Economic commentary

As in earlier issues of the *Bulletin*, the economic commentary analyses the recent past as a basis for assessing short-term prospects. There are now clearer signs that the low point of the recession has been passed in the United Kingdom, so attention is focused on the form which recovery is likely to take. It is suggested on page 5 and in the concluding assessment that the outlook for UK exports is quite favourable. But investment remains a matter for concern: last year, the volume of capital spending fell more sharply than in any other post-war year (page 5), and recovery from this very low base cannot be expected until demand and, equally, profitability improve. (Estimates of the decline in companies' real post-tax rate of return since 1960 are given in an article on page 36.) Neither personal nor public consumption are likely to increase very much in the short term; but a change in stocks could continue to provide some stimulus to output for a time (page 4). In the section on costs and prices (page 6), it is noted that the present £6 limit continues to be well observed; but even though the rise in retail prices later this year may be close to the Chancellor's target, inflation nevertheless remains a very serious problem (see the assessment).

The analysis of monetary developments on page 12 discusses the recent heavy sales of government debt by the authorities, and trends in private sector liquidity as a whole. The reasons behind the lack of growth in the money stock in recent months, and the fall in interest rates, are further discussed in the final section of the assessment.

International developments[1]

Output in the main industrial countries as a whole began to recover in the second half of last year (see table). In the United States, GNP grew strongly in the third quarter before slowing to an annual rate of 5% in the fourth. In Europe, recovery came rather later, but towards the end of the year appeared to be well established in Western Germany and to be making good progress in France. In Japan, however, there were signs that the recovery was faltering by the end of the year.

The general recovery in output in the second half of 1975 partly reflected a further rise in final domestic demand (excluding stocks). Consumers' expenditure was more buoyant in a number of countries. In the United States and Western Germany, consumers began to spend the increase in incomes stemming from tax changes earlier in the year, and in Western Germany the personal saving ratio fell back in the third quarter after being abnormally high in the previous six months. In France, too, consumer spending was partly boosted by larger social benefits and by other government measures taken in September. Car sales increased in most countries in the second half of the year. There was also an upturn in housebuilding in the United States, Canada, and the United Kingdom. However, the largest contribution to the growth in output came from changes in stockbuilding (see second table). In the earlier part of the year, de-stocking had depressed output in several countries, particularly the United States. But once the rate of de-stocking began to slow down, output was quick to recover in the United States and later in Western Europe.

The recovery in the main industrial countries led to a revival in world trade. In volume terms, imports into these countries picked up in the third quarter of 1975, growing faster than their exports. This in turn helped to check the relative decline in commodity prices, and the terms of trade ceased to move in favour of the industrial countries: the current accounts of the main industrial countries as a group moved

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

Industrial production

Industrial production had picked up in most industrial countries by the final quarter of last year.

1970 = 100: *seasonally adjusted*

	1975			
	1st qtr	2nd qtr	3rd qtr	4th qtr[a]
United States	105	103	107	110
Canada	120	119	118	118
Japan	106	110	113	113
France	114	111	111	114
Italy	110	106	105	110
Western Germany	106	103	102	106
United Kingdom	105	100	100	101
Other OECD	118	117	115	118
Total OECD	108	106	108	111

[a] Partly estimated.

Factors contributing to changes in GNP in five major countries[a]

Changes in stockbuilding have had the largest influence on changes in output in recent quarters.

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

	1975		
	1st qtr	2nd qtr	3rd qtr
Change in GNP	−7¾	+1¾	+8
Attributable to:			
Consumers' expenditure	+2½	+2½	+2¼
Other final domestic demand	−2¾	− ¼	+2½
Stockbuilding	−7½	− ½	+4¼
Net exports of goods and services	+ ½	+ ¼	−1¼

[a] United States, Canada, Japan, Western Germany and the United Kingdom. Changes in the components of GNP are expressed as percentages of the total in the previous period. They may not add to totals because of rounding.

Aggregate current account balances[a]

The current account surplus of the main industrial countries as a group was eliminated in the second half of last year.

$ billions: *seasonally adjusted*

	1973	1974	1975		
			1st half	3rd qtr	4th qtr
Main industrial countries[b]	−2	−20	+ 7	+1	− 1
Smaller industrial countries[c]	+4	−13	− 7	−2	. .
Oil-exporting countries[d]	+4	+62	+16	+8	. .
Other developing countries	−5	−24	−16	−7	. .

. . not available.

[a] The columns may not sum to zero, largely because of errors and omissions and the exclusion of Sino/Soviet countries.

[b] United States, Canada, Japan, France, Italy, Western Germany, and the United Kingdom.

[c] All other OECD countries.

[d] As listed in the footnote to Table 20 of the statistical annex.

Retail prices

Retail prices generally rose more slowly in the second half of 1975.

Percentage changes on previous quarter: *not seasonally adjusted*

	1975				
	1st qtr	2nd qtr	3rd qtr	4th qtr	Year to 4th qtr 1975
United States	+1·8	+1·6	+2·1	+1·6	+ 7·2
Canada	+2·1	+2·2	+3·4	+2·1	+10·3
Japan	+1·5	+3·4	+0·9	+2·3	+ 8·3
France	+2·7	+2·4	+2·3	+2·1	+ 9·8
Italy	+3·7	+2·7	+2·0	+2·9	+11·8
Western Germany	+1·9	+1·8	+0·8	+0·9	+ 5·5
United Kingdom	+6·0	+9·5	+4·3	+3·4	+25·3
Weighted average of above	*+2·3*	*+2·5*	*+2·1*	*+1·9*	*+ 9·1*

Domestic activity

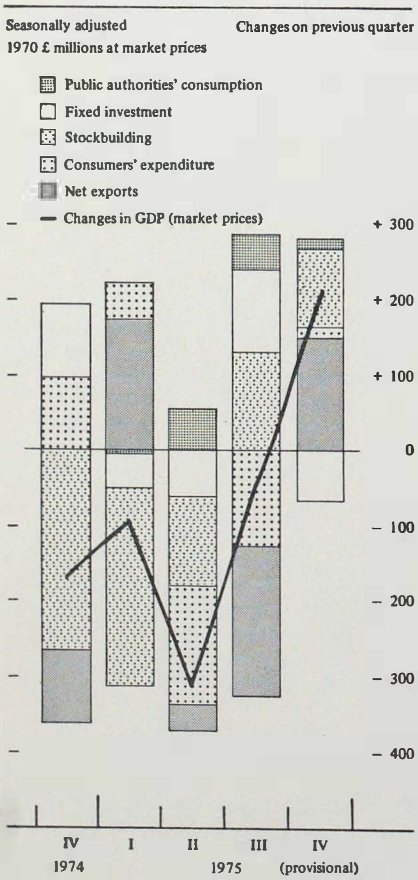
With exports rising sharply, total output increased a little in the fourth quarter.

