Economic commentary

The present economic commentary surveys trends extending to about the middle of this year. Trends for the rest of the year, and into next, may in many respects be somewhat different. Implications for policy are discussed in the concluding assessment (page 220).

The second quarter saw a further deepening of recession in Europe, though industrial production rose in Japan, and in the United States showed a rise in June. Many of the larger countries have, however, now adopted, or are strengthening, reflationary policies.

UK exports, though high in relation to falling world trade, have been declining in volume terms. A clear upturn seems unlikely until world trade recovers -- perhaps not until the early part of next year.

In contrast to most other countries, inflation in the United Kingdom accelerated sharply in the second quarter – largely reflecting past wage increases: the Government's policy of pay restraint became effective last month.

Economic activity in this country, which has so far fallen less than abroad, showed a marked further decline in the second quarter. Unemployment also rose rapidly in the second quarter, but more slowly in August when it reached 967,000 (seasonally adjusted). Most components of domestic demand, with the exception of public spending, have been weak. The major influence underlying the decline in activity in the first half of the year has, however, been an exceptionally large turnround in stockbuilding. The recession has been accompanied by a sharp drop in the volume of imports. With a sizable improvement in the terms of trade, the trade deficit narrowed further in the second quarter.

The reserves in the second quarter were nevertheless drawn down – by appreciably more than the current deficit – and, against other main currencies taken together, sterling depreciated about 10%, with some recovery since.

Short-term interest rates abroad, which had been falling in the early months of the year, had begun to turn up in some centres by the end of June, eroding the differential in favour of sterling. The UK authorities therefore encouraged a rise in domestic short-term rates, but were content for this not to be transmitted to the longer end of the market.

In spite of the continuing public sector borrowing requirement, the rise in the money stock has tended to decelerate, partly because of large receipts of sterling through the Exchange Equalisation Account, and further purchases of gilt-edged stocks by the general public. At the same time, bank lending to the private sector has remained subdued. The financial position of companies has been prevented from worsening by the cutback in investment and stocks. With the recovery in equity prices, companies have been able to raise substantial equity funds by means of rights issues.

Industrial production

In the second quarter production continued to fall in most of the large industrial countries.

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

	1974		1975		
	3rd qtr	4th qtr	1st qtr	2nd qtr (provisional)	Cyclical situation[a]
United States	–	−3·3	−8·0	−1·5	−18
Canada	−1·2	−1·3	−2·8	−0·8	−10
Japan	−3·3	−5·3	−7·7	+2·6	−32
France	+0·8	−5·6	−3·4	−2·9	−14
Italy	−4·4	−6·7	−1·7	−2·7	−22
Western Germany	−1·8	−3·6	−2·8	−1·9	−17
United Kingdom	+0·9	−2·8	−1·0	−3·9	−10
All OECD countries	−0·8	−3·4	−6·1	−1·3[b]	−19[b]

[a] Percentage deviation of industrial production in second 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] Weighted average of the above seven countries.

International developments[1]

There are as yet only partial signs of a general recovery from the recession in industrial countries – the deepest since the war – although several countries have introduced reflationary measures this year. In the second quarter as a whole, industrial production rose only in Japan, although it did turn up in June in the United States: these two are among the countries which showed the earliest and steepest falls in output. In the main European countries output is stagnant or still

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

Household saving[a]

Saving appears to have been very high in recent years.

Percentage of personal disposable income

	Average 1964-74	1973	1974	1975 1st qtr
United States	7·2	8·4	8·1	7·5
Canada	6·9	7·8	8·2	7·7
Japan	19·9	24·1	25·6	. .
France	11·7	13·3	12·4	. .
Italy	16·2	17·1	14·7	. .
Western Germany	12·7	13·5	14·8	16·5
United Kingdom	9·3	11·3	12·1	12·6

Source: OECD, (apart from the first quarter 1975 where the figures are derived from local sources).

. . not available.

[a] These figures are residuals in national income accounts, and are therefore subject to large margins of error.

Current account balances

The surplus of the main industrial countries as a group doubled in the second quarter.

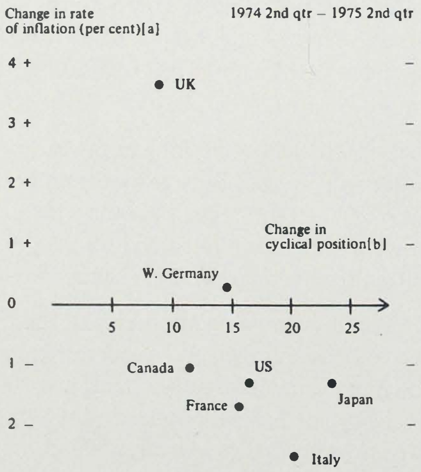
$ billions: *seasonally adjusted*

Surplus +/deficit –

	1974 Year	1974 3rd qtr	1974 4th qtr	1975 1st qtr	1975 2nd qtr (provisional)
United States	– 3·6	–1·5	–0·2	+2·1	+3·8
Canada	– 1·6	–0·5	–1·0	–1·5	–1·3
Japan	– 4·7	–0·9	–	+0·4	+0·5
France	– 5·9	–1·9	–1·0	–	+0·7
Italy	– 7·9	–2·2	–1·1	–0·1	–0·1
Western Germany	+ 9·3	+1·7	+2·7	+2·3	+1·7
United Kingdom	– 9·0	–2·0	–2·5	–0·7	–0·3
Total	–23·4	–7·3	–3·1	+2·5	+5·0

Changes in rates of inflation and cyclical positions

Only in the United Kingdom, where spare capacity has grown least, have retail prices accelerated sharply.



[a] Change in rate of increase in retail prices.

[b] Percentage increase in spare capacity, defined as in table headed 'Industrial production'.

Retail prices

In the first half of 1975, the rise in retail prices accelerated in the United Kingdom, but slowed down in most other industrial countries.

