Economic commentary

Some economic indicators now point to a change of trend in the UK economy. After many months of steady decline, output may now have levelled off, essentially because the rate of de-stocking has recently stopped rising. For reasons given in the concluding assessment, there should be an expansion of activity, perhaps slow at first, next year.

The rate of inflation has slowed down appreciably since the summer. The new incomes policy has been well observed, and in the next few months earnings are likely to increase on average by under 1% a month. On the other hand, the benefits of falling import prices over the past eighteen months cannot be expected to continue next year.

Companies' liquidity has become less of a problem this year, though this owes much to the running down of stocks and the cutting back of investment. A revival in investment is unlikely to occur until demand and, equally, profitability improve. (Company finance is discussed in some detail in the assessment.)

After narrowing in the first half of the year, the current account deficit widened again in the third quarter, but largely because of the purchase of oil platforms. With recovery in this country and abroad, imports and exports are each likely to rise, and the current account could continue less favourable than earlier this year.

The money stock continued to grow at a moderate rate in the third quarter, thanks in part to heavy official sales of government debt to the general public. Partly for external reasons, but also to ensure that the large and growing public sector borrowing requirement continued to be financed as far as possible outside the banking system, minimum lending rate was allowed to rise by a full percentage point in early October. However, the rate was reduced twice during November, on each occasion by ¼%. A feature of the past few months has been the unusually large volume of Treasury bills held outside the banks: with demand for bank credit still depressed, the banks have had little incentive to bid for deposits, and the yield on bank deposits has generally been below that on Treasury bills.

International developments[1]

There are now signs that the main industrial countries have reached, and perhaps passed, the low point of the deepest recession since the war. Industrial output in these countries as a whole grew slowly in the third quarter, after eighteen months of decline (see table). The turn-round this year has been particularly marked in the United States and Japan. In the United States, the growth in real GNP in the third quarter, at about 3% (compared with ½% in the previous quarter), was the highest in any quarter for twenty years. But this sharp upturn owed much to a slower rate of de-stocking, with real final demand – excluding stockbuilding – rising by only about 1% in both the second and third quarters. In Japan industrial output grew rapidly in the second quarter, but slackened a little in the third. The European economies remain depressed. The UK economy, which went into recession later and less deeply than most of the others, is among the more sluggish.

Industrial production

The steady decline in output in the main industrial countries taken together was reversed in the third quarter.

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

	1974	1975		
	4th qtr	1st qtr	2nd qtr	3rd qtr
United States	–3·3	–8·0	–1·1	+3·4
Canada	–1·3	–2·8	–0·7	–0·7
Japan	–5·9	–8·2	+3·9	+3·0
France	–5·6	–3·4	–2·6	–0·9
Italy	–6·7	–1·9	–2·6	–1·6
Western Germany	–3·6	–2·8	–1·9	–
United Kingdom	–2·5	–0·9	–4·7	–0·8
All OECD countries	–4·2	–5·3	–1·9	+1·8[a]

[a] Weighted average of the above seven countries.

In many countries output is now being sustained primarily by public sector spending. Several governments have taken further reflationary measures in recent months, and budget deficits have increased very sharply. These countries now face the problem of reconciling the

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

immediate need to support output by public spending with the longer-term need to free resources when other claims on them begin to grow.

The other main components of demand have generally contributed little or nothing to the growth of output. Capital investment is weak in most countries, and seems likely to remain so until existing capacity is more fully used. In Western Europe at least, further de-stocking will probably continue to depress output well into the first half of next year. In the first half of this year, consumers' expenditure was growing fairly slowly in most countries. Saving continued to increase during this period, perhaps because of widespread uncertainty about employment prospects and because consumers were slow to spend tax rebates. In the third quarter, the saving ratio declined in the United States, and perhaps also in Western Germany.

Current account balances

The surplus of the main industrial countries as a group was much reduced in the third quarter.

$ billions: *seasonally adjusted*

Surplus +/deficit –

	1974	1975		
	4th qtr	1st qtr	2nd qtr	3rd qtr[a]
United States	–0·1	+2·0	+4·1	+3·3
Canada	–1·0	–1·6	–1·0	–1·0
Japan	–	+0·3	+0·6	–0·8
France	–1·0	–	+0·7	+0·1
Italy	–1·1	–0·1	+0·1	+0·2
Western Germany	+2·7	+2·3	+1·2	+0·3
United Kingdom	–2·5	–1·0	–0·9	–1·3
Total	–3·0	+1·9	+4·8	+0·8

[a] Partly estimated.

In the first half of 1975, the volume of imports into the main industrial countries fell very sharply, but their exports declined more slowly, largely because of continued strong demand from oil-exporting countries. By the middle of the year, however, there were signs of a turning point in the balance of trade in volume terms as domestic output levelled out in the main industrial countries while other countries moved more deeply into recession. This was accompanied by a deterioration in the terms of trade of industrial countries: their export prices had already begun to decline (in dollar terms) during the second quarter, and commodity prices rose in July and August. With imports of oil rising steeply in the third quarter, in anticipation of a further increase in price, the aggregate current account surplus of these countries narrowed from $5 billion in the second quarter to less than $1 billion in the third (see table). In Japan, the current account balance swung from a surplus of $½ billion to a rather larger deficit; Western Germany's surplus was almost eliminated, and the US surplus was also reduced.

Retail prices

In the third quarter retail prices rose more slowly in most industrial countries.

Percentage changes on previous quarter: *not seasonally adjusted*

	1974	1975			Year to 3rd qtr 1975
	4th qtr	1st qtr	2nd qtr	3rd qtr	
United States	+2·9	+1·8	+1·6	+2·1	+ 8·7
Canada	+2·7	+2·2	+2·2	+3·4	+10·9
Japan	+4·4	+1·5	+3·4	+0·9	+10·6
France	+3·2	+2·7	+2·4	+2·3	+11·0
Italy	+6·1	+3·6	+2·7	+2·0	+15·1
Western Germany	+1·3	+1·9	+1·8	+0·8	+ 6·0
United Kingdom	+4·5	+6·1	+9·4	+4·3	+26·5
Weighted average of above	+3·1	+2·3	+2·5	+2·0	+10·5

In most countries wholesale prices had stopped rising, or had begun to fall, in the first half of the year, reflecting lower commodity prices and also a degree of restraint in wage settlements. By the third quarter the effects had begun to work through into consumer prices (see table). However, wage rates were still rising in spite of high unemployment, and commodity prices were firmer in the third quarter.

A further recovery in output is to be expected. Although the pace of recovery is unusually difficult to predict after such a deep recession, real GNP in the main industrial countries may well be some 4% higher next year than this. As demand revives in the industrial countries, their total imports must be expected to turn up once more. In previous periods of recovery, UK exports have benefited quite rapidly from an increase in output in these countries. But on this occasion there is a possibility that the outlook for UK exports may be less promising. In the first place, growth in continental Western Europe (a major market for UK exports) may be only modest next year. Recovery in Western Germany now seems likely to be slower than had been expected earlier in the year, while in many of the smaller OECD countries, in Europe and elsewhere, where output did not begin to fall until well into 1974, a strong revival is now thought to be unlikely before well into 1976. Secondly, although imports by oil-exporting countries are expected to continue to grow fast, other developing countries will have little scope for any increase in imports. So far this year exports by many developing countries have fallen sharply, and are unlikely to recover until the revival of activity in industrial countries is well under way. Their reserves may have started to fall in the latter part of 1975, borrowing will be difficult for many countries already heavily in debt, and aid may be less forthcoming. The overall prospect, however, is that demand for UK exports, which has fallen sharply this year, will begin to recover in 1976.

Current account of the UK balance of payments

In the third quarter the visible trade deficit widened sharply even though the terms of trade continued to improve.

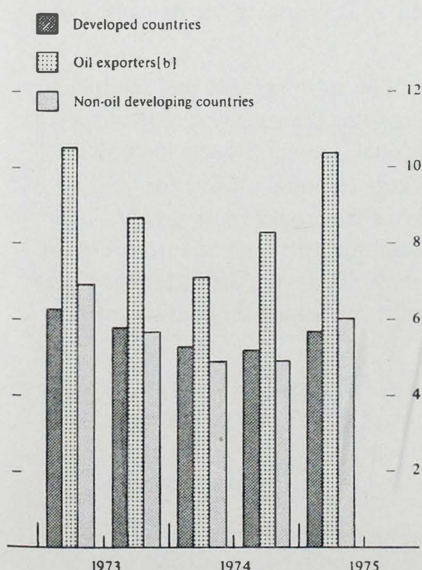
£ millions: *seasonally adjusted*

	1974		1975		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Exports of goods	4,230	4,170	4,530	4,460	4,640
Imports of goods	5,430	5,595	5,400	5,145	5,610
Visible balance	−1,200	−1,425	− 870	− 685	− 970
Net invisibles	+ 375	+ 375	+ 435	+ 340	+ 385
Current balance	− 825	−1,050	− 435	− 345	− 585
Changes from preceding quarter:					
Visible balance *of which:*	+ 135	− 225	+ 555	+ 185	− 285
Volume[a]	*+ 120*	*− 205*	*+ 450*	*− 45*	*− 310*
Price	*+ 15*	*− 20*	*+ 105*	*+ 230*	*+ 25*
Volume of exports (percentage)	+ 1·4	− 5·7	+ 3·4	− 5·3	− 1·6
Volume of imports (percentage)	− 1·2	− 0·7	− 5·7	− 3·6	+ 4·7

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

UK share of main world markets[a]

In the first half of 1975 the United Kingdom improved its share in each group of markets, but particularly among oil exporters.



[a] Excludes Sino-Soviet bloc. UK exports at current prices to each group of countries expressed as percentage of the total imports of that group.

[b] Listed in footnote [a] to Table 20 of the statistical annex.

The UK balance of payments[1]

The current account[2]

In the third quarter the value of imports rose quite sharply (see table), but even so was only slightly above the peak in the fourth quarter of 1974. Most of the increase was in volume, and owed much to the arrival of oil production platforms in the North Sea. More oil was imported, partly no doubt in anticipation of the latest rise in price. In volume terms, imports of food recovered from the unusually low rate earlier in the year, probably reflecting anxieties over future supplies as well as the need to maintain adequate stocks; but industrial materials as a whole were virtually unchanged, while finished manufactures continued to fall.

The price of imports (unit value in sterling terms) rose by only 2½% between the second and third quarters. During the same period, sterling depreciated on average by some 4½%. Prices of finished manufactures in sterling terms rose strongly, while foodstuffs and industrial materials were little changed. In the earlier part of the third quarter world commodity prices rose quite sharply in dollar terms, but have since eased back and towards the end of November were not much higher than at the end of June. In sterling terms, however, the increase was much larger because of the pound's depreciation, and the effects have recently begun to work through to UK import prices.

The volume of imports has fallen far more during 1974 and 1975 than might have been predicted from experience over the previous two decades, although that period did not contain a recession as severe as the current one. In present circumstances, forecasts of imports are therefore more than usually difficult, with the timing and size of any turn-round in stockbuilding particularly uncertain. However, when industrial output in the United Kingdom and abroad begins to revive, both the price and volume of UK imports could rise steeply.

In the third quarter the value of exports recovered after the slight fall in the second quarter, but this was more than accounted for by higher prices, which rose by 4½% as the effects of past cost inflation worked through.

The chart shows that in the first half of this year UK exports increased their share of world markets. Some of this was probably reversed in the third quarter, when the volume of exports fell by 1½% to around 9% below the peak of a year earlier. Future prospects for exports are discussed in the previous section.

In sum, after narrowing in the first half of the year, the deficit on visible trade widened again in the third quarter, in spite of a further improvement of some 2% in the terms of trade. Thus, although the estimated surplus on invisibles was rather larger than in the second quarter, the current account remained in heavy deficit. Nevertheless, the current deficit in the first nine months of this year was some £1,350 million less than in the corresponding period last year.

In October the visible deficit was virtually unchanged. In volume terms, exports rose more than imports, but import prices rose sharply, and the terms of trade moved against the United Kingdom for the first time this year. There was a rise in exports to oil-exporting countries after several months of little growth.

Financing the deficit

Before seasonal adjustment, the current account deficit in the third quarter was much larger than in the second (see table overleaf).

[1] It has not been possible to include in Table 23 of the statistical annex the latest balance of payments figures used here, which were released earlier this month by the Central Statistical Office.

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

Financing of the current account deficit

In spite of a sharp rise in the current account deficit, the reserves fell much less than in the second quarter.

£ millions: *not seasonally adjusted*

	1974		1975		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Current balance	–880	–900	–660	–340	–570
Capital transfers	– 40	– 10	–	–	–
	–920	–910	–660	–340	–570
Financed by:					
Decrease (+) in reserves	–180	+180	–140	+420	+170
Foreign currency borrowing:					
Central government	–	+640	+420	–	–
Other public sector (net)	+220	+200	+ 70	+160	+ 50
Increase (+) in sterling holdings (official and private):					
Oil-exporting countries[a]	+900	+420	+330	–170	–250
Other	–280	– 40	– 80	+190	–130
Other identified capital flows (net)	–190	–440	–470	–100	+230
Balancing item	+450	– 50	+530	–160	+500

[a] Listed in footnote [a] to Table 20 of the statistical annex.

Domestic activity

Total output fell more slowly in the third quarter and there was a sizable switch of resources out of 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	2nd half 1974 to 1st half 1975	2nd qtr 1975 to 3rd qtr 1975 (provisional)
Gross domestic product (output measure)	–0·8	+0·7	–1·2	–0·4
of which, industrial production	*–2·0*	*+0·4*	*–2·2*	*–0·5*
Consumers' expenditure	–0·8	+0·8	–0·1	–0·8
of which, retail sales	*–1·2*	*+1·3*	*–0·5*	*–3·1*
Exports of goods and services	+2·6	–0·3	–0·7	–2·0
Imports of goods and services	–0·9	–0·6	–3·4	+4·9

Factors contributing to changes in total final expenditure [a]

Falls in consumers' expenditure and exports were more than outweighed by rises in the other components of demand, so that total final expenditure probably rose slightly in the third quarter.

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 half 1975	2nd qtr 1975 to 3rd qtr 1975 (provisional)
Change in total final expenditure	–0·3	+1·0	–1·4	+0·7
Attributable to:				
Domestic expenditure (less stockbuilding)	–0·5	+0·5	+0·1	+0·9
of which:				
Consumers' expenditure	*–0·4*	*+0·4*	*–*	*–0·4*
Public authorities' consumption	*+0·2*	*–*	*+0·1*	*+0·3*
Fixed investment	*–0·2*	*+0·1*	*–*	*+1·0*
Stockbuilding	–0·3	+0·5	–1·3	+0·2
Exports of goods and services	+0·5	–0·1	–0·2	–0·4

[a] Changes in the components of total final expenditure are expressed as percentages of the total in the previous period. They may not add to totals because of rounding.

Sterling holdings fell, partly because of a continuing high rate of expenditure by some oil-exporting countries. After a heavy outflow in the second quarter, transactions by oil companies produced a large inflow in the third quarter, mainly because of North Sea operations. On the other hand, transactions by UK banks in foreign currencies had little net effect on capital flows after the large inflow on this account in the June quarter. There was a large positive balancing item in the third quarter. The total currency outflow, financed from the reserves, was £170 million.

In November the UK Government announced their intention to apply to the International Monetary Fund for a drawing of SDR 1,000 million (about £575 million) under the 1975 oil facility, and for facilities up to the amount of the first credit tranche within the Fund's general account, which would provide a further SDR 700 million (about £400 million).

The UK economy

Output and demand [1]

By the third quarter of this year industrial production had fallen to 8% below the corresponding period last year, and was lower than the average for 1970. On the same comparisons, GDP fell by rather less. However, the rate of decline of industrial output has slowed down in recent months – it fell by only ½% in the third quarter compared with 4% in the second (see table) – and, although as yet there are no clear signs of an upturn, the decline may now have levelled off.

The fall in demand between the second half of last year and the first half of this was concentrated almost entirely in stockbuilding (see table below). Consumers' expenditure and fixed investment each declined slightly, but this was more than offset by a rise in public consumption. On provisional figures, de-stocking in the third quarter, though still heavy, was no heavier than in the second, and thus ceased to depress demand further. The balance of trade, however, had a contractionary effect: in volume terms, exports of goods and services probably fell by about 2% while imports may have risen by some 5%. Consumers' expenditure fell for the second successive quarter, although more slowly, and is unlikely to revive until the decline in real incomes comes to an end. Total private sector investment is provisionally estimated to have risen in the third quarter, because of North Sea investment. But manufacturing industry's capital formation fell further and cannot be expected to recover significantly before existing capacity is more fully used and prospects for demand and profitability improve.

A slower rate of de-stocking would be an important prelude to any revival in demand; and in the third quarter the pace was at least no faster than in the second (on provisional figures). De-stocking by manufacturers accelerated, and is likely to remain heavy for some time. But wholesalers ran down their stocks more slowly, while retailers actually added £60 million to theirs (a turn-round of over £100 million during the quarter). However, the latter may have been partly involuntary, reflecting the continued sluggishness of retail sales.

On balance, operational and financial factors (see 'company spending and finance') each point to a somewhat slower rate of aggregate de-stocking, but a significant turn-round is unlikely to occur until there are clear signs of a sustained revival in other elements of demand.

Capacity and unemployment

Since the last peak in activity – in the third quarter of 1973 – productive capacity has perhaps grown by around 5%–6%, while

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

Indicators of the pressure of demand on resources

The amount of spare capacity is now unusually high; unemployment exceeded one million in October and is still rising.

Seasonally adjusted: Great Britain unless otherwise stated

	Previous 'low'	1974 2nd half	1975 2nd qtr	1975 3rd qtr	Latest
Deviation of industrial output from trend[a] (percentage)	−7 (1st qtr 1972)	−3	−10	−13	
Unemployment (thousands)[b]	876 (March 1972)	599	813	967	1,073 (November)
Vacancies (thousands)	118 (October 1971)	297	157	133	115 (November)
Short-time workers (thousands; not seasonally adjusted)	1,137[c] (January 1974)	60	229	130	140 (November)
Orders on hand in the engineering industries (end of period, trend estimates, 1970=100)	93 (3rd qtr 1971)	128	113		110 (August)
Companies reporting below capacity working[d] (percentage)	71 (January 1972)	55	71	75	73 (October)

[a] Percentage deviation of UK industrial production (excluding construction) from the exponential trend of output calculated over 1956 to date.

[b] Excluding school-leavers and adult students.

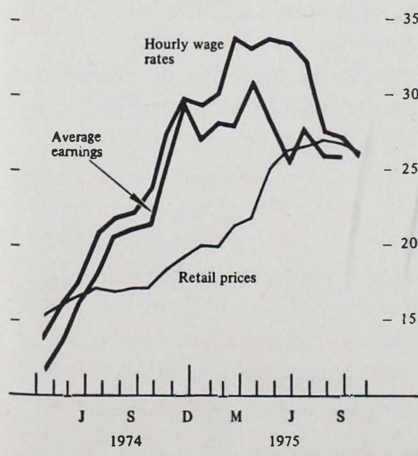
[c] Affected by the energy crisis.

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

Retail prices, earnings and wage rates

The rate of inflation has moderated in recent months.

Percentage increase on one year ago



national output (measured by the 'average' estimate of GDP) has fallen by some 2½%. The amount of spare capacity in the economy thus appears unusually high. The number of unemployed has risen steadily since the beginning of 1974 (see table) to well over one million (excluding school-leavers and adult students). Short-time working has been much reduced since the second quarter, perhaps reflecting a greater inclination among employers to declare redundancies after the holiday period. In September the Government announced measures designed to alleviate unemployment, particularly among school-leavers. Much will depend on the response by industry, but the overall effect of the measures on unemployment is unlikely to be very significant.

As long as production shows little sign of recovery, unemployment is likely to rise further as employers continue to adjust their labour force to the reductions in output that have already taken place. But if by next spring there is firm evidence that a sustained recovery is under way, experience suggests that unemployment would stop rising a few months later, and then begin to fall, possibly quite rapidly. If the upswing were to be sharp, skilled labour could quite soon be scarce, and the present apparent degree of spare capacity could prove to be somewhat misleading.

Costs and prices

The new incomes policy has been fully observed by unions and employers. Reported settlements since the policy was introduced in August have involved some 2½ million people, of whom one million were local authority manual workers. The latter negotiated the maximum allowed, as did some other groups in the public sector. In the private sector there is one large group (150,000 supermarket and grocery workers) where the majority settled for an increase of less than £6 a week. A small number of settlements for more than £6 per week have come into effect, but these were specifically allowed under the policy's transitional arrangements.

The reported settlements have effectively increased basic wages by an average of 15%–20%. Since the increases will not be incorporated into overtime rates, but instead will form a flat rate addition to earnings, the impact on earnings will be considerably less.

In July – the month before the incomes policy was introduced – earnings rose by as much as 4½%. Part of the increase reflected the delayed effects of earlier settlements, including back-dated payments in the engineering industry. Subsequently the growth of earnings slowed down to about 1% in August and 1½% in September. Looking ahead, earnings should probably increase at an average of rather less than1% per month: this would reduce the year-on-year increase to less than 20% by the end of the year and to around 15% or possibly less by the spring of 1976.

As widely expected, retail prices rose more slowly in the third quarter (see chart), and the retail price index was only 4·4% higher than in the second quarter. The increase through the quarter – 10% at an annual rate – was even slower. In the immediate future, prices may well rise rather faster, suggesting that real pre-tax earnings, which increased in the third quarter, will decline again in the fourth.

After falling steadily during the first half of the year, world commodity prices, as measured by *The Economist* dollar index, rose in the third quarter to 1¾% above the second. With the pound depreciating further during the quarter, *The Economist* sterling index rose by about 11%. Although this increase relates to commodities traded on the open market, whereas some imports are purchased under long-term contracts, the impact on the United Kingdom's import bill is likely to grow in time, because the recovery in world industrial

production, now beginning, will tend to boost prices of industrial materials. Thus, the beneficial effects of falling import prices on inflation (and on the terms of trade) over the last eighteen months cannot be expected to continue. Indeed, the terms of trade moved against the United Kingdom in October, for the first time this year.

Manufacturers' selling prices continued to rise more slowly in the third quarter (+3·9%), and again in October (+1·2%). Unit labour costs and buying prices rose by more than this, suggesting that profit margins in manufacturing industry narrowed in the third quarter. The present weakness of demand suggests that profit margins are unlikely to increase significantly in the immediate future, though eventually they should recover somewhat as the rise in labour costs slows down.

Personal incomes and spending [1]

Consumer spending, which rose very slightly in the first quarter but fell by 2% in the second, is provisionally estimated to have fallen by a further ¾% in the third to below the average for 1973. Retail sales remained depressed and were 3% below the previous quarter. Within the total there was a sizable fall in sales of electrical goods.

In the second quarter consumer spending fell much less than real personal disposable income, and the saving ratio declined from over 14% to about 13½%. However, the decline in saving was less than might have been expected from past relationships between changes in real income and consumer spending.

In the third quarter average earnings increased by 7½% while employment fell by ¾%, so that the total wage and salary bill may have risen by 6½%–7%. But the other elements of personal income are unlikely to have risen as fast, and after allowing for the relatively rapid growth of income tax and other deductions, personal disposable income probably rose by only about 4%. With retail prices rising by nearly 4½%, this implies a fall of some ½% in real personal disposable income. As consumer spending appears to have fallen by about 1%, these estimates, if correct, would imply that the saving ratio was little changed in the third quarter.

The sustained high rate of saving this year, when real personal disposable income was falling, is a significant and somewhat unexpected development. It rather undermines the view that higher saving can be attributed largely to the lag which normally occurs before spending adjusts to changes in incomes: if this were true, persons could be expected to maintain their consumption for a time, even though real incomes were falling, and the saving ratio would therefore decline markedly. There are a variety of possible explanations for the continued high rate of saving, including the need to save in the face of uncertainties about future income, and the desire to restore the real value of assets eroded by inflation (see September *Bulletin,* page 216). High net saving has been associated with a substantial reduction in borrowing – both by households and unincorporated businesses – reflecting widespread uncertainty about future income and employment, together with an increase in the cost of loans relative to yields on financial assets. Since these various influences seem likely to continue, at least in the short term, the present high saving ratio could well persist for a time.

Housebuilding

There was a further modest upturn in private sector housebuilding in the third quarter, and a recovery of activity in the public sector. The number of houses started in the private sector, which since February had been static at about 12,000 a month (seasonally adjusted), began to rise again in June, and averaged 12,600 in the following three months.

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

Although well above the average for last year, this is still exceptionally low by comparison with any other period since the late 1950s. The number of houses under construction has fallen only slightly since the beginning of the year, and is still high in relation to previous cycles. With this continuing backlog of uncompleted houses, a stronger revival in starts may not occur until the rate of completions, little changed since the first quarter, begins to rise.

The recovery in private sector activity will have been encouraged by the steady rise in house prices since the beginning of the year (3%–4% a quarter);[1] by the slower rise in building costs (1% in the third quarter, compared with 10% in the second);[2] and by the prospect of a continuing heavy flow of mortgage finance. The building societies attracted a large inflow of funds in the third quarter, particularly during August and September, despite generally higher short-term interest rates following the increase in minimum lending rate on 25th July; and net receipts remained buoyant during October. Until recently, the societies as a whole have lent less for house purchase than the scale of inflows would have allowed, and built up their liquid assets instead: their liquidity ratio rose above 20% in September. However, new commitments in September and October, at £511 million and £523 million, were appreciably higher than in earlier months, implying that advances will rise more strongly in the fourth quarter.

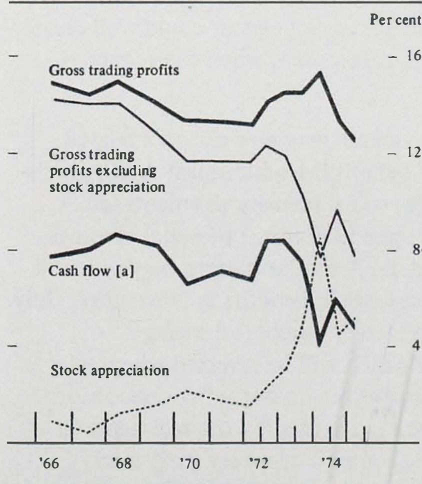
The further increase in short-term interest rates which followed the rise of 1% in minimum lending rate on 3rd October (only partly reversed by reductions of ¼% each on 14th and 28th November) is unlikely seriously to affect the competitive position of the societies: banks are still not keen to compete for funds in the money markets, and raised their deposit rate by only ½%; and flows into the Government's index-linked savings schemes have remained small in comparison with the societies' net receipts. For this reason, and also because of the societies' ample liquidity, adequate finance for house purchase seems assured for some time.

Company spending and finance[3]

After further cutbacks in capital spending, companies' financial deficit (the excess of capital expenditure over cash flow)[4] was substantially reduced in the first half of this year, and their net liquidity improved steadily. But a significant revival in investment cannot be expected until there are clear signs of a sustained recovery in demand and, equally, of an improvement in profitability.

Profits and cash flow as percentages of gross domestic income

In the first half of 1975, companies' cash flow and basic gross trading profits each declined.



[a] As defined in footnote to text.

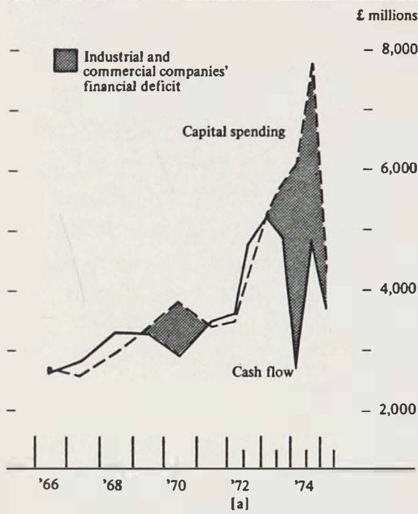
In the second quarter, gross trading profits of industrial and commercial companies fell, both before and after adjusting for stock appreciation. As a share of gross domestic income, profits net of stock appreciation have fallen back virtually to the low point touched in the first half of 1974 (see chart). Weak demand has depressed profit margins, and the Price Commission in their latest report do not foresee a significant recovery in the second half of the year; this is borne out by the preliminary evidence for manufacturing industry referred to earlier (page 330).

Investment by distributive and service industries (excluding shipping) fell only slightly in the third quarter, suggesting that the steady decline since the end of 1973 may shortly come to an end. But the volume of investment by manufacturing industry fell by a further 6½%: this was rather more than had been indicated by the Department of Industry's intentions survey in October, which would now imply little, if any,

[1] Department of Environment/Building Societies Association index of new house prices at approval stage.
[2] Nationwide Building Society index of housebuilding costs.
[3] This section is in seasonally-adjusted terms.
[4] Cash flow is defined as retained profits (including depreciation) plus investment grants and other capital transfers, but excluding stock appreciation.