Percentage changes in volume on previous quarter: *seasonally adjusted*

	1974	1975			
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr (provisional)
Gross domestic product (output measure)	−1·3	+0·3	−2·5	−0·6	+0·9
of which, industrial production	*−3·2*	*–*	*−4·4*	*−0·2*	*+1·2*
Consumers' expenditure	+1·0	+0·5	−1·7	−1·4	+0·2
of which, retail sales	*+0·1*	*–*	*−2·2*	*−3·1*	*+0·3*
Exports of goods and services	−3·8	+0·7	−3·9	−2·2	+5·0
Imports of goods and services	−1·2	−4·2	−3·1	+3·6	+0·6

Factors contributing to changes in GDP

A slower rate of de-stocking and rising public consumption provided the main stimulus to demand in the second half of 1975.



from a surplus in the first half of the year to near balance in the second (see table on previous page). It is not yet clear which group of countries showed a corresponding improvement in their current balances. The oil-exporting countries will have had a much smaller surplus in 1975 as a whole, as their imports continued to grow rapidly while the recession in the industrial countries reduced the demand for oil. But the surplus may have been rather larger in the second half of the year, when the volume of oil exports was higher and the 10% increase in prices announced in September began to work through to receipts towards the end of the fourth quarter. The smaller industrial countries continued to run a large current deficit in the first half of the year, but information on the outturn for the second half is still incomplete. They were badly affected by the downturn in demand from the larger industrial countries, and in some cases by the decline in the prices of primary products. But they have so far been able to finance their deficits without too much difficulty: in fact, as a group they were even able to accumulate reserves in the course of 1975. The non-oil developing countries were similarly affected by lower demand and falling prices, and also by the continuing effects of dearer oil. On provisional estimates, these countries reduced their imports (and hence probably their current account deficit) in the third quarter. Most of the deficit in 1975 as a whole was financed by borrowing from both official and private sources, but their reserves also had to be drawn down. A series of measures was announced by the International Monetary Fund in January, which will go some way towards easing the financing problems of these countries – the establishment of a trust fund, to be financed largely by selling part of the Fund's stock of gold, larger credit facilities in advance of an increase in quotas, and greater access to a special facility designed to help finance fluctuations in the exports of primary-producing countries.

Rates of inflation generally slowed down in the course of 1975 (see first table) but remain uncomfortably high in many countries. So in spite of high and growing unemployment, it seems probable that governments will remain cautious in their efforts to stimulate recovery, especially where they have balance of payments problems. According to official forecasts, real GNP in the United States will be about 6% higher in 1976 than in 1975, but elsewhere rates of growth may well be lower than this.

The UK economy

Output and demand [1]

There are now fairly clear signs that output in the United Kingdom has stopped falling; in fact, it appears to have risen slightly in the final quarter of last year (see second table). Industrial production reached a low point around last August and has since risen fairly slowly; in the fourth quarter it was still some 8% below the average for 1973. The upturn has been confined to intermediate goods rather than consumer or investment goods, presumably reflecting a slower rate of de-stocking.

In the short term, domestic demand should continue to be stimulated by the turnround in stockbuilding which now seems to be taking place. The run-down of stocks was by far the largest influence depressing demand in the first half of 1975 (see chart) but had slowed down considerably by the third quarter, although it was still heavy, at £160 million. In the fourth quarter, figures for manufacturers and distributors suggest that de-stocking throughout the economy may have come to an end or even that positive stockbuilding is now under way. However, it will require a manifest improvement in other components

[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 remains high and unemployment continues to rise steadily.

Seasonally adjusted: Great Britain unless otherwise stated

	Previous 'low'	1975 2nd qtr	1975 3rd qtr	1975 4th qtr	Latest
Unemployment (thousands)[a]	876 (March 1972)	811	959	1,087	1,185 (February)
Vacancies (thousands)	118 (October 1971)	161	131	111	111 (February)
Short-time workers (thousands: not seasonally adjusted)	1,137[b] (January 1974)	229	130	142	135 (February)
Orders on hand in the engineering industries (end of period, trend estimates, 1970 = 100)	93 (3rd qtr 1971)	112	106		102 (November)
Companies reporting below capacity working[c] (percentage)	71 (January 1972)	71	75	73	78 (January)

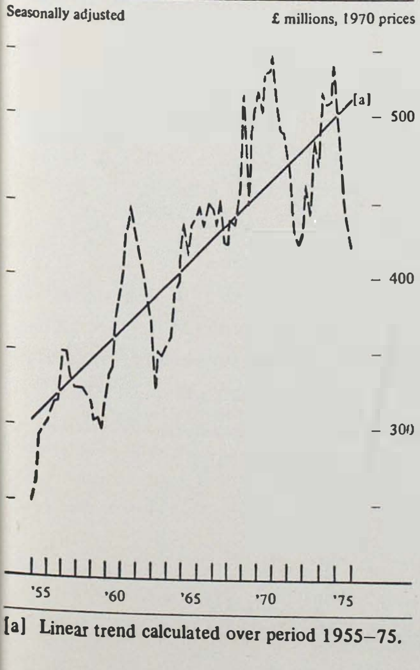
[a] Excluding school-leavers and adult students.

[b] Affected by the energy crisis.

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

Gross domestic fixed investment by manufacturing industry

Manufacturers' fixed investment is further below trend than at any time in the last twenty years.



[a] Linear trend calculated over period 1955–75.

of demand, and also in the financial position of companies, if restocking is to be sustained.

Consumers' expenditure did not decline further in the fourth quarter, and there were signs of an upturn in January. But a sustained recovery will depend on a resumption of growth in real incomes, which in turn will be influenced by the rate of inflation and the trend of employment. Public consumption has been growing fairly steadily but the Government have announced their intention to restrict its growth to about 1¼% in the next financial year – well below the recent trend. Fixed investment has fluctuated in recent quarters, but apart from expenditure on North Sea activities, has basically been very depressed: in 1975 as a whole, manufacturers' fixed investment was some 14% less than in 1974 – a sharper fall than in any other post-war year – and the latest Department of Industry investment intentions survey suggests a further fall in 1976 (see page 9), although the decline should come to an end later in the year. Since the April Budget, some £330 million (at current prices) has been made available by the Government under various selective schemes for restructuring and modernising industry and for bringing forward investment projects. Only part of the funds has so far been taken up; but time limits have been set, and some of the schemes also require companies to commit their own funds, so the stimulus to investment within the next twelve months could be quite significant.

There was a pronounced shift of resources into net exports of goods and services in the fourth quarter, broadly reversing the shift in the previous quarter: the volume of imports in the third quarter had been inflated by the arrival of three North Sea oil production platforms, and the volume of exports recovered strongly in the fourth quarter. Hopes for a sustained economic recovery this year must rest mainly on the ability of UK exporters to keep pace with any revival in their overseas markets, and this should be easier now that the domestic market is particularly slack. The monthly CBI survey suggests that new export orders may now be increasing quite strongly, although the strength of world economic recovery remains uncertain (see page 4).

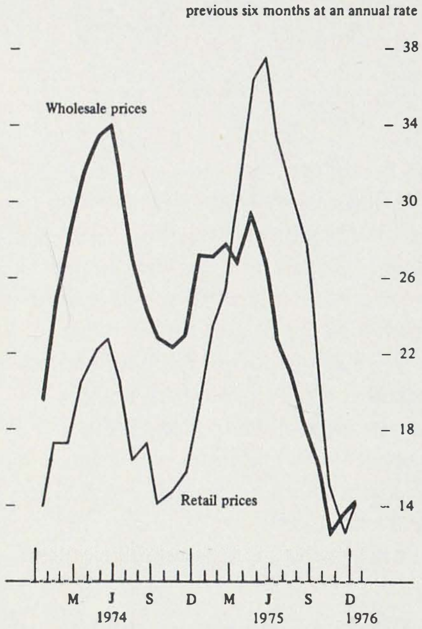
Capacity and unemployment

Although production shows some signs of recovery, unemployment will probably continue to rise for some time, although perhaps at a declining rate: an improvement in output at this stage of the cycle will initially be reflected in higher productivity by those in employment. According to the CBI industrial trends survey conducted in January, a record 78% of companies were then operating below capacity. Orders on hand in the engineering industries declined by a further 5% in the third quarter (and fell again in October and November): nearly all firms continue to quote orders or sales as the dominant constraint on output. After seasonal adjustment, unemployment in Great Britain exceeded one million last October (excluding school-leavers and adult students), and rose by some 40,000 a month between then and January. The increase in February was just over 20,000, bringing the total to nearly 1.2 million (see table). Meanwhile, unfilled vacancies rose slightly in February, after falling steadily for several months. The numbers on short-time working or temporarily laid off fell slightly in February but remain very high. In February the Government announced a further series of measures designed to encourage investment and alleviate unemployment. These were similar to schemes announced last September and December, and were aimed at creating extra temporary jobs and providing more training in industry.

The true extent of spare capacity in industry may not be as large as the figures for unemployment and short-time working suggest. Fixed investment in manufacturing has been below its longer-term trend in the last few years (see chart), and the peak in 1974 was below that of the preceding cycle around 1970. One likely consequence of this

Wholesale and retail prices

The rate of inflation was halved during the second half of 1975.



Wage settlements concluded since July [a]

Settlements between July and January increased basic wages by an average of 17%; the impact on average earnings may have been less.

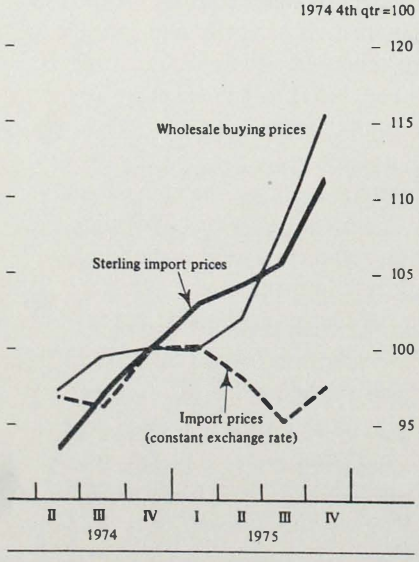
	Cash increase (£ per week)	Percentage increase[b] (weighted by group)	Numbers covered (thousands)
1975 Aug.	6·00	14·0	15
Sept.	4·12	14·0	98
Oct.	5·71	12·0	117
Nov.	5·88	17·6	1,335
Dec.	6·00	17·5	403
1976 Jan.	6·00	17·0	706
Weighted average	*5·86*	*17·0*	*2,674*

[a] Confined to settlements for which reliable published information could be found.

[b] Average of percentage increases for the highest and lowest paid in each group.

Import prices and wholesale buying prices

Import prices have risen entirely, and wholesale buying prices largely, because of the depreciation of sterling.



decline is a rise in the average age of the capital stock in manufacturing industry. As technical progress is largely embodied in the latest plant and equipment, the persistent weakness of manufacturing investment is probably now inhibiting the underlying growth of productive potential. If so, capacity constraints could well emerge earlier than the unemployment figures suggest when recovery eventually gets under way, unless existing plant can be used more effectively.

Costs and prices

The rate of inflation was halved during the last six months of 1975. Manufacturers' selling prices and retail prices each rose by 6½% – well below the respective rates in the previous six months (see chart). In the same period, wholesale prices in other main industrial countries rose by about 3%, and retail prices by about 3½%. Inflation in the United Kingdom began to slow down some time before the new incomes policy could have had a direct effect; but the early and widespread acceptance of the policy probably helped to foster expectations of lower prices, and the policy's direct impact on labour costs must now be an important influence on prices.

Since the pay policy was introduced at the beginning of August, the £6 limit has continued to be well observed by unions and employers. More than four million people are so far reported to have settled within the terms of the policy. The great majority of these have obtained increases of the full £6, though 10% of workers appear to have settled for less. Settlements up to and including January have added about 17% to basic wages (see table), but less to weekly earnings. The wage rate index rose by 9% between July (immediately before the policy was introduced) and January, a monthly rate of 1½%. Earnings increased a little more slowly during the five months to December. The rate of growth of earnings is rather higher than might be expected over the full year of restraint, but it may have been inflated by a bunching of settlements and by final adjustments before the Equal Pay Act came into force at the end of the year. Overtime working was unchanged during this period; but it had fallen sharply in the first half of 1975, so that the year-on-year growth of earnings was reduced to 19% by December.

Manufacturers' selling prices grew more slowly in the fourth quarter; if oil is excluded, the underlying growth was perhaps slightly less than 1% a month. The increase in January was rather larger, at 1¾%, but this may simply reflect an apparent recent tendency for firms to review prices in the first month of the quarter. Wholesale buying prices rose by 15% in 1975, largely because of the fall in the exchange rate (see chart); with sterling becoming more stable in recent months, the increase in buying prices may have slackened slightly.

The rise in unit labour costs has slowed down appreciably, and in the fourth quarter was only 3%, mainly reflecting a further sharp increase in productivity. Nevertheless, manufacturers' profit margins may have fallen slightly in the fourth quarter as the gains in productivity were probably more than offset by the rise in buying prices.

Retail prices rose by 3½%in the fourth quarter and by 1¼% in January. Thus, although the growth of earnings since last summer has been slow, there has not been a further fall in real pre-tax earnings. Year-on-year, the increase in prices was still well above that of earnings (25% and 19% respectively in December), but only because real earnings had fallen sharply early in 1975: the gap should narrow considerably during the second quarter of 1976 if the rise in retail prices (other than for seasonal food) continues to moderate.

Inflation should moderate further in the next few months if the £6 limit continues to be well observed. However, the precise rate of inflation in the autumn will depend on the behaviour of import prices, productivity, and profit margins as well as on wages and salaries. As noted on page 12, the trend in commodity prices is unlikely to be sharply upwards. Productivity in manufacturing might rise at perhaps 1%–1½% per quarter when recovery gets under way, which should be sufficient to allow profit margins to rise without the need to increase prices. Finally, the unusually sharp rise in the price of fresh food, which has recently inflated the retail price index, should have tapered off by the end of the summer. For all these reasons, it would be surprising if, later this year, the retail price index was much out of line with the Chancellor's target.

The rate of increase in prices beyond the autumn of this year depends crucially on the course of wages and salaries. The Government have stated that pay increases under the next stage of the incomes policy should be less than at present, in order to bring inflation in this country more closely into line with rates abroad. As the economy moves steadily out of recession during 1976/77, there will be scope for increased overtime working and a reduction in short-time working: this would help to make a low limit for wage rates more acceptable without having an adverse effect on unit labour costs.

Personal incomes and spending[1]

After an unusually sharp fall in each of the two previous quarters, real consumer spending was probably little changed in the fourth. The volume of retail sales in the fourth quarter was a little larger than in the third, but sales of new cars (excluded from the measure of retail sales) fell steeply after the large increase in September associated with price cutting and promotional campaigns.

Total personal income increased by less than 3% in the fourth quarter: average earnings rose by almost 4% but employment probably fell, so that the total wage and salary bill may have risen by just over 3%. Other elements of personal income (in particular, employers' contributions to private and state pension schemes, and current grants from the public sector) probably continued to rise a little. But income taxes and national insurance contributions are likely to have risen faster than nominal incomes, implying an increase of less than 2½% in disposable income. Retail prices rose by 3½% between the third and fourth quarters, so that real personal disposable income appears to have fallen by more than 1%. With consumer spending little changed, the saving ratio probably declined by over half a percentage point but would still be very high at about 12%–13%. Demand for consumer credit remained weak, and instalment credit outstanding fell fairly steadily in the second half of 1975, before increasing slightly in December. Bank lending to persons other than for house purchase also continued to decline.

The volume of retail sales in January provisionally increased by some 2%, reflecting buoyant 'sales' early in the month and also, perhaps, the easing of credit restrictions in the middle of December.

Several theories have been put forward to explain the persistence of abnormally high personal saving in the last two years or so. The results of a recent attempt to test some of them, using econometric techniques, are described in an article on page 53. These suggest that the high rate of saving may partly reflect attempts to counteract the steep fall in the real value of net liquid assets, which the fast rate of inflation in the last few years has produced. The effect on saving, though initially quite small, would gradually build up, and could account for a good deal of the underprediction of the saving ratio from mid-1973 by models based mainly or exclusively on real incomes.

If this is so, it is perhaps surprising that changes in the value of illiquid assets (arising from fluctuations in security prices and from inflation) do not appear to have had a similar effect, even though such

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

changes have been quite large over the past ten years. The quality of the data is not very satisfactory, but if the results are taken at face value, they seem to imply that individuals regard fluctuations in the price of bonds, equities and property as temporary, and that the number of individuals with substantial holdings of financial securities are too small to have a significant impact on aggregate consumption.[1]

Other possible explanations of the abnormal rate of saving include the influence of *realised* capital gains or losses on consumer spending, and the impact of uncertainty about employment prospects on saving; but these could not be properly tested because the data are not adequate for the purpose. However, the findings did suggest that there may be some force in the simple notion that consumer resistance to price increases becomes more important in periods when inflation is rising faster than generally expected.

