Economic commentary

Although the contraction in world industrial activity — the most severe since the thirties — continued in the first quarter, it seems probable that the low point of the recession has now been reached. Output in this country has been about stable this year so far, at a level, however, slightly below the plateau reached in 1973; the degree of economic slack appears less great than in other industrial countries, though it may now be about as large as in the winter of 1971/72.

Exports recovered in the first quarter despite the world recession, while the volume of imports, which had already declined in each successive quarter last year with the easing pressure of domestic demand, fell steeply. As a result, the current account deficit was only about a third of the quarterly average last year. It was financed without difficulty, thanks partly to the final instalments of the Government's $2.5 billion euro-dollar loan and a further increase in sterling holdings.

Short-term interest rates in foreign centres continued to fall in the first part of the year as monetary policies were relaxed to help counter the recession. UK money rates were allowed to follow, and a fall in yields encouraged the capital market: official sales of gilt-edged stock in the first quarter were very large. In April and May there was some hardening of rates because of increased concern with inflation and the prospects for sterling, which weakened significantly in early May. The equity market, however, remained buoyant, and there was a continuing flow of rights issues by companies.

Demand for bank loans from companies has remained slack, and banks have not been bidding vigorously for funds. Rates on both overdrafts and deposits have fallen relative to rates on alternative assets, for example on building society deposits. Accordingly, holdings of interest-bearing eligible liabilities with banks have declined since February, despite the suspension of the supplementary deposits scheme, and the money stock broadly defined, M_3, has continued to expand only moderately despite a faster growth of current accounts and therefore of M_1.

The Budget continued last November's tax relief on stocks: this may have prevented further cut-backs in investment plans, but low profitability has continued to preclude a revival of private investment. Despite the increases in taxation in the Budget — probably equal to about 1¾% of personal disposable income — the estimated public sector borrowing requirement for 1975/76 remains at about 10% of GDP, and larger at current prices than the large outturn for 1974/75.

Neither economic slack, nor the comparatively moderate growth of money in recent quarters, have led to a diminution of domestic inflation. The rise in consumer prices in this country is now distinctly faster than a year ago, and faster than in other major industrial countries; and the rate is unlikely to ease before the autumn. The main element is labour costs, with wage settlements continuing to exceed the rise in prices.

International developments [1]

The worst recession since the thirties in industrial activity continued in the first quarter of this year, when output, employment and world trade all contracted further. However, particularly in Western

[1] Output, employment and trade are discussed in seasonally-adjusted terms.

Industrial production

Production in the main industrial countries fell very steeply in the first quarter, generating further slack.

Percentage changes on previous quarter: *seasonally adjusted*
Excluding construction

	1974				1975	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr (provisional)	Cyclical situation [a]
United States	—1.6	+0.4	—	—3.2	—8.3	—16
Canada	+2.4	—0.9	—1.2	—1.2	—2.8	— 8
Japan	—2.0	—2.0	—3.3	—5.3	—8.7	—32
France	+2.8	+0.5	+1.1	—6.6	—3.0	—10
Italy	+4.4	+1.9	—5.4	—8.5	+1.2	—18
Western Germany	—0.9	—	—1.8	—2.7	—4.6	—15
United Kingdom	—5.8[b]	+5.2[b]	+1.0	—2.9	—0.1	— 6
All OECD countries	—0.8	—	—0.8	—3.4	—5.2	—17[c]

[a] Percentage deviation of industrial production in first quarter of 1975 from the exponential trend of output calculated for each country over 1955-74 (1956-74 for France and the United Kingdom).

[b] Figures affected by short-time working in the first quarter of last year.

[c] Weighted average of the above seven countries.

Germany and the United States, there are now signs that the low point of the recession has been reached. The weakness of demand has helped to reduce the rate of inflation in most industrial countries. At the same time, the combined current account deficit of the OECD countries last year, at $\$ 34\frac{1}{2}$ billion, was substantially less than at one time expected — and signs of improvement have grown stronger since the turn of the year.

The recession in the main industrial countries, which characterised the second half of 1974, deepened further and very sharply in the new year. This was particularly true of the United States, where real GNP, largely because of a sharp reduction in stocks, fell by $2\frac{3}{4}\%$ in the first quarter, after falling by $2\frac{1}{4}\%$ in the previous quarter, and industrial production fell by as much as $8\frac{1}{2}\%$. Industrial production also fell very steeply in Japan. Meanwhile, in the United Kingdom and Italy output was broadly maintained.

The severity of the recession during the last twelve months or so has produced a considerable degree of slack in all the main industrial countries. However, the fall in the pressure of demand has varied widely. To judge by the shortfall of industrial production in the first quarter from the longer-term trend, the pressure of demand appears to have fallen least in this country, partly because of measures taken during 1974, while the degree of slack seems to have been greatest in Japan (see table on previous page).

The depth of the recession has led to a marked growth in unemployment, which in many countries is now at a post-war peak. The increase over the past year has ranged from a rise of nearly a third in this country to a two-fold one in Western Germany (see table). But however sharp the increases, they must still understate the degree of spare capacity, because as yet they can have reflected only part of the very sharp recent falls in output.[1]

In the early months of the year retail prices in the main industrial countries generally rose much less fast than during 1974, particularly in Italy, Japan and the United States (see table). The main exception was the United Kingdom, where the effects of stable or falling commodity prices have been outweighed by rising domestic costs, particularly wages and salaries. In contrast, wage increases in the other main industrial countries (apart from Canada and Italy) have now moderated substantially under the influence of growing unemployment and more optimistic expectations about the future rate of inflation.

The current account balances of most of the main industrial countries improved markedly in the first quarter (see table). This reflects both an improvement in the terms of trade and a tendency for the volume of exports, helped by growing demand in the oil-exporting countries, to fall less than the volume of imports. Oil imports in particular were heavily cut by the generally low rate of industrial activity, the mild winter, and measures to conserve energy.

The counterpart to these developments was that the massive current account surpluses of the oil-exporting countries were reduced more quickly than expected, and that the external position of other developing countries deteriorated because of a sharp reduction in the demand for their exports affecting both volume and prices. As measured by *The Economist* dollar index, prices of raw materials

[1] For many reasons, any measure of spare capacity must be interpreted with caution, particularly when making international comparisons. Measuring it by the deviation of industrial production from trend implies that potential output has continued to expand at the trend rate, and the rate of unemployment is often taken as an indication of spare capacity. But because measures of unemployment vary between countries, adjustments are needed before international comparisons can be made. Adjusted figures for a few countries, based on work done some years previously at the Bureau of Labor Statistics, Washington, were published in the March 1975 *Bulletin* (page 3). The bureau have more recently devised new adjustments and, using a simple scaling of these, the figures for January on the British measure of unemployment would have been 7·1% for the United States, 4·7% for France, and 2·5% for Western Germany, compared with 3·1% in this country. For April, the comparison gives Great Britain 3·3%, United States 7·7%, France 5·1%, and Western Germany 3·4%.

Unemployment

Unemployment in industrial countries has continued to rise. The figures for different countries are not comparable (see footnote to text).

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

	1974				1975	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	April
United States	5.2	5.1	5.5	6.6	8.4	8.9
Canada	5.4	5.3	5.3	5.6	6.9	7.4
Japan	1.3	1.2	1.4	1.7	1.9	..
France	2.0	2.1	2.2	2.9	3.4	3.7
Italy [a]	2.7	2.8	2.9	3.1	2.8	..
Western Germany	1.9	2.3	2.9	3.5	3.6	4.7
United Kingdom	2.4	2.4	2.7	2.7[b]	3.1	3.3

.. Not available.

[a] First week of the following quarter.

[b] At the October and November counts.

Retail prices

Inflation has slowed down markedly in most industrial countries.

Percentage change on previous quarter

	1974				1975	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	1st qtr on a year ago
United States	+2.8	+2.8	+3.1	+2.9	+1.8	+11.0
Canada	+2.4	+3.3	+3.0	+2.7	+2.2	+11.6
Japan	+9.9	+4.7	+3.8	+4.4	+1.5	+15.2
France	+3.7	+4.1	+3.3	+3.2	+2.7	+14.0
Italy	+5.3	+5.2	+6.0	+6.1	+3.6	+22.6
Western Germany	+2.4	+1.6	+1.0	+1.3	+1.9	+ 5.9
United Kingdom	+4.2	+5.9	+2.5	+4.5	+6.1	+20.2
Weighted average of above	+4.1	+3.4	+3.0	+3.0	+2.2	+12.3

Current account balances

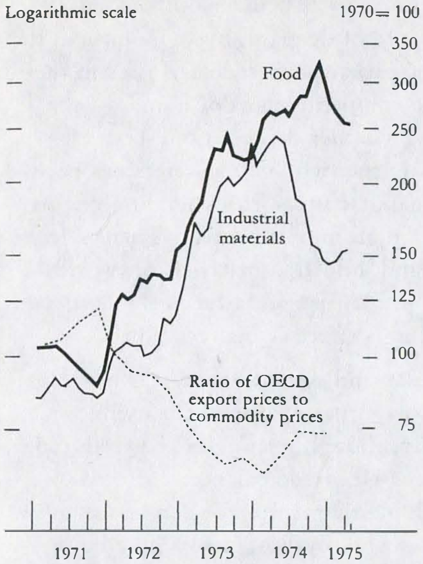
The main industrial countries as a group reverted to surplus in the first quarter.

$ billions: *seasonally adjusted*
Surplus +/deficit —

	1974				1975
	Year	1st half	3rd qtr	4th qtr	1st qtr (provisional)
United States	— 4.0	— 2.2	—1.5	—0.3	+1.5
Canada	— 2.0	— 0.4	—0.5	—1.1	—1.4
Japan	— 4.7	— 4.2	—0.8	+0.3	+0.4
France	— 6.0	— 3.2	—1.9	—1.0	—0.3
Italy	— 7.9	— 4.6	—2.0	—1.3	+0.2
Western Germany	+ 9.0	+ 5.0	+1.7	+2.3	+2.3
United Kingdom	— 8.9	— 4.6	—1.8	—2.5	—0.7
Total	—24.5	—14.2	—6.8	—3.6	+2.0

World commodity prices[a]

So far this year, food prices have fallen but prices of industrial materials have turned up a little.



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

Current account of the UK balance of payments

In the first quarter the visible trade deficit was greatly reduced.

£ millions: *seasonally adjusted*

	1974				1975
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Exports of goods	3,500	3,900	4,160	4,030	4,575
Imports of goods	4,780	5,215	5,370	5,485	5,290
Visible balance	—1,280	—1,315	—1,210	—1,455	— 715
Net invisibles	+ 345	+ 360	+ 380	+ 405	+ 375
Current balance	— 935	— 955	— 830	—1,050	— 340
Changes from preceding quarter:					
Visible balance	— 305	— 35	+ 105	— 245	+ 740
of which:					
Volume [a]	*+ 270*	*+ 95*	*+ 85*	*— 200*	*+ 595*
Price	*— 575*	*— 130*	*+ 20*	*— 45*	*+ 145*
Volume of exports (percentage)	+ 5.9	+ 2.1	+ 1.9	— 7.1	+ 7.3
Volume of imports (percentage)	— 2.2	— 0.5	— 0.2	— 1.8	— 5.5

[a] Measured in each quarter at the prices of the preceding quarter.

fell for the third successive quarter, though more slowly than before, and on average they were over 35% down on the peak (see chart). The reserves of other developing countries rose in total by about \$½ billion in the quarter, but only some of the countries were in fact able to maintain or increase their reserves (thanks largely to exports of foodstuffs, where prices are still high, or to borrowing): the remainder suffered very sharp losses and have generally reacted by imposing, or intensifying, restrictions on imports.

Although the timing and scope of the upturn in industrial countries is uncertain, it seems fairly probable that the bottom of the recession has now been reached, and that subsequent recovery will be led by Western Germany and the United States. In the United States, part of the uncertainty over prospects ended when the President signed a Bill at the end of March authorising a reduction of \$22·8 billion in net tax receipts — over 1½% of GNP.

Together with reflationary action taken in Western Germany and in France, these measures should stimulate demand during the second half of this year, and growth in industrial countries should be fairly strong in total in 1976. Even so, if past relationships with output over previous cycles continue to hold, employment is unlikely to expand much until recovery is well under way, and the number of unemployed could continue to rise for most, if not all, of this year.

The UK balance of payments

The current account[1]

In the first quarter there was a very distinct improvement in the visible balance due to a large shift in resources, probably of around 3% of gross domestic product, assisted by a favourable movement of 2½ in the terms of trade. Even with some reduction in the surplus on invisibles, partly due to heavier interest payments abroad, the current account deficit, though still large, was little more than one third of the quarterly average in 1974 (see table).

Exports of goods rose markedly after the disappointing performance in the fourth quarter. The increase in volume was over 7%, making good the drop in the previous quarter, and the increase in value was 13½%. Exports of machinery rose steeply, shipments of food were unusually large, and sales of whisky included a backlog from an earlier strike by lorry drivers in Scotland. Exports recorded for the first quarter are thought to have been largely unaffected by the London docks strike and the trawlermen's blockade of east coast ports. Shipments to oil-exporting countries increased substantially: they were some 120% up in value on a year earlier and accounted for almost 10% of UK exports in the quarter; the corresponding increase in volume was probably about 70%.

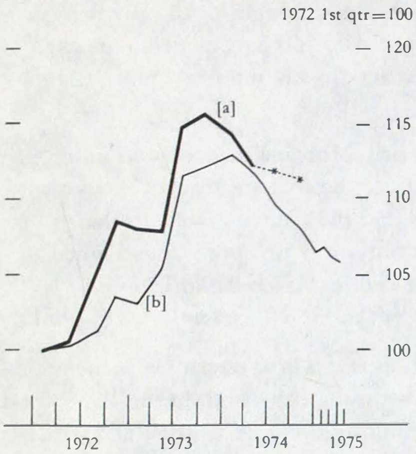
UK exports have probably still been benefiting from the marked improvement in price competitiveness that took place in the eighteen months or so up to about the end of 1973, even though in 1974, despite some further depreciation of the pound, the competitive position deteriorated — as may be seen from the comparisons of export prices in the chart overleaf. While far from perfect, such comparisons give a broad indication of trends in price competitiveness. The depreciation of sterling in the current quarter (not yet affecting the chart) will probably have arrested the decline in competitiveness. If further depreciation is to be avoided, it is clear that the growth of domestic costs must be contained.

