b]	-120	+90	-160	-20	-370
Other capital flows[c]	+150	-220	+640	+220	+590
of which, net investment - 'oil and miscellaneous'	+250	-20	+470	+360	+200
Decrease (+) in reserves	+260	-20	+40	-110	-180

[a] Excluding sterling held by international organisations.

[b] Excluding borrowing to finance lending to UK public bodies and for UK private investment overseas.

[c] Including the balancing item.

Further detail is shown in Table 20 of the statistical annex. Oil-exporting countries are listed under Table 25.

Table F

## Domestic activity

Percentage changes in volume: seasonally adjusted, quarterly rates

	2nd half 1973 to 1st half 1974	1st qtr 1974 to 2nd qtr 1974	2nd qtr 1974 to 3rd qtr 1974
	Gross domestic product (output measure)	-0.9	+2.1
of which, industrial production	-1.8	+4.6	+1.1
Consumers' expenditure	-0.5	-1.2	+1.6
of which, retail sales	-1.2	-2.2	+3.3
Exports of goods	+2.1	+3.4	-0.4
Imports of goods	-0.5	-1.5	+0.5

Table G

## Changes in total final expenditure and its components [a]

Percentages: seasonally adjusted, constant prices, quarterly rates [b]

	2nd half 1973 to 1st half 1974	1st qtr 1974 to 2nd qtr 1974	2nd qtr 1974 to 3rd qtr 1974
	Total final expenditure	-0.4	+1.5
Components:			
Domestic expenditure (except on stocks)	-0.5	-2.0	+1.4
of which:			
consumers' expenditure	-0.2	-0.6	+0.8
public spending [c]	+0.1	-1.2	+0.5
private fixed investment	-0.3	-0.1	+0.2
Stockbuilding	-0.3	+2.9	-0.4
Exports of goods and services	+0.4	+0.5	-0.1

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

[b] Because of rounding, the figures do not necessarily tally.

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

some further build-up of oil company funds held in this country. Once again, too, UK portfolios of overseas securities were reduced, this time by net sales of as much as £240 million. Against this, however, there was a further net outflow, of £370 million, from UK banks' foreign currency borrowing and lending overseas (excluding borrowing to on lend to the public sector) - unusually, there was no net borrowing to finance investment overseas, because repayments were heavy, especially of sums that had been borrowed for portfolio investment. The balancing item indicates a substantial unidentified inflow, which may well have been associated with the financial constraints affecting many UK companies (see page 395).

In October and November the Government made the first drawings, of \$1,250 million (£536 million), on the \$2.5 billion euro-dollar facility announced in the March Budget. [1] The drawings were necessary if the facility was not to lapse, though the funds were not immediately required. In November the first drawing, \$400 million (£173 million) by the National Water Council, was made on the \$1.2 billion line of credit from Iran announced in July. [2] The rest of the public sector borrowed £4 million in October and November, and the reserves rose by some £270 million. From the middle of November, the exchange rate tended to weaken, and by the end of the month the effective depreciation since the Smithsonian settlement had increased to 20.5%.

## The domestic economy

## Output and demand [3]

Total domestic output rose by about 1% in the third quarter, so continuing the recovery of the second quarter but at a much slower rate (see Table F). Industrial production as a whole increased by about 1%, as did manufacturing output - but in September each was still about 1½% less than a year earlier.

The main contribution to the rise in the volume of total final expenditure in the third quarter came from consumer spending (see Table G). Public spending also continued to grow, but private fixed investment - apart from shipping - fell; stockbuilding was comparatively modest after the recovery in the second quarter and was no longer adding to demand; and exports of goods and services were little changed. As already noted, there was a small movement of resources out of the balance of payments.

The volume of consumer spending rose by 1½% in the third quarter, making good the fall in the first half. Movements in both incomes and prices contributed to the revival. Large increases in pay (see page 391) and bigger social security benefits produced a large increase in personal incomes of probably about as much as in the first two quarters together. Even after deducting taxes and social security contributions, personal incomes will still have risen strongly, and, with the slower growth of prices, there will have been an increase in real disposable incomes - the first for a year. Saving as a percentage of personal incomes probably rose slightly. The savings ratio has thus continued to hold up well, although the high rate of inflation over the last year may well have led to anticipatory spending by consumers.

Retail sales covered by the official index rose by 3¼% in the third quarter, twice as fast as consumer spending as a whole. As might have been expected, sales of durable goods other than cars increased particularly strongly, rising by about 5¼%. Many of these goods are subject to hire-purchase controls, and the revival in the third quarter followed the usual

[1] June Bulletin, page 126.

[2] September Bulletin, page 255.

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

pattern of recovery, after the introduction of controls last December had produced abrupt falls in the first quarter, and further, less sharp ones in the second. In September sales of durable goods were still 1% less than a year earlier, while total retail sales were over 1½% greater.

New car registrations rose in the third quarter by 3¾%, but were still almost 25% fewer than a year before. Although production was reduced in September, partly because of labour disputes, it seems unlikely that supply constraints can explain the protracted depression in car sales. Nor can the hire-purchase controls alone explain it, because their effects on other durable goods are evidently wearing off, and car registrations were already falling before the controls were introduced. During 1974 initial concern over fuel supplies has been replaced by resistance to a particularly large increase in the cost of buying and running a car. Between January and September the price of an average British made family saloon increased by nearly 25%, compared with an increase in retail prices generally of 11%. The effect of these higher prices on demand has been intensified by the big increase in monthly payments caused by the shorter repayment period since last December and by higher interest rates. Between the introduction of the December measures and September this year, monthly payments in a fairly typical case may have increased by about 40% (see Table H). Running costs have also risen sharply. Substantial numbers of cars are of course bought by companies, including operators of hire fleets, and increases in prices are also an important influence on their investment in cars, along with more general considerations of cash flow and liquidity.

The depression in the car market is reflected in the reduction for the third consecutive quarter in the net amount of hire-purchase credit outstanding. However, the rate at which outstanding debt fell was again slower than in the preceding quarter, and the decline in net lending by finance houses was in part offset by more lending by retailers. Bank lending outstanding to persons fell too, but also at a slower rate than in the second quarter (see chart).

