

## Economic commentary

In the first few months of this year, with which this commentary is mainly concerned, economic activity expanded quite strongly. The main impetus came from a further pronounced shift of resources into the trade balance; and there are good reasons to expect the recent growth in exports to be sustained (page 155). Consumer spending also rose fairly rapidly in the first quarter, but given the impact of the counter-inflation policy on real incomes, any further growth is likely to depend on whether there is a decline in the saving ratio. Last year's heavy run-down of stocks appears to have come to an end in the March quarter, and restocking is likely to be resumed and to provide a stimulus to growth during the rest of this year. Good progress has been made towards reducing inflation, but this remains the country's most critical problem, with domestic inflation still well above that of our main competitors (see the concluding assessment).

In the early part of this year, the monthly figures of the money stock (on both the wider and narrower definitions) showed a faster rise than in previous months, but according to the quarterly figures there was little acceleration in the rate of monetary growth: some of the difficulties of interpreting movements in the various alternative aggregates are outlined on page 164.

### International developments

Towards the end of last year and in the early months of 1976, output in the industrial countries was expanding rapidly. In Europe, most countries had begun to emerge from the recession by last autumn; and in the first quarter of this year output in Japan turned up sharply after several months of little growth.

In several countries the main impetus to output came from a continued expansion in consumer spending. This was partly induced by government measures, but also reflected a revival of confidence as rates of inflation slowed down and unemployment stopped rising or (as in the United States) began to decline. There was also a further rise in government expenditure in some countries. Not surprisingly, there is as yet little evidence of a recovery in investment in plant and machinery, although margins of spare capacity are generally being used up fairly rapidly and there are signs that profits are improving. Housebuilding has also begun to recover in a number of countries. The heavy de-stocking which had depressed output in the first half of 1975 had almost come to an end by the third quarter, thereby adding appreciably to the growth in output. Positive stockbuilding generally appears to have been very small in the fourth quarter, but it turned up sharply in the first in the United States.

The volume of world trade probably expanded by around 5% in the fourth quarter. Exports and imports by the main industrial countries were both much higher than in the previous quarter, but in aggregate there was a small shift of resources into the balance of payments. However, for some individual countries the change in the balance of resources was much more pronounced. Thus in Japan, where domestic demand was declining in the fourth quarter, the improvement in the trade balance more than accounted for the growth in output. In the United Kingdom, a good deal of the recovery in the fourth quarter also came from this source.

In spite of this shift of resources, the aggregate current account balances of these countries as a whole (measured at current prices) worsened in the fourth quarter, because of a deterioration in the terms of trade. The current accounts of Japan and the United Kingdom improved, but those of most other countries worsened significantly. In the first quarter of this year, there was a further deterioration in the

### Industrial production [a]

*Industrial production continued to expand in most industrial countries in the first quarter.*

1970=100: seasonally adjusted

	1975				1976
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr [b]
United States	105	103	107	110	113
Canada	120	120	119	121	123
Japan	106	110	113	113	117
France	114	111	111	114	120
Italy	110	107	106	110	113
Western Germany	103	102	101	105	107
United Kingdom	107	101	101	101	103
Other OECD	117	115	114	119	119
Total OECD	108	106	108	111	113

[a] Excludes construction.

[b] Partly estimated.

### Aggregate current account balances[a]

In the fourth quarter the current account balances of the main industrial countries moved into deficit while oil exporters' surpluses increased.

\$ billions: seasonally adjusted

	1975				1976
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Main industrial countries[b]	+2	+5	+½	-1¼	-2¼
Other industrial countries[c]	-2¾	-3½	-2½	-2¾	..
Oil-exporting countries[d]	+8¾	+5½	+8	+11	..
Other developing countries	-6¼	-10½	-7¾	-8¼	..

.. not available.

[a] Estimates: the columns do not sum to zero, largely because of recording errors 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

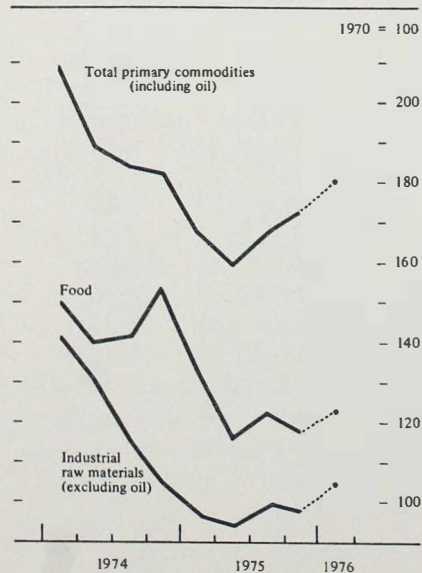
In the first quarter retail prices rose more slowly in North America and Japan, but faster in the main European countries.

Percentage changes on previous period: not seasonally adjusted

	1975				1976	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	1st qtr on a year ago
United States	+1.8	+1.6	+2.1	+1.6	+1.0	+6.4
Canada	+2.1	+2.2	+3.4	+2.1	+1.3	+9.2
Japan	+1.5	+3.4	+0.9	+2.4	+2.1	+9.0
France	+2.7	+2.4	+2.3	+2.1	+2.5	+9.7
Italy	+3.7	+2.7	+1.9	+2.9	+4.2	+12.3
Western Germany	+1.9	+1.8	+0.8	+0.9	+1.8	+5.4
United Kingdom	+6.0	+9.5	+4.3	+3.4	+3.6	+22.5
Weighted average of above	+2.3	+2.6	+2.0	+1.9	+1.8	+8.5

### Terms of trade between commodities and manufactures[a]

Export prices of primary commodities are estimated to have risen faster than those of manufactures in the first quarter.



\*Estimated.

[a] Ratios of export prices of primary products to those of manufactured goods; for 1974 and 1975 the figures are based on the *United Nations Monthly Bulletin of Statistics*.

aggregate current balances of the group, but almost entirely because the United States moved into deficit after being in surplus by \$3 billion in the fourth quarter: US imports, particularly of manufactures, increased sharply while exports of food declined. Most of the other countries showed an improvement, particularly Japan whose current balance changed from a deficit of \$¾ billion to a surplus of over \$1 billion, thanks to a very rapid rise of 15% in exports (in dollar terms).

The main counterpart to the deterioration in the current account balances of the industrial countries in the fourth quarter was a marked increase in the oil exporters' surpluses (see table). The volume of imports by these countries appears to have changed little after rising rapidly during the previous two years. This lack of growth was not confined to those countries with a high capacity to absorb imports, and which were already running into deficit; a number of countries with a low capacity to import and with continuing large trade surpluses imported little more than in the previous quarter, suggesting that physical, as well as financial, constraints on imports may have begun to operate. In the early months of this year the rise in oil revenues was quite small: the effects of the price increases on 1st October were partly offset by a relatively low volume of exports in the fourth quarter, for which payment would be received mainly in the following quarter. Imports are expected to pick up again, but to grow much more slowