Economic commentary

Output fell in the fourth quarter last year – though perhaps less steeply than in other industrial countries – and the rise in unemployment to January was more rapid than earlier. The current account, despite a narrowing in the non-oil visible trade deficit, showed little overall improvement in the course of 1974.

Though the rise in commodity prices slackened off and ceased by the fourth quarter, the rate of inflation rose through the year, with a growing proportion attributable to domestic costs.

Despite the relief given to companies in the November Budget, their finances have remained tight, leading some of them to cut investment programmes and making them cautious in incurring new debt, including borrowing from the banks.

International developments

There were increasing signs of deepening world recession towards the end of 1974, with little hope of an upturn before 1976. Output in the industrial countries, already stagnating in the first half of the year, subsequently declined steeply as the big increase in oil prices and widespread restrictive policies depressed demand. World trade began to grow more slowly in the second half of the year after remaining quite buoyant in the first half. Despite their continuing concern about inflation, a number of countries, including the United States and Western Germany, have undertaken cautious reflation.

In the United States, industrial production fell sharply in the fourth quarter after remaining more or less flat over the previous nine months (see table), and real GNP, after declining in each of the first three quarters of the year, fell by a further 2¼%. In Japan, GNP failed to recover from the sharp fall in the first quarter of the year, and the decline in industrial production accelerated in the last quarter. In Western Germany GNP fell after rising a little in the first half of the year; and industrial production fell sharply. Even in France and Italy, where output in the year as a whole was substantially greater than the year before, it fell in the second half of the year. In most of the main countries output is now well below capacity, and unemployment is rising. The rise in unemployment has been particularly marked in the United States, Western Germany, and France (see table), [1] and it will go at least some way further in most countries.

Meanwhile, prices have continued to rise fast. Over the year to December, consumer prices in the OECD countries as a whole rose by over 14%; among the main countries only in Western Germany was the rise less than 10%. There was a seasonal improvement during the year in Japan, where consumer prices rose by over 9% in the first quarter of the year but by only 4¼% in the last quarter. Price inflation began to slacken in Canada and France, as well as in Western Germany (see table).

The slower rise in prices in some industrial countries owed something to a fall in the prices of commodities other than oil and food. Commodity prices generally reached their peak last May, when *The Economist* dollar index (which excludes oil) had risen by 179% since December 1971, food prices being up by 183% and prices of industrial materials by 171%. Food prices continued to rise until recently, while the prices of industrial materials, especially fibres and metals, have

[1] Because of differences in methods of collection and compilation, the figures are not comparable for different countries, but if rough allowance is made for these differences, the latest figures in the table, corresponding with the 3·1% in the United Kingdom, might have been 5·5% in the United States, 1·8% in Western Germany, 3·3% in France, and 2·7% in Italy.

Industrial production

Production in all the main industrial countries fell in the fourth quarter.

Percentage changes on previous quarter: *seasonally adjusted*

	1974			
	1st qtr	2nd qtr	3rd qtr	4th qtr (provisional)
United States	–1½	+ ½	–	– 3
Canada	+2½	–1	–1½	– 1½
Japan	–2	–2	–3½	– 5
France	+1½	+1	+1	– 6½
Italy	+4½	+2	–5½	– 7½
Western Germany	–1	+ ½	–3	– 3
United Kingdom	–5½	+6	+1	– 2½
All OECD countries	–1	–	–1	– 3½

Source: OECD.

Unemployment

Unemployment in the main industrial countries has generally been rising since the middle of 1974.

Percentage of labour force, average of monthly figures: *seasonally adjusted*

	1973	1974				1975
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr	Jan.
United States	4·7	5·2	5·1	5·5	6·5	8·2
Canada	5·5	5·5	5·2	5·4	5·6	6·7
Japan	1·2	1·3	1·3	1·4	1·7	1·8
France	1·9	2·1	2·0	2·3	2·9	3·3
Italy [a]	2·8	2·8	2·9	3·1	3·7	3·7
Western Germany	1·4	1·8	2·5	3·1	3·6	3·5
United Kingdom	2·2	2·5	2·5	2·7	2·8	3·1 (Feb.)

[a] First week of following quarter; the latest figure is estimated.

Consumer prices

Price inflation in some industrial countries has slackened a little.

Percentage change on previous quarter

	1973	1974			
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr
United States	2·3	2·8	2·9	3·0	2·9
Canada	1·8	2·4	3·3	3·0	2·8
Japan	4·3	9·2	4·4	3·7	4·2
France	2·7	3·7	4·1	3·3	3·2
Italy	2·7	5·3	5·2	6·0	6·1
Western Germany	2·0	2·4	1·6	0·9	1·3
United Kingdom	3·2	4·1	5·9	2·8	4·5
Weighted average of above	2·6	3·9	3·4	3·0	3·2

Source: OECD.

Volume of trade and industrial production in OECD countries

Despite the slackening of activity in OECD countries, their exports continued to grow throughout 1974, though less fast in the second half of the year when imports began to grow again.

Percentage change on previous half-year: *seasonally adjusted*

	1973 1st half	1973 2nd half	1974 1st half	1974 2nd half
Industrial production	5½	2½	–	–2½
Exports	9½	3½	6	3
Imports	8	3½	–	1½

Current account balances

Except for Western Germany, the main industrial countries' current balances worsened in 1974, although with some improvement in the second half of the year.

$ billions: *seasonally adjusted*

Surplus+/deficit–

	1973	1974	1974 1st qtr	1974 2nd qtr	1974 3rd qtr	1974 4th qtr (provisional)
United States	+ ½	– 4	–	– 2	– 1½	– ½
Canada	– ½	– 1¾	– ¼	– ¼	– ½	– ¾
Japan	–	– 4½	– 2¾	– 1½	– ¾	+ ½
France	– ¾	– 6¼	– 1¼	– 2	– 2	– 1
Italy	– 2½	– 7¾	– 2	– 2¼	– 2¼	– 1¼
Western Germany	+4½	+ 9¾	+ 2¾	+ 2½	+ 2	+ 2½
United Kingdom	– 3	– 8¾	– 2¼	– 2½	– 1¾	– 2¼
Total	– 1¾	–23¼	– 5¾	– 8	– 6¾	– 2¾

Changes in reserves

OECD countries' reserves increased a little further in the fourth quarter.

$ billions

	1974 1st half	1974 3rd qtr	1974 4th qtr
United States[a]	–2·6	–1·6	–
Canada	+0·4	–0·3	–
Japan	+1·2	–0·3	+0·4
France	–0·4	+0·4	+0·3
Italy	–1·2	+2·3	–0·7
Western Germany	+1·1	–1·7	+0·2
United Kingdom	+0·2	+0·4	–0·4
Other OECD countries	–4·6	+1·5	+0·7
All OECD countries	–5·9	+0·7	+0·5

[a] Balance on official reserve transactions.

fallen sharply (see chart opposite). Oil prices continued to rise to the end of last year, partly because of revised agreements on sharing output between producer governments and the main oil companies.

As the prices of manufactured goods have continued to rise fast, the terms of trade have once more moved slightly in favour of industrial goods, possibly resuming a trend which had been broken in the fourth quarter of 1971. Between the fourth quarter of 1971 and the second quarter of last year, according to UN indices export prices of manufactured products had risen by 46% while commodity prices, including oil, had risen by 150%; but in the second half of the year, while the prices of manufactured exports rose by perhaps 8% or 9%, commodity prices rose by only about 4%.

Demand for the exports of industrial countries was growing during 1974. The buoyancy of primary producers' export prices in 1972 and 1973 had helped many of them to build up their reserves and then to expand their imports. The oil exporters also soon began to spend some of their extra revenues. Demand from oil exporters and other primary producers explains why world trade grew in the first half of 1974 despite the slackening activity in most industrial countries. The volume of imports into OECD countries (which include some, like the United States, Canada, and Australia, which may themselves have benefited from the commodity boom) was, indeed, little changed in the first half of the year compared with the second half of 1973 (see table). But the volume of their exports rose by 6%, with those to oil-exporting countries growing particularly strongly. In the second half of the year, while OECD imports now increased a little, the volume of their exports rose much less fast than in the first half. Exports to oil exporters continued to expand strongly, but those to other countries probably fell.

With the terms of trade again moving in their favour, the trade balance of the OECD countries improved during the year despite the slower growth in the volume of their exports. Consequently, by the fourth quarter, the combined current deficit of the main countries, although still large, was much smaller than in the second and third quarters (see table). Japan, whose current balance improved dramatically throughout the year, moved out of deficit from August onwards. Western Germany's current surplus remained large, if slightly less strong than in the first half of the year.