*Fixed investment by private industry* rose slightly in the third quarter, but only because of a spurt in shipping, an erratic series. Investment in manufacturing and in the distributive and service industries each fell, no doubt in part reflecting the financial pressures on companies (discussed later). Recent surveys by the Department of Industry and the Confederation of British Industry point to a general weakening of investment intentions in the second half of the year. While the department's survey envisages a small recovery by manufacturers next year, the CBI survey, taken over a month later, but before the November Budget, was more pessimistic, mainly because of the outlook for new orders, but also because of financial constraints. After two years of fairly steady growth, investment by manufacturing industries, which remained surprisingly strong in the first half of the year – nearly 7% up in volume on the second half of 1973 – fell by about 3½% in the third quarter. Investment by the distributive and service industries fell for the fourth successive quarter, and was over 9% less than a year earlier. This decline reflects the depressed state of the property sector, and also the particular effects of the price code on the distributive sector.

In the third quarter the fall in investment in *housebuilding* continued. The number of houses started in the public sector fell back, but remained distinctly higher than at any time during 1973. The number completed was somewhat increased at an annual rate of some 140,000.

In the private sector, the number of starts fell again, thus continuing the decline of the previous five quarters (see chart). The annual rate of about 90,000 was under 40% of that at the peak of activity in the first quarter of 1973. Slightly fewer houses were completed than in the second quarter but, as they again outnumbered starts, the stock of houses under

**Table H**  
The increasing cost of buying a car on hire purchase

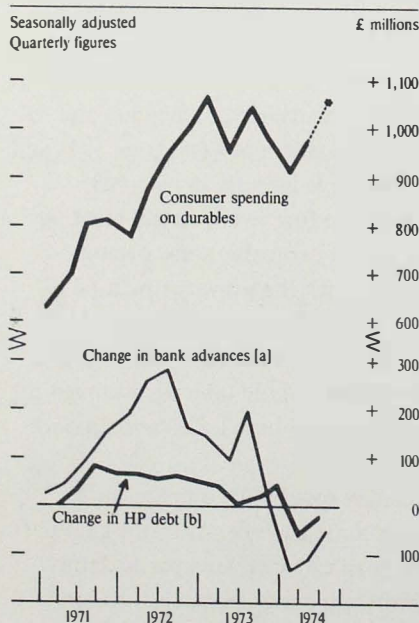
	1973	1973		1974
	Jan.	pre-measures	post-measures	Sept.
Repayment period (months)[a]	36	36	24	24
Interest rate charged per cent	11	14	14	15½
Purchase price of 'average' saloon car (£)[b]	1,090	1,165	1,165	1,430
Deposit per cent[a]	20	20	33½	33½
Monthly repayment required (£)	32	37	41	52

[a] The normal repayment period and deposit before December 1973; since then, the legal requirements.

[b] Source: *Autocar*.

### Consumer credit and spending on durables

*Spending on durables recovered strongly in the third quarter despite a further, smaller, fall in consumer credit outstanding.*



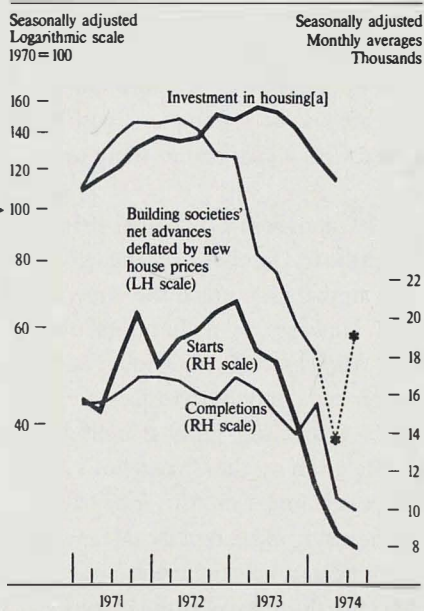
[a] Net change in outstanding advances by banks to persons, other than for house purchase.

[b] Net change in outstanding hire-purchase debt of the personal sector.

\* Estimated.

## Housing finance and housebuilding in the private sector

Although private housebuilding was still depressed in the third quarter, the inflow of funds to building societies should lead to an increase in activity.



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

\* Estimated.

construction fell by a further 6,000, to about 230,000. With increasing financial pressures on builders, this de-stocking could clearly go much further; the turning point in previous cycles has not been reached until the figure has fallen to 180,000–190,000.

A more encouraging note is struck by the strong recovery in the third quarter in building societies' net receipts (aside from official loans) and new commitments. Both were almost back to the peaks of the first half of 1973, although worth less if allowance is made for the rise in house prices. As the increased commitments lead to a greater number of advances, builders will become busier. However, the process will take some time, during which the construction industry will be encountering additional financial pressures. With confidence in this industry already low, there is no early prospect of a rebound in activity. The rise in commitments continued into the fourth quarter even though the building societies had to begin to repay the official loans (see page 411), all £500 million of which was drawn by the societies.

*Stocks held by private industry* rose by only some £160 million in volume in the third quarter, implying little change in stock/output ratios, and leaving the ratio for manufacturers at little more than the average for 1973, which was the lowest for more than a decade. There was, none the less, a strong increase in manufacturers' stocks, possibly because there was still scope in some industries for rebuilding stocks run down during short-time working; however, as the rise was accompanied by a run-down of retailers' and wholesalers' stocks, part of the increase in manufacturers' stocks of finished goods (well over £100 million) may have been involuntary. There is no statistical evidence of a general move to prune stocks in response to financial pressures, although according to the October CBI survey this may have begun.

### Wages and prices

Prices have increased at a somewhat reduced rate since the middle of the year, while the rate of pay increase has continued to accelerate. Recent developments, however, particularly of wages, have been difficult to assess.

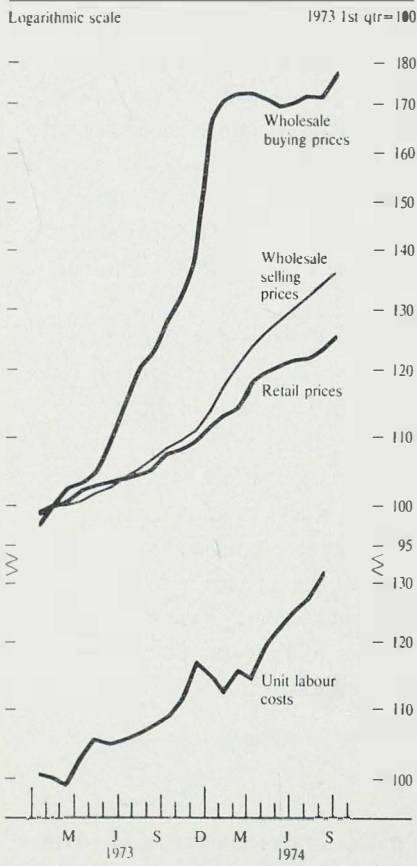
The index of manual workers' hourly wage rates rose strongly in the third quarter. It was about 8½% higher than in the second quarter on average, compared with average increases of 4½% a quarter in the first half-year. In September the index was 21½% higher than a year earlier; in June it had been 18% higher. The rise in the index has, however, been affected by the incidence of threshold payments and, notably, a bunching of settlements in August, especially for engineering workers, which have tended to exaggerate the rate of increase. In October, the index rose by a further 1½%, and was 23% higher than twelve months earlier; again, the rise was partly accounted for by threshold payments. Average earnings, which are less distorted by bunching of settlements but which reflect backdating, rose by 9% in the third quarter.

During the third quarter, as average earnings increasingly outpaced average output per head, the rise in manufacturers' unit labour costs accelerated (see chart over page). Although this series tends to be a little erratic, the increase in the third quarter, 8%, is double the increase in the previous quarter; by September the index was nearly 23% higher than a year earlier.

In contrast to the jump in wage rates and earnings, retail prices increased by only 2½% in the third quarter; this put them 17% higher in September than a year earlier, only slightly more than the corresponding comparison in June. An increase of nearly 1% in the index in July was followed by virtually no change in August and an increase of 1% in September. The main causes of the improvement were the reductions in value added tax and local authority rates announced by the Chancellor on 22nd July; they took perhaps 1½% off the rate of growth of prices in

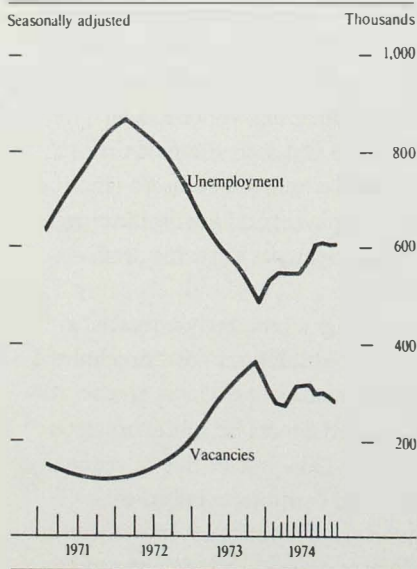
### Wholesale prices, unit labour costs, and retail prices

*Although manufacturers' buying prices have levelled off, their selling prices continue to rise steadily, partly reflecting the earlier increases in materials and partly the sharp rise in their unit labour costs.*



### Unemployment and vacancies

*Both the number unemployed and the number of vacancies have remained comparatively steady.*



August. Seasonal reductions in the prices of some foodstuffs also helped. The rate of increase in the prices of manufactured goods under the direct control of the Price Commission had fallen from an annual rate of 23% last winter to 9½% during June to August.

The easing in commodity prices (see page 386) has helped to hold back the rise in manufacturers' buying and selling prices. Buying prices were unchanged in the third quarter after rising only slightly in the second (see chart). Manufacturers' selling prices reflect the benefits of lower commodity prices only after an interval, but already in the third quarter some deceleration was evident: the increase was 4¾% compared with 7¾% in the second quarter, although compared with a year earlier there was a further acceleration.

In October, retail prices increased by 2% and were 17% higher than a year earlier; the increase in the three months to October over the preceding three months was 10¼% at an annual rate, much the same as the corresponding comparison in September. However, manufacturers' buying prices resumed their upward movement, rising by 3¼% in October and presumably reflecting the hardening of certain commodity prices. Wholesale selling prices increased by 1¾%, after rising fairly steadily by 1½% a month since May. Thus, the respite given by the Chancellor's July measures and by seasonal factors during the summer months may have been wearing off, and prices may again be rising more rapidly. Meanwhile, the recent trend of wage settlements is not clear, because many awards have taken account of restrictions under the third stage of the incomes policy, and the current negotiating round is still incomplete. The course of domestic costs will have been helped by the slowdown in commodity prices, but will now depend mainly upon the course of wages.

### The pressure of demand

In general, the pressure of demand has continued to ease in the past few months, although the change has been less marked and less consistent than earlier in the year. The rise in the number unemployed which began in June has continued, but at a diminishing and somewhat irregular rate; somewhat surprisingly the number fell slightly in October to 607,000 (2.7% of employees) and scarcely rose in November (see chart). The CBI survey in October suggested that there would be no great immediate increase in labour shedding, though the longer-term prospects for employment seemed markedly weaker. The number of unfilled vacancies has meanwhile fallen (to 276,000 in November). This evidence of a lower pressure of demand is supported by the declining amount of overtime worked in manufacturing industry and by the October CBI survey, which showed a small increase in the number of firms working below full capacity (see Table J).

The pattern is not, however, uniform throughout the economy: and specific shortages, if less acute than at the end of last year, nevertheless persist, and, according to the CBI survey, are still historically large. In particular, labour still appears to be generally short in the south east. Acute shortages of skilled employees remain a more widespread problem, particularly in much of manufacturing industry.

Supplies of components and materials have generally improved, but shortages were still being reported in October, notably among special steels, electric motors, and packaging materials — and especially in the capital goods industries. Some shortages may now be explained by companies cutting out unprofitable lines as financial pressures have compelled them to look more carefully at all aspects of their business.