The value of UK imports of goods fell in the first quarter, with a decline of 5½% in volume more than offsetting a rise of 2½% in

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

Price competitiveness of UK exports of manufactures

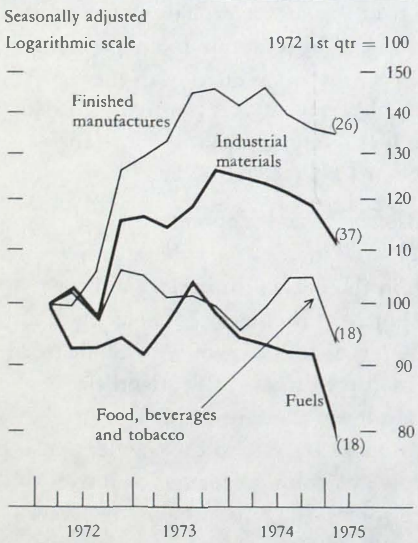
The lines show, on a common currency base, ratios of the weighted average of main competitors' export prices to UK export prices.



[a] Competitors' prices from national sources (as in *Economic Trends*, Table 44, April issue).
[b] Competitors' prices obtained by applying UK export weights to UK import prices, by SITC manufacturing section.
* Estimated.

Volume of UK imports

In the first quarter imports of finished manufactures fell only a little; the other broad categories all fell sharply.



Figures in brackets show the percentage of total imports by value in 1975 1st qtr.

unit value (the fall in volume would have been somewhat smaller but for the port disputes mentioned above). The volume of imports, both absolutely and as a proportion of total final expenditure, has declined quarter by quarter since the beginning of last year. The chart shows the breakdown by broad category. The development can be explained by the slackening pressure of demand, by economies in the use of fuel and materials after the earlier unprecedented rises in their costs, and by the improved price competitiveness of home-manufactured goods after sterling's earlier depreciation. The particularly sharp fall in imports in the two latest quarters has been associated with a turnround in manufacturers' stockbuilding of materials and fuels, which have a high import content. Thanks mainly to lower prices for food and industrial materials on world markets, UK import prices as a whole rose no faster in the first quarter than the increase in sterling's effective depreciation.

The sharp recession in world demand over the past year has clearly limited the scope for UK exports to expand. Meanwhile the downturn in domestic activity, though less severe, has reduced the volume of UK imports. As the UK trade balance is affected much more by a change in the domestic pressure of demand than by an equivalent change in world demand, cyclical factors may have had a comparatively small net impact on the balance of trade by volume. But the fall in commodity prices associated with the world-wide recession has substantially assisted the trade balance at current prices. A strong and sustained expansion of exports is certain to be required if the current account is to move further towards balance over the next year or so and if any growth in domestic demand, with an associated rise in imports, is to be acceptable.

The visible trade deficit in April was £290 million, probably including some unfavourable effects from the port disputes. Exports fell sharply while imports were still subdued.

The surplus on invisible transactions fell back in the first quarter to about the average for last year. Net receipts of interest, profits and dividends fell sharply, partly with the growing cost of servicing external liabilities; unusually large receipts from EEC funds reduced the net deficit on government account; and the travel account was in record surplus.

Financing the current account deficit

The actual deficit to be financed in the first quarter was, at some £600 million, significantly larger than the seasonally-adjusted total, though much less than the average last year. It was financed without difficulty. Transactions included the final instalments of the Government's $2.5 billion euro-dollar loan: foreign currency borrowing by the rest of the public sector was smaller than in
borrowing by the rest of the public sector was smaller than in
preceding quarters (see first table on opposite page). Capital inflows, including very large unidentified movements, exceeded the current deficit, and the reserves rose. Sterling came under some pressure at times in January, but was in good demand in most of the first quarter (see the financial review below).

Oil-exporting countries added further to their holdings of sterling, though by less than in each of the previous three quarters — partly because of some reduction in their surpluses (further details are in the financial review). Other countries ran down their sterling holdings, reflecting both some diversification of reserves after the termination of guarantee arrangements and the need of some countries to finance their own current deficits. At the end of March, oil-exporting countries held £3,400 million out of £4,900 million official sterling

Financing of the current account deficit

The deficit in the first quarter was financed without difficulty, and the reserves rose.

£ millions: *not seasonally adjusted*

	1974				1975
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Current balance	—1,080	— 970	—870	—850	—630
Capital transfers	—	— 30	— 40	— 10	—
	—1,080	—1,000	—910	—860	—630
Financed by:					
Decrease (+) in reserves	+ 40	— 110	—180	+180	—140
Foreign currency borrowing:					
Central government	—	—	—	+640	+420
Other public sector (net)	+ 330	+ 500	+200	+190	+ 70
Increase (+) in sterling holdings (official and private):					
Oil-exporting countries[a]	+ *230*	+ *590*	+*880*	+*420*	+*330*
Other	— *50*	— *200*	—*260*	— *40*	—*100*
Other identified capital flows (net)	+ 150	+ 240	—300	—440	—700
Balancing item	+ *380*	— *20*	+*570*	— *90*	+*750*

[a] Oil-exporting countries are listed in the section on oil-money movements in the financial review.

Domestic activity

Output rose slightly in the first quarter. There was a sizable switch of resources into the balance of payments.

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

	2nd half 1973 to 1st half 1974	1st half 1974 to 2nd half 1974	3rd qtr 1974 to 4th qtr 1974	4th qtr 1974 to 1st qtr 1975 (provisional)
Gross domestic product (output measure)	—1.8	+1.5	—1.5	+0.2
of which, industrial production	*—4.0*	*+1.3*	*—2.9*	*—0.4*
Consumers' expenditure	—1.5	+2.4	+1.5	—0.3
of which, retail sales	*—2.5*	*+2.5*	*+0.5*	*—0.2*
Exports of goods and services	+5.0	—0.5	—5.0	+5.2
Imports of goods and services	—0.5	—1.2	—2.2	—4.9

Changes in total final expenditure and its components [a]

In the first quarter, total final expenditure fell substantially despite a sharp increase in exports.

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

	2nd half 1973 to 1st half 1974	1st half 1974 to 2nd half 1974	3rd qtr 1974 to 4th qtr 1974	4th qtr 1974 to 1st qtr 1975 (provisional)
Total final expenditure	—0.4	+1.1	—0.6	—1.1
Components:				
Domestic expenditure (except on stocks)	—0.5	+0.6	+1.3	—1.0
of which:				
Consumers' expenditure	*—0.4*	*+0.6*	*+0.7*	*—0.1*
Public spending[b]	—	*+0.1*	*+0.7*	*—0.1*
Private fixed investment	*—0.2*	*—0.1*	*—0.2*	*—0.7*
Stockbuilding	+0.4	+0.6	—0.8	—1.0
Exports of goods and services	+0.5	—0.1	—1.0	+1.0

[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.

holdings; they also accounted for £ 300 million out of £ 2,500 million private holdings.