Percentage changes on previous quarter

	1974 3rd qtr	1974 4th qtr	1975 1st qtr	1975 2nd qtr	2nd qtr 1974 to 2nd qtr 1975
United States	+3·0	+2·9	+1·8	+1·6	+ 9·7
Canada	+3·0	+2·7	+2·2	+2·2	+10·5
Japan	+3·8	+4·4	+1·5	+3·4	+13·7
France	+3·3	+3·2	+2·7	+2·4	+12·1
Italy	+6·0	+6·1	+3·3	+2·7	+19·6
Western Germany	+0·9	+1·3	+1·9	+1·9	+ 6·2
United Kingdom	+2·5	+4·4	+6·1	+9·5	+24·3
Weighted average of above	+3·0	+3·2	+2·2	+2·6	+11·5

falling. The United Kingdom suffered a larger fall in output in the second quarter than the other main countries, but was still among the least depressed economies (see table on previous page).

Demand for investment goods has been weak in all these countries, and stocks have been run down. In the United States, the rate of de-stocking decelerated in the second quarter, and in Western Germany stocks may now have ceased to fall. But capacity utilisation remains low, and an upturn in fixed investment will no doubt take longer to materialise. In recent years, the rate of household saving appears to have been historically high in most countries (see table), despite rapid rates of inflation. This may largely reflect uncertainties about future employment and income, and appears to be one reason why reflationary measures have so far been insufficient to produce much effect in some countries.

There was an unexpectedly large improvement in the balance of payments of the main industrial countries between last year and the first half of this, from substantial deficit into surplus (see table). The improvement amounted altogether to nearly $6 billion between the final quarter of 1974 and the first quarter of this year (the latest date for which firm figures are available). One third of the improvement seems to be due to a sharp increase in the imports of the oil-exporting countries. Most of the remainder can be attributed to the deeper recession in the industrial countries, the counterpart of which was a marked deterioration in the current balances of the smaller industrial countries ($1½–2 billion) and of developing countries other than oil exporters (perhaps $1–1½ billion). The eventual recovery of world trade could well be delayed if more of these countries react by reducing their imports.

The improvement in current balances has not been evenly spread among the industrial countries. Apart from the United States, the imbalances of the countries with the largest current account deficits last year had been virtually eliminated by the second quarter: France and Japan moved into modest surplus, and the United Kingdom and Italy had only small deficits. But the United States moved from a large deficit of some $3½ billion in 1974 to an even larger surplus of nearly $6 billion in the first half of this year alone. Western Germany's surplus, although reduced in the second quarter, was still substantial.

Effective exchange rates have reflected in some measure current and prospective rates of inflation, which have continued to differ considerably from country to country. In the second quarter, the French franc appreciated strongly and sterling weakened; other important currencies were little changed on balance. Since mid-year, the improving US trade balance and firmer dollar interest rates have caused the dollar to strengthen sharply against most currencies.

Undoubtedly the recession has damped down inflation in most industrial countries, although there have been some recent signs of renewed price increases in the United States. As can be seen from the table, retail prices in nearly all countries grew much more slowly than last year. Only in the United Kingdom was there a marked acceleration of prices, partly reflecting measures taken in the April Budget. It seems likely that prices will continue to rise more slowly in most countries, even after activity begins to recover.

The UK balance of payments

The current account [1]

In the second quarter the visible trade deficit continued to narrow,[2] wholly because of a further improvement in the terms of trade.

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

[2] Comparisons between the March and June quarters, particularly of imports, are somewhat distorted by the effects of port disputes in March and April.

Current account of the UK balance of payments

In the second quarter the visible trade deficit continued to narrow, because the terms of trade again improved.

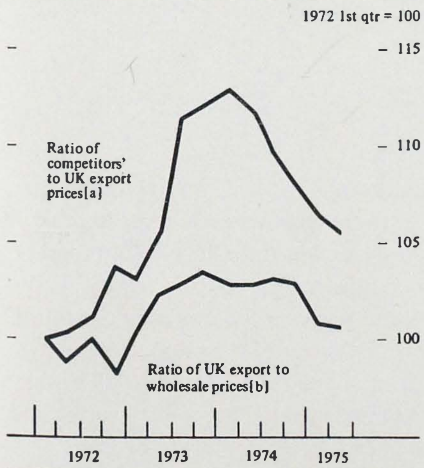
£ millions: *seasonally adjusted*

	1974			1975	
	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Exports of goods	3,980	4,240	4,105	4,640	4,480
Imports of goods	5,285	5,445	5,550	5,360	5,005
Visible balance	−1,305	−1,205	−1,445	− 720	− 525
Net invisibles	+ 390	+ 375	+ 375	+ 405	+ 290
Current balance	− 915	− 830	−1,070	− 315	− 235
Changes from preceding quarter:					
Visible balance	− 30	+ 100	− 240	+ 725	+ 195
of which:					
Volume[a]	*+ 100*	*+ 80*	*− 200*	*+ 570*	*−*
Price	*− 130*	*+ 20*	*− 40*	*+ 155*	*+ 195*
Volume of exports (percentage)	+ 2·1	+ 2·1	− 7·5	+ 7·5	− 7·2
Volume of imports (percentage)	− 0·4	− 0·1	− 2·2	− 4·7	− 6·2

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

Price ratios relevant to UK export performance

The price-competitiveness and relative profitability of UK exports each continued to decline in the second quarter.



[a] Competitors' export prices approximated by applying UK export weights to UK import prices, by SITC manufacturing section.

[b] Home selling prices of manufacturing industries other than food, drink and tobacco.

Although the surplus on invisibles was substantially reduced, the current account deficit fell by £80 million.

The volume of imports fell by 6¼% in the second quarter. This was associated with a fall in total demand, in particular heavy de-stocking. The volume of exports fell by 7¼% to 4½% below the average for 1974. But the volume of world trade is estimated to have contracted by some 10% over the same period, indicating that the UK share increased – as it has tended to do in the past when world trade has been cyclically depressed.

In July, the visible deficit widened to nearly £300 million. In volume terms, exports were close to the average of the second quarter, but imports rose sharply, owing to the arrival of an oil production platform and to unusually heavy deliveries of ships abroad to UK owners.

The price of imports, as measured by their unit value in sterling terms, rose by only 1½% in the second quarter even though sterling depreciated by about 5% on average against the other main currencies taken together. Commodity prices as a whole were lower, even in sterling terms; but prices of finished manufactures rose quite sharply, and were also largely responsible for a further rise in the unit value of imports in July. The effects of sterling's depreciation in the second quarter, and of a recent firmer tone in commodity prices, especially foodstuffs, can be expected to work through more fully to import prices during the remainder of the year.

The unit value of exports rose by 4½% in the second quarter and accelerated in July, reflecting continuing cost inflation at home. Thus, there was another sizable improvement in the terms of trade.

Although the volume of exports has fluctuated widely in recent months, the underlying trend was probably downwards. Influenced by sterling's depreciation, the decline in the price-competitiveness of UK exports (see upper line of chart) slowed somewhat in the second quarter and may since have been reversed. The lower line of the chart gives some indication of the profitability of exports relative to domestic sales by UK industry. It appears that, since the final quarter of 1974, the keener competition in world markets associated with weakening demand has forced manufacturers to hold down their export prices more than domestic prices, even though only the latter are subject to the price code.

As was seen in July, equipment for the development of North Sea oil – in particular oil production platforms – is adding heavily to the import bill, but it is misleading to consider such transactions in isolation: the UK balance of payments benefits on capital account from inflows of investment funds that finance much of North Sea operations, and the current account will benefit in the future from the resulting flow of oil. These items apart, the depressed outlook for UK demand as a whole would seem to rule out any sustained general increase in imports for some time yet, though a slower rate of de-stocking could check the decline in the volume of imports which has lasted now for eighteen months.

The terms of trade appear to have benefited this year not only from the weakness of world commodity prices but also from the United Kingdom's rate of inflation, which has been faster than in other industrial countries. Food prices have been firmer recently; but the depth of the world recession may for some time prevent any marked rise in the prices of industrial materials.

In the second quarter, the estimated surplus on invisibles, at £290 million, was over £100 million lower than in the first. About half of the decline was accounted for by the timing of transfers to and from EEC funds, which had been unusually favourable in the previous quarter. Among other items, net receipts from interest, profits and dividends were lower, reflecting a fall in earnings from direct investment abroad

Financing of the current account deficit

Although the current account deficit was smaller in the second quarter, the reserves fell sharply.

£ millions: *not seasonally adjusted*

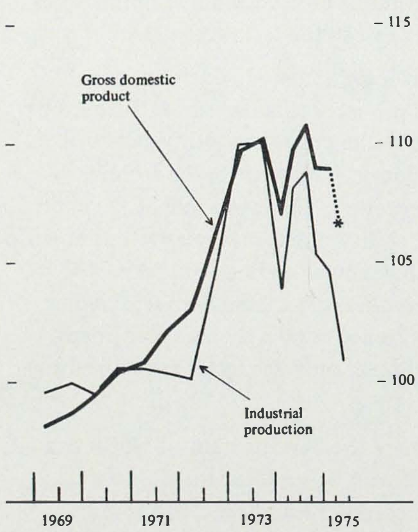
	1974			1975	
	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Current balance	−900	−880	−900	−600	−340
Capital transfers	− 30	− 40	− 10	–	–
	−930	−920	−910	−600	−340
Financed by:					
Decrease (+) in reserves	−110	−180	+180	−140	+420
Foreign currency borrowing:					
Central government	–	–	+640	+420	–
Other public sector (net)	+510	+220	+200	+ 80	+170
Increase (+) in sterling holdings (official and private):					
Oil-exporting countries[a]	+590	+900	+420	+330	−170
Other	−200	−280	− 40	− 90	+200
Other identified capital flows (net)	+300	−220	−410	−450	−130
Balancing item	−160	+480	− 80	+450	−150

[a] Listed in footnote [a] to Table 21 of the statistical annex.

Gross domestic product and industrial production

Industrial production has fallen sharply since March.

Volume, seasonally adjusted 1970 = 100



* Estimated.

Factors contributing to changes in total final expenditure[a]

In the second quarter, all the main components of demand apart from public spending contributed to the sharp fall in total final expenditure.

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

	2nd half 1973 to 1st half 1974	1st half 1974 to 2nd half 1974	2nd half 1974 to 1st qtr 1975	1st qtr 1975 to 2nd qtr 1975 (provisional)
Change in total final expenditure	−0·4	+1·2	−0·4	−3·0
Attributable to:				
Domestic expenditure (except on stocks)	−0·6	+0·7	+0·3	−0·8
of which:				
Consumers' expenditure	*−0·4*	*+0·6*	*+0·1*	*−0·8*
Public spending[b]	*+0·1*	*+0·1*	*+0·5*	*+0·2*
Private fixed investment	*−0·3*	*–*	*−0·3*	*−0·3*
Stockbuilding	−0·4	+0·6	−0·9	−1·0
Exports of goods and services	+0·6	−0·1	+0·2	−1·2

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

[b] Total spending on final goods and services by the public sector.

by UK companies; and the depressed volume of world trade increased the deficit on shipping account.

Financing the deficit

Before seasonal adjustment, the current account deficit for the second quarter was only some £340 million, but in contrast to the previous quarter, the reserves fell sharply (see table). Sterling was under considerable pressure at times, and in spite of some official intervention its effective depreciation widened during the quarter from 21% to 29% below the Smithsonian settlement rate. Conditions were mostly calmer over the following two months, although the reserves fell by a further £100 million. Sterling's depreciation narrowed, and was 27½% at the end of August.

The public sector borrowed a further £170 million in foreign currencies in the second quarter, but there was only a small inflow through a rise in sterling holdings. Other identified capital flows are shown in detail in the statistical annex (Table 20). Within the total, UK banks' net liabilities in foreign currencies, as recorded, rose by an unusually large £820 million: [1] a large payment of oil revenues was delayed from the first quarter, the banks apparently switched heavily into sterling, and UK residents resumed borrowing in foreign currencies to finance investment abroad. But there was a heavy net outflow through private investment – direct inward investment was lower; both domestic and overseas investors transferred portfolio funds abroad; and UK oil companies made heavy repayments of credit abroad (though some of this has a counterpart in the inflow of foreign currency to UK banks mentioned above).

The UK economy

Output and demand [2]

Activity in the United Kingdom has been slowing down for some time, but only recently at rates similar to those experienced earlier in other OECD countries. After declining fairly slowly since July 1974 (apart from an erratic drop in December), industrial production fell by nearly 4% in the second quarter, and by June was over 9% down on the third quarter of 1973 – the sharpest decline (except during major industrial disputes) since the war, although from a peak of high activity. The fall in output in the second quarter was concentrated in manufacturing and construction. Output of other goods and services tends to be more stable, and total output probably fell by about 2%.

The only element of domestic demand to have grown since the second half of last year has been public spending on goods and services (see table). Consumers' expenditure has been subdued (it fell by 1½% in the second quarter), and private fixed-capital formation has declined generally. But the largest contribution to the fall in output so far this year has come from a massive turnround in stockbuilding. De-stocking on the scale of the first half of this year is, however, unlikely to continue for long, and the prospective slowdown will remove a severe brake on output.

The substantial improvement in the trade balance in real terms in the first quarter did not continue in the second when a further large fall in the volume of imports was broadly matched by a fall in exports (see page 213).

Since the third quarter of 1973, potential output has probably expanded by around 5%. Industrial production fell by 9% over the same period, suggesting that it was as much as 14% below potential in the June quarter of this year. However, late 1973 was a period when

[1] See the cautionary note under 'Banking sector' (page 230).

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

Indicators of the pressure of demand on resources

All the indicators show a continued weakening in the pressure of demand on resources; unemployment is now well above the previous post-war peak.

Seasonally adjusted: Great Britain (except where stated)

	Previous 'low'	1973 2nd half	1974 2nd half	1975 1st qtr	1975 2nd qtr	Latest
Deviation of industrial output from trend[a] (percentage)	−7 (1st qtr 1972)	+1	−3	−6	−10	(2nd qtr)
Unemployment (thousands)	870 (March 1972)	524	600	701	813	967 (August)
Vacancies (thousands)	119 (December 1971)	348	297	189	157	134 (August)
Short-time workers (thousands)	1,138[b] (January 1974)	16	60	176	231	128[c] (August)
Companies reporting below capacity working[d] (percentage)	71 (January 1972)	41	55	61	71	75 (July)

[a] Percentage deviation of UK industrial production (excluding construction) from the exponential trend of output (about 3% per annum) calculated over 1956-74.

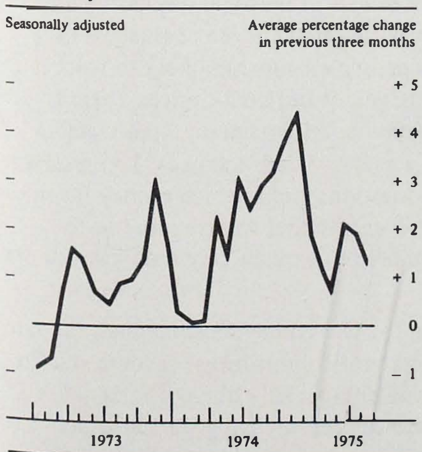
[b] Affected by the energy crisis.

[c] Estimated.

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

Unit labour costs in manufacturing industry

Unit labour costs grew much more slowly in the first few months of 1975.



resources were under pressure; and industrial production in the second quarter was perhaps only 10% below a more normal degree of capacity utilisation. This has been reflected in rapidly rising unemployment, which has grown at an average of around 40,000 per month since November 1974 to 967,000 in August (or 4·2% of the labour force), exceeding the previous post-war peak in March 1972 (see table). As changes in unemployment typically follow changes in output, there must be some further rise in unemployment still to come.

The deepening recession was also reflected in a decline in the number of notified job vacancies (although there was a small rise in August), and in the rising percentage of companies working below capacity. According to the CBI survey in July, more companies were then operating below capacity than at any time during the last fifteen years – including the period of short-time working early in 1974.

Prices and costs

While activity has fallen later in the United Kingdom than abroad, inflation here has been very much worse. The seriousness of the inflation led the Government, after extensive discussions with the Trades Union Congress and the Confederation of British Industry, to propose a new and tougher voluntary incomes policy in July, designed to reduce the year-on-year increase of retail prices to 10% by the third quarter of 1976. Under this policy, pay increases from 1st August (apart from those made to achieve equal pay for women) should not exceed £6 per week for all employees earning £8,500 per annum or less; no increases are to be allowed for other employees. The policy implies a sharp reduction in the growth of earnings: increases in wage rates (other than those aimed towards establishing equal pay for women) should add at most 11% to earnings over the next year. Only increases in wage costs which conform to this limit may be reflected in higher prices: no part of any larger pay increase can be passed on. The Government expect this and related measures to be sufficient to secure compliance with the policy, but have undertaken to introduce statutory sanctions if the policy is not observed. They have also made it clear that, when the present policy expires, further measures will be taken to ensure that the rate of inflation continues to slow down.