These considerations, among others, have made the standard indicators of the pressure of demand less easy to interpret, especially, perhaps, the unemployment figures. There seems to have been a gradual increase since



**Table J**  
**Indicators of the pressure of demand on resources**  
*Seasonally adjusted: Great Britain*

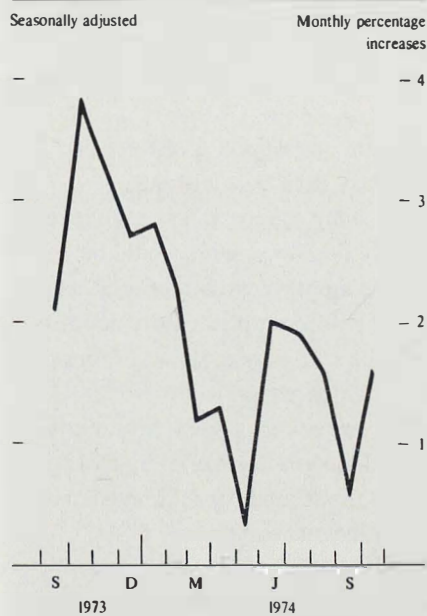
	1973	1974			
	4th qtr	1st qtr	2nd qtr	3rd qtr	Nov.
Unemployment (percentage)	2.2	2.4	2.4	2.7	2.7
Unfilled vacancies (percentage)	1.6	1.2	1.4	1.3	1.2
Overtime (1970=100)[a]	104.8	76.1	95.8	94.6	
Percentage of firms reporting below capacity working[b]	44 (Oct.)	71 (Jan.)	50 (Apr.)	54 (July)	56 (Oct.)

[a] Per employee in manufacturing.

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

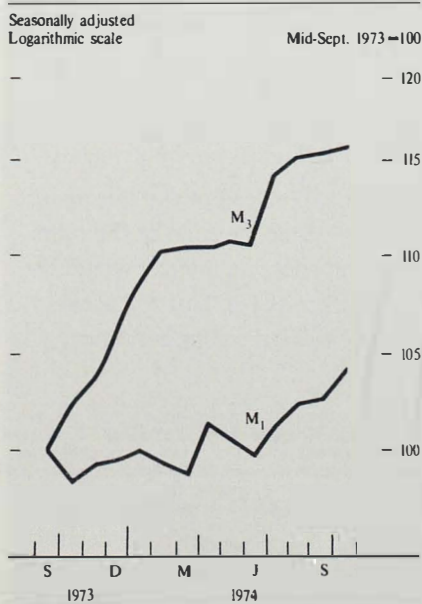
### Lending to private sector

*Bank lending to the private sector, though fluctuating widely, has recently been rising less rapidly.*



### Money stock

*After the sharp rise in July,  $M_3$  again rose only slowly.  $M_1$  has recently grown a little faster.*



the early 1960s in the rate of registered unemployment compatible with a given pressure of demand, perhaps because of improvements in social security benefits and redundancy payments, perhaps because of a 'shake-out' (associated in part with the selective employment tax) and structural changes in the economy. At all events, the pressure of demand on productive resources has certainly eased during the past year. But this has not gone as far as might have been expected in eliminating bottlenecks or relieving shortages in the economy.

## Financial developments

### Money and banking

The upturn in the demand for bank credit which had seemed to have occurred in June and July was not fully sustained in the next three months, when bank lending to the UK private sector, though fluctuating widely from month to month, generally grew at a more moderate rate (see chart). Some companies faced with the need for more working capital, particularly for restocking at higher prices and to finance accelerated tax payments, have had increasingly to turn to the banks in the absence of other forms of finance on terms they could afford (see next section). But some, again influenced by fears about profitability and cash flow, have probably already begun to economise on less essential expenditures and to borrow less. Furthermore, the banks may, for prudential reasons, have become somewhat more discriminating. Lending to persons has continued to decline (see chart, page 390).

$M_3$ , the broadly-defined version of the money stock, rose by nearly 4½% after seasonal adjustment in the three months to mid-September (see Table K). There were, however, wide variations in the rate of increase from month to month, and a quarterly figure which includes the exceptional rise in July almost certainly exaggerates the underlying trend (see chart). In the following month to mid-October, a period when the central government borrowing requirement was unusually small,  $M_3$  rose by only ½%. This meant that during the six months to October – broadly since the beginning of the current financial year –  $M_3$  had risen on average by under 1% a month. This is less than half the rate of increase in 1973 and considerably slower than the increase in the national income at current prices. The significance of the slower growth of  $M_3$  may not, however, be very great. At least in the earlier part of the financial year, the smaller rise to some extent reflected the reversal of arbitrage and other special influences which inflated the figures in 1973. Moreover, one of the consequences of the supplementary deposits scheme introduced last December has probably been to encourage some switching by the private sector out of bank time deposits into short-term public sector debt – a change which would reduce the broad measure  $M_3$  without, probably, having much immediate effect on the liquidity of the private sector.

The narrowly-defined money stock,  $M_1$ , now seems to be rising more strongly than it was. During the three months to mid-October it rose by nearly 3%, though at the end of this period it was still less than 6% larger than a year earlier.

The counterparts to the growth in  $M_3$  are shown in Table K. In the three months to mid-September, the growing public sector deficit was one of the main expansionary influences. (Even before the Budget measures announced on 12th November, the forecast of the public sector borrowing requirement for the current financial year as a whole had risen from the £2,700 million stated in the March Budget to about £5,500 million.) Within the public sector, the central government borrowing requirement was as much as £1,150 million in the three months. At the same time, the

**Table K**  
**Influences on money stock (M<sub>3</sub>)**  
 £ millions: seasonally adjusted

	1973		1974		
	Mid-June to mid-Sept.	Mid-Sept. to mid-Dec.	Mid-Dec. to mid-Mar.	Mid-Mar. to mid-June	Mid-June to mid-Sept.
Central government borrowing requirement	+ 570	+ 180	+ 540	+ 560	+1,150
Purchases (-) of central government debt by private sector other than banks	- 290	- 210	- 490	- 740	- 190
Other public sector[a]	+ 630	+ 460	+ 50	+ 50	+ 230
Lending to private sector[b]	+1,990	+2,370	+1,680	+1,010	+1,240
External items	- 430	- 670	- 400	- 620	- 540
Other	- 70	- 260	- 110	- 170	- 430
<b>Money stock(M<sub>3</sub>)</b>	<b>+2,400</b>	<b>+1,870</b>	<b>+1,270</b>	<b>+ 90</b>	<b>+1,460</b>
<b>Percentage increase</b>	<b>+ 8½</b>	<b>+ 6%</b>	<b>+ 4</b>	<b>+ ¼</b>	<b>+ 4%</b>

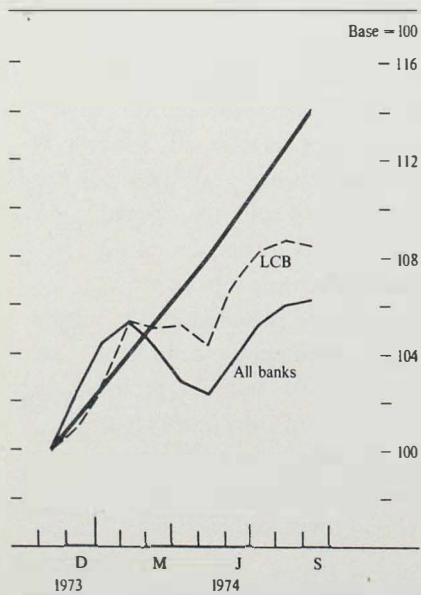
[a] The borrowing requirement of local authorities and public corporations less purchases of local authority and public corporation debt by the private sector (other than banks).