The heaviest financing in the quarter came from unidentified movements (the balancing item), where the net inflow was in fact larger than the whole current account deficit. Unidentified inflows are usual in the main revenue-gathering season, but they were exceptionally large this year.

In April, foreign currency borrowing by the public sector was quite small, at £ 15 million, and there was little change in the reserves. In May sterling came under pressure at times, and its effective depreciation increased; the public sector borrowed another £30 million in foreign currency, and the reserves fell by nearly £280 million.

The domestic economy

Output and demand[1]

After the sharp downturn in the previous quarter, output in the first quarter appears to have levelled out (see table). Even so, it was still only about 2% above the corresponding quarter of 1974 — when it had been depressed by the energy crisis — and some 1% below the plateau reached in 1973. The slight rise in the quarter was concentrated in manufacturing and service industries, but there was a marked decline in the power industries, where the unusually mild winter held back demand in January and February. Manufacturing production has generally been declining since last August.

Domestic demand other than for stockbuilding weakened slightly, owing chiefly to a decline in fixed investment (see table). Private industrial investment fell by about 10%. Substantial increases in the number of dwellings started suggest some revival in investment in housing.

Real personal disposable income is thought to have declined in the first quarter, and consumers' expenditure fell slightly. Retail sales rose strongly in April with heavy spending to beat post-Budget tax increases.

Stocks held by private industry fell (provisionally) by some £50 million in the first quarter: manufacturers' stocks of raw materials fell by £110 million and distributors' stocks by £95 million. However, manufacturers' stocks of finished goods and work in progress rose for the fourth successive quarter, by £155 million: with final demand tending to fall over this period, it seems likely that the rise was largely unplanned and that the sharp adjustment over the past six months in holdings of stocks has still some way to go. A reduction in stocks of some finished goods must indeed have taken place in April after the Budget.

Output was sustained in the first quarter by the considerable shift of resources into the trade balance already noted, which amounted to almost 3% of GDP: the volume of exports of goods and services is estimated to have increased by about 5% over the previous quarter and the volume of imports to have fallen by about the same percentage.

An early hint of some recovery in economic activity later in the year is given by an upturn in the longer composite leading indicator recently introduced by the Central Statistical Office.[2] This typically leads the cycle by about a year. It has risen strongly

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

[2] *Economic Trends*, March 1975, page 95.

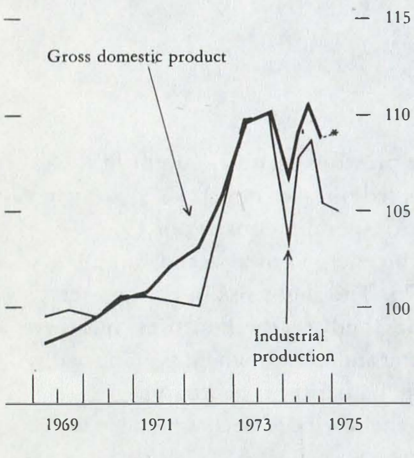
in the last three months. Although such indicators have not proved capable of predicting the timing of upturns in activity at all accurately, and although they are very sensitive to later information and revised figures, the rise seems strong enough to be significant.

The pressure of demand

Compared with the third quarter of 1973, total output in the first quarter of this year had fallen by a little more than 1% (on the output measure of GDP) and industrial production by about 5% (see chart). Assuming growth of almost 3% a year in potential output, this suggests that the gap between actual and potential output has widened by about 5½% of GDP in 1½ years; and for industrial production the gap may have widened by about 9½%. In the previous cycle, which reached its peak in about the second quarter of 1969 and its trough in the strike-affected first quarter of 1972, the corresponding figures were about 6% and 12% respectively. The emergence of the gap has been reflected in rising unemployment, the increase in which since November has been particularly rapid, at nearly 35,000 a month, reaching 820,000, or 3·6%, in May. The previous peak in March 1972 was 870,000. The number of workers on short time was put at some 225,000 in April and about 250,000 in May, more than three times as many as at the end of last year.

Gross domestic product and industrial production

In the first quarter industrial production continued to fall, but less sharply.



* Estimated.

Figures of vacancies confirm the general pattern, falling by an average of about 20,000 a month between November and May. The recent increases in unemployment remain fairly evenly spread among the regions, with Scotland and the North — traditionally areas of high unemployment — faring better than average, probably because of the growth of activities related to North Sea oil.

The degree of slack in the economy is now about as great as in the previous recession in the winter of 1971/72. The percentage of companies reporting below capacity working in the Confederation of British Industry's April survey (71%) was much higher than in January (61%), and equalled the previous high point in January 1972. If output grows at the rate forecast in the April *Financial Statement* — 1½% between the first half of 1975 and the first half of 1976 — further slack, accompanied by a continued rise in unemployment, seems certain to develop.

The slackening of the pressure of demand has been associated with a continued fall in imports.[1] The decline in imports of chemicals, basic materials and fuels in the first quarter was particularly strong, partly reflecting the degree of destocking by manufacturing industries in raw materials, and also the influence of a mild winter on fuel consumption. Unless stocks of raw materials are reduced further, some revival of imports in these categories seems likely.

Wages and prices

The index of weekly wage rates of manual workers rose by 6% in the first quarter — slightly less than in the previous quarter (6½%), but bringing the increase on a year ago to a little over 30%. In April, the index rose by only 0·2%, but is expected to be revised upwards when settlements for printers and railwaymen are taken into account (these were payable from April but settled too late for inclusion in the index). Average earnings rose less than wage rates in the first quarter (5%, seasonally adjusted) and markedly less than in the previous quarter (8%). This was partly because of the growing incidence of short-time and reduced overtime working; to the extent that this reflects lower output, the moderation in

[1] March *Bulletin*, page 12.

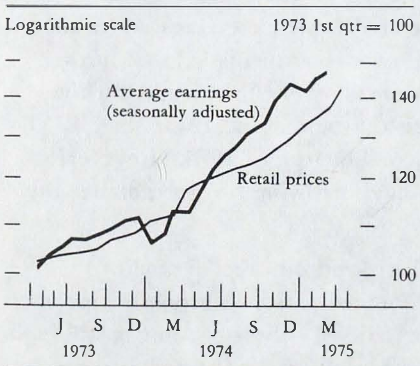
earnings implies no corresponding moderation in unit labour costs.

During the past twelve months, slightly more than one third of the increase in wage rates has been accounted for by threshold payments payable under the third stage of the previous Government's counter-inflation policy. This is broadly the amount by which the rise in wage rates has exceeded the rise in retail prices. As time goes on, last year's threshold payments will constitute a diminishing part of the total increase in wages since the last settlement.

Import prices continued to rise only slowly in the first quarter, largely because of lower commodity prices: *The Economist* sterling commodity price indicator fell by 12½% despite some depreciation of sterling. The upward pressure on prices has therefore continued to come from higher domestic costs, particularly labour costs; and although there was some further improvement in profit margins (excluding stock appreciation), they still remain very low historically.