Company cash flow and capital spending

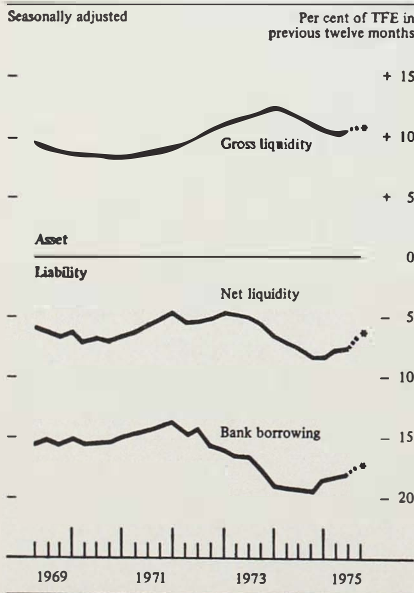
In the first half of 1975 heavy cuts in capital spending easily outweighed a deterioration in cash flow, and companies' financial deficit was substantially reduced.



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

Company liquidity – gross and net

The chart shows companies' liquid assets and their borrowing from banks as percentages of total final expenditure (a proxy for turnover). Their gross and net liquidity each improved in the first half of 1975.



* Estimated.

recovery during next year. The CBI survey expects investment to stop falling, but is less certain about any upturn. However, there should be some stimulus to investment next year from a scheme announced by the Government in September, under which £80 million is to be made available for new capital projects. This followed a scheme announced in the April Budget, allocating £100 million for similar purposes.

De-stocking continued in the third quarter, at much the same rate as in the previous quarter. The largest fall was in manufacturers' stocks (£240 million at 1970 prices) – mainly in raw materials and work in progress. The CBI predicted that the phase of heaviest de-stocking may be almost at an end, although they did not foresee an immediate resumption of stockbuilding.

Despite the tax relief on stocks, cash flow has remained under pressure. Nevertheless, the move towards financial balance has been extremely rapid, largely because of cuts in capital spending. Companies' financial deficit amounted to £360 million in the first half of the year, or less than a quarter of the deficit in the previous half-year (see chart) – and the recorded figure may have understated the improvement (see page 345).

The reduction in their financial deficit and a substantial inflow of equity funds so far this year have contributed significantly to the improvement in companies' gross and net liquidity positions (see chart). For the first time since 1971, industrial and commercial companies became net suppliers of funds to the banking system in the first half of the year. This process continued in the third quarter, when companies' deposits and holdings of notes and coin rose by nearly £1,000 million, while their bank borrowing fell by nearly £150 million. They also bought Treasury bills in the third quarter. Consequently, companies' net liquidity, as a proportion of turnover, was estimated to be at its highest for nearly two years.

The public sector [1]

The volume of current expenditure on goods and services by the public sector rose by 3% between the first and second quarters. Fixed capital expenditure fell over the same period, but was still running at a higher annual rate than in 1974, so that total public expenditure on goods and services has helped to moderate the depth of the recession. However, the Government's stated priorities are for export-led growth, with adequate room left for industrial investment. If the scale of public expenditure is not contained in the next few years, it could well create problems for the desired allocation of resources when the economy recovers.

The rapid growth of transfer payments may give rise to a related problem. After the higher rates of benefit introduced last April, grants to the personal sector (i.e. pensions, social security payments, etc.) accounted for over 40% of the increase in nominal personal incomes between the first and second quarters. A similar pattern may occur in the fourth quarter after further increases in benefits in November. Only a small part of the rise is due to the larger numbers drawing unemployment benefits – a trend which will be reversed when economic activity recovers. These transfers do not, of course, absorb resources directly but a high proportion is used by the recipients to finance personal consumption. As economic recovery progresses, resources available for private consumption are likely to be tightly constrained by the need to expand investment and to improve the trade balance, so that further increases in benefits could be accommodated only at the cost of privately-financed personal spending, or of other public spending.

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

The Chancellor anticipated these problems in the last Budget when he announced plans for reducing the amount of public spending in 1976/77 and emphasised the importance of ensuring that programmes were not exceeded in the current financial year. Nevertheless, quite apart from extra expenditure generated by post-Budget changes in government policy, spending in current price terms now seems to be running sufficiently ahead of the Budget forecasts to suggest that volume, as well as prices, is partly responsible. This must increase the difficulties of achieving the lower level of expenditure planned for the next financial year. Detailed analysis is not yet possible, but central government and local authority spending are each likely to have contributed to the excess so far this year.

The other side of the problem of the allocation of resources is that public spending must be financed either by taxation (plus charges for certain services provided by the public sector), or by borrowing. In the last Budget, the Chancellor raised taxation in order to reduce a prospective public sector borrowing requirement of over £10 billion to just over £9 billion. The evidence now available makes it clear that the borrowing requirement will be higher than was expected in April. First, the central government borrowing requirement in the first half of this financial year was £4,600 million, compared with the post-Budget forecast of £7,800 million for the year as a whole. This reflects both the unforeseen depth of the recession and the strength of price increases in the central government sector. Secondly, with local authority expenditure likely to be higher than expected, borrowing by local authorities from sources other than the central government may also turn out to be above forecast.

The Government have taken action to control the growth of costs. The £6 limit on wage and salary increases should reduce the growth of labour costs (although, with workers in the public sector having been awarded the full £6 while some private sector workers have settled for less, labour costs in the public sector will continue to grow faster than those in the private sector). The proposed extension of cash limits should also help to control other costs, as well as facilitating control over the volume of spending. For example, the allowance for the rise in costs between this financial year and next in local authority expenditure financed out of the rate support grant has recently been limited to 10% – 11%. But there will be large areas where control remains less direct, in particular local authority current spending not financed from the rate support grant.

Monetary developments

Influences on the money stock (M_3) [a]

Half of the large central government deficit in the third quarter was offset by sales of government debt outside the banking system.