Even before the announcement of the new counter-inflation policy, earnings had begun to rise less quickly than prices. Early this year the growth of average earnings began to slow down considerably, and the rise of 4% in the second quarter was only half as large as in the fourth quarter of last year. The slower growth of earnings was partly due to the expiry of almost all threshold agreements, but is mainly a reflection of the slackness of the labour market. This has not only increased short-time working and reduced overtime as output has declined, but may also have been narrowing the margin by which local rates of pay exceed nationally agreed minimum rates.[1]

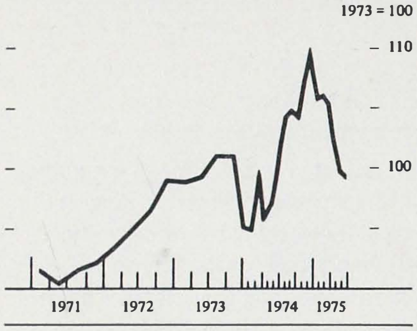
The slower growth in earnings resulted in a lower rate of growth in unit labour costs in manufacturing industry (see chart). And with wholesale buying prices showing little rise in the six months to June (although they have since risen sharply), the increase in output prices (of industries not affected by changes in duty in the Budget) slackened off somewhat in the second quarter.

No such moderation had occurred until recently in the growth of retail prices, which rose by no less than 9½% in the second quarter – or by 16% since the fourth quarter of last year. Most of the rise reflected the large increase in unit labour costs in the second half of 1974; higher indirect taxes introduced in the Budget did not work through until late in the second quarter, and so contributed only 2% to the quarterly increase. Nationalised industries' selling prices also rose very rapidly in the second quarter in line with the policy of reducing subsidies. So real

[1] Unlike earnings, basic hourly wage rates for manual workers as established in national settlements have continued to rise rapidly.

Ratio of average earnings to retail prices

Real earnings fell sharply in the first half of this year.



earnings have already been falling for some time (see chart). The trend of costs and of industry's output prices in the first half of 1975 suggests that retail prices should rise more slowly in the second half; and by the early part of next year they may cease to outpace earnings.

The new incomes policy could well reduce pay differentials more severely than was the case under previous policies. If the low paid receive the maximum £6 increase, their pay rates will rise significantly. The pay of women would be particularly affected; for example, four out of five women working full time could receive an increase greater than 13% whereas only about one out of ten men might receive so large an increase. Many women will also receive increases under the Equal Pay Act.

Personal incomes and spending[1]

Consumer spending fell for the second consecutive quarter: it had dropped by ½% in the first quarter and fell by 1½% in the second to slightly below the second half of 1973. The volume of retail sales was exceptionally large in April but this was in anticipation of the increase in value added tax in May. Sales fell back so much in the succeeding two months that total sales in the second quarter were 2% down on the first, and lower than the average quarterly volume in either 1973 or 1974.

The decline in consumer spending in the second quarter was noticeably smaller than the fall in real personal disposable income, which could have been as much as 4% (after falling very slightly in the March quarter). After continuing well above normal at around 12½% in the first quarter, saving as a proportion of disposable income probably fell quite appreciably in the second, although remaining relatively high.

The unusually high rate of personal saving in the past two years of rapid inflation may seem surprising, especially when it is considered that the real rate of return on liquid or near liquid assets has virtually always been negative. But there is normally a lag before spending adjusts to rapid increases in incomes such as occurred last summer. Also, the need to save in the face of uncertainties about future income, generated by the economic climate, could have been a more powerful influence than the wish to beat price increases by bringing forward purchases of goods. Another factor may have been the steep fall in the value of financial assets produced by inflation in general, combined with the weakness of the stock and property markets. Tentative estimates suggest that in 1974 the effects of general inflation, together with the relatively slower increase in house prices and the fall in the prices of stocks and shares, may have been to reduce the purchasing power of net assets owned by persons by very roughly 20%, or some £40 billion – equivalent to well over half of personal disposable income in that year. Some holders may wish to restore some of this loss of wealth by saving more. Although people are most unlikely to react immediately to the decline in share values and house prices, there is evidence to suggest that they actively seek to maintain a fairly stable relationship between their liquid assets and their incomes. To preserve this relationship in inflationary conditions under which money incomes rise more and more quickly, people need either to save more or to liquefy other assets. This too may help to explain why they have chosen to save more.

If pay increases are kept within the Government's guidelines, the rate of saving may now fall. While uncertainty about future income and the wish to restore the real value of assets (especially liquid assets) will persist to some degree, the pressure to keep up living standards may be more important. Further pressure towards saving less could arise from the distributional impact of the incomes policy, for those who normally save most will suffer the greatest decline in real disposable income under the policy.

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

Housebuilding

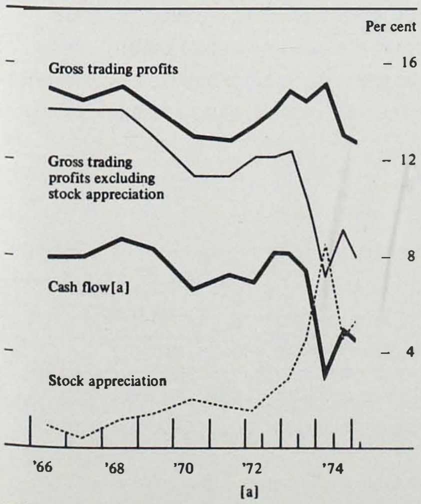
The unusually mild winter, combined with an upturn in mortgage lending, led to a strong recovery in housebuilding early this year after the depressed activity in late 1974. But in the second quarter the revival did not continue (in seasonally-adjusted terms), and public sector housebuilding fell back from its peak.