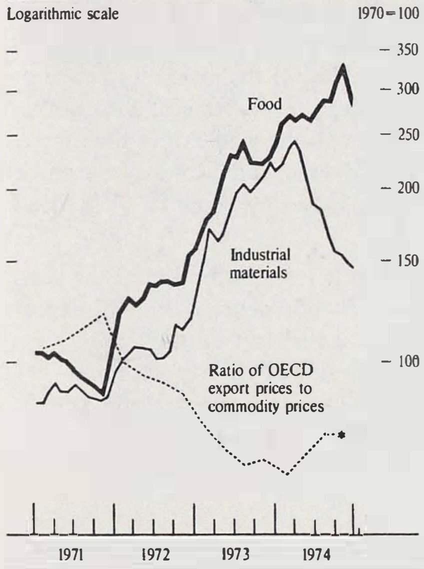
The deficits did not in fact create many short-term financing problems for industrial countries. Italy alone among the main countries has had recourse to the International Monetary Fund. The reserves of OECD countries increased in the third and fourth quarters (see table).

The position of developing countries other than oil exporters deteriorated sharply. From the middle of the year, these countries began to feel the full effects of dearer oil; the prices of industrial imports were rising fast but the prices of many commodities they export began to fall; and reduced demand in industrial countries cut the growth in the volume of their exports. Although the volume of their imports also declined in the second half of the year, their combined current account deficit widened sharply – in all, from about $8 billion in 1973 to probably something over $20 billion in 1974. Their borrowing increased substantially: for example, they drew almost $2 billion from the IMF, half of it under the oil facility; obtained somewhere around $3 billion from other international agencies; borrowed perhaps $2½ billion directly from oil exporters; and some of them were able to arrange large borrowing in euro-markets, though this source of funds contributed less later in the year. All this did not prevent some fall in their reserves in the second half.

The oil exporters' current account surplus in 1974 is now estimated at some $70 billion. After allowing for normal lags in payment, this suggests a cash surplus of around $55 billion, of which 37% is estimated

World commodity prices[a]

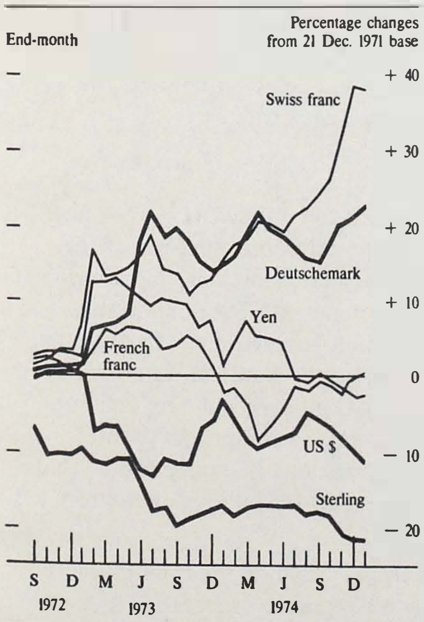
The sharp fall in prices of industrial materials (excluding oil) has helped to improve OECD countries' terms of trade.



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

Effective changes in exchange rates

Sterling, the US dollar and the yen weakened in the last months of 1974 while the Swiss franc, deutschemark and the French franc strengthened.



to have been placed in the United Kingdom (two thirds in foreign currency deposits with banks), 20% in the United States, 37% in other countries, and 6% with international organisations (further details are given in the section on oil money movements in the financial review).

The main oil exporters have indicated that there may be no further price rises until the end of this year. If so, and if their imports continue to increase rapidly, their current account surpluses will fall back in the course of this year. The current deficits of other developing countries seem very likely to increase further. This would imply a further reduction in the current account deficits of industrial countries as a group.

Exchange rates since the middle of last year have been influenced by many developments other than the state of countries' current balance of payments. The US dollar weakened as monetary conditions eased in the United States and (perhaps perversely) as fears of recession there grew. The main currencies to strengthen as the dollar weakened (see chart) were the deutschemark, under the influence of renewed talk of a revaluation against the other currencies in the 'EEC snake', and – dramatically – the Swiss franc, which in the second half of the year appreciated by 16% against other currencies generally, despite strenuous measures to discourage inflows. The French franc also strengthened. The lira and the yen each weakened from the middle of the year – the latter despite the improvement in Japan's current balance and a much slower rate of price inflation. Sterling remained fairly stable measured against other currencies as a whole until near the end of the year.

The prospect for most industrial countries this year is a continued depression of economic activity. No significant recovery in demand seems likely until the end of the year, even if further reflationary measures are taken. There has already been some relaxation of policy, notably in Western Germany and the United States. In Western Germany, the Government have recently relaxed fiscal policy through personal tax cuts for 1975, greater investment incentives, and increased public investment; and monetary policy has also been eased. These measures may allow a moderate growth in GNP this year. In the United States, the President has proposed a package of fiscal measures, including a tax rebate of $16 billion this year, and increased taxation on oil and natural gas, with plans to return to the economy the $30 billion expected to be raised thereby. These proposals may be much changed before enactment, probably in an expansionary direction. But, even as they stand, and taken with the easing of monetary policy that has occurred, they could have a modest reflationary impact on the economy by the end of this year.

The UK balance of payments

The current account[1]

After an improvement in the third quarter last year, the current account deficit widened again in the fourth (see table over page). The deterioration was largely accounted for by a worse visible trade balance.

The volume of exports fell very sharply in the fourth quarter, by 8%. Even if allowance is made for a slight contraction of world trade, the result is disappointing. The volume of imports meanwhile fell by 3% – doubtless a reflection of lessening domestic activity. Thus there was a significant reduction in the fourth quarter in the net amount of real resources devoted to the visible balance of payments, a marked contrast to the preceding quarters. However, comparing the full year 1974 with 1973 there was a very substantial improvement in the balance of trade

[1] The section is in seasonally-adjusted terms throughout.

Current account of the UK balance of payments
The current deficit worsened in the fourth quarter largely through trade in goods other than oil.

£ millions: *seasonally adjusted*

	1973	1974	1974 2nd qtr	1974 3rd qtr	1974 4th qtr
Current balance	–1,115	–3,830	– 985	– 795	–1,075
Components:					
Net invisibles	+1,185	+1,430	+ 330	+ 415	+ 380
Visible trade:					
Exports of goods	11,510	15,590	3,900	4,160	4,030
Imports of goods	13,810	20,850	5,215	5,370	5,485
Visible trade balance	–2,300	–5,260	–1,315	–1,210	–1,455
of which, non-oil[a]	*–1,360*	*–1,815*	*– 435*	*– 335*	*– 535*
Changes on preceding year/quarter:					
Visible trade balance	– 35	–1,620	–2,960	+ 105	– 145
of which:					
Price	*– 135*	*–1,455*	*–3,655*	*+ 5*	*– 65*
Volume[b]	*+ 100*	*– 165*	*+ 695*	*+ 100*	*– 180*
Volume of exports (percentage)	+ 2·5	+ 11·5	+ 6·5	+ 2·0	– 8·0
Volume of imports (percentage)	–	+ 13·0	+ 0·5	– 0·5	– 3·0

[a] The balance of trade other than in petroleum and petroleum products (Standard International Trade Classification: division 33).
[b] Measured in each period at the prices of the preceding period.

Financing of the current account deficit
In the fourth quarter the deficit was largely matched by official foreign currency borrowing. Over the year as a whole, however, the biggest source was the increase in sterling balances of oil-exporting countries, and less than half was provided by foreign currency borrowing by the public sector.

£ millions: *not seasonally adjusted*

	1973	1974	1974 2nd qtr	1974 3rd qtr	1974 4th qtr
Current balance	–1,115	–3,830	–965	–860	–915
Capital transfers[a]	– 60	– 75	– 30	– 40	– 5
	–1,175	–3,905	–995	–900	–920
Financed by:					
Decrease (+) in reserves	– 210	– 80	–110	–185	+175
Foreign currency borrowing:					
Central government	–	+ 645	–	–	+645
Other public sector	+1,100	+1,240	+500	+215	+190
Increase (+) in sterling holdings (official and private)	+ 155	+1,560	+385	+615	+375
of which, oil-exporting countries	..	*+2,215*	*+595*	*+925*	*+430*
Other capital flows	+ 130	+ 540	+220	+255	–465
of which:					
Oil and miscellaneous	*+ 395*	*+ 600*	*+305*	*+210*	*–415*
Balancing item	*+ 175*	*+1,145*	*– 35*	*+610*	*+190*

[a] The nine-month sterling guarantee arrangements which expired in December 1974 did not fall to be implemented: however, some amounts outstanding from the previous arrangement were settled in the fourth quarter.