The theories examined are by no means fully developed, and leave scope for much more investigation. But it may be tentatively concluded that the reason why forecasts of saving – based mainly or exclusively on real income – have underpredicted the saving ratio in the last two years or so is that they have not taken account of some of the effects of inflation. For what they are worth, the findings suggest that the recent high saving ratio should eventually decline if the rate of inflation continues to slow down. However, this could be a long process: personal holdings of liquid assets are no longer falling in real terms, but personal liquidity is still well below its normal relationship with income.

Housebuilding[2]

Private sector housebuilding continued to recover in the fourth quarter, and there was a further rise in activity in the public sector. The number of new houses started in the public sector fluctuated sharply in 1975, but the trend was strongly upward, averaging about 9% per quarter. Private sector starts were 40% higher than in 1974, but most of the increase occurred early in the year and the pace has since been slower. According to the Private Enterprise Housing inquiry conducted in November, builders expect the expansion to continue this year, but the projected number of starts (a monthly average of about 13,300) is still low by pre-1974 standards. This is not altogether surprising: although sales of new houses seem to have risen faster than completions in recent months, the number of completed but unsold houses is still high, as is the number of houses under construction. Builders' profit margins are probably still under pressure: although the rise in the cost of labour and materials has slowed down, it is unlikely to have been below the increase in house prices, which was sharply reduced towards the end of last year. Thus, new house prices are estimated to have risen by no more than 1% in the fourth quarter, compared with 3%–4% in each of the three preceding quarters.[3]

Building society lending again rose substantially in the fourth quarter. New commitments also increased, indicating that lending will continue to expand in the early months of 1976. Although less than in the previous quarter, net receipts remained very large and, together with capital repayments, were sufficient to finance the growth in lending, so that the societies' high liquidity ratio was little changed. The decline in net receipts over the quarter occurred in the first two months after the rise in competing interest rates at the beginning of October. But in December, when other interest rates began to decline again, the inflow recovered to £350 million and, with rates subsequently

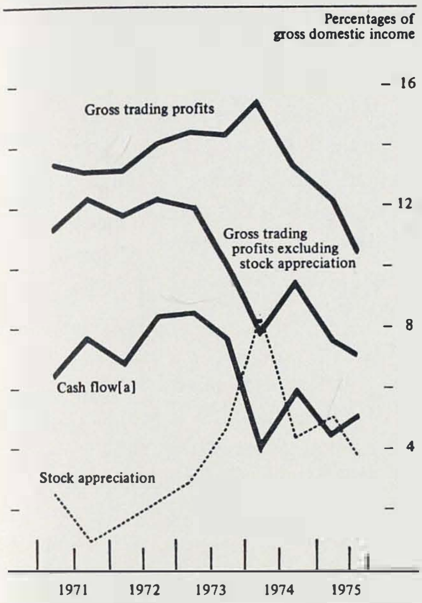
[1] A sizable proportion of equities and gilt-edged stocks is held by financial intermediaries, in particular life assurance and pension funds. Individuals may be largely unaware of changes in the value of assets underlying their holdings of life assurance policies and pension rights, and are thus unlikely to react quickly to such changes.

[2] Apart from references to prices, this section is in seasonally-adjusted terms.

[3] Department of Environment/Building Societies Association index of new house prices at mortgage approval stage.

Company profit and cash flow as percentages of gross domestic income

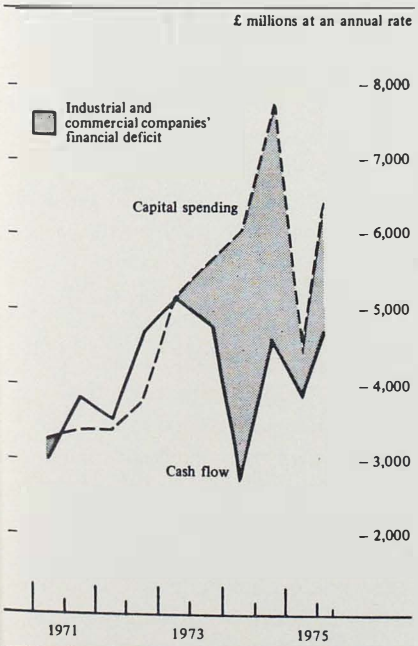
In the third quarter companies' cash flow improved slightly although their profits declined.



[a] As defined in footnote to text.

Company cash flow and capital spending[a]

Although cash flow improved, companies' financial deficit widened because of a sharp rise in capital spending.



[a] As defined in footnote to text.

easing back further, net receipts in January increased further to some £395 million – the highest for nine months – while the liquidity ratio rose to a record 20.7%. The supply of finance for mortgage lending therefore seems assured for some time.

The final repayments of the official loans of £500 million extended in 1974 were made on 27th January.

Company spending and finance

Gross trading profits of industrial and commercial companies fell again in the third quarter (see chart), largely because of the continuing weakness of demand. The Price Commission reported that on average, margins in the third quarter were at their lowest since the introduction of price controls, and that while the price code is still proving to be an effective constraint on some companies, for others the fall in profits is attributable to competition and declining output. Although stock appreciation was lower in the third quarter, profits net of stock appreciation also fell slightly. The preliminary evidence for manufacturing industry (see page 6) suggests a further decline in margins in the fourth quarter.

In spite of the decline in profits, companies' cash flow[1] is estimated to have improved slightly in the third quarter, but their overall financial deficit appears to have worsened because of a steep rise in capital spending[2] (see chart below). However, the latter mainly reflected increased expenditure on the development of North Sea oil and gas resources: excluding this, the financial position of many firms may have improved slightly.

At the same time, companies invested much less abroad and, with bank borrowing little changed, their gross and net liquidity each improved.[3] Companies also raised substantial amounts of new equity capital during the quarter. There may have been a further improvement in company liquidity in the fourth quarter (see page 14).

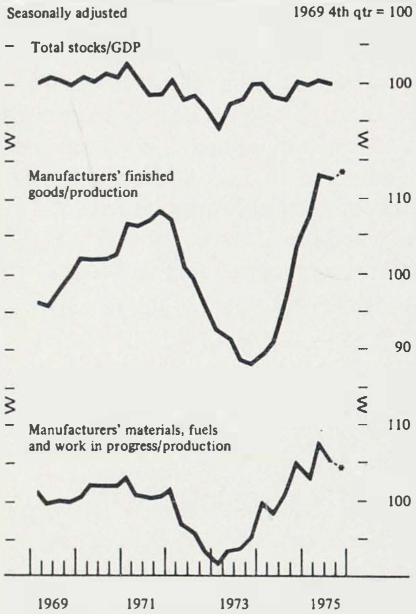
Progress towards financial balance last year, after the massive deficit of 1974, was achieved largely through cuts in investment in fixed assets and stocks. The volume of gross fixed investment by manufacturing industry fell by 5% in the fourth quarter, and by 14% in the year as a whole. Investment by distributive and service industries (excluding shipping) also fell in the fourth quarter, by 4%, and in the year as a whole was 12% below 1974. According to the Department of Industry's latest investment intentions survey, fixed investment will be lower again this year, in the case of manufacturing by about 5%–8% compared with 1975. However, for both manufacturing and the distributive and service industries, the quarterly average this year is predicted to be little different from the fourth quarter of last year, in which case investment would stop falling in the fairly near future. A turning point in manufacturing investment later this year is also implied by the CBI survey conducted in January.

After the heavy run-down of stocks in the two previous quarters (some £315 million at 1970 prices), de-stocking by manufacturers almost came to an end in the fourth quarter (on provisional figures), and their stock/output ratio remained high by previous standards (see chart overleaf). Wholesalers and retailers each added to their stocks, the latter for the second consecutive quarter; and taking manufacturers and distributors together, stocks rose by some £70 million during the quarter.