[b] Includes net purchases (+) of commercial bills by the Issue Department through 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 the three-monthly averages for the growth of interest-bearing eligible liabilities, both for all banks and for the London clearing banks, have remained well within the limit.



general public bought less gilt-edged stock than earlier in the year. And bank lending to the private sector (including market transactions in commercial bills by the Issue Department) was again substantial, partly as a result of the inclusion in these three months of a very large rise in July.

In contrast, the balance of payments deficit was tending to reduce the money stock. In the three months, the 'external items' shown in Table K – which are, broadly, a measure of the balance of payments deficit on current account less capital inflows to the private sector (other than banks) – were contractionary to the extent of £540 million. [1] This was much the same amount as for some quarters past.

### Supplementary deposits and measures of 12 November

Most banks have been able to keep the growth of their sterling resources within the unpenalised limit fixed under the supplementary deposits scheme (see chart). The average total of interest-bearing eligible liabilities at the three reporting dates in August, September and October, taking the banking system as a whole, was only some 6% above the October/December 1973 base compared with the 'limit', for each bank individually, of 14%; and in no month has there been any substantial excess among the banks as a whole. Within the banking system the clearing banks' sterling resources have on balance grown more strongly than those of other banks, and the August/October average for the London clearing banks was about 8½% above the base.

Companies' needs for finance to maintain output and investment are discussed below. To enable the banks to play their part without encouraging a more rapid growth of the money supply, it was announced on 12th November that the supplementary deposit scheme would be extended for a further six months. [2] The monthly growth of each bank's sterling interest-bearing resources allowed before supplementary deposits become payable remains unchanged at 1½% of the base. However, the first band of excess interest-bearing liabilities, which are subject to supplementary deposits at the rate of 5%, has been widened; it now covers any excess of up to 3% over the permitted growth, instead of up to 1%. The penalties otherwise remain as before: the second band, charged at 25%, covers any further excess up to 5%, and any excess over 5% is charged at 50%. This small relaxation should allow banks a little more flexibility and enable them to move closer to the penalty-free limit with less risk of incurring the heavier penalties. The banks were also asked to continue to give priority to lending to industry over lending for personal consumption, financial transactions, and property companies.

At the same time the London and Scottish clearing banks and the Bank of England, along with other financial institutions, have agreed to provide the necessary resources for a considerable expansion in the activities of Finance for Industry. It is thereby intended to make up to £1,000 million available over a period of two years or so in medium-term loans for productive investment. [3]

In his Budget the Chancellor also announced the end of the agreement made with the banks in October 1973 that, for the duration of the third stage of the Government's counter-inflation policy, no interest would be paid on a proportion of the banks' special deposits. [4] This will provide some help to the banks at a time when they will be making additional commitments to industry.

[1] This is not to say that external influences necessarily reduced the money stock by this amount. As with the other entries in Table K, different 'influences' may offset each other, and should not be regarded as carrying through automatically to the money total. Nor is there any implication regarding causality. For example, bank lending (+) may provide some of the funds which are paid abroad (-) when the country is in balance of payments deficit. Moreover, the deficit may be regarded as giving rise to some of the demand for bank credit, or the supply of such credit (if too easy) could be regarded as helping to cause the deficit. The uses and limitations of this kind of table were described in an article in the December 1972 *Bulletin*, page 512.

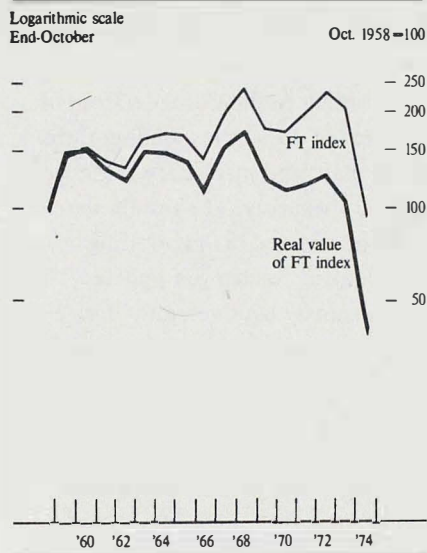
[2] The notice is reprinted on page 420.

[3] The announcement is reprinted on page 401.

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

## The real value of equities

The FT industrial ordinary share index reached its lowest since 1958—and in real terms its lowest since it was first compiled in 1935.



## The stock market and company issues

The capital markets have continued to reflect, both in low prices and thin trading, the poor financial prospects of the company sector and the lack of profits of industrial companies in particular. The FT industrial ordinary (30) share index (the stock market indicator with the longest run) went to its lowest since the summer of 1958 (see chart), and, in real terms, its lowest since the index began in the mid-thirties.

The fall in the last two years was faster than in 1929–31 or in 1937–40. The decline in stock market values has not been confined to the United Kingdom but has occurred in most foreign equity markets as well, doubtless reflecting a tendency for the share of profits in total incomes to fall with rapid inflation, and, consequently, a lack of confidence in equities as a hedge against inflation.