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

.. Not available.

by volume. The enormous increase in the trade deficit by value can be more than accounted for by the deterioration in the terms of trade – a deterioration resulting mainly from much dearer oil, but also from higher prices for many foodstuffs and raw materials. The terms of trade in 1974 were on average some 17% worse than in 1973. They reached their low point in April, when the full effect of the main oil price rises had appeared and when other commodity prices were near their peak. Commodity prices in sterling have fallen on the whole since the first quarter of 1974, even though the pound depreciated towards the end of the year. In the third week of February they were some 18% less than a year earlier.[1]

The downturn in the volume of exports towards the end of the year in part reflects the general weakening of world demand; but UK exports performed less well than those of other industrial countries. For example, in the third quarter the dollar value of UK exports to oil-exporting countries was 50% higher (and their volume perhaps 20% higher) than in the same quarter of 1973, but the corresponding values of exports by the United States, Western Germany, and Japan were each 65%–100% greater.

In January there was a sharp recovery in exports, and trade in goods other than oil was in surplus for the first time since April 1973.

The surplus on invisible transactions was £380 million in the fourth quarter, bringing the total for 1974 to £1,430 million, some £250 million more than in 1973. There was a significant increase in net earnings from private services: the travel account benefited from a marked reduction in holidays abroad and moved into substantial surplus, and the surplus on services such as insurance and banking was larger. Net receipts of interest, profits and dividends totalled £1,250 million, compared with £1,090 million in 1973; to some extent their growth reflected sterling's weaker exchange rate, because credits tend to be denominated in foreign currency and debits in sterling. The deficit on government account increased somewhat.

The financing of the deficit

Without seasonal adjustment, the deficit to be financed in the fourth quarter was not much bigger than in the third, but the form of the financing was different (see table). The main items were the drawing of £645 million ($1·5 billion) on the Government's $2·5 billion euro-dollar facility; some other borrowing in foreign currency by the public sector (chiefly $400 million from Iran by the National Water Council); a rise in official sterling holdings of £390 million; and a reduction of £175 million in the reserves, which at times were used to counter pressure on sterling. Over the quarter, sterling effectively depreciated against other currencies in general by some 4½%, though it appreciated slightly against the US dollar.

The rise in sterling holdings was smaller than in the third quarter. The lower rate of accumulation by oil exporters as recorded in these statistics was, however, in part offset by their increased investments in UK property or equities, and by direct lending to the public sector. Saudi Arabia's decision in December to take all future oil revenues in dollars, instead of taking about one quarter in sterling and three quarters in dollars, reduced the amount of sterling temporarily held by British or foreign oil companies before payment and by Saudi Arabia afterwards. Meanwhile sterling holdings of countries other than oil exporters again fell in the fourth quarter, though much more slowly than before.

Among other capital flows, oil company transactions swung sharply into deficit: working funds built up in this country earlier in the year were reduced in order to repay trade credit obtained from oil exporters and to finance increased investment overseas.

[1] As measured by *The Economist* sterling index of world commodity prices; this index excludes oil, and refers mainly to prices on the open market.

Correction

Bank of England Quarterly Bulletin

Volume 15 Number 1 March 1975

The table at the top of page 6 should read as follows:

Current account of the UK balance of payments

The current deficit worsened in the fourth quarter largely through trade in goods other than oil.

£ millions: *seasonally adjusted*

	1973	1974	1974		
			2nd qtr	3rd qtr	4th qtr
Current balance	−1,115	−3,830	− 985	− 795	−1,075
Components:					
Net invisibles	+1,185	+1,430	+ 330	+ 415	+ 380
Visible trade:					
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of which, non-oil[a]	*−1,360*	*−1,815*	*− 435*	*− 335*	*− 535*
Changes on preceding year/quarter:					
Visible trade balance	−1,620	−2,960	− 35	+ 105	− 245
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Price	*−1,455*	*−3,655*	*− 135*	*+ 5*	*− 65*
Volume[b]	*− 165*	*+ 695*	*+ 100*	*+ 100*	*− 180*
Volume of exports (percentage)	+ 11·5	+ 6·5	+ 2·5	+ 2·0	− 8·0
Volume of imports (percentage)	+ 13·0	+ 0·5	−	− 0·5	− 3·0

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

[b] Measured in each period at the prices of the preceding period.

In 1974 as a whole, oil-exporting countries financed the largest part of the UK current account deficit by adding £2,220 million to their sterling holdings – only slightly less than the increase in the UK oil bill. The sizable inflow of investment through UK oil companies was also in part associated with the rise in price of oil, reflecting, among other things, an increase in trade credit for oil imports (particularly in the early months) and inflows of finance for North Sea operations. Somewhat over half of the estimated total of £800 million spent on oil exploration and development in the UK sector of the North Sea in 1974 is thought to have been spent on imports of goods and services for use there – an amount roughly matched by the directly associated capital inflows. Another feature of 1974 was sales of interests overseas by UK oil companies.

Foreign currency borrowing by the public sector, including the first drawings on the central government's euro-dollar facility, provided nearly £1,900 million in 1974, compared with £1,100 million in 1973. The balancing item represented a very large net inflow for the year as a whole: this is doubtless explained in part by the cash flow difficulties of UK companies.

In January a further £300 million was drawn on the central government facility and about £10 million was borrowed by the public sector under the exchange cover scheme. The reserves rose by some £20 million.

Domestic activity

Output, particularly industrial production, fell in the fourth quarter, and imports fell more than exports.

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	3rd qtr 1974 to 4th qtr 1974 (provisional)
Gross domestic product (output measure)	−1·4	+2·0	+1·1	−1·0
of which, industrial production	*−2·0*	*+4·3*	*+1·1*	*−2·4*
Consumers' expenditure	−0·7	−1·2	+1·6	+1·3
of which, retail sales	*−1·2*	*−2·2*	*+3·3*	*+0·5*
Exports of goods	+2·8	+3·2	−0·1	−4·2
Imports of goods	−0·2	+0·3	+0·3	−4·5

Changes in total final expenditure and its components[a]

Falls in stockbuilding, exports and private investment outweighed increased public and personal spending.

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

	2nd half 1973 to 1st half 1974	1st qtr 1974 to 2nd qtr 1974	2nd qtr 1974 to 3rd qtr 1974	3rd qtr 1974 to 4th qtr 1974 (provisional)
Total final expenditure	−0·4	+1·5	+1·2	−1·5
Components:				
Domestic expenditure (except on stocks)	−0·6	−1·9	+1·3	+0·6
of which:				
Consumers' expenditure	*−0·3*	*−0·6*	*+0·8*	*+0·6*
Public spending[b]	–	*−1·3*	*+0·4*	*+0·3*
Private fixed investment	*−0·3*	–	*+0·1*	*−0·3*
Stockbuilding	−0·4	+2·8	–	−1·2
Exports of goods and services	+0·6	+0·7	–	−0·9

[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.

The domestic economy

Output and demand[1]

There was a perceptible downturn in domestic activity in the later months of 1974. After two quarters of progressively weakening recovery from the supply disruptions earlier in the year, output appears to have fallen in the fourth quarter (see table). The fall-back seems to have been concentrated mainly in industrial production, especially manufacturing. GDP in the fourth quarter is provisionally estimated to have been about 1% lower than a year earlier; industrial production was down by some 2½%.

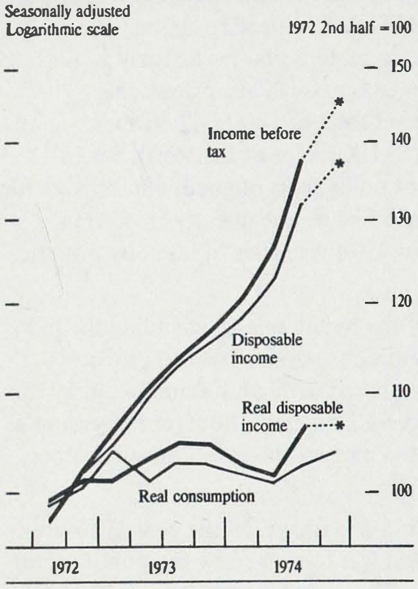
Domestic demand, other than for stockbuilding, increased slightly in the fourth quarter owing to continued buoyancy in both private and public consumption, and despite some weakening of private investment. However, the volume of total final expenditure declined because of falls in exports and in stockbuilding (see table). Although there has been very little shift of real resources into net exports since the second quarter of 1974, the shift between 1973 and 1974 (annual averages) was the largest on record, and in relation to total output was similar to that achieved between 1968 and 1969.

The volume of *consumer spending* rose by about 1¼% in the fourth quarter and was almost 1% higher than a year earlier (see chart over page). Income from employment again rose rapidly; average earnings increased substantially faster than prices. Social security pensions (helped by the Christmas bonus) and other benefits again increased, but it is unlikely that income from self-employment, rent, dividends and net interest kept pace with inflation. However, the progressive nature of personal income tax and increased national insurance contributions, together with an acceleration in the rate of increase in consumer prices, make it likely that real personal disposable incomes grew little further if at all in the fourth quarter. Accordingly, as consumer spending increased, personal saving must have dropped back from the unusually high figure for the third quarter. In that quarter, the saving ratio rose to over 13% with the surge in incomes after the end of the third stage of the counter-inflation policy. There was therefore ample room for a fall in the fourth quarter while still leaving an historically high ratio.