[1] Cash flow is defined as retained profits (including depreciation) plus investment grants and other capital transfers, but excluding stock appreciation.
[2] Capital spending is defined as expenditure on fixed capital and stocks after deducting stock appreciation.
[3] Both in absolute terms and as percentages of total final expenditure in the preceding twelve months.

Stock/output ratios

Manufacturers' stock/output ratios remained relatively high in the fourth quarter.



*Estimated.

While the worst of the recession may be over, profits will need to rise substantially if there is to be a sustained revival in investment. Profitability has fallen over a long period of years, but was particularly low in 1974 and 1975. An article on page 36 estimates that, allowing for inflation, the real post-tax rate of return on the capital stock of industrial and commercial companies was roughly halved between 1960 and 1973, and would have disappeared completely in 1974 but for the introduction of tax relief on stocks in November of that year. For profitability to improve, output and profit margins will each need to rise. Economic recovery and diminishing inflation will help to bring this about; but the present system of price restraint – based on the historic cost margins and reference levels prevailing when the code was introduced – would, if maintained, help to prevent a return to adequate profitability.

The public sector [1]

There were signs that the growth in public spending in real terms had moderated a little in the second half of 1975, though it is too early to assess whether this will be a continuing trend. Most of the main categories of expenditure rose rather more slowly in the third quarter than earlier in the year; and within transfer payments, expenditure on subsidies has fallen quite sharply since the first quarter of 1975. Debt interest is perhaps the only category now accelerating in real terms.

Nevertheless, the recent White Paper on public expenditure indicates that the volume of public spending programmes in 1975/76 is likely to have been around 3½% higher than planned in the previous White Paper. Spending on programmes is projected to fall slightly in 1976/77, but it would still be some 1% higher than planned last year, even though the cuts subsequently announced in the April 1975 Budget are to be put into effect. In 1975/76 about half of the increase over last year's plans relates to extra spending on goods and services (public sector employment, direct procurement, etc.); but in 1976/77 virtually all of the rise is attributable to additional transfer payments, especially in the trade, industry and employment programme and in social security benefits. Estimates of the volume of debt interest have also been heavily revised, largely because the borrowing requirements are larger than previously expected, but also because a slower rate of inflation has been assumed, thus lowering the rate at which the real value of nominal interest is eroded. Debt interest is, in fact, now expected to increase by 50% in real terms between 1975/76 and 1978/79, compared with a rise of less than 25% in the previous five years. The effect of interest payments on demand for goods and services is greatly reduced by taxation levied on most recipients and, further, by the amounts which are saved. Nevertheless, the Government are committed to freeing resources for investment and exports, and the recent White Paper raised the amount to be set aside for each of these purposes. So the heavier burden of debt interest has increased the need for restraint on other forms of expenditure, which in total are planned to remain unchanged from 1976/77 to 1979/80.

The central government borrowing requirement in the December quarter of 1975 was lower than in each of the previous two quarters, bringing the total for the first nine months of the financial year to some £6,500 million. This looks a little high in relation to the estimate of £7,800 million for the year as a whole published at the time of the last Budget, but the size and timing of both expenditure and receipts has been particularly uncertain this year, thus making it more difficult to monitor the progress of the borrowing requirement (see page 13). The United Kingdom's Letter of Application to the International Monetary Fund in December indicated that the borrowing requirement for the whole public sector might be as large as £12,000 million in 1975/76, but the final result now seems likely to be rather lower than this.

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

The UK balance of payments

The current account deficit of the balance of payments was halved in 1975. The domestic recession reduced the demand for imports; the recession abroad led to a fall in commodity prices, and thus helped to improve the United Kingdom's terms of trade; and UK exports suffered less than the exports of most other countries from the fall in world demand. The trade balance of the countries now leading the recovery in world activity began to deteriorate in the second half of last year, and the trend is expected to continue during 1976. In contrast, the United Kingdom's balance of trade may improve further this year.

Current account of the UK balance of payments

The visible trade deficit was much reduced in the fourth quarter although the terms of trade deteriorated.

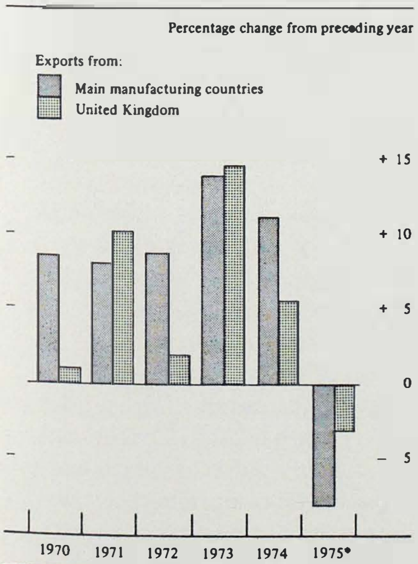
£ millions: *seasonally adjusted*

	1974	1975 Year	1975 2nd qtr	1975 3rd qtr	1975 4th qtr
Exports of goods	15,895	18,770	4,480	4,635	5,125
Imports of goods	21,160	21,970	5,160	5,620	5,810
Visible balance	– 5,265	– 3,200	– 680	– 985	– 685
Net invisibles	+ 1,615	+ 1,500	+ 345	+ 360	+ 380
Current balance	– 3,650	– 1,700	– 335	– 625	– 305
Changes from preceding year/quarter:					
Visible balance	– 2,930	+ 2,065	+ 170	– 305	+ 300
of which:					
Volume[a]	*+ 665*	*+ 870*	*– 85*	*– 315*	*+ 330*
Price	*– 3,595*	*+ 1,195*	*+ 255*	*+ 10*	*– 30*
Volume of exports (percentage)	+ 6·8	– 4·0	– 4·9	– 2·1	+ 6·9
Volume of imports (percentage)	+ 1·0	– 7·1	– 2·6	+ 4·3	+ 0·2

[a] Measured for each period at the prices of the preceding period.

Volume of exports of manufactures

Last year, UK exports of manufactures fell much less than those of the other main industrial countries.



*Estimated.

The current account[1]

After declining in the second and third quarters, the volume of exports rose sharply in the fourth quarter of 1975. The increase was concentrated in sales to developed countries, notably the EEC and the United States, indicating that activity in the industrial countries (and hence world trade) was beginning to recover towards the end of the year (see page 3). The volume of exports to oil-exporting countries probably fell in both the third and fourth quarters: imports by those countries had risen very rapidly earlier in the year, but physical and financial factors appear to have slowed down (at least temporarily) the rate of growth. Nevertheless, the volume of UK exports to that group was perhaps around 60% greater in 1975 than in 1974. UK exports of manufactures fell by 3% between the two years but world trade fell much faster, so that the UK share of world trade in manufactures increased (see chart).

The volume of imports was virtually unchanged in the fourth quarter, but there was an underlying increase because imports of North Sea installations had inflated the previous quarter's figure. Total domestic demand probably rose a little, and there may have been some restocking during the quarter; this was reflected in imports of industrial materials, which rose by some 4% in volume terms. Over the year as a whole, the volume of total imports fell by 7%.

The shift of resources out of the trade balance in the third quarter appears to have been broadly reversed in the fourth. Between 1974 and 1975 the improvement in the trade balance is estimated to have contributed about 1% to the gross domestic product.

The terms of trade moved against the United Kingdom by 1% in the fourth quarter, the first significant deterioration for eighteen months: import prices accelerated while export prices rose more slowly than earlier in the year. Sterling continued to depreciate against the other main currencies, but by rather less than in each of the two previous quarters. Over the year as a whole, the terms of trade improved considerably on 1974 and contributed rather more than the volume of trade to the reduction of £2 billion in the visible deficit. By area, most of this reduction can be attributed to trade with oil-exporting countries.