£ millions: *seasonally adjusted*

	1974		1975		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Central government borrowing requirement	+ 960	+1,390	+1,850	+2,090	+2,510
Purchases (–) of central government debt by non-bank private sector	– 480	+ 370	–1,650	– 490	–1,220
Other public sector borrowing requirement	+ 720	+ 760	+ 510	+ 630	
Purchases (–) of other public sector debt by non-bank private sector	– 480	– 510	– 40	– 170	+ 320
Lending to private sector	+1,460	+ 330	+ 430	– 50	– 80
DCE [b]	*+2,190*	*+2,540*	*+1,000*	*+2,090*	*+1,470*
External items	– 390	–1,450	– 470	–1,530	+ 330
Other	– 600	+ 400	– 300	+ 170	– 240
Money stock (M_3)	+1,190	+1,290	+ 330	+ 650	+1,620

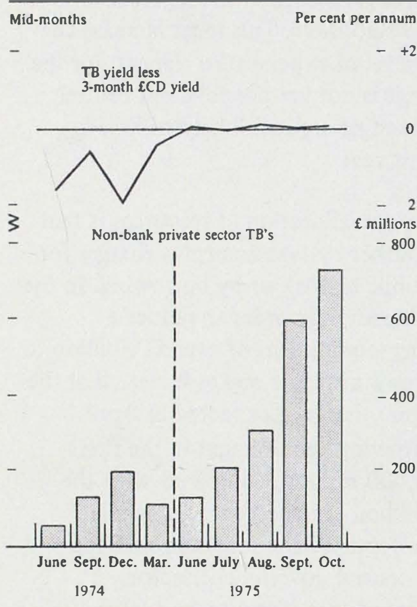
[a] For further detail see Table 12 / 3 in the statistical annex. Changes in the treatment of foreign currency transactions in this table are described on page 346.

[b] DCE is the sum of the items above this line with two adjustments: the exclusion of bank lending to the UK private sector in foreign currencies for investment overseas, and the inclusion of bank lending to overseas residents in sterling.

As the table shows, the very large central government borrowing requirement was one of the main influences making for growth in the money stock in the third quarter. M_3 rose by 4¼%, seasonally adjusted, during the quarter (or by 4% during the three 'banking' months to mid-October). This was a faster rate of growth than earlier in the summer, and owed much to the absence of any offset from 'external items' (which are broadly equivalent to the current account deficit of the balance of payments, less capital inflows to the private sector). This reflected the capital inflows described on page 328. Domestic credit expansion (DCE), which broadly measures the domestic counterparts of the money supply, rose appreciably less than in the previous three months. M_1 rose by a comparatively large 6% during the quarter, though the monthly series suggests that this rise was probably erratically large: during the three months to mid-October M_1 rose by 4½%.

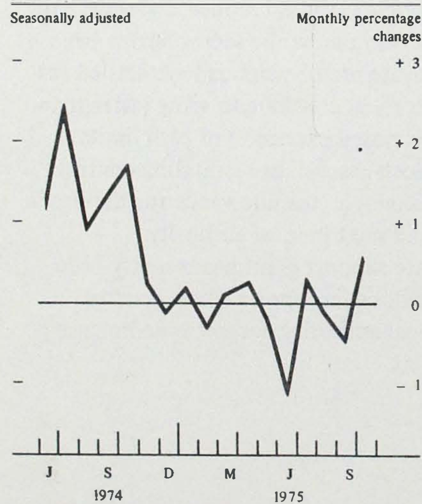
Holdings of Treasury bills by the private sector (other than banks)

In recent months the yield on Treasury bills has been higher than that on sterling certificates of deposit, and non-bank private sector holdings of bills have become unusually large.



Sterling lending to the private sector

Bank lending to the private sector has been subdued in 1975.



The effects of the borrowing requirement in this period were to an important extent offset by official sales of government debt to the general public, including appreciable amounts of gilt-edged and, unusually, of Treasury bills. The chart shows that private holdings of such bills outside the banking system rose from about £125 million or so in June to nearly £600 million in September and about £725 million in October. This new popularity of Treasury bills was due to the slightly higher yield which they have offered in recent months compared with bank deposits and sterling certificates of deposit of similar maturity. The bills have been bought mainly by financial institutions, such as insurance companies, pension funds and building societies, but industrial and commercial companies have also been in the market. Sales of national savings securities were also rather larger than usual in the third quarter, having been helped by the introduction of the new index-linked securities in June and July.

The relatively low return on bank deposits reflected the continuing low demand for bank loans from the private sector, and in particular from manufacturing industry, which meant that the banks had little incentive to bid for deposits. In these circumstances, and given that the Government needed to borrow considerable amounts beyond what was provided by the general public, the banks' additional funds were employed very largely in liquid assets, especially Treasury bills, of which the banks' holdings increased between June and October by something over £1,000 million. Not all liquid assets count as reserve assets for the purposes of the reserve ratio; even so, the ratio rose from 14·6% in June to 15·9% in September, though it fell back slightly to 15·7% in October. During the same period the banks also bought £215 million of gilt-edged stocks with more than one year to maturity.

The rise in short-term interest rates in the United Kingdom which began in May, and the increases in the Bank's minimum lending rate from 9¾% to 10%, and subsequently to 11%, were described in the September *Bulletin.* Towards the end of September the continued weakness of sterling, and further increases in rates in the United States and in the euro-dollar markets, suggested that another increase in UK short-term rates would be appropriate. Furthermore, some rise in domestic interest rates also seemed desirable on internal grounds in order to help secure additional finance for the public sector from outside the banking system, and thereby maintain appropriate restraint on the growth of the money supply. A rise in the Treasury bill rate at the tender on 3rd October brought about another increase in minimum lending rate from 11% to 12%, though it fell back slightly to 11¾% on 14th November, and again to 11½% on 28th November.

Shortly after the rise in minimum lending rate, the clearing banks raised their base rates from 10% to 11%; but their rates for seven-day deposits were increased by only half as much, from 6½% to 7%. The margin between base rates and deposit rates thus widened to 4%. This continued a process which began at the beginning of the year (when the margin was 2½%), and was further evidence of the pressures put upon the banks by the absence of any significant demand for private sector loans and advances, and of their reluctance in present circumstances to compete for funds.