[1] This section is in seasonally-adjusted terms and at constant prices throughout.

Personal incomes and consumption

In the fourth quarter disposable income grew only slightly faster than prices; real consumption, however, was over 1% greater than in the third quarter.



The volume of retail sales recorded by the official index rose by ½% in the fourth quarter. Much of this appears to have been due to increased expenditure on durable household goods and alcoholic drink. Retail trade in January was slightly above the fourth quarter average, reflecting successful new year sales. By contrast, the volume of car sales fell for the second consecutive quarter; and although sales were reported to be up in January, the underlying trend then was probably fairly flat.

No doubt the tightening of hire-purchase terms in December 1973 was partly responsible for the reduced spending on cars in 1974,[1] but vehicle price increases, the greater cost of petrol, and general uncertainties may have been more important influences. Terms controls appear to have had only a temporary effect for the most part on durables other than cars. After falling sharply in the first quarter of 1974 sales of other durables have risen continuously, and by the fourth quarter were almost as large as a year earlier. The rise in the fourth quarter may have been affected by pre-Budget buying, but it does not appear that expenditure in general has included much extra buying as a hedge against inflation. The main pattern is reflected in the figures for new instalment credit. The amount extended by retailers increased slightly during 1974; conversely, the amount extended by finance houses, which devote a higher proportion of their business to car sales, often to firms, fell very sharply at the beginning of the year and thereafter fluctuated but with no underlying recovery.

To some extent, durables expenditure in 1974 followed the usual pattern of recovery after the imposition of terms controls. But the initial reduction in sales was less marked than experience would have suggested. It may perhaps be that hire-purchase controls have become a rather less effective instrument of demand management than they used to be, but it is not easy to find convincing reasons why this should be so. One possibility is that the general rise in real incomes over the last few years may have brought about a reduction in the sensitivity to hire-purchase terms of the demand for durables, because consumers may have been able to find cash for purchases more easily. Another possibility is that expenditure may have been directed to durables which are not covered by the controls, but this seems unlikely because they are generally minor items. Consumers cannot have found it easy to obtain alternative sources of finance. In December 1973 banks had been asked not to provide loans for the purchase of goods covered by the hire-purchase controls on terms easier than the controls; and they had already been asked to restrain lending to persons generally. This, together perhaps with restraint stemming from the supplementary deposits scheme introduced in December 1973, helps to explain why bank lending to persons (other than for house purchase) increased less in 1974 than in 1973.

The volume of *fixed investment by private industry* is estimated to have fallen by 2% in the fourth quarter. The amount of manufacturing investment was about the same as it had been in the second and third quarters, but investment in distribution and services fell by 1%; shipping investment was some 12% down on the erratically high third quarter total.

The upswing of the investment cycle came to an end in the fourth quarter of 1973, and was short-lived compared with earlier cycles. Thus while GDP rose by 9% between the investment peaks of 1970 and 1973, private industrial investment (manufacturing, distribution, services, and shipping) rose by only 6%.

Since the latest peak there has been a marked difference between the path of investment in manufacturing and that in distribution and services. Manufacturing investment must have benefited from the fact that order books in certain industries (particularly those closely

[1] December 1974 *Bulletin*, page 389.

engaged in the development of the North Sea, but also chemicals, steel, and the heavier end of engineering) remained strong throughout 1974. It remained virtually flat over the course of the year and in total it was 10% greater in 1974 than in 1973. As late as October the Department of Industry's investment intentions survey had been predicting a rise of only 5%. Apparently it has taken manufacturers longer than expected to adjust expenditure to the financial pressures and reduced prospects for demand that developed last year. It is difficult to know why, although, of course, in any area of investment rapid cutbacks are difficult. Compensation usually has to be paid if an order is cancelled, and projects under way have usually to be completed much as originally planned.

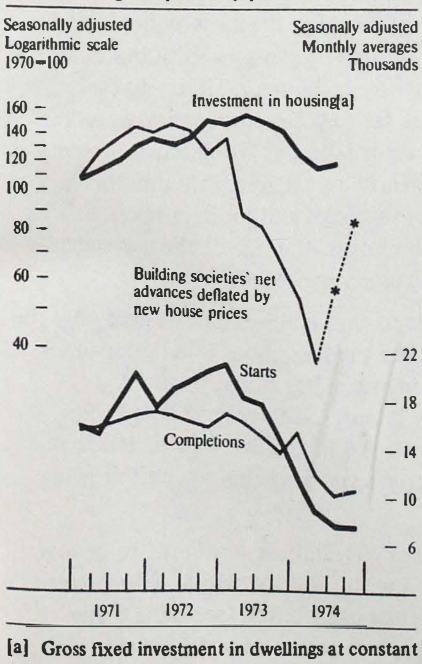
Investment in distribution and services, on the other hand, fell for the fifth consecutive quarter, and was 6½% lower in 1974 than in 1973. This is only the second reduction from one year to the next in fifteen years; and on the previous occasion, in 1965, the reduction was only 2½%. Falls this time were widespread, with investment by distributors, road hauliers, and the construction industry seemingly well down.

The Department of Industry's January intentions survey, conducted after companies had had time to consider the implications of the November Budget, suggested that the volume of manufacturing investment would fall by 7%–10% between 1974 and 1975, which was much in line with the industrial trends survey undertaken by the Confederation of British Industry in October, although not quite so pessimistic as the CBI January survey. The corresponding figure for distribution and services was a fall of 5%. If these expectations are fulfilled, private industrial investment in 1975 will be at its lowest since 1969. Further reductions in 1976 were foreshadowed in both areas.

Housebuilding was little changed in total between the third and fourth quarters, according to provisional figures. In the public sector the number of new houses started fell by about 6%, but the total for the year was still nearly 30% larger than in 1973 and easily the best since 1970. The number completed was also down, by 4%, in the fourth quarter. Completions have yet to reflect fully the earlier upturn in starts – it takes an average of eighteen months to build a local authority house – and in 1974, although some 20% up on 1973, completions were considerably fewer than three of four years earlier.

Housing finance and housebuilding in the private sector

Although still depressed in the fourth quarter, private housebuilding has probably passed the worst.



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

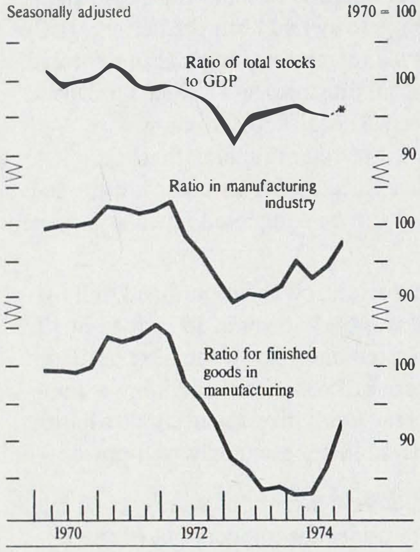
The number of private houses started in the fourth quarter was about 1% more than in the third, after five successive quarters when fewer were begun. It is also encouraging that 8% more houses were completed. It therefore seems that the bottom of the downswing may have been reached. However, the number of houses under construction, which fell by over 9,000 in the fourth quarter to 223,000, is likely to decline further.[1] Accordingly, despite continuing substantial rises towards the end of 1974 in building society inflows (see the financial review) and advances on mortgage (see chart), an upturn in the amount of actual building work will probably take some time to develop.

The Department of the Environment's survey of builders' intentions suggests that builders are expecting 135,000 starts in 1975. This is considerably better than the 105,000 recorded in 1974 but is still some 35% below the average of the previous ten years. Even this modest rise could be in jeopardy if builders cannot foresee a satisfactory profit. Statistics here are scarce but, with new house prices rising by perhaps little more than 5% on average during 1974, profit margins calculated on historic costs must have fallen significantly. Prospective margins must now in some cases be so low as to discourage new development; but individual builders are very differently placed as regards land prices, the size and cost of bank borrowing, and local demand for their particular range of houses.

[1] December 1974 *Bulletin*, page 391.

Stock/output ratios

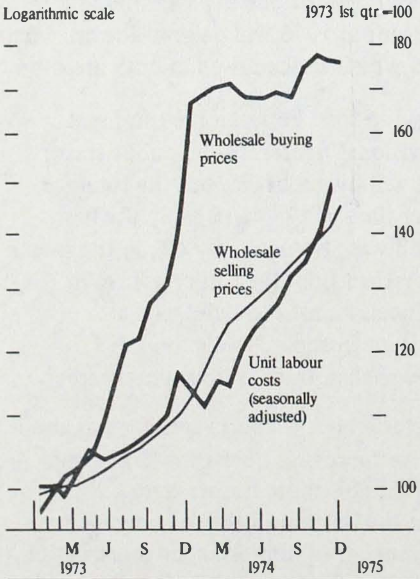
There was little change in the stock/output ratio for the economy as a whole, but in manufacturing the ratio rose quite sharply, particularly in respect of finished goods.