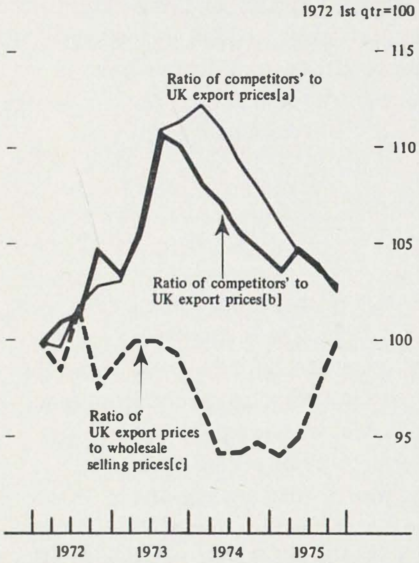
The surplus on invisibles rose slightly in the fourth quarter, but over the year as a whole was some £115 million smaller than in 1974. The deterioration reflected heavier interest payments associated with increased borrowing by the Government and other public sector bodies to finance the current deficit, and a rise in government expenditure abroad on services. The surplus earned by the private sector during the year was larger than in 1974, mainly because of higher net earnings from interest, profits and dividends.

The current account deficit in the fourth quarter was about £320 million less than in the third, and in the year as a whole was only half as large as in 1974, at £1,700 million.

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

Price ratios relevant to UK export performance

The price competitiveness of UK exports declined further in 1975, but their profitability relative to home sales improved.



[a] Competitors' export prices approximated by applying UK export weights to UK import prices by SITC for all manufactures.

[b] Calculated as in [a] but for finished manufactures only.

[c] Ratio of UK export prices for finished manufactures to home selling prices of manufacturing industries other than food, drink and tobacco.

The visible deficit narrowed further in January. In volume terms, exports continued to rise while imports fell back slightly; there was also a small improvement in the terms of trade.

With the prospect of some expansion in world trade in 1976, the recent rise in UK exports is likely to be sustained. Although the chart suggests that the price-competitiveness of UK exports may have deteriorated further towards the end of last year, the counter-inflation policy is now helping to contain the rise in export prices as well as reducing the uncertainty which surrounds the pricing and profitability of export contracts in periods of rapid inflation. The chart also suggests that the profitability of exports of finished manufactures relative to home sales has recently improved. Imports must also be expected to rise during the course of 1976, when domestic demand recovers.

The outlook for the terms of trade is less clear, both for the United Kingdom and for other industrial countries. But prices of raw materials may not rise very fast: as suggested on page 4, activity is not expected to recover strongly in the industrial countries so that, at least in the initial stages of the upturn, there may be little or no deterioration in the terms of trade. In sum, the current account is likely to improve further this year.

Although the United Kingdom is not expected to be self-sufficient in oil until 1980, production from the North Sea should lead to savings of the order of £1 billion in net imports of oil this year. Against this must be set further imports of related equipment and services, and interest remitted abroad. After allowing for these factors, together with repercussions through other sectors of the economy, the net impact of North Sea oil on the current account may be quite small this year, but should be increasingly beneficial from 1977 onwards. Inflows on capital account for the development of the oil fields will again be substantial in 1976, and the effect on the total currency flow should be favourable.

Financing of the current account deficit

The current deficit was much smaller in the fourth quarter, but the reserves were again drawn down.

£ millions: *not seasonally adjusted*

	1974	1975			
		Year	2nd qtr	3rd qtr	4th qtr
Current balance	−3,650	−1,700	−370	−560	−120
Capital transfers	− 70	−	−	−	−
	−3,720	−1,700	−370	−560	−120
Financed by:					
Decrease (+) in reserves	− 80	+ 670	+420	+170	+220
Foreign currency borrowing:					
Central government	+ 640	+ 420	−	−	−
Other public sector (net)	+1,240	+ 410	+160	+ 40	+130
Increase (+) in sterling holdings (official and private):					
Oil-exporting countries[a]	+2,220	− 180	−170	−250	− 90
Other	− 660	+ 90	+190	−130	+120
Other identified capital flows (net)	−	− 730	−100	+330	−560
Balancing item	+ 360	+1,020	−130	+400	+300

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

Financing the deficit

Before seasonal adjustment, the current account deficit in the fourth quarter was the smallest for two and a half years (see table). However, the reserves fell again despite further foreign currency borrowing by public sector bodies. Sterling holdings rose slightly: a fall in the balances of central monetary institutions, both in oil-exporting countries and elsewhere, was more than offset by increases in other holdings, including those of international organisations. Within other identified capital flows, there was a very sharp fall in UK banks' net external liabilities in foreign currencies, partly reflecting an increase in currency deposits of UK residents, notably oil companies. There was another sizable positive balancing item, which in the year as a whole was as large as £1,020 million. Apart from this, the current deficit in 1975 was financed mainly by the reserves and by foreign currency borrowing by the Government and other public sector bodies. Total sterling holdings fell slightly during the year.

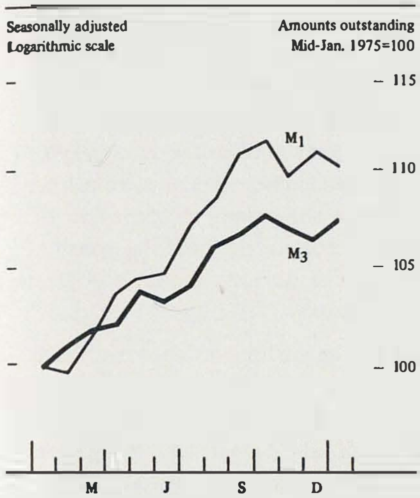
At the end of December the IMF formally approved UK applications for a drawing under the Fund's 1975 oil facility and a stand-by in the first credit tranche (SDR 700 million, or about £400 million). The drawing on the oil facility (SDR 1,000 million or about £575 million) was made in January and explained most of the rise of £670 million in the official reserves.

Monetary developments

In the late summer, the rate of growth of the money stock appeared to be accelerating. However, in the last few months of the year and the beginning of 1976 this growth fell back sharply, and in the three

Money stock

The growth in the money stock fell back towards the end of 1975.



Influences on the money stock (M_3)[a]

The check to the growth of M_3 in the fourth quarter was associated with a smaller government deficit and heavy official sales of debt outside the banking system.

£ millions: *seasonally adjusted*

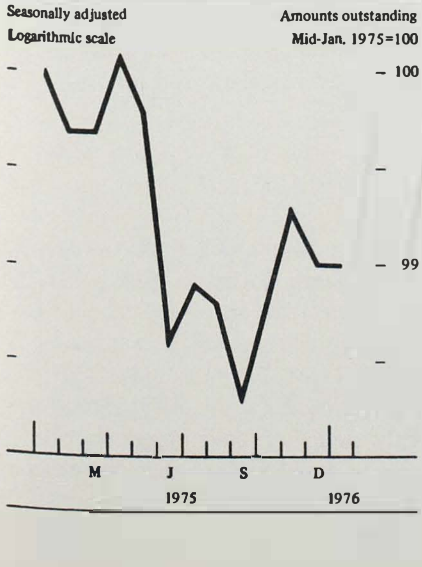
	1974	1975			
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr
Central government borrowing requirement	+1,390	+1,850	+2,090	+2,520	+1,910
Purchases (–) of central government debt by non-bank private sector	+ 370	–1,650	– 490	–1,230	–1,950
Other public sector borrowing requirement	+ 780	+ 510	+ 660	+ 180	+ 580
Purchases (–) of other public sector debt by non-bank private sector	– 530	– 40	– 200	+ 120	
Lending to private sector:					
In sterling	+ 90	+ 470	– 290	– 430	– 80
In foreign currencies	+ 240	– 40	+ 240	+ 320	+ 50
DCE[b]	*+2,540*	*+1,000*	*+2,090*	*+1,440*	*+ 310*
External items	–1,450	– 470	–1,530	+ 370	– 230
Other	+ 400	– 300	+ 170	– 270	+ 30
Money stock (M_3)	+1,290	+ 330	+ 650	+1,580	+ 310

[a] For further detail see Table 11 / 3 in the statistical annex.