Retail prices and earnings

Prices continue to follow in the wake of earnings.



The growth in retail prices accelerated in the first quarter to 6%, bringing the year-on-year increase to over 20% (see chart). Prices of food manufactured in the United Kingdom stood out, with a rise of 12% in the quarter, and a year-on-year increase of 38%. Seasonal fresh food prices were only 11% up on a year earlier; other home-produced fresh food prices fell in the year to February largely because of food subsidies, but rose by 10% in March after the decision to stabilise subsidies. Nationalised industry prices rose by 5½% in the quarter, reflecting higher gas and postal charges. Much of the exceptional rise of 4% in the April retail price index stemmed from increases in coal and electricity prices, bus fares, and local council rents and rates. The large electricity price increases which began in April will affect the index for three months; prospective increases in other nationalised industry prices will affect the index in the autumn. The Budget measures will themselves have contributed an estimated 2¾% to the index by July. After these developments, however, there is reason to hope that prices will rise more slowly.

Personal sector[1]

The volume of consumer spending fell by about ¼% in the first quarter of 1975, after an increase of 1½% in the previous quarter. Since the end of 1973 it has risen on average at an annual rate of about 1%.

Income from employment again rose rapidly in the quarter, with the wage and salary bill increasing by an estimated 5% despite a fall in employment of over ½%. However, retail prices also grew rapidly, and the real value of income from employment probably did not increase. The value of social security benefits and other grants may have been lower than in the fourth quarter, when payments were inflated by the Christmas bonus to pensioners; and it is unlikely that income from self-employment, rent, dividends, and net interest kept pace with inflation. On balance, personal income before tax probably declined in real terms, and allowing for the progressive nature of taxation, real personal disposable income may have fallen by as much as 1½%. As consumer spending fell very little, the personal saving ratio, which dropped by nearly 1% in the fourth quarter, must have fallen further — though remaining historically high.

The volume of retail sales recorded by the official index was little changed in the first quarter compared with the previous quarter, although monthly figures indicate that trade in clothing and footwear

[1] This section is in seasonally-adjusted terms unless otherwise stated.

was heavy in January, confirming reports of very active January 'sales'. Sales of durable household goods were buoyant in January and February (though not in March): this may partly reflect the decline in their prices relative to retail prices generally (about 5%-10% since January 1973). There was a big increase in retail sales in April, particularly of alcohol, tobacco, and electrical goods, as people bought heavily before Budget tax increases took effect. New car registrations — a high proportion of which are by companies — apparently recovered in January and February from the very depressed rate of last year, although the data appear to be distorted by a revised basis of compilation. Demand was stimulated by promotional price cutting by manufacturers, both direct and through reduced interest rates on credit terms, after a period of rapidly rising prices. But registrations fell back in March and April to below the average for the fourth quarter.

The demand for durables was not accompanied by a significant increase in credit. In the fourth quarter last year, new credit extended by retailers was 12½% above the average for 1973, but this must have been worth less in real terms, while credit extended by finance houses, which is mainly for vehicles, was 23% less than in 1973. In the first quarter, new credit extended increased by about 6½%, mostly by retailers, but heavier repayments led to a further fall in debt outstanding. Persons repaid debt to the banks for the third successive quarter, and their outstanding debt was some £260 million below the peak in the second quarter of 1974. However, there was some increase in personal borrowing before and after the Budget.

In aggregate, bank, hire-purchase, and other retail credit to persons has declined relative to nominal personal disposable income since the middle of 1973; but the ratio of debt to income is still high compared with the late sixties. The small scale of personal sector indebtedness at that time was almost wholly due to supply constraints and hire-purchase restrictions, whereas the recent decline appears to be partly the result of relatively weak demand. This weakness may appear surprising in view of low real interest rates. But the uncertainties generated by inflation and by unemployment may be deterring consumers from incurring more debt.

Company sector[1]

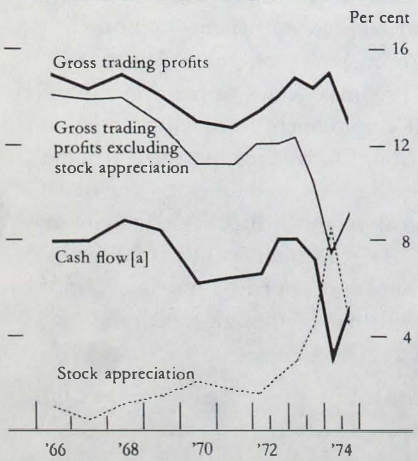
The financial position of the company sector eased in the first quarter. This reflected the tax relief on stocks initiated in the November Budget, a smaller amount of stock appreciation, and, to some extent, the decisions to make severe cuts in capital spending programmes which had been taken during the course of last year and which are now becoming effective. In view of the poor outlook for domestic demand, a really substantial recovery in profit margins this year seems unlikely, despite the relaxations made in the price code.

The combination of falling production and rapidly rising wage costs produced a fall in profits in the fourth quarter, even excluding stock appreciation. In the second half of the year as a whole, however, profits (excluding stock appreciation) formed a larger share of gross domestic income than when they had been very depressed in the first half, though still a significantly smaller share than in earlier years (see chart).

Company cash flow[2] followed a roughly similar pattern to profits in the course of 1974. The recovery in the second half of the

Profits and cash flow as percentages of gross domestic income

In the second half of 1974 there was some improvement in the cash flow of companies and in their basic gross trading profits.



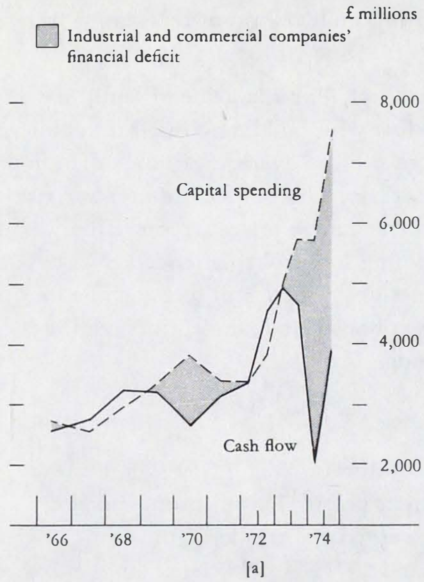
[a] Defined in footnote to text.

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

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

Company cash flow and capital spending

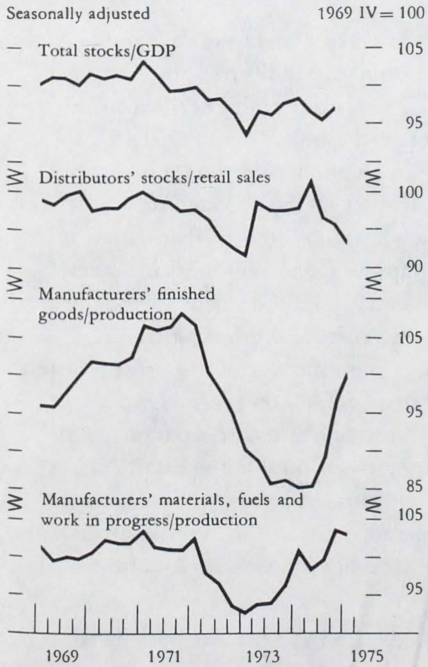
In the second half of 1974 the financial deficit of companies was little changed on the first half, with an improvement in cash flow absorbed by the increased cost of spending on stocks and fixed investment.