*Estimated.

Wholesale prices and unit labour costs

Manufacturers' selling prices have continued to rise steadily under the impetus of steeply-increasing labour costs and earlier rises in buying prices.



Factors contributing to the general rise in prices[a]

Labour costs are now the main element in inflation.

Percentage increases at annual rates

	1st half 1973 to 2nd half 1973	2nd half 1973 to 1st half 1974	2nd qtr 1974 to 3rd qtr 1974	3rd qtr 1974 to 4th qtr 1974 (estimated)
General rise in prices[b]	13	19	21	20
of which, attributable to:				
Labour costs	*5·9*	*7·7*	*15·2*	*16·6*
Import costs	*8·0*	*12·4*	*0·8*	*1·4*
Taxes less subsidies	*0·6*	*– 0·4*	*– 4·0*	*– 0·5*
Other costs (including profits)[c]	*– 1·4*	*– 0·9*	*9·1*	*2·5*

[a] Values of each cost component were divided by an index of total final output to give increases in costs per unit of output. Cost increases for each component were then weighted by the several shares of those components in output in succeeding base periods to give increases in total costs attributable to particular components. No lags were incorporated in the figures (see text).

[b] Implicit price index of total final expenditure.

[c] A residual category that includes profits net of stock appreciation per unit of output, as well as income from property and self-employment.

Recognising the depressed situation in private housebuilding, the Government issued proposals at the end of January designed to restore builders' confidence and to stimulate private demand for housing. These included an undertaking by the Government to co-operate with building societies in assuring continued availability and stability of mortgage finance, if necessary by offering further short-term loans like those of 1974 which are now being repaid; support for low-start mortgage schemes for first time buyers and, temporarily, all buyers of new houses; and encouragement to building societies to expand their loans for construction to builders.

According to provisional figures, *stocks held by private industry* fell slightly in the fourth quarter, a sharp contrast with the large increases of the previous two quarters. The ratio of total stocks to GDP increased slightly (see chart) but was down a little on a year earlier. Manufacturers' stocks were virtually unchanged, while stocks of wholesalers rose by about £20 million and those of retailers fell by about £35 million.

Manufacturers may well have wished to reduce stocks more than they were able to, for their holdings of finished goods rose by almost £100 million, while their stocks of materials and fuel and their work in progress each fell by about £50 million. This was the third successive quarter in which stocks of finished goods rose, increasing the ratio of such stocks to manufacturing output by 7%, to its highest since the middle of 1972 (see chart). Thus, after the very large involuntary stockbuilding, particularly of finished goods, in the third quarter, manufacturers do appear to have reduced their output during the fourth quarter, but not by enough to offset further significant de-stocking by retailers.

Wages and prices[1]

Despite fairly stable commodity prices, inflation continued at a high rate in the fourth quarter as the pressure from domestic costs intensified. The retail price index rose by some 4½% on the third quarter, and in January was 20% up on a year earlier. The wage rate index was 28% up.

Falls in the prices of many industrial materials traded on free markets were offset by increased prices of foodstuffs, so that there was little change in commodity prices (excluding oil) between September and December (monthly averages of *The Economist* sterling index). Manufacturers' buying prices rose by 4% over the same period (see chart), reflecting the importance to them of energy and of materials not traded on free markets, but fell slightly in January. Home market selling prices have continued to rise fast; by December they were 28% up on a year earlier and remained so in January. Wholesale selling prices have outstripped retail prices for nearly a year, and although this is partly accounted for by changes in subsidies and indirect taxes, as well as by differences in what the indices cover, the size of the gap suggests that retail margins have been particularly squeezed.

Of the price rises likely to result from the November Budget only the increase in tax on petrol had affected the December retail price index. In support of the policy of removing subsidies to nationalised industries, gas, coal and electricity prices, rail fares, and Post Office charges have been or are due to be raised in the first half of 1975; and new increases for coal and electricity have been announced following the miners' settlement.

The contribution of import prices to inflation continued to be low towards the end of 1974 compared with the first half, and domestic elements took over as the main source of inflation (see table). The picture is not yet very clear for the final quarter, but labour costs must

[1] Information on earnings and labour costs is seasonally adjusted, but not that on wage rates and prices.

Recent pay settlements[a]

Those obtaining settlements were generally getting increases in rates of pay well above the rise in retail prices.

	Number of workers (in thousands)	Date of implementation	*Percentage increase on one year ago*[b]
Local authority manual workers	1,000	Nov. 1974	*35*
Retail grocery assistants	100	,,	*35*
Multiple bakeries, manual workers	33	Dec.	*38*
British Steel, management and clerical	40	,,	*21* [c]
Water supply, manual workers	40	Jan. 1975	*37*
Gas supply, manual workers	41	,,	*35*
Furniture industry, manual workers	80	,,	*33*[d]
Paint industry, manual workers	20	,,	*43*
Private sector open-cast coal mining	5	,,[e]	*35*
British Airways, clerical and administrative	17	,,	*21* [f]
NHS technicians	15	,,	*19*[g]
Construction workers	1,000	Feb.[h]	*35*
Road passenger transport, drivers and conductors	150	Mar.	*42*
Coal mining, manual workers	240	,,	*28* [j]

[a] Based on stated increases in minimum rates rather than earnings. Some of these increases may not be representative of the industry as a whole. Information was obtained from press reports and only those agreements for which reliable published information could be found were included. Although every effort was made to ensure reasonable accuracy, the figures are probably no more than broadly correct. Manual workers on the list comprise about one fifth of those covered by the wage rate index, that is, the bulk of those settling in the period covered.

[b] Includes threshold and interim payments.

[c] Plus complete indexation of salaries from December 1974.

[d] Plus new threshold agreement at 12% above the retail price index in December 1974.

[e] Eight months after last settlement; further increase of 13% in five months' time.

[f] Plus a further payment of 5% in April and a new threshold agreement at 20% above the retail price index in December 1974; the increase on a year earlier is approximate.

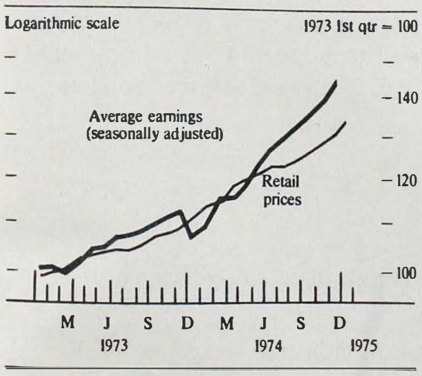
[g] Interim award.

[h] This award was made six months after previous increase; 16% further to be paid in June 1975.

[j] Face workers received 5% more. All groups will receive payments under a production bonus if current rates of output are maintained.

Retail prices and earnings

Average earnings of manual workers, before tax, rose considerably more quickly than retail prices in the second half of 1974.



again have made the main contribution to rising prices. No allowance is made in the table for lags in the transmission of cost increases to final prices; it simply shows the size of cost increases as they were incurred. The figures therefore need careful interpretation. The high figure for 'other' costs in the third quarter includes the partial recovery in profits *excluding* stock appreciation recorded then; there was no increase in gross trading profit margins during the quarter – the reconciliation being a substantial fall in stock appreciation (see page 12).[1]

The increase in the wage rate index in the twelve months to December (29%) was considerably more than the corresponding rise in the retail price index (19%). It appears, however, that whereas until the end of the third stage of the counter-inflation policy wage rates in general did little more than keep pace with retail prices, since then they have outpaced prices by a growing margin. The rise in the wage rate index last year included the effect of threshold payments: excluding these, 'new money' [2] given in settlements accounted for an increase of about 13%. In the second half of the year the size of 'new money' settlements seems to have remained fairly steady. Most of those getting settlements were also benefiting from threshold payments, which by the end of the third quarter may have added some 7% to average wage rates with more still to come, and by the end of the year about 13%. Thus by the fourth quarter those obtaining settlements were getting increases in wage rates which, including thresholds, amounted to 25%–30% above the rate fixed at each group's previous settlement – well above the rise in retail prices. Some major settlements between November and February show even larger increases (see table).

Settlements around the turn of the year were especially large because they covered groups such as local authority manual workers which include a high proportion of lower paid employees whose rates were being brought up to the target of £30 a week proposed by the Trades Union Congress. The effective rate of wage increase may moreover decline in future as last year's threshold payments cease to affect the comparison with the rates ruling at the date of the previous settlement. However, a decline may be postponed, because in time further price increases may trigger newly-negotiated thresholds or may lead to the reopening of agreements that do not contain thresholds.