[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.

Bank lending in sterling to the private sector

The demand for bank credit has remained subdued.



'banking' months to mid-January M_3 was little changed after seasonal adjustment while M_1 fell by about 1% (see chart). The table, which compares the counterparts of M_3 (seasonally adjusted) in the fourth calendar quarter of 1975 with earlier quarters, shows that the slowing down was associated with very heavy official sales of central government debt to the general public, but also owed something to a smaller central government borrowing requirement.

The course of M_3 from month to month – and from quarter to quarter – is very much affected by sizable erratic movements in the timing of government cash receipts and payments. The seasonal corrections for the central government borrowing requirement, which affect the adjustments for the money supply and for bank lending, attempt to smooth out fluctuations where these have a regular pattern or where some factor which would change this pattern can be identified. But the process of seasonal adjustment must be somewhat arbitrary and cannot allow for large random movements. The latter also make it difficult to judge how far changes in the seasonally-adjusted borrowing requirement from month to month represent variations in the pattern of receipts and payments rather than a change in the underlying government deficit.

Bank lending to the private sector has remained subdued (see chart below): in January the amount outstanding in sterling was actually about 1% lower than a year earlier – which, given the rise in prices, implies quite a sharp reduction in real terms.

Some relaxation in the minimum terms for hire-purchase contracts was announced on 17th December. But the guidelines which the banks are expected to follow in their lending remained broadly unchanged, i.e. they should continue to give priority to the needs of manufacturing industry and, apart from meeting any new demands resulting from the hire-purchase relaxations, continue the existing restraint on lending to persons, to property companies and for purely financial transactions (see notice on page 35).

As the table shows, 'external items' also moderated the growth of the money stock in the fourth quarter, as the seasonally-adjusted current account deficit of the balance of payments was partly offset by capital inflows into the private sector.

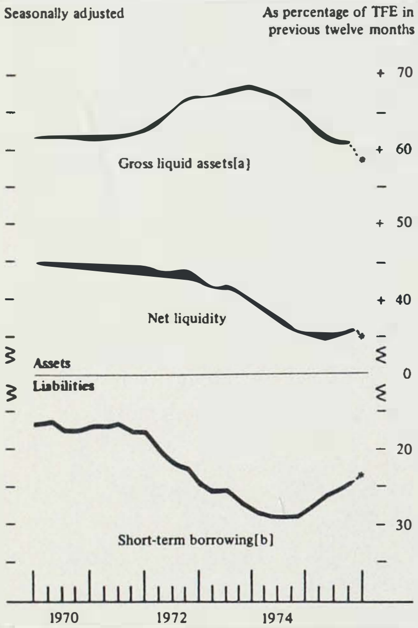
As already mentioned, the recent small figures for M_3 have owed much to very large official sales of gilt-edged to the general public. Such periods of selling occur irregularly through the year. In mid-October, short-term rates in London started to ease, largely following the course of rates in the United States. Minimum lending rate, which had risen in early October from 11% to 12%, started to move downwards in the middle of November, and thereafter a series of reductions of ¼% brought it down to 10½% by 23rd January. The rate subsequently fell more sharply, to 10% on 30th January, and to 9½% on 6th February; it fell further to 9¼% on 27th February. As these reductions in short rates proceeded, and as confidence in the Government's counter-inflationary policies grew, the prevailing yields on gilt-edged stocks became increasingly attractive.

In this situation the authorities had two main considerations in mind. First, they needed to sell stocks to meet the Government's financing needs in a non-inflationary way; and to that extent they wished not only to respond to the market's demand, but also to keep in mind the prospective scale of government borrowing as well as its current size. Secondly, and on the other hand, they felt it important that the rate of monetary expansion should not be kept so low, and interest rates so high, as to impede a soundly-based industrial recovery.

In the event, very substantial amounts of gilt-edged were sold, as is described in more detail in the financial review, while at the same time an appreciable fall in medium and long-term rates was allowed. Leaving aside the problems of seasonal adjustment and the general question of

Gross and net liquidity of the private sector (other than banks)

Gross and net liquidity of the private sector are each estimated to have fallen in relation to total final expenditure in the fourth quarter.



*Estimated.

[a] Comprises M_3 plus holdings of local authority temporary debt, Treasury bills, tax reserve certificates and tax deposit accounts, finance house deposits, national savings, and building society deposits.

[b] Comprises bank advances, commercial bills and HP debt. Excludes borrowing for house purchase.

Financing the public sector deficit

The public sector needed much less bank finance in the fourth quarter of 1975 compared with earlier in the financial year.

£ millions: *not seasonally adjusted*

	1975 2nd and 3rd qtrs	1975 4th qtr
Public sector borrowing requirement	+5,597	..
of which:		
Central government:		
Notes and coin held by the non-bank private sector	+ 32	+ 401
Bank lending in sterling	+2,780	+ 405
Purchases of gilt-edged stocks by the non-bank private sector	+1,051	+1,678
Purchases of other central government debt by the non-bank private sector	+ 681	+ 235
Other[a]	+ 136	− 34
External[b]	− 25	+ 52
	+4,655	+2,737
Public corporations and local authorities:		
Bank lending in sterling	+ 460	+ 329
Purchases of other public sector debt by the non-bank private sector	+ 97	..
Other[a]	+ 119	+ 45
External[b]	+ 266	+ 136
	+ 942	..

.. not available.

[a] Issue Department and National Insurance Fund transactions in local authority debt (which are included as contra-items in both parts of the public sector) and in commercial bills (under central government).

[b] Includes foreign currency transactions with the UK banking sector.

interpretation (discussed in the assessment), the consequent reduction in the growth of M_3 probably conveys too restrictive an impression of developments in private sector liquidity. As mentioned in the previous issue of the *Bulletin* (page 334), the structure of short-term interest rates has encouraged a flow of funds into liquid assets which are not included in the conventional measures of the money stock (which are limited to notes and coin and bank deposits). With the banks not bidding actively for deposits, substantial private funds, equivalent to nearly two percentage points of M_3, were invested in the second half of 1975 in Treasury bills. The building societies also continued to attract large amounts. In all, total liquid assets of the private sector (other than banks) probably continued to expand a little in the fourth quarter but by less than the growth of total final expenditure; so the ratio of gross and net liquidity to final expenditure probably fell slightly (see chart).

Most of the gilt-edged stocks sold by the authorities appear to have been bought by financial institutions other than banks. The liquidity of these institutions had become unusually high during 1973 and 1974; and the readjustment of their holdings of liquid assets to a more normal size accounts for part of the latest decline in liquidity ratios of the private sector as a whole.

Elsewhere in the private sector, there seems to have been some further recovery in the net liquidity of industrial and commercial companies, although much less pronounced than in the first three quarters of 1975. In contrast, the personal sector's gross and net liquidity has continued to decline sharply in relation to personal disposable income, reflecting the continued erosion of liquid balances by inflation and also, perhaps, some fall in the saving ratio.

During the first three quarters of the current financial year, official sales of gilt-edged stocks to the private sector (other than banks) amounted to some £2,700 million – possibly about one third of the total public sector borrowing requirement during that period. (Full details of the whole public sector borrowing requirement, and its financing, in the fourth quarter of 1975 are not yet available.) The big increase in such sales in the December quarter was largely responsible for the sharp decline in the Government's need for finance from the banking system. During the December quarter, bank lending in sterling to the central government rose by only a little over £400 million, compared with a rise of almost £2,800 million in the previous six months, thus checking the growth in bank liquidity that had been apparent in the autumn. The banks' combined reserve ratio, which had risen to 15.9% in mid-September, stood at 15.5% in mid-January after falling to 15.1% in mid-December. A heavy concentration of tax payments in early January seemed likely to reinforce the pressure already being exerted on reserve assets by the continued sales of gilt-edged, and on 15th January the Bank announced that 1% of special deposits would be temporarily released on the 19th of that month in order to prevent pressure on reserve assets leading to a rise in short-term interest rates. As planned, the funds were redeposited with the Bank on 10th February when the main revenue flow had slackened off.