Assessment

All the indicators reported in the present economic commentary (which generally, however, do not go beyond the third quarter) still suggest a declining level of activity. Nevertheless there are good reasons to believe that the economy is now near the trough of the recession, and that there will shortly be an expansion of activity. The main impetus to

recovery is likely to come partly from a turn-round in stockbuilding and partly from a revival of exports. This general picture emerges from the forecasts made by outside bodies. It emerges also from the Bank's own assessments indicated at various points earlier in the commentary; these suggest a recovery, slow at first, but gathering momentum by the end of next year.

The reasons why expansion seems likely to be slow in the first part of next year are first, that the run-down of stocks still appears to have some way to go, though the pace may decline; and second, that while in the United States and Japan economic recovery is now an established trend, in Europe – a third of our export market – the turning point is only beginning to appear.

But at a later stage, a build-up to more rapid expansion appears likely to be in train. The unprecedented decline in stocks earlier this year accounted for most of the fall in output in this country (and was important in most European countries): when the decline has run its course and gives place to positive stockbuilding, as is likely next year, this will itself be enough to produce significant expansion and will in addition have side effects on other categories of domestic expenditure. Economic recovery abroad is also likely to become more generalised; and when this happens, experience suggests that the markets for our exports could expand by 10% a year in volume terms, and possibly by more. In past cycles, failure to allow for the expansionary forces already in prospect has often led to undue action being taken to stimulate the economy in a recovery phase.

The balance of payments on current account worsened in the third quarter after the unexpectedly favourable performance in the first half of the year, when imports were heavily reduced by the depth of domestic recession. With domestic recovery next year, the deficit could continue less favourable than in the first half of this year – as is likely to be the case for many other industrial countries. But throughout recent years, the balance of payments of this country has been far less favourable than in most of these other countries – a discrepancy which needs to be corrected. Progress has been made this year, but it will clearly take some time to restore better balance. The financial support sought from the International Monetary Fund will provide a space of time for the full adjustment to be achieved.

Mainly as a result of the Government's policy of pay restraint, there has been a marked slowing down in the rise in domestic costs. In the first four months of this policy, settlements have been reached within the £6 limit affecting at least 2½ million workpeople, which represents some 15% of employees. Wage increases of £6 represent on average an increase in earnings of 10%–12%, as compared with 27% in the twelve months up to July. There must therefore have already been a clear break in the rate of rise of money national income. The cost of materials and fuel bought by manufacturing industry has recently been rising more rapidly, and by October was 15% higher than in October last year (in large part because of the rise in the cost of imported materials and oil). This cost increase would account for a rise in retail prices of about 1½%: and even if it were to continue, it should not prevent the rise in retail prices from slowing down to a rate broadly in line with the present aim of policy by the end of next year.

Last year companies were faced with a severe liquidity problem which led them to cut back investment plans, and to trim stock levels severely in the ensuing quarters. Industrial and commercial companies recorded an unprecedented financial deficit of over £3 billion. This year several important factors have eased the position: the stock relief granted in November 1974; smaller, though still large, stock appreciation; and the reductions in fixed investment and in stocks, which have been partly induced by companies' liquidity position. While

companies in aggregate have remained in financial deficit this year, the deficit has been declining rapidly. Next year – though this must still appear uncertain from the point of view of individual companies, whose position in any case varies widely – present trends suggest that companies may show a substantial financial surplus. This would, however, do no more than enable companies to begin to reconstitute their liquidity after the depletion of recent years.

While the liquidity of companies may become a less pressing concern, the trend in their profitability shows a less happy picture, and may be less easy to reverse – a matter to which the Governor has recently called attention. [1] Though the rate of profit earned by companies has been known to be declining for some time, traditional accounting methods (for reasons set out in the report of the Sandilands Committee) have failed to reveal how low it has become. The replacement cost of capital is considerably higher than its historic cost; and when profits are expressed as a percentage of the current value of the capital stock, the rate of return is correspondingly lower. The value of capital consumed in the course of production is similarly higher; and the value of such depreciation also needs to be deducted from gross profits, along with stock appreciation, to arrive at a figure of true profits. Calculations on this basis suggest that the rate of profit net of capital depreciation had by 1973 fallen to little more than half what it was in the early sixties: in 1974 and 1975 the rate will have been even lower, though in both years it was depressed by special factors. Expressed on a post-tax basis, the fall in the rate of profits appears to have been as great; and despite last year's stock relief, the rate of profits appears to have fallen so low as to leave little incentive to new investment.

This is a complex problem which needs to be attacked by a variety of methods. Whatever other steps are needed, it would seem in any case to call for a reassessment by firms of their own positions. While the provision of inflation-adjusted accounts will inevitably take time, firms will no doubt wish from now on to make rough adjustments to show the broad effect of inflation on their financial position.

The need to encourage investment has implications for price control. Under present demand conditions, price control may not in many cases be an operative constraint on profits; but when demand revives this could cease to be the case. A change in the price code to allow more adequate profit margins would help to give firms some assurance that they will be permitted to rebuild profit margins on the scale required to provide a probability of reasonable profits on new investment.

Investment needs to be increased not only to make good the decline that has occurred in the present recession, but to improve on the historic trend. This will require not only a profit incentive, but also that room be left in the economy for such an expansion, as well as for the improvement in the balance of payments that is still needed. As the economy recovers, resources will be reabsorbed into employment. To spare resources for rebuilding the domestic and external strength of the economy is a major reason for seeking to ensure that public expenditure takes a smaller share than now of national income.

Unless public expenditure is contained, the only way to reduce the public sector borrowing requirement would be by a considerable increase in the already high tax burden. The abnormal size of the public sector deficit is matched by an equally abnormal financial surplus for the private sector – both on account of persons and, next year, of companies. A persistent public sector deficit of the present magnitude

[1] See the Governor's speech given at the Lord Mayor's dinner, page 365.

could nevertheless make it difficult to finance an adequate proportion by sales of gilt-edged stock outside the banking system. The aim for monetary policy is that, apart from unavoidable short-term fluctuations, monetary expansion should continue to be at a moderate rate. This is desirable in order to reinforce the Government's other counter-inflationary measures. The achievement of this aim may have been assisted by the rise in gilt-edged yields since September.