The recovery in private sector housebuilding earlier this year is somewhat surprising: in the past, an upturn in the number of houses started in the private sector has not occurred until the stock of houses under construction declined to well below the present total (210,000). It may be that further recovery will be delayed until sales of new houses speed up. But new work must also be profitable, and present building costs appear to be high in relation to house prices. The latter were stable in the fourth quarter of 1974, but are now beginning to rise – by about 3% in the first quarter and 4% in the second.[1] At the same time, the costs of labour and materials have continued to rise more rapidly (they went up by about 8% in the first quarter, and about 10% in the second).[2] However, profitability will have benefited from lower interest charges; and pay restraint, together with rising unemployment, should help to slow down the future rate of growth of labour costs. On balance, it would seem that a further moderate growth in house prices is necessary to sustain a recovery in housebuilding, though too rapid a rise would be generally undesirable. This will require a continuing, but not excessive, flow of mortgage finance.

After an exceptionally large inflow in each of the previous three months, building societies' net receipts turned down sharply in June when the recommended interest rate paid on share accounts was lowered to 7% (10·77% gross of income tax at the standard rate). Subsequently there has been some recovery. The index-linked national savings schemes appear to have had little impact so far on societies' receipts, although future inflows could be reduced by the rise in competing interest rates since July and by the possible fall in personal saving. Nevertheless, the societies have built up a large cushion of liquidity and would be in a position to sustain the recent volume of lending for many months even if inflows were, in fact, significantly reduced. The squeeze on incomes will tend to reduce people's capacity to repay mortgages and hence their willingness to borrow, but this has not yet become apparent. Demand is at present concentrated on cheaper houses, and may be affected by the cutback in local authority lending for house purchase announced in May (although the building societies have agreed in principle to help offset this). Demand for dearer houses remains weak and, with higher incomes being particularly squeezed, there is little prospect of an early recovery.

Profits and cash flow as percentages of gross domestic income

In real terms, companies' profits and cash flow each fell in the first quarter.



[a] Defined in footnote to text.

Company spending and finance[3]

Although industrial and commercial companies improved their immediate financial position in the first half of 1975, they did so primarily by reducing their fixed investment and, even more, by running down stocks. Cash flow [4] appears to have been slightly lower in real terms than in the second half of 1974, but with the recovery in equity prices, companies have nevertheless been able to attract substantial equity funds by means of rights issues.

In the first quarter of this year, the latest period for which full information is available, gross trading profits rose slightly, but, without stock appreciation and expressed as a share of gross domestic income, they were almost as low as in the first half of 1974 (see chart). In this period, it would appear that the adverse effects of depressed demand on

[1] Department of Environment/Building Societies Association index of new house prices at approvals stage – provisional estimate.

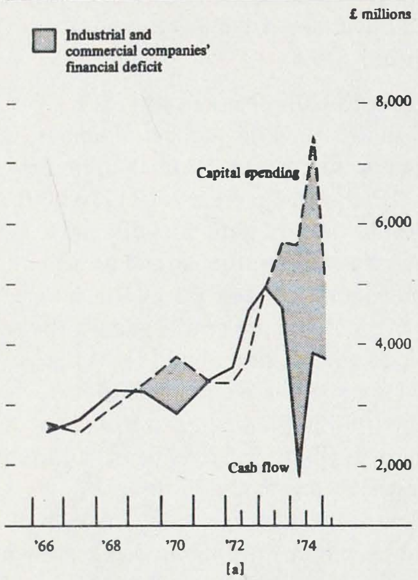
[2] Nationwide Building Society index of housebuilding costs.

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

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

Company cash flow and capital spending

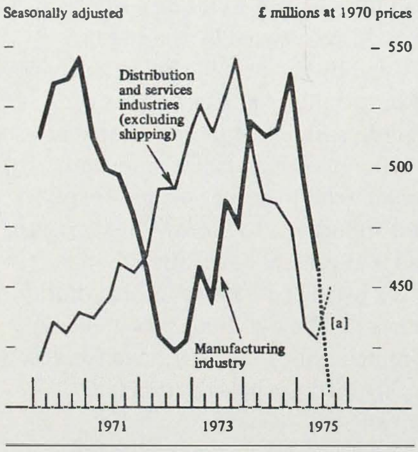
In the first quarter companies' financial deficit was more than halved, because of large cuts in investment.



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

Fixed capital expenditure in manufacturing, and distribution and services

Investment fell by 10% in the first half of 1975, and a further steep fall is likely in the second half.



[a] Quarterly totals implied for the second half of the year by the June Department of Industry investment intentions survey.

profit margins had more than offset the benefits stemming from the relaxations in the price code announced in November. The Price Commission reported little sign of improvement in profit margins in the second quarter: the rapid rise in retail prices during this period was essentially due to an earlier sharp increase in labour costs, and profit margins continued to be depressed by weak demand.

Companies' cash flow was also little changed in the first quarter, so that in real terms it too fell. Companies paid over the final instalment, amounting to nearly £100 million, of the advance corporation tax surcharge, but their tax bill was broadly the same as in 1974 thanks to the stock relief scheme, which may have reduced company tax payments by as much as £200 million.[1] But although cash flow remained depressed, industrial and commercial companies' financial deficit – the excess of their capital expenditure over their cash flow – was reduced to £350 million, largely because of substantial cuts – even at current prices – in investment (see chart).

The cutback in capital spending continued in the second quarter. Expenditure cuts foreshadowed by the CBI and other industrial surveys are now coming through, and there was a further 5% reduction in the volume of fixed investment by private industry in the second quarter. Investment fell by 7% in manufacturing industry and by 1½% in the distributive and service industries – the sixth successive quarterly decline in the latter sector (see chart below). To judge from the latest investment intentions survey conducted by the Department of Industry, the volume of investment in the second half of the year could still fall much further. Given the outturn for the first two quarters, this implies a reduction in capital spending of as much as 15% in manufacturing industry in the second half compared with the first, but a small rise for the distributive and service industries.