Assessment

Good progress has been made in reducing the rate of inflation which, however, is still the country's major problem. During the last six months of 1975, retail prices rose by some 7% – an annual rate of 14%, or half the rate of the first half year; and there seems at present good prospect that the rate of increase will fall to 10% by the end of the year. Further prospects depend critically on the scale of pay increases permitted under the next phase of the policy of restraint, which it is widely accepted will have to be prolonged when the present phase ends at mid-year.

Progress so far can only be regarded as a first stage. Though the rate of inflation has been more than halved, it remains double the average rate of our main competitors. Moreover, until the rate of inflation can be brought down further, and kept to very small figures for a period, a new outbreak of accelerating inflation will remain a serious possibility. It would, therefore, not be too ambitious, given the reasonable prospect of achieving the 10% target, to seek to halve the rate of inflation once again in the next twelve-month period.

This would not itself be enough firmly to re-establish stability; but it would give hope subsequently of bringing inflation to the minimal rates which could be expected to endure in the longer term, and of putting this country into a tenable relation with our competitors.

Continued price stability will inevitably imply annual rates of pay increase, from now on, which are only a fraction of what has been common in the last few years. Thus, full stability of prices would require pay increases of no more than 3% a year – unless the trend of productivity could be improved, and brought more closely into line with that in more prosperous countries.

Though the world economy has for some time been expanding, it is still difficult to judge how rapidly expansion will continue and how general it will be among industrial countries. In this country there is increasing confirmation that output is beginning to rise slowly. It is inevitable, however, that unemployment will increase further before it starts to decline. What is now needed is a period of balanced growth.

Any action taken this year must have regard to the future pattern of demand. Unemployment plainly needs to be reduced as soon as possible. But any stimulus to demand now will have a large effect on output and employment only from the end of the year onwards; and by then the economy may in any case be expanding at a more nearly satisfactory rate. Apart from other considerations which tell in the same direction, this consideration must limit severely the scope for immediate action.

The pattern of growth will need to be different in future from what it has been in recent years. Public expenditure has been rising at a rate which could hardly be sustained, and has already reached a level difficult to accommodate within the economy. This situation has only been tenable because, in the cyclical circumstances of the last two years, other types of demand – which, in the period ahead, should expand – have been stagnant or falling.

Government policy as set out in the White Paper on public expenditure, while not opening the way to any reductions in taxation, envisages no further increase in public expenditure, apart from debt interest, beyond the 1976/77 level. The difficulty will be to ensure that what in fact happens corresponds to present plans so that, with public demand no longer a main expansionary force, the economy has room to respond to other types of demand. The most desirable sequence would be a large expansion of exports, which would in turn generate an expansion of domestic demand.

There appear fair prospects of an export-led expansion. UK exports have been less depressed than world trade, and have more than held their share. They now seem to be on a rising trend – a good response to the initial stages of world expansion; and exporters in general appear optimistic. As world recovery proceeds, exports might be growing at 10% a year, and the economy by over 3% a year, by the end of 1976.

The danger is that, from this base, the response of investment will be too late and too small. Some delay in response is normal, and it is most likely that private investment will be rising again next year or even by the end of this. But it is generally accepted that past performance has been inadequate; and investment will take some time even to regain its previous peak. Ideally, investment should provide an unusually large part of the impetus to expansion in the next phase; and if room is to be left for this, the probability of greater investment should be clear at not too late a stage. But while more than a normal cyclical recovery is needed, a less than normal recovery is quite possible.

One reason for fearing this is that inflation itself has been (and even at its present declining rate, continues to be) a serious deterrent to investment. Future prices and costs are made more difficult to calculate; while inflation continues, government economic strategy must appear uncertain; and high nominal rates of interest deter borrowers, given the uncertainties about future prices.

Even more important has been the way in which inflation – and the fact that accounting and pricing policies have not been fully adapted to it – has eroded profits. Profits have fallen in many other countries, but the fall has been greater in this country, where inflation has also been worse. A special article on page 36 shows that, when adjustment is made for price changes and for stock appreciation, the profitability of industrial and commercial companies has declined steadily over the last fifteen years, both in terms of the pre-tax return on capital employed and, even more spectacularly, in terms of the post-tax return. The terminal year in those calculations, 1974, was probably a particularly bad year, as 1975 may also have been; and profits should show some recovery as inflation ebbs and as expansion proceeds. But a lot of ground has been lost, and profits are unlikely to be restored to an adequate level unless the need for conscious adjustments to this end is realised.

A third, possibly unfavourable, factor is the liquidity position of industry, although this has been improving. This year, industrial and commercial companies should show an overall financial surplus in place of the deficits of the last three years. This would, however, be partly due to earlier decisions to reduce stocks and fixed investment; and some surplus is also required to allow lost liquidity to be rebuilt. If the recovery of investment demand were especially rapid, liquidity might again prove to be a restraint on investment.

These adverse factors make it important to find ways to encourage investment; the effects of price control should be looked at in this connection. At present, price control is probably not an effective constraint on prices; but, with recovery, it could soon become one again, and this must affect investment intentions. It is important that firms should have assurance that price controls, while they continue, will not be such as to prevent a rebuilding of profits. Because firms need to look ahead, this might best be done by making appropriate modifications to the control rather soon; these should be specially directed towards making cost-cutting investment clearly profitable.

Consideration of the role of monetary policy in the present phase requires an interpretation of the lack of growth in the money stock over the last few months as a whole, compared with a moderate growth through most of last year. This should not necessarily be read as an indication that monetary policy has become more restrictive: at the same time, interest rates have fallen.

There have been several circumstances accounting for the recent stability of the monetary aggregates. In the first place, there have been fluctuations in the course of the public sector borrowing requirement. Seasonal adjustment has been made especially difficult by the effect of changes in the tax system on the timing of tax payments; and the distinction between erratic movements and seasonal variations is clear-cut neither in practice nor in principle. It is not easy, therefore, to monitor the trend of the borrowing requirement from month to month. Nevertheless, there have been recent signs that the underlying financial position of the public sector has ceased to deteriorate; and it seems likely that the borrowing requirement fell below trend during the late autumn months.

More important as a factor tending to restrain the growth of the money stock have, till last month, been the exceptionally large official sales of government stocks. The fall in interest rates abroad, and reduced expectations of inflation at home, created a large demand for gilt-edged in anticipation of a fall in domestic interest rates. Conditions for such sales were therefore especially propitious. Given the continuance of a large borrowing requirement, the authorities will wish to take advantage of opportunities to sell when they occur, in the expectation that periods of heavy sales will be interspersed with periods during which sales will be much less. Thus, there are bound to be fluctuations month by month, and even quarter by quarter, in the rate of monetary growth; and it has appeared reasonable to regard the recent figures in this light.

Nevertheless, large-scale sales of gilt-edged restrain a downward movement of interest rates. In recent circumstances, a fall seemed appropriate on both external and domestic grounds. Externally, the fall in interest rates abroad had created an unusually large differential in favour of sterling. At home, it appeared desirable, particularly at a time of depression in the economy, to allow interest rates to reflect the change in inflationary expectations: this could be of some help to business investment and housing.

The authorities therefore responded to a variety of considerations in judging how keenly to sell stock. In the event, large sales were made till 23rd January, but not thereafter. Nevertheless, both before and after this date, there was a marked easing of interest rates, both at the short and the long end, which continued from the New Year to mid-February.

With US rates appearing to have reached their trough, and in view of the continuing large size of the public sector deficit to be financed, there were plainly limits to how far the fall in interest rates could go. The possibility of further downward movement will depend above all on developmemts pointing to a significant further decline in the pace of inflation.