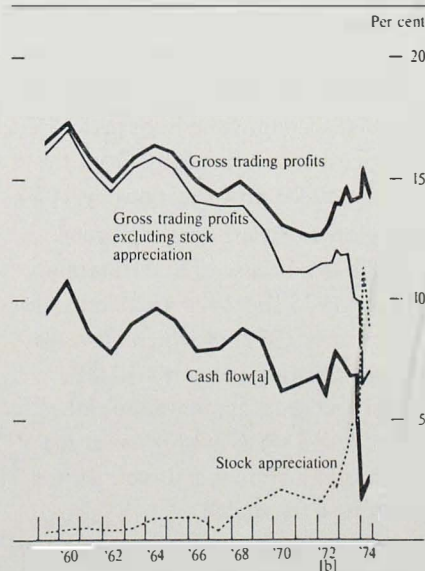
The decline in UK stock market values has discouraged new equity issues; and high nominal yields have made debenture issues look too expensive. With large uncertainties concerning the prospects for profits and the future rate of inflation, companies have been unable to judge whether they could achieve a real return on new investment adequate to justify raising new funds in either form. Gearing constraints, too, are becoming more prevalent; and both banks and companies are now anxious to conserve for increased working capital such further room as they may still have for growth in bank finance.

The Budget, and the associated changes in the price code, will have brought better prospects for profits; but uncertainties that affect borrowing remain, including doubts about the prospective real cost of servicing new long-term or permanent capital raised in the markets. It is likely that for some time new issues will be difficult to make on terms that the industrial borrower can accept and yet provide the lender with a positive real return.

The erosion of equity earnings also poses a problem for companies in the management of their pension funds. The need, with inflation, to finance rapidly growing pension liabilities in the face of a reduction in the real income from their accumulated equity funds will become a further drain on their resources.

## Profits and cash flow as percentages of gross domestic income

Before 1972, profits, both before and after deducting stock appreciation, followed normal cyclical patterns, although around a declining trend. Since then, profits, after deducting stock appreciation, have accounted for a much smaller proportion of gross domestic income.



## Company finance

The share of profits in total domestic income has tended to fall over the last fifteen years (see chart). This is true whether the calculation is done before or after deducting stock appreciation, but the latter is far more striking. The trend cannot continue without serious repercussions for private investment, because the amount of profit is now frequently insufficient to compensate for the risk-taking associated with equity investment, and those risks have increased as inflation has intensified.

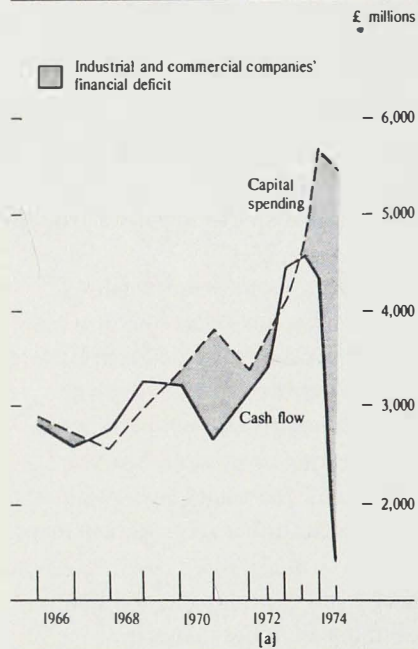
The failure of cash flow [1] to keep pace with capital spending has led industrial and commercial companies into exceptionally heavy financial deficit in 1974 (see chart over page). Having been typically less than 10% of profits before 1968, stock appreciation has soared in recent years until it comprised some 60% of them in the first half of 1974 (see second chart over page). The need for companies to raise money to finance stocks has consequently risen to unprecedented amounts. At the same time, as noted above, the possibility of raising new funds in the capital markets has been sharply reduced, and bank borrowing has become almost the only available source of external finance. Interest payments have risen in step with the heavy increase in borrowing at high rates, and have contributed further to the worsening liquidity position.

[a] Defined in footnote [1] on this page.  
[b] Quarterly plots from 1972.

[1] Defined as retained profits (including depreciation) plus investment grants and other capital transfers, but excluding stock appreciation.

## Company cash flow and capital spending

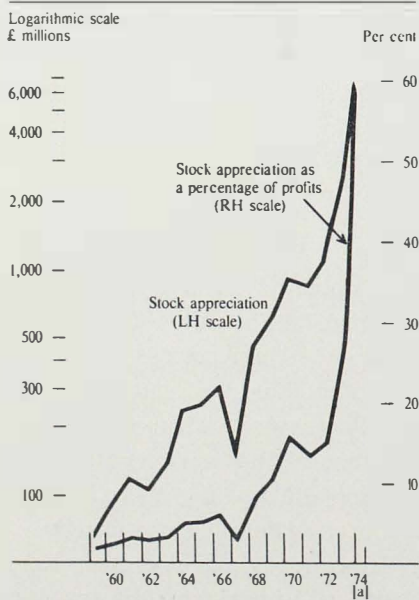
Financial pressures on companies have led to some cutback in fixed investment and stockbuilding, as in earlier periods of company sector deficit.



[a] From 1972 onwards, half-yearly figures at an annual rate.

## Stock appreciation and gross trading profits

Stock appreciation, both in amount and as a proportion of gross trading profits, has increased sharply.



[a] First half at an annual rate.

**Table L**  
Stock appreciation  
£ millions

	1963-72 (annual average)	1973	1st half 1974 (annual rate)
Companies' stock appreciation	500	2,500	6,400
Total stock appreciation	600	3,100	7,500
as percentage of total domestic income	1.6	4.8	10.5

As a result of these developments many companies have come much nearer in the second half of the year to the limit of their willingness to borrow. The three-day week and its aftermath was apparently weathered better than was first feared, but since the summer the magnitude of the problem facing many companies has become increasingly clear.

So far the strongest indications of a sharpening response to financial pressures can be seen in the downward revision in investment plans that occurred between July and October. According to the Confederation of British Industry's October survey, a balance of 33% of responding firms were expecting to reduce expenditure on plant and machinery in the next twelve months, compared with 6% in the July survey. The results were thought to imply a reduction in the volume of fixed-manufacturing investment of probably over 10% in 1975, given unchanged policies. This was appreciably more pessimistic than the survey conducted by the Department of Industry in September, which indicated a small rise in manufacturing investment in 1975, following a sharp fall of 8% foreseen between the first and second halves of 1974. The intended expenditure cuts appear to reflect a greater pessimism about demand as well as heavier financial pressure. Intentions to reduce stocks and shed labour where possible were also more prominent than earlier.