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

Stock/output ratios

In the second half of 1974, manufacturers' stock/output ratios rose sharply as output fell and after de-stocking by retailers.



year was closely matched by an increase in capital spending: the volume of fixed investment was broadly maintained and stocks, primarily of finished goods, continued to accumulate, often involuntarily. Industrial and commercial companies consequently continued in heavy, if diminishing, financial deficit — by the end of the year still at an annual rate of almost £3,000 million (see chart, and the financial review).

Financial pressures were further eased in the revenue quarter by the reduction, estimated at £800 million, in company tax bills stemming from the relief of tax on stocks. There were also, however, clear signs of cuts in company spending: the volume of fixed investment by distributive and service industries fell in the quarter for the sixth time in succession, by 8½%, while that by manufacturers, which had remained firm throughout 1974, fell equally sharply, by 8%, bearing out for the first time the pessimistic forecasts of the surveys conducted by the CBI and the Department of Industry. Before the first quarter, attempts by industry generally to cut stocks had been partly frustrated, and there had been an involuntary build up of finished goods in factories (see chart). In the first quarter a more or less unchanged volume of final demand appears to have been met by progressively lower industrial output and a small fall in stocks held by private industry.

In all, a distinct easing in companies' immediate financial position will have occurred early in 1975. This was reflected in a substantial rise in the first quarter in industrial and commercial companies' holdings of bank deposits which was broadly as big as their borrowing from the banking system — a significant change from their net reliance on the banking sector in previous quarters. Reliance upon predominantly short-term finance since the spring of 1973 had brought many companies close to the gearing limits considered prudent, and the change in sentiment in the equity market from the beginning of the year brought forward a large flow of new issues (details in the financial review). The revival of the equity market as a source of finance is a welcome development, not only going some way to ease the liquidity problems of industry, but also providing a more stable capital base from which to finance the next expansion.

Housebuilding

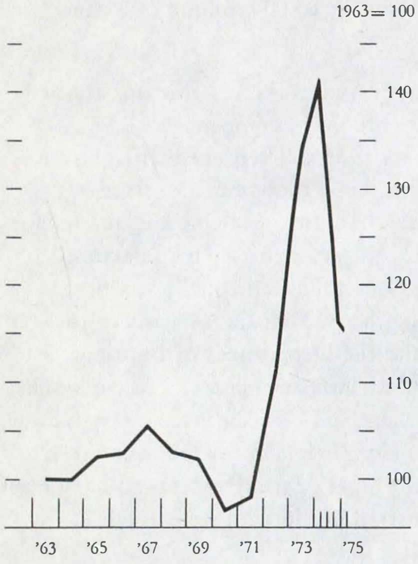
There were distinct signs of a revival in housebuilding in the first quarter. The number of new houses started in the private sector rose by about 55% (seasonally adjusted) and those completed by 15%. For the public sector the figures were 25% and 10% respectively.

The speed of the recovery in the private sector will depend partly on the revival of builders' confidence, which in turn will depend on demand and on the relationship between building costs and house prices. With inflows into building societies continuing at a high rate, the related increase in demand for houses should cause prices to rise somewhat faster than recently: they increased by about 3% on average in the first quarter. Costs, other than land, appear to have been rising rather more quickly, but the recent falls in interest rates will help builders. An agreement was reached in April between the Government and the Building Societies Association whereby societies would plan their lending policies this year with a view to avoiding an 'undue' increase in house prices, while supporting an active housing market. Progress of the agreement will be closely monitored by the official Joint Advisory Committee set up in 1973.[1]

[1] December 1973 *Bulletin*, page 428.

Ratio of new house prices to average earnings

New house prices rose much faster than average earnings from 1972 to early 1974; since then the trend has been reversed, but new house prices remain historically high.



Main components of public expenditure[a]

Public expenditure continues to grow strongly.

Percentage changes

	1974/75 (£ billion)	1969/70 to 1973/74 (annual rate)	1973/74 to 1974/75 (provisional outturn)	1974/75 to 1975/76
Goods and services:				
Current	17.8	14	29½	25½
of which:				
Volume		*3*	*3*	
Price		*10½*	*25½*	
Capital (excluding stocks)	7.0	12½	17	16
of which:				
Volume		*1*	*— 2*	
Price		*11½*	*19½*	
Transfer payments:				
Subsidies	3.4	20½	85	6½
Grants	9.7	12	23½	30½
Debt interest	4.0	11½	25	27½
Total (including stocks)	42.4	13½	29½	23
of which:				
Volume		*3*	*6½*	
Price		*10*	*21½*	

[a] Excluding net lending.

The price level necessary to sustain a revival in the industry is not entirely clear. Since the beginning of 1974, new house prices have risen by about 8% while building costs have risen by about 26%.[1] On the other hand, there had been a very large increase in prices between 1972 and 1974; this was much faster than the rise in building costs, probably boosting builders' profit margins as well as land prices.

In the long term, house prices (excluding the value of land) may be expected to move broadly in line with building costs. Meanwhile, houses are now much dearer in relation to average earnings than in the ten years up to 1972 (see chart). Even if housebuilding costs rise slightly faster in the long term than average prices (among other things, productivity in housebuilding has probably tended to rise more slowly than national productivity), there still seems scope in the short term for a smaller rise in house (and land) prices than in other prices generally or in earnings.

Public sector

Total public expenditure[2] rose by almost 30% in 1974/75, nearly half as fast again as GDP at current prices. This disproportionate increase in public spending represented a sharp departure from recent trends: between 1969/70 and 1973/74 public spending and domestic output had risen broadly in line. Within the total for 1974/75, expenditure on goods and services rose by rather more than 25%, with capital spending rising less fast than consumption. Among transfer payments, the increase in subsidies was especially big.

Although the distinction between increases in volume and increases in prices embodied in public expenditure cannot be very precise, most of the rise in 1974/75 was due to higher labour costs, which appear to have risen faster in the public services than elsewhere in the economy. (In part this reflected the tendency of public sector pay to catch up with that of the private sector after the ending of the statutory pay policy last July, and to that extent may prove to be a temporary factor. Rapidly rising building costs were also important.) Of the rise of over £9½ billion in total expenditure, some £7½ billion represented higher costs and prices, including rather under £1 billion attributable to public sector costs rising faster than those elsewhere — while perhaps £2 billion represented a real increase. The increase in volume (when transfer payments are included) was thus also very large, about double the rate in the preceding period (see table). While current public spending on goods and services increased somewhat faster in real terms than earlier, capital spending fell; and the big increase in volume was in transfer payments.

Much of the sharp rise in subsidies, 85%, was attributable to food subsidies, reintroduced in the spring of last year, and housing subsidies, which together accounted for about half of the total increase. Payments to nationalised industries, largely to compensate for price restraint in the face of higher labour and material costs, accounted for about a quarter of the increase.