Earnings (see chart) lagged behind wage rates in the third quarter owing to the greater impact of thresholds on the latter, but caught up in the fourth quarter – at the end of which, like wage rates, they were about 29% up on a year earlier. After allowing for this, it appears that higher wages in the second half of last year must have added about 25% to labour costs in those parts (about half) of the economy affected – a considerably faster rate of annual increase than in the first half of the year. Much of this increase in costs has yet to be reflected in prices, and doubtless will be during the course of this year.

The pressure of demand

Demand probably fell increasingly sharply towards the end of last year and in the early months of this year. As noted earlier, output declined in the fourth quarter, to fall slightly below the peak of the third quarter of 1973, and total final expenditure dropped rather more sharply.

The increasing gap between actual and potential output in 1974 has lately been associated with a resumption of the sharp rise in unemployment seen last summer (see table over page). The continued weakening of demand tended first to be reflected in reduced overtime working, particularly last October and November, and then in more short-time working. Between December and February the number of

[1] In effect, prices were rising in the third quarter partly because of earlier increases in costs, whereas increases in costs incurred in the third quarter but not passed on were smaller than in previous quarters.

[2] The increase in wage rates apart from threshold payments or their consolidation into wage rates.

Indicators of the pressure of demand on resources

The indicators all show a decreasing pressure of demand on resources, with, however, some way to go to the 'low' points of 1971/72.

Seasonally adjusted: Great Britain

	Previous 'low' pressure of demand	1974 2nd qtr	1974 3rd qtr	1974 4th qtr	1975 Feb.
Unemployment (percentage)	3·9 (1st qtr 1972)	2·4	2·7	2·7 (Nov.)	3·1
Unfilled vacancies (percentage)	0·5 (4th qtr 1971)	1·4	1·3	1·2 (Nov.)	0·9
Overtime (1970=100)[a]	73·9 (1st qtr 1972)	95·8	94·6	88·6	..
Percentage of firms reporting below capacity working[b]	71 (Jan. 1972)	50 (Apr.)	54 (July)	56 (Oct.)	61 (Jan.)

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

.. Not available.

Changes in output and imports

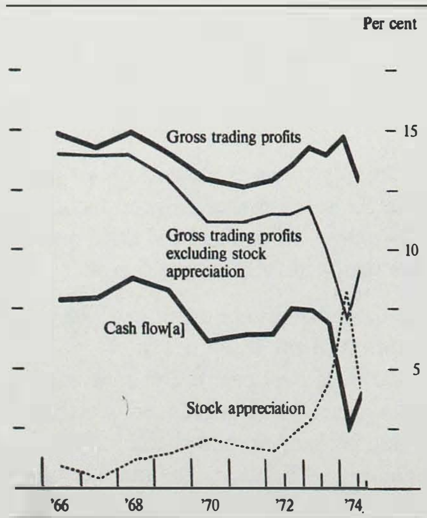
Slackening of demand has been reflected in a smaller volume of most categories of imports.

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

	2nd half 1971 to 1st half 1973	1st half 1973 to 2nd half 1973	2nd half 1973 to 2nd half 1974 (provisional)
Gross domestic product (output)	+ 5	+ 1½	− ½
of which, manufacturing	*+ 7*	*+ 1½*	*− 1½*
Imports of goods (fob)	+14½	+10½	− 3
of which, main components (cif):			
Finished manufactures	*+27*	*+33*	*− 6½*
Semi-manufactures	*+13*	*+17*	*+ 5½*
Basic materials	*+10½*	*–*	*−13½*
Fuel	*+ 1*	*+17*	*− 7½*
Food, drink, and tobacco	*+ 3½*	*− 2*	*− 2½*

Profits and cash flow as percentages of gross domestic income

In the third quarter there was a slight improvement in the cash flow of companies and in their basic gross trading profits.



[a] Defined in footnote [1] on this page.

manufacturing workers on short time rose from 72,000 to probably over 200,000, nearly twice as many as during the downturn in 1971/72; the car industry was particularly affected. Substantial shedding of labour also seems to have begun in December, and notified adult vacancies fell by some 20,000 in that month for the second month running. Between 11th November and 20th January (when unemployment figures again became available), unemployment rose by an estimated 67,000 to a total of 675,000 (3% of employees); this was the largest increase over two months since March–May 1971, not counting the period of short-time working during last year's energy crisis. The general pattern continued in February, when unemployment rose by a further 28,000 and vacancies continued to fall sharply.

On these figures the degree of slack in the labour market is increasing significantly, although it has not yet reached that of the winter of 1971/72. The percentage of companies reporting below capacity working in the January CBI survey was somewhat greater than in October's, though still some way below the previous high point of January 1972. Even if output revives somewhat in coming months, some further rise in unemployment (apart from seasonal movements) seems inevitable this year.

The recent increases in unemployment have been fairly evenly spread among regions, though they appear to have been below the national average in areas of traditionally high unemployment – Scotland, Wales, and the North – and the South West and East Anglia appear to have been most heavily affected. Shortage of unskilled labour no longer seems a problem anywhere, and although the CBI survey in January still showed capital goods producers needing more skilled labour, poor prospects for demand and inadequate financial resources were increasingly cited as the main general constraints. Scarcities of components and materials were much less widespread than in preceding surveys, though still quite high compared with earlier years; lately, de-stocking by wholesalers may be causing local difficulties of supply.

The slackening of the pressure of demand in 1974 appears to have brought a reduction in imports from the high rates ruling at the end of 1973. Although output fell only slightly between the second halves of 1973 and 1974, the volume of imports fell perceptibly (see table), the decrease being particularly marked in basic materials, fuel, and finished manufactures; semi-manufactures was the only main category that grew. The decrease in fuel imports doubtless reflects the greater cost of oil and associated energy-saving measures. Imported manufactures have however tended on the whole to become cheaper in relation to home products in the past year, and import reductions in this category must be generally attributable to slacker total demand and readier home supplies.

Company finance

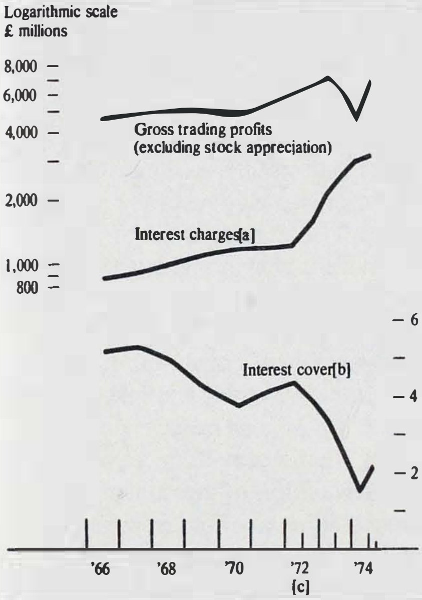
In the second half of 1974 firms became increasingly aware of their weak financial position.

The share of gross trading profits of industrial and commercial companies in the national income fell back somewhat in the third quarter after a period of recovery (see chart). According to the Price Commission, rapidly rising unit labour costs were responsible for this pressure on profit margins. But stock appreciation, although historically still very large, accounted for a rather smaller proportion of total profits than earlier in the year, and profits excluding stock appreciation – a better measure – had a greater share of gross domestic income than in the first half year, when the share had been very low. This improvement produced a modest recovery of cash flow[1] – restrained

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

Interest charges and gross trading profits

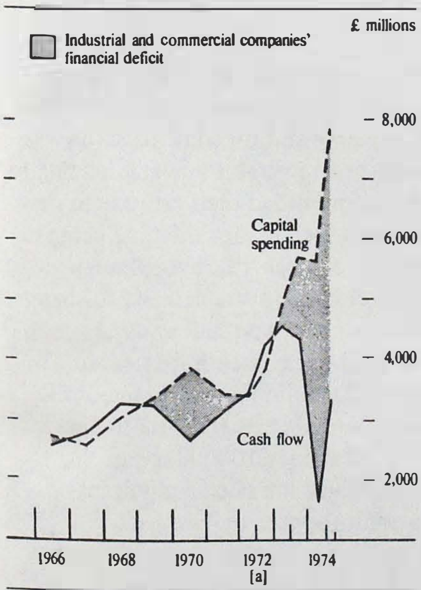
Interest charges in recent years have been rising much more quickly than gross trading profits, thereby eroding cover for interest payments.



[a] Mainly on fixed-interest stocks and bank finance.
[b] Ratio of gross trading profits to total interest charges.
[c] From 1972 onwards, half-yearly and quarterly figures at an annual rate.

Company cash flow and capital spending

The improvement in cash flow in the third quarter was insufficient to finance increased capital spending on stockbuilding and an unchanged volume of investment, so that the financial deficit of companies grew a little further.



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

however, by a sharp increase in tax payments as the surcharge upon advance corporation tax became effective, and by a continued steep rise in companies' interest charges (see chart).