There is some resemblance between the fall in investment suggested by the latest survey and experience in 1971-72, when fixed investment in manufacturing fell by about 10% after heavy financial deficits in 1970 and 1971. Those years also witnessed bigger cutbacks in stocks and in employment than the course of demand would seem to have warranted. Because companies' financial deficits in 1973-74 were much larger in relation to incomes than those of 1970-71, and because companies had in the meantime become subject to the price code, which strictly limits their ability to pass on higher costs, the likely consequences for fixed investment, stockbuilding and employment threatened, before the November Budget, to be far more serious than in 1971-72. The prospect was for shedding of labour and plant closures on an accelerating scale as one company after another took cost-cutting action only to involve others - because of the interdependence of companies - in further difficulties.

One factor that brought companies' financial difficulties to a head was the impact of price controls. Under the third stage of the counter-inflation policy, many firms were in effect compelled to reduce their gross profit margins as a percentage of sales, owing to the operation of the 'productivity deduction', under which firms were in general obliged to absorb up to 50% of any increase in unit labour costs. With wages rising at around 20% a year, the impact of this deduction on profits was more severe than when the control began. In money terms, gross profits per unit of output sold on the home market have probably fallen quite sharply in 1974, and the productivity deduction must account for a large part of the fall (although the code contained a safeguard exempting firms from the deduction once its cumulative effect had reduced profit margins by 10%).

While the price code has borne heavily on profit margins, abnormal increases in the cost of stocks has been the main cause of deteriorating cash positions. The exceptional figures for 1973 and 1974 are due to the extremely rapid rise in commodity prices since 1972, of which oil is the most dramatic and recent. Total stock appreciation of some £3,100 million in 1973, as shown in the national accounts, amounted to rather more than 15% of the book value of stocks and work in progress at the end of 1972, of which about one third was in materials and fuel. During 1973 prices of materials used in industry rose some 50%.

Stock appreciation, of which by far the greater part relates to industrial and commercial companies, rose further to some 10% of total domestic income in the first half of 1974 (see Table L). The ratio of stock

appreciation in companies' home sales is probably much the same. With the ending of the commodity boom, the rise in stock values is likely to moderate but, even so, appreciation will be very much larger next year than has hitherto been normal, given the present rate of inflation of home costs.

## The Budget

One of the principal objectives of the measures announced in the Budget Speech on 12th November was to meet the threat of a recession brought about by shortage of liquidity in the company sector. In other respects the prospective balance of demand was left little changed.

A scheme was announced to defer corporation tax on profits arising from abnormal increases in the value of stocks, under which the maximum amount of profit represented by increases in stock values on which tax will be payable this financial year is limited to 10% of trading profit in the accounting period which ended in the financial year 1973/74. For practical reasons, relief this year will be confined to larger companies, but an assurance was given that smaller businesses will eventually receive comparable treatment, suitably backdated. The estimated effect will be to reduce companies' tax payments by nearly £800 million in this financial year. Decisions on the later treatment of profits for tax purposes under inflationary conditions were postponed until next year, when the recommendations of the Committee on Inflation Accounting should be available. The Chancellor however made it clear that he envisaged a need for further deferment of taxation next year on abnormal increases in the value of stocks arising in the present year's profits.

Concurrently with the Budget, proposals were published for the relaxation of the price code in several important respects, the changes mostly to be effective with the revision of the code in December. First, it was proposed that the productivity deduction should be generally reduced from 50% to 20% and its application tailored more closely to the weight of labour costs experienced by different firms. [1] Secondly, firms should be permitted to recoup in increased prices over one year up to 17½% of the cost of their investment programmes covering plant, machinery, and industrial buildings. Thirdly, improvements should be introduced in the 'safeguard' provisions which set a limit to the erosion of profit margins and a minimum return on net assets. Fourthly, companies should be able to recover through higher prices the losses incurred through delays in the adjustment of prices for increases in allowable costs.

The effect on profit margins of these changes is difficult to gauge because it is not known, for example, how far companies would have been able to take advantage of existing safeguards and how far they might react to the investment incentives in the revised code, or be able to raise prices to the extent allowed there. The Chancellor estimated that company profits will be some £800 million higher in 1975 than they would have been if existing margins had been maintained. The extra profits will in due course be subject to tax, but the immediate effect will be to improve the cash position by the full amount. It was estimated that under the revised price code the retail price index will probably be nearly 1½% higher by the middle of next year than it would have been under the existing code, but less than 1% higher than it would have been if present profit margins had been maintained. It will be some time before the effect will be seen of companies' improved financial position on their ability to borrow on the capital market in the ordinary way.

[1] For example, in the case of firms with labour costs amounting to 80% of total costs, the deduction would be 9%, while for firms where labour accounts for 5% of total costs, the deduction would be 35%.

**Table M**  
**Estimated effects of the Budget on revenue and expenditure**  
 £ millions

	1974/75	1975/76
<b>Revenue</b>		
Deferment of tax on the increase in stock values	-775	-105
Extra value added tax on petrol	+ 10	+200
Special income tax allowance for elderly	-	-220
Lower threshold for investment income surcharge	-	+ 40
Other revenue measures	- 25	- 45
	<u>-790</u>	<u>-130</u>
<b>Expenditure</b>		
Increased pensions and social security benefits (net)[a] [b]	-	-200
Increased family allowances[b]	-	-205

[a] Gross expenditure on benefits will be raised by £925 million in 1975/76, but this will be largely offset by revenue from national insurance contributions.

[b] Subject to income tax at normal rates.

The estimated effects of the Budget measures on revenue and expenditure are summarised in Table M. The public sector borrowing requirement in 1974/75 is put nearly £800 million above the pre-November Budget estimate of £5,500 million. The effect on the requirement in 1975/76 is less certain, for it will depend on the buoyancy of tax receipts, including receipts from higher value added tax on petrol; moreover, the Chancellor foreshadowed a continuation of deferment of tax on abnormal profits on stocks in his next Budget and a review of personal tax allowances, while also warning that excessive wage increases would lead the Government to curtail demand. As the effect of deferment of part of the tax on profits will essentially be to prevent the deterioration in the financial balance of companies otherwise foreseen, the net addition to investment resulting from this measure will probably be small; its impact will rather be to forestall reductions which might otherwise have occurred. The effect of increased pensions next year will be largely offset by increased revenue from contributions.