De-stocking was much larger in the second quarter than in the first, with distributors' and manufacturers' stocks each falling by £125 million (1970 prices). Distributors had been running down stocks since the middle of last year (though not as fast as in the latest quarter), but this was the first fall in manufacturers' stocks since 1972 (apart from a small decline in the first quarter of 1974). Previously, de-stocking of materials and fuels by manufacturers had been more than offset by increases in their work in progress and in stocks of finished goods; but in the second quarter there was a reduction in all three categories of stocks. Nevertheless, in spite of the massive rundown in stocks, the sharp fall in output has led to further increases in manufacturers' stock/output ratios.

The reduction of companies' capital commitments has coincided with an exceptional flow of new funds from capital issues, although market conditions became less favourable towards the end of the period. Between March and the end of August, some £615 million was raised by industrial and commercial companies. While part of these funds will have been channelled towards existing capital spending programmes, some companies have used them to repay short-term debt and generally strengthen their balance sheets: demand for bank credit has therefore remained subdued.

Public expenditure[2]

Public spending appears at present to be the only component of domestic demand which has been rising. The volume of public consumption rose by ¾% between the December and March quarters. Public investment rose by 5% in the same period, much of which was in housing.

Information for the public sector as a whole is not yet available for the second quarter. But the central government borrowing requirement,

[1] Before seasonal adjustment, the relief of tax on stocks is estimated to amount to £800 million.
[2] This section is in seasonally-adjusted terms.

seasonally adjusted, was about £2,200 million in the quarter, compared with the forecast of around £7,800 million for the financial year as a whole in the *Financial Statement and Budget Report*.

Much attention has focused recently on the need for closer control over public expenditure. The Government have announced their intention to extend the use of cash limits on spending programmes from the beginning of the next financial year. At present, only a limited number of programmes, mainly affecting the construction sector, are controlled in this way. Where cash limits are applicable, departments will be able to obtain additional allocations only in exceptional circumstances. The use of such limits represents an important reinforcement of the present system of control, which was devised in less inflationary times and concentrates mainly on estimates of the volume of expenditure (i.e. at constant prices). Longer-term plans will continue to be drawn up in volume terms because it is thereby easier to assess the implications for the allocation of resources, and to calculate the requirements for different types of public services. But spending departments will in future be under greater pressure to limit the total cost of the goods and services which they purchase.

Monetary developments [1]

The steady fall in short-term interest rates in the United Kingdom, which had continued since the beginning of the year, was reversed in early May when the Bank's minimum lending rate rose from 9¾% to 10%. Rates then remained fairly steady. In the second half of June, however, rates in the United States and in the euro-dollar market began to turn upwards, eroding the differential that had been established in favour of sterling, and which it seemed desirable to maintain. To this end, the discount market was required to borrow from the Bank for seven days at minimum lending rate. The authorities thereby initiated an upward movement in market rates and, following the Treasury bill tender on 25th July, minimum lending rate was raised from 10% to 11%. Early in August the London and Scottish clearing banks raised their base rates from 9½% to 10%.

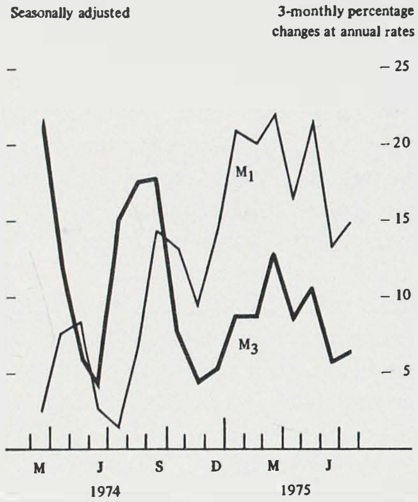
The authorities were able to sell an appreciable amount of government stocks around the time of the referendum in June, but demand then weakened while the Government's proposals to curb inflation were awaited. When these were made known, demand revived and very large official sales were made: these were mainly to the general public, and exceeded official purchases and repayments of the maturing 3% Savings Bonds which was redeemed on 15th August. The market in short-dated stocks weakened with the rise in minimum lending rate at the end of July. The Bank had no wish to see a similar rise in rates carried to the longer end of the market, and were content to see some flattening of the yield curve.

Government expenditure has continued to increase more rapidly than revenue in the second quarter, leaving a growing deficit to be financed. Some of this deficit has been met by receipts of sterling through the Exchange Equalisation Account, particularly in May, as well as by the official sales of gilt-edged stocks mentioned above, thus reducing the Government's need to borrow from the banking system. Even so, bank lending to the central government rose appreciably in both June and July. As a corollary, the banks accumulated reserve assets, their combined reserve ratio rising to 14·6% at mid-June and 15% at mid-July.

In contrast, private sector demand for bank finance has remained very sluggish. In the three months to mid-July bank lending to the private sector in sterling actually fell, after seasonal adjustment, by

[1] A more detailed description will be found in the financial review.

Money stock
In recent months both versions of the money stock have risen more slowly.



Influences on the money stock (M_3)
The central government again had a large deficit in the second quarter; but bank lending to the private sector was subdued and external items were strongly 'minus'.

£ millions: *seasonally adjusted*

	1974			1975	
	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Central government borrowing requirement	+ 650	+ 960	+1,390	+1,850	+2,190
Purchases (–) of central government debt by non-bank private sector	– 630	– 480	+ 370	–1,660	– 430
Other public sector borrowing requirement	+ 770	+ 730	+ 800	+ 540	
Purchases (–) of other public sector debt by non-bank private sector	– 680	– 480	– 520	– 50	+ 450
Lending to private sector	+1,170	+1,460	+ 330	+ 430	+ 350
External items	– 460	– 400	–1,480	– 480	–1,830
Other	+ 10	– 600	+ 400	– 300	– 100
Money stock (M_3)	+ 830	+1,190	+1,290	+ 330	+ 630

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

about £200 million – even though the Issue Department's holdings of commercial bills were run down by a similar amount.