But the slightly improved cash flow was sufficient to finance less than half of capital spending in the third quarter and companies incurred a further substantial financial deficit, amounting this time to over £1,200 million (see chart); in the year to September 1974, it amounted to £3,650 million. Compared with the first half of 1974, capital spending rose sharply in the third quarter – the volume of fixed investment had thus far been maintained, the prices of buildings and equipment were higher, and there was a large, perhaps partly involuntary, increase in stocks. The deficit continued to be financed largely by further bank borrowing, supplemented by what appears to have been a reduction of trade credit to the personal sector.

During the fourth quarter however, companies' borrowing from the banks began to moderate significantly, doubtless reflecting not only the reluctance of companies and the banks to allow further increases in debt but also the burden of interest charges on profits, besides general uncertainties. Meanwhile, companies with bank deposits ran them down quite sharply. Financial considerations also provided a severe restraint on firms' expenditure. The volume of fixed investment fell; and certain areas of industry – particularly the retail and distributive trades – continued to run down their stocks, although this once again led to some involuntary stockbuilding in other areas.

Despite the relaxations made in November to the price code and the tax relief on increases in values of stocks given in the autumn Budget, these trends have continued. The reduction in companies' January tax bills will itself have been a cause of their borrowing less from banks around the turn of the year, but their financing needs may continue to moderate through the year because of retrenchment in stockbuilding and in plans for fixed investment as indicated by the Confederation of British Industry's and (for fixed investment) the Department of Industry's latest surveys (page 9). The CBI survey indicated, too, a growing pessimism about prospective demand amongst industrialists: they also appeared to expect no improvement in the relative movements of costs and selling prices. Weak demand may have deterred many firms from taking full advantage of the relaxations in the price code – especially the investment relief – and from raising their prices to the extent permitted.

Financial developments

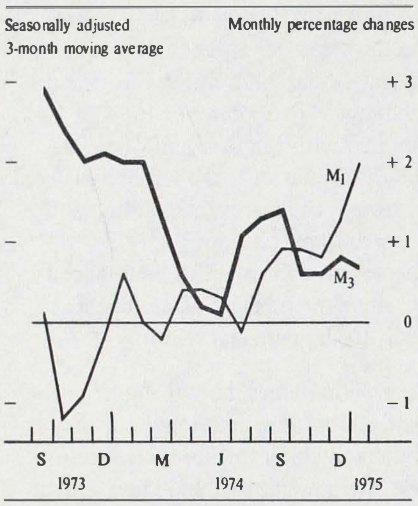
The stock market and company issues

The decline in equity prices continued during the fourth quarter of 1974, reflecting uncertainties about company cash flow and profitability. Requests from a number of prominent companies for financial aid from the Government heightened the anxiety. The decline was not stemmed by the reliefs to company finances included in the November Budget. The new issue market remained dormant, apart from a large rights issue by Commercial Union Assurance.

Early in January a strong rally began, which despite some profit-taking continued well into February. The rise was triggered by the buoyancy of the gilt-edged market and sustained by the general fall in interest rates. The initial upswing was exceptionally fast because there had been few willing sellers at the prices which had prevailed, and even a few purchases made a heavy impact. The improvement in equity prices, if sustained, will revive interest among industrial companies in making new issues.

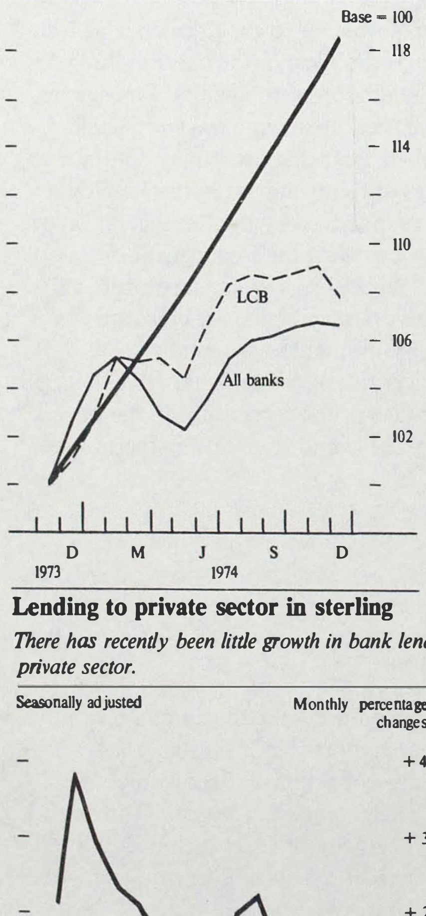
Money stock

The growth of M_3 has slowed down, fluctuating around 1% a month in the latest six months; the growth of M_1, on the other hand, has been faster.



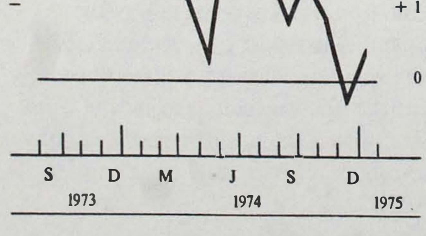
Supplementary deposits scheme

The growth of interest-bearing eligible liabilities — measured by three-monthly averages — for all banks and for the London clearing banks had been much less on average than the scheme allowed (the heavy line shows the penalty-free limit for individual banks), and the scheme was suspended at the end of February.



Lending to private sector in sterling

There has recently been little growth in bank lending to the private sector.



Money and banking

Although the broader and narrower versions of the money stock each grew by around 12% during 1974, their growth from one month to the next, and their underlying trends at the end of the year, differed considerably (see chart). Whereas the growth of the broader version (M_3) slowed down during the year, that of M_1 tended to accelerate; and during the three months to mid-January, M_3 rose by about 2% (seasonally adjusted) but M_1 by over 6%.

The different behaviour of the two aggregates is not surprising. Changes in M_1, which consists of the private sector's sterling current accounts plus notes and coin in circulation, largely reflect the need for cash to finance day-to-day transactions. The increase in the three months to mid-January may have been somewhat exaggerated, and was perhaps associated with the unusually high rate of government expenditure at the end of the year. In the longer run, however, it is reasonable to suppose that the underlying rate of growth of M_1 will usually be more closely associated with the growth of nominal incomes. Besides having the same components as M_1, M_3 also includes deposit accounts and certificates of deposit: in other words, balances which could readily be converted into alternative forms of investment. During the latter part of 1974 the banks were tending to offer less competitive rates on their deposit accounts than they had previously done. This partly reflected the comparatively small demand made on them for advances (see below), but the continuation of the supplementary deposits scheme will also have influenced the banks' behaviour, as will, perhaps, some concern on their part with the prospects for their profits. Over the year as a whole, the private sector seems to have put a large volume of funds into local authority and other short-term assets at the expense of term deposits with the banks. Such a preference would not necessarily have been seen by investors as a move into less liquid assets, though it might have had the effect of restraining the growth of M_3 as defined. On a definition wider than M_3, the rate of growth of the money stock might well have been greater.

The banks' interest-bearing sterling resources kept, in general, very well within the limits at which penalties had become payable under the supplementary deposits scheme (see chart); and for some time the scheme had not, in practice, been any great restraint on bank lending to the private sector, although it may have modified their attitude to new business. Accordingly, the scheme was suspended for the time being on 28th February (see the notice reprinted on page 40). Even though most other avenues of finance remain closed, private demand for bank credit has become more subdued. The amount lent has, as usual, fluctuated widely from month to month (see chart). But after an average increase in sterling of about £250 million a month, seasonally adjusted, in the three months to mid-November, there was little net change in the next two months, a fall of about £100 million in December being followed by a rise of nearly the same amount in January. As already indicated, companies appear to have been increasingly cautious of taking on new long-term commitments, which initially tend to raise their demand for bank finance. Even so, the main weight of bank lending continues to go to manufacturing industry (advances to manufacturers had risen by some 40% in the year to mid-November), with lending to persons and financial institutions tending to decline – partly because of the qualitative guidance, which remains in force (see the notice on page 40).

There was a distinct change in the course of last year in the relative weight of the main underlying contributions to the growth of M_3. This may be seen from the table over page, which shows the counterparts to the growth of M_3 during the four calendar quarters. Broadly speaking, lending to the private sector tended, as suggested above, to become a less important 'source' of money – although the particularly small figure shown in the table for the fourth quarter probably exaggerates

Influences on money stock (M_3)

The central government was in heavy deficit in the fourth quarter, but there was little growth in bank lending to the private sector, and external items were strongly 'minus'.

£ millions: *seasonally adjusted*

	1973	1974			
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr
Central government borrowing requirement	+ 680	+ 230	+ 830	+ 760	+1,730
Purchases (–) of central government debt by non-bank private sector	– 390	– 90	– 640	– 520	+ 370
Other public sector borrowing requirement	+ 660	+ 520	+ 750	+ 800	+ 230
Purchases (–) of other public sector debt by non-bank private sector	– 240	640	– 640	– 480	
Lending to private sector	+2,350	+1,480	+1,200	+1,350	+ 310
External items	– 760	– 210	– 630	– 460	–1,420
Other	– 160	– 250	– 230	– 350	+ 150
Money stock(M_3)	+2,140	+1,040	+ 640	+1,100	+1,370

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.

the recent trend. The restraining effect of the external deficit also increased substantially. As against these, the public sector borrowing requirement grew; and, towards the end of the year, the private sector reduced its holdings of central government debt (although soon returning as a heavy buyer early in 1975).

The 'minus' under external items in the table was, until the fourth quarter, appreciably smaller than the current account deficit itself. This was because the deficit continued to be partly financed by capital inflows to the private sector. (The entry for 'external items' shown in the table represents the balance left to be financed through the public sector – whether by a fall in the official reserves, sales of marketable debt to overseas holders, or direct borrowing abroad – or through the banking sector.[1]) In the fourth quarter, however, there appears to have been some outflow of capital from the private sector; the effect of this, and the continuing current deficit, was to produce a very much larger minus under this head.

Figures are not yet available for the total public sector borrowing requirement in the fourth quarter of 1974. The central government requirement, which appears in the table as some £1,730 million after seasonal adjustment, was as much as £2,280 million before adjustment. The deficit in this quarter is normally large, chiefly because certain big items of supply expenditure occur each December before the main seasonal inflows of tax revenue begin in January. This time the deficit was further swollen by particularly heavy winter supplementary estimates, mainly to meet pay and price increases. The cumulative total of the central government borrowing requirement in the first three quarters of 1974/75 was £4,140 million, only about £200 million larger than the November Budget estimate for the full financial year. This suggests that the usual large surplus in the March quarter will not materialise.

The market was concerned in the last few weeks of 1974 about the possibility of a sterling outflow leading to upward pressure on interest rates, and these fears prevented any easing of rates in the UK money market, though there was some falling back in the parallel markets from the peaks of mid-December. However, a sharp fall in US and other overseas rates in early January permitted some general reduction in UK rates. The Bank's minimum lending rate fell in four stages from 11½% to 10½% between 17th January and 14th February. After the first fall in minimum lending rate, the clearing banks, whose borrowing and lending rates had been left rather high by the fall in rates in the markets generally, announced a reduction in their base rates from 12% to 11½%. With rates on clearing banks' seven-day deposit accounts falling to 9%, the request to banks not to pay more than 9½% on amounts under £10,000 was withdrawn on 28th February (see notice on page 40).

Assessment

It seems clearly desirable that over the next few years there should be a shift of resources, so that a lesser share goes to consumption, and more to investment and the balance of payments; and that the rate of inflation should be brought down. The problems are interconnected: in particular the high rate of inflation is making it more difficult to achieve the distribution of resources that is needed.

At an earlier stage, the acceleration of inflation in this country was due primarily to the world-wide rise in the price of commodities including that of oil. Since the middle of last year commodity prices have generally eased: the rise in domestic prices, on the other hand, has continued, or even accelerated. Domestic costs have been an increasingly dominant cause, and, now that the cycle of commodity

[1] An article on page 41 discusses the relationship of the balance of payments deficit and its financing to the domestic money stock.

prices is in a downward phase, pay increases are becoming much the largest cause of rising prices.

The trend of wages last year has been described earlier in this commentary. Wage increases agreed at settlements were generally of the same order as the rise in prices, and most of those who got settlements were also getting statutory threshold payments. In effect, many of those getting settlements have had increases in wages that were significantly more than the price increase since their previous settlement. This year, certain inflationary forces at work last year may no longer be operative. Statutory thresholds are no longer adding to wages, although newly-negotiated cost of living agreements may do so again on a smaller scale later in the year; some of the large wage increases at the end of last year came in settlements which aimed to bring low-paid workers up to the TUC target of £30 a week, which may be a once-for-all adjustment; and wage rates and earnings, especially in the private sector, may be influenced by the easing pressure of demand.

It is however likely to be more difficult to bring about a deceleration of inflation now that prices are rising at 20% a year, than when they were rising at 7% or 8% – a rate which some years ago used still to be regarded as excessive. The rate of inflation could then be appreciably reduced by a relatively short period of more moderate growth in money wages and salaries. For example, if productivity could be counted on to increase by 3%, if import prices in sterling terms could be expected to be stable, and if wage and salary increases did no more than keep up with the rise in retail prices, the rate of price increase might, after one year, be brought down from 7% or 8% to about half that rate. But with rates of inflation around 20%, the counter-inflationary stabilising factors count for less. It is likely to take continuing moderation in rates of increase in money wages and salaries to bring inflation down to an acceptable rate.

But it is important that such a deceleration be achieved. There is no doubt that were it clearly in train, this would transform the economic prospects. A high rate of inflation must have harmful effects both on exports and on investment. Though exports are now favoured by a competitive exchange rate, future trends are rendered uncertain by inflation – which makes it difficult for firms to quote forward prices and offer acceptable escalation clauses, though the ECGD-backed cost escalation scheme recently announced is designed to help in the latter respect. Rapid inflation must similarly deter investment, both generally, in that it leaves much uncertainty as to economic prospects and future rates of return and, more directly, because providing for the high cost of stocks pre-empts firms' finances, while medium-term outside finance appears unattractive at the high nominal rates of interest which inflation brings. Investment and exports are, however, the two branches of demand where a rising trend is most desirable. Only an economic expansion led by investment and exports is likely to prove viable; and it would not be a satisfactory solution for expansion to be maintained, instead, by an excessive rise in consumption. Continuing inflation would thus be bound greatly to complicate the task of economic management.

The financial factors restraining investment are now well recognised; and, despite the substantial alleviation created by the tax relief on stocks in the November Budget, their effect is evident in the present severe cutback in private investment plans. In some respects the situation may have stopped deteriorating; stock appreciation which rose rapidly last year under the influence of rising commodity prices – accounting for over half of trading profits – is likely to be smaller this year. But any such alleviation of the position can hardly be enough in relation to the needs of the economy. What is required as soon as possible is a large and sustained increase in industrial investment. That will not be possible without a large and sustained increase in profits, and hence in profit margins, to provide an adequate return after proper allowance for the replacement cost of both stocks and fixed assets.

The trend of exports is at present difficult to determine. After a strong rise in the early part of last year, the trend flattened and gave place to a steep fall in volume terms in the fourth quarter; but there was a recovery in January. Other industrial countries on average are probably in more of a recession than is this country, so that cyclical (and presumably temporary) factors are making the balance of payments worse than it otherwise would be. If the world recession is in fact near its low point, UK exports should by next year be showing a clear benefit from the recovery.

In contrast to the trend of investment and of exports, public expenditure has been rising rapidly – in total, and including transfers, by some 9½% in real terms between the financial years 1973/74 and 1974/75. The public sector borrowing requirement has risen fast. That for 1974/75 was estimated in November at £6,300 million; since when there have been a number of new outgoings; and both this and the trend of inflation could point to a higher borrowing requirement in 1975/76.

Much has recently been made of the relationship between the public sector financial deficit and the deficit on current external account. In fact, a reduction of the public deficit is not an automatic way to improve the balance of payments. Nor is the relation between it and the balance of payments precise and unchanging. In the short term it is plain – and perhaps also in the long term – there can be changes in the public sector deficit which are not at all paralleled in equal changes in the current balance of payments – for the net financial position of the private sector may, and does, also vary. An example is the likely reduction of the financial deficit of companies this year, to which the enlargement of the public sector deficit would in some degree be counterpart. But if a reduction of the public deficit is not a sufficient condition for the improvement of the balance of payments, it is a necessary one; and it is clear that the public sector deficit will need over the period ahead to be substantially reduced, as part of the process of restoring equilibrium to the economy.

The precise timing of the adjustment must depend on the pace at which the growth of net exports can take up the slack which would otherwise be created, but it will clearly be necessary to secure a reduction of several billion pounds over the next few years if the balance of payments is to be restored to balance. The recent white paper on public expenditure proposes that over the next four years real public spending should increase no faster than national output. This entails that, unless expenditure is held below the projected level, the reduction of public borrowing will have to come about as a result of a progressive increase in the tax burden over the period.

Despite the upward trend in the borrowing requirement, the growth of the money stock on the wider definition (M_3) has continued to slow down. Demand for bank credit has been subdued, and official sales of gilt-edged have recently been heavy. Moreover the way the external deficit has been financed has also exerted a stronger restraining effect on monetary growth. The supplementary special deposits scheme, on the other hand, was not exerting any great restraint and it was therefore appropriate at the end of February to suspend its operation. It will however be important that monetary expansion be kept within moderate limits, and the supplementary deposits scheme remains available for reactivation if required.