Only about one half of the rise of £9½ billion in total expenditure was budgeted for in March last year. New measures announced during the year added some £¾ billion, and a further £¾ billion represented unplanned increases in real expenditure, particularly by local authorities. Apart from debt interest, which was revised upwards by £½ billion mainly on account of heavier borrowing, the

[1] From an index compiled by the Royal Institute of Chartered Surveyors.

[2] Current and capital expenditure on goods and services and transfer payments; but excluding net lending by the public sector as it has little immediate impact on resources. In 1974/75 net lending amounted to £1¾ billion.

Public expenditure and the burden of taxation

Public expenditure measured as a proportion of GNP increased very sharply in 1974/75.

Percentage of GNP at current factor cost

	1973/74	1974/75
Public expenditure[a]	51	54½
Public sector financial deficit	5½	7½
Taxation (including national insurance contributions)	38	40
Other receipts[b]	7½	7

[a] Excluding net lending.
[b] Gross trading surpluses, rent, dividends and interest.

Estimated effects of the Budget tax changes on revenue

Tax increases were directed almost entirely at personal spending.

£ millions

	1975/76	A full year	Amounts for 1975/76 as percentage of estimated disposable income
Income tax			0.2
Increases in allowances	— 440	— 550	
Increases in rates of tax etc.	+ 620	+ 790	
Value added tax	+ 220	+ 360	0.3
Revenue duties on tobacco and alcohol	+ 570	+ 610	0.8
Vehicle excise duties	+ 250	+ 270	0.3
Other tax changes	+ 40	+ 10	
	+1,250	+1,470	1.8[a]

[a] Components do not add to total owing to rounding.

rest can be attributed to unforeseen wage and price increases. For example, unplanned subsidy payments amounted to some £1 billion, including £½ billion for support of various kinds to the nationalised industries.

As a result of these increases, public expenditure as defined rose to about 54½% of GNP in 1974/75 — much more than in the previous year (51% — see table). The increase was financed equally by greater borrowing and greater taxation, so that each increased appreciably as a proportion of GNP. Although public spending is expected to grow more slowly this year, it will on present programmes, and on the limited expansion forecast for output, rise still further as a proportion of GNP, to perhaps 56%.

The Budget

The April Budget was aimed principally at limiting the increase in the prospective public sector borrowing requirement and reducing the balance of payments deficit. Tax increases were directed almost exclusively at personal spending: in all, the tax changes will increase revenue by an estimated £1,250 million in 1975/76 and by about £1,470 million in a full year. As the estimates in the third column of the table show, the increase in revenue is relatively small — in total, for 1975/76, it seems likely to be only about 1¾% of personal disposable income — and the borrowing requirement is put at £9·1 billion, against a provisional outturn of £7·6 billion in 1974/75.

Cuts of £900 million (2¼%) at 1974 survey prices in public spending programmes for 1976/77 were also announced, and it seems likely that the impact of the Budget on the real economy will not be very significant until the middle of 1976, when these cuts start to take effect. Consumers' expenditure in the official post-Budget forecast is unchanged between the first half of 1975 and the first half of 1976. Given that other components of demand will be little affected by the Budget measures before then, this would imply a reduction in total final expenditure of rather less than 1% by mid-1976, and a reduction in GDP on about the same scale.

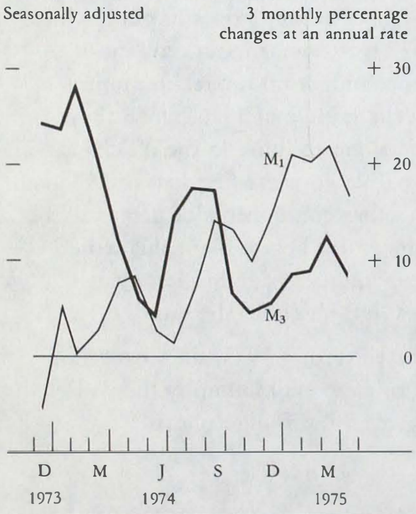
With no growth of GDP expected during 1975, the Chancellor foresaw a rise in unemployment to almost a million by the end of the year, including 20,000 stemming from the Budget measures themselves.

Monetary developments

Short-term interest rates in the United Kingdom fell steadily during the early part of 1975. The downturn appeared first in the parallel markets and followed reductions in rates abroad, particularly in the United States, and in the euro-dollar market. The reductions quickly spread to Treasury bill rates and thus to the Bank's minimum lending rate, which dropped in several stages to 9¾% by the end of April, having been 11½% in the middle of January. During the same period, the clearing banks' base rates were reduced, though not uniformly or simultaneously, from 12% to 9½%. Long-term interest rates on both public and private sector debt also began to fall soon after the new year. The authorities encouraged the trend towards lower interest rates through their open-market operations, though from about the middle of March they were content to see some stabilising of longer rates. Although the initial impetus came from overseas, the general reduction in rates was welcome for a number of domestic reasons: private industry had in many cases become overdependent on short-term borrowing at high rates of interest, and the fall in the capital value of assets, resulting in part

Money stock

M_1 has continued to grow faster than M_3 (see text).



Influences on the money stock (M3)

Heavy sales of gilt-edged stock outside the banking system helped to restrain the growth of the money stock in the first quarter.

£ millions: *seasonally adjusted*

	1974				1975
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Central government borrowing requirement	+ 230	+ 830	+ 760	+1,730	+1,780
Purchases (—) of central government debt by non-bank private sector	— 90	— 640	— 520	+ 390	—1,630
Other public sector borrowing requirement	+ 520	+ 750	+ 790	+ 750	+ 400
Purchases (—) of other public sector debt by non-bank private sector	— 640	— 640	— 470	— 520	
Lending to private sector	+1,480	+1,200	+1,350	+ 300	+ 290
External items	— 210	— 630	— 460	—1,410	— 350
Other	— 250	— 230	— 350	+ 140	— 200
Money stock (M_3)	+1,040	+ 640	+1,100	+1,380	+ 290

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

from the earlier sharp rise in rates, threatened to create balance-sheet problems for some financial institutions; high interest rates and low equity prices had also severely hampered the new issue market.

In the gilt-edged market, falling rates soon generated expectations of further reductions, and the authorities were able to sell very substantial quantities of government stocks. At the same time, companies were enabled to bring forward a large number of rights issues and raise substantial sums. Despite the advantages flowing from a fall in rates, their trend in the longer term must depend to a large extent upon expectations about the rate of inflation. Furthermore, the scope for reductions in UK rates relative to those of other countries is limited, particularly while the country remains in substantial external deficit.

Government expenditure in the March quarter was again very heavy, and with the seasonal inflow of tax revenue diminished by the tax reliefs in the November Budget, the central government had a large borrowing requirement instead of the usual surplus. But owing to the very large official sales of government stocks, the amount of sterling finance raised by the Government from the banking system fell quite sharply, as it normally does this quarter. By April the demand for gilt-edged had abated and, with a larger central government borrowing requirement after the end of the main revenue-gathering season, the banks' position tended to ease, causing a further fall in short-term interest rates.