The underlying rate of growth of both versions of the money stock seems to have moderated slightly in recent months (see chart). During the three months to mid-July, the narrow version, M_1, rose (seasonally adjusted) by around 3½% while the broader version, M_3, rose only by 1½%; both these figures were below the rates of growth reported earlier in the year. During the last twelve months M_1 has risen by 16½% and M_3 by 7¾%.

The table (which is provisional and relates to calendar quarters) illustrates how monetary expansion – as measured by the growth of M_3 – has been contained over the last year despite the growing borrowing requirement of the public sector. Although the picture inevitably varies with market conditions – which can change considerably from one quarter to the next – the table shows that a large part of the borrowing requirement has effectively been offset by purchases of public sector debt by the general public as well as by a very large net outflow (under 'external items') of private funds (see page 214). At the same time, the growth in bank lending to the private sector has been greatly reduced – implying, if allowance is made for inflation, a sharp reduction in the amount outstanding.

Assessment

The major economic problem with which the country is faced is that of inflation: the prospects have now been greatly improved by the reception given to the policy set out in the Government's White Paper, *The Attack on Inflation*. This does not mean that the economy is now on a straight course. But success here will also greatly facilitate the task of solving the other outstanding problems. Economic expansion will need to be resumed in due course; and over the next few years – a period during which it is reasonable to hope that a strong revival of economic activity will be possible – the balance of payments will need to be further strengthened, and a major reduction in the public sector borrowing requirement will have to be brought about.

The effect of pay restraint should be to cause a sharp break in the trend of costs. The effect on prices will inevitably be more gradual because of cost increases in the pipeline, arising predominantly from past wage increases; but if the rise in wage costs is held to about 10%, the rise in prices should, in twelve months' time, be slowed down to a similar pace. There are inevitably difficulties associated with the policy. It involves sacrifices, for a time, in real incomes; and the restraints will have to be accepted by all if they are to be thought to be fair. Through price control, the sanctions on employers are also severe. The policy also leaves problems for the subsequent stage, to which answers will need to be found. Against these difficulties must be set the fact that, without a policy of strict restraint on pay increases, there would have been no way of avoiding continuing rapid inflation and more severe recession and unemployment: and this would again be the case were the policy to fail.

So far this year the domestic recession has deepened sharply and unemployment has reached its highest post-war level. These trends should not be expected to continue unchanged, for two main reasons. First, the major depressing influence on activity has been a massive run-down of stocks, on a scale not seen in the last twenty-five years. This is most unlikely to continue for long; and as stock depletion lessens – and, later, is replaced by accumulation – this major depressant to the level of output will be reduced and later reversed. Second, a recovery of world trade has been expected for some time; it is still reasonable to expect at least some recovery soon. UK exports, though fluctuating from quarter to quarter, have remained fairly high in relation to falling world trade, and should benefit from a world recovery.

Against this, consumer demand is likely to be held back during the early stages of pay restraint; and private investment is all too likely to remain weak until recovery of the economy has advanced and unused capacity is diminished. Nevertheless is seems a fair probability that output may not fall much below its present level, and may soon show at least some recovery. Immediate prospects, and hence the implications for policy, are particularly difficult to weigh when economic trends are near a turning point. The constraints on demand management will become less narrow only when the deceleration of price inflation has become established; this will not be clear till the early part of next year. The rebuilding of sound conditions for steadily increasing prosperity in any case demands a long perspective; and over the next two or three years, if world economic expansion is fully resumed, it is not impossible to foresee trends which might bring back pressure on resources, as domestic investment revives and as resources are shifted further to strengthen the balance of payments.

There has been a major improvement in the balance of payments this year, but some of this may prove temporary. The current account deficit in the first half year was about £½ billion, which at an annual rate is less than one third of last year's figure. This improvement owes much to the deepening domestic recession, particularly the massive rundown in stocks, which has produced a sharp fall in the volume of imports. There has also been an improvement in the terms of trade. In the second half of this year the influence of these factors is likely to be less marked. Commodity prices appear now to be past their low point, and there will be costly imports of oil rigs and other equipment for the North Sea. As a result, the deficit will probably be rather greater than in the first half. Next year, the speed with which resources can be shifted into the balance of payments will depend on the timing and speed of economic recovery both in this country and in other industrial countries.

It is widely agreed also that the level of private productive investment needs to be raised. The share of resources taken by investment has long been low; and it would be desirable, not merely to reverse the present investment recession, but to improve on the previous performance. To rebuild the conditions of confidence required for a revival of investment demand may, however, take time: it may well require not only a more buoyant trend in the economy, but also a reversal of the secular decline in profitability. The report of the Sandilands Committee provides a basis for reassessing the profitability of industry, and it is important that its findings be widely considered and decisions on its recommendations be made as promptly as possible.

The size of the public sector borrowing requirement and successive upward revisions of its prospective size last year, have given much concern; and there is a plain need to ensure that control of public expenditure is effective. Such control is essential if a reduction in the public sector borrowing requirement is to result from the real increase in revenue which economic recovery will generate.

It also remains important that the finance ot the public sector deficit should not lead to excessive monetary expansion. The rate of monetary expansion this year has remained less than the rise in money national income. Between mid-January and mid-July this year, M_3 and the narrower version of the money stock, M_1, have risen at annual rates of 7½% and 16% respectively; and for each the rate has been decelerating in the course of the year. The reasons for this are threefold: a very substantial volume of public sector debt, notably gilt-edged securities, has been taken up outside the banking system; part of the borrowing requirement has been met from abroad by receipts of sterling through the Exchange Equalisation Account; and private sector demand for bank credit has been weak. But as the economy recovers, companies may again wish to increase bank borrowing, and at the same time may be seeking increased finance from the capital market. It will probably be desirable at this stage that the banks should be in a position to respond to industry's needs and should play a smaller role in financing public sector borrowing.