### Assessment

A main object of the autumn Budget was to relieve the financial predicament in which British industry has found itself this year; of which, since the summer, firms have become increasingly aware. The situation has resulted from the impact of inflation on corporate finances, and it might have been recognised more widely and earlier had accounting practices generally been adapted to take account of inflation. The elements of the situation have both been building up, and seem likely to persist, for some time.

The long-term and fundamental problem is lack of profitability, particularly the lack of an adequate real return on capital invested; the immediate and acute manifestation of the problem in 1974 has been the rapid loss of liquidity, which had already been depleted by insufficient retained profits, measured in real terms, in earlier periods. The situation has been made worse by the financial strain of short-time working earlier in the year, and by the working of the price code; and it has been brought to a head by the much sharper rise in the cost of materials, requiring vastly increased sums to finance stocks and working capital. Both the Budget and the proposed revisions of the price code will alleviate the problem.

As a result of inadequate internal resources, firms have heavily increased their borrowing over the last two years. Before the Budget, many firms were increasingly being forced to the view that further additions to debt could not prudently be contemplated, and that, for them to survive, all avoidable expenditures would have to be eliminated. This has shown up in a rapid pruning of investment plans, and would no doubt have resulted in widespread cutbacks in output, stocks, and employment. The efforts of firms individually to economise could only have worsened their collective situation, and a further tightening of trade credit might have exaggerated the financial stringency. It is important to keep in mind that such a train of developments appeared not impossible, despite the continuance of government high employment policies. The action taken in the Budget should have helped to remove this kind of danger.

It would seem that the financial position of companies in some other countries has been weakened over the last two years in the same way as in this country, but to a smaller degree. It is not entirely clear why industry's difficulties should have become so much more acute here than elsewhere. The share of profits in national income has for a long time been tending to fall in many other countries: but though exact international comparisons are not available, it is possible that the return on capital in this country

had fallen to a lower level than in other industrial countries. It may also be the case that the recent rapid rise in costs in at least some other countries has been passed on more quickly than here in higher prices: if so, firms there will have been able to obtain from their own resources some of the finance required for abnormally large increases in the cost of stocks. The rise in commodity prices has been international, affecting all countries. But import prices in terms of national currencies have risen appreciably more in this country than most other industrial countries, partly because of the depreciation of sterling last year; in consequence the scale of stock appreciation has probably been correspondingly greater.

The financial difficulties of industry will be very substantially eased by the tax relief announced in the Budget, and the proposed relaxations of the price code. Though the scale of relief was appreciable, it remains of course to be seen how completely it will restore companies' positions. How quickly they will resume an expansion of their fixed investment will depend not only upon financial considerations but on more general factors such as industrial confidence and on firms' evaluations of their present uncertain prospects.

Some elements of the present problem are likely to persist. Taken together, the tax reliefs and the relief through the price code may not provide companies in the next twelve months with much more than a third of the prospective increase in the cost of their stocks in this period; and, while stock appreciation next year is likely to be less than this year, it is still likely to be larger than in any other previous year. In whatever way profits associated with stock appreciation may be given relief in future, it may well need to be considered whether over a term of years British industry will not need to improve its margin of profitability; it should in any case pay more regard to its real rate of return, as distinct from the nominal rate of return. One aspect of this question — namely the adequacy under present conditions of provisions made by firms for the replacement of fixed capital — will no doubt be clarified when the report of the Sandilands Committee is available.

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The Budget reliefs inevitably increase the public sector borrowing requirement. This year it now appears to have been running at £5,500 million, and after the Budget measures will probably be £6,300 million.

A requirement of this size naturally raises the question whether it can readily be financed without causing excessive monetary expansion. Indeed fears on this score led immediately to some fall in the price of gilt-edged. So large a borrowing requirement is clearly abnormal and unwelcome. But, circumstances being what they are, there are a number of considerations which need to be borne in mind. A large requirement has to be regarded as necessary in order to balance the economy at a time of the abnormally large deficit on external current account; and the provision of external finance to meet this deficit will at the same time provide much of the funds needed to finance the borrowing requirement. It is partly because of the external circumstances that in the last few quarters — although the requirement must recently have been running at an annual rate of around £5,500 million, and despite a sizable increase in bank lending to industry — the authorities have been able to reduce the rate of growth of  $M_3$  to a more moderate pace. The Budget measures to alleviate the financial position of companies, while adding to the borrowing requirement, should of course at the same time reduce their need for recourse to the banks. This should reduce the growth of bank lending to companies, which has been a main source of monetary expansion in recent years.

The impact of the Budget can be regarded as expansionary chiefly in the sense that it should prevent the large-scale decline in industrial investment

that was previously in prospect. The direct impact on consumer spending of the changes in taxation and government expenditure announced at the Budget were in total small.

Even after the Budget measures, the economy is expected to expand at a relatively modest rate, of about 2% a year. This is somewhat less than should be possible in a normal year. But at the end of last year the economy was operating under some strains, and though shortages of labour, materials and components have eased, they have not disappeared entirely. There seem therefore distinct limitations on the capacity of industry to achieve a normal increase in production without setting up renewed inflationary stresses; and an undue expansion of demand would react unfavourably on the trend of imports.

The rate of expansion will, necessarily, depend to an important degree on developments in other countries and the course of world trade. World trade is likely to grow more slowly next year, but this slowdown will not last indefinitely. In several countries weak domestic demand has been reflected in a rather rapid increase in unemployment, and it is reasonable to expect that at some stage more expansionary policies will be adopted. In the course of the next twelve months this could begin to produce a stronger trend in international trade. It is necessary to provide room in the economy for taking advantage of the return of a more buoyant world demand.

To achieve the conditions for continuing economic expansion, there is need both for a revival of industrial investment and for a diversion of resources to the balance of payments. But the large uncertainties which inflation creates for business act against both investment and exporting; and it is doubtful whether a satisfactory pattern of expansion can be achieved unless the pace of inflation is greatly reduced. Recent experience has shown that more cannot be expected of price control: on the contrary, some domestic prices may have to rise faster to reflect more of past cost increases than has hitherto been allowed. Restraint of the rate of price increase will clearly depend on restraint of the rate of increase of money incomes. The position of some particular groups will still need to be favoured; but, to this extent, there will be less room fully to maintain the real purchasing power of the population at large.