By early May, in view of the weakness of sterling, the fall in short-term rates was thought to have gone far enough, and the authorities accepted a rise in Treasury bill rates and hence in minimum lending rate.[1]

Despite the fall in interest rates, demands for finance from the banks by the private sector have become even more subdued, and lending has grown very little since the early winter. Such new lending as has taken place seems to have continued to go to manufacturing industry, mainly for working capital. Lending to persons and most other borrowers has continued to decline, though there was some increase in personal borrowing at the time of the Budget.

The broadly-defined money stock, M_3, has continued to rise relatively slowly — by around 10% at an annual rate (see chart). The banks' interest-bearing eligible liabilities have also grown only modestly and, taking all banks together, have kept well within the guidelines set before the suspension of the supplementary deposit scheme. On the other hand, the narrowly-defined version, M_1, though fluctuating widely from month to month, has on balance again risen faster than M_3 — by around 20% at an annual rate. The different behaviour of the two aggregates continues the pattern described in the March *Bulletin* (page 14). The growth in M_3 has probably been restrained by the transfer to other forms of investment of short-term funds hitherto employed with the banks in term deposits or certificates of deposit. The growth of M_1, on the other hand, reflects the need to hold larger cash balances to finance day-to-day transactions swollen by inflation.

The changes during 1974 in the relative weight of the main underlying contributions to the growth of M_3 were also described in the March *Bulletin*. Comparable figures for the first quarter of 1975 are shown in the table. The central government borrowing requirement, after seasonal adjustment, was again substantial, but the effect of this was largely offset by the general public's renewed demand for gilt-edged stocks, which was particularly heavy. Bank

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

lending to the private sector again grew very slowly. External items, however, were much less 'minus' than in the previous quarter, partly because of the substantial improvement in the current account deficit, but also because there appears to have been some revival of capital inflows to the private sector outside the banks.

Assessment

The country is faced with a number of major problems. There is need to shift resources into the balance of payments, and to secure renewed expansion instead of a falling trend in investment; this severely limits the share of national resources that can go to current public expenditure. Until both the large external deficit and the large deficit of the public sector can be reduced, they have to be financed. All these problems stand to be exacerbated by continuing inflation; and to bring inflation under control is now very clearly the most urgent problem.

Inflation in this country has been accelerating since 1971. There are three reasons for which it must be seen now to have reached a critical stage. Whereas until fairly recently it had been only slightly greater than in other industrial countries, the margin has been increasing, and the rate of inflation is now 10% — 15% faster than in the United States and Western Germany. In the second place, much of the rise in prices a year ago could be regarded as imported inflation, a reflection of the worldwide rise in costs of imported commodities. Now it is predominantly due to the rise in domestic costs. Third, it has been demonstrated in practice how easy it is for inflation to accelerate. Since last summer pay settlements (together with the effects of threshold payments) have been exceeding the rise in prices by a substantial margin. The effect has been to inject into the economy an accelerating rise in costs, appearing after some months' delay as a more rapid rise in prices.

There is hope that in the autumn the price rise can be slowed down. Not only will the Budget tax increases have had their impact on prices; equally important, the costs being passed through into prices will have ceased by then to reflect the increases in pay brought about by last year's threshold payments. This hope of a slower price rise in the autumn depends, however, on there being no large increase in the new money given in settlements. Over the last twelve months' phase of accelerating inflation, pay settlements have been greater than the rise in prices — on a scale, indeed, only possible at the cost of acceleration. For a phase of deceleration to be made possible, this trend needs to be reversed.

A slowing down of inflation cannot be an easy and painless adjustment. Other countries have recently demonstrated their ability to slow down the rise in prices, though from a less extreme rate. They have done so by deflation. If this route were to be followed here, there can be no doubt that it would involve much greater unemployment than now existing or probable, and that this phase would have to be prolonged. There is therefore a strong argument, as an alternative means of slowing down inflation, either for seeking a stricter form of voluntary restraint, or for the Government to seek to exercise, by one means or another, a restraint over the size of pay settlements. Whatever the method, there are great and obvious difficulties in the way of effectively applying a restraint, and some considerable disadvantages in this approach. Such costs would hardly be worth incurring for an overmild and ineffective restraint. To make it worthwhile, there would have to be early and visible results on prices; for example, as a first stage it should offer something like the prospect of halving the present rate of inflation.

If a severe restriction on the scale of pay increases were adopted, it could not last indefinitely; and were one adopted it would be desirable from the outset to consider the arrangements that should follow. Among other considerations, there seems a case for working towards a system of wage negotiations (such as exists in some other countries) in which claims and settlements in all major industries came forward at the same date in the year. This should make it easier to deal with relativities and avoid leap-frogging.

The question of price control has to be considered in the context of the need to secure an expansion of private investment. The financial difficulties of companies are less severe than last year. This is partly because the finance required for stock appreciation, though large, is somewhat less, and because of the tax relief on stocks. But it is partly also because investment in fixed assets and stocks has been cut back. In the next phase the latter will have to be reversed; but companies are likely still to be in a weak position for undertaking re-expansion. The problem is not that finance cannot be raised from financial institutions for profitable projects, but rather that after years of decline the level of profits does not provide an adequate return on existing capital, nor make new investment attractive. This is a situation which will not be remedied quickly; but it is too acute for it to be capable of being neglected in the short term in the hope of using tighter price control to slow inflation. Because of past increases in pay, there are a lot of costs in the pipeline, already incurred but not yet passed through as higher prices. To seek to arrest the latter process would clearly produce insupportable deficits in the accounts of industrial enterprises, both private and public. What would be advantageous, in an economic climate in which there is in any case no room for extravagant price increases, would be a control less detailed in its method of application.

The January white paper on public expenditure projected a situation in which, while public expenditure continued to expand more or less in line with national output, the diversion of resources to the balance of payments and to domestic investment left little for the private consumer. Private consumption can be squeezed for a short time, but it is hardly a practicable aim to seek for long to go on denying it a fair share of rising output. It could only be attempted by means of a steep and progressive rise in taxation above its already high levels. This would be very difficult: the present level depends on the fact, for instance, that income tax thresholds have only partially been adjusted for recent inflation. The conclusion seems inescapable. Everything cannot be done at once; and if the balance of payments and domestic investment are to be strengthened, there is in practice no room for increases in the volume of public expenditure. The cuts in spending plans announced in the Budget aimed to achieve this for 1976/77, but did not deal with later years. In addition to fixing a realistic programme, it will be equally important to keep spending to the programme. At a time of rapid inflation it is difficult to distinguish increases due to rising costs and prices from increases due to a higher volume of spending; and in the light of the large increases last year, it is clearly important to have more effective arrangements — whether by fixing cash ceilings or by other means — to prevent unbudgeted increases in spending. This degree of restraint seems the minimum required to bring about even a gradual reduction of the borrowing requirement of the public sector.

A firm hold will also need to be kept on monetary conditions. The large public sector borrowing requirement remains the main source of monetary expansion, while industry has not recently had great recourse to the banks for finance. Industrial demand for credit may however increase, and it would be desirable to avoid adding to industry's difficulties and to accommodate this demand. In these circumstances, a greater proportion of the public sector deficit will need to be financed from outside the short-term markets and the banking system if appropriate monetary conditions are to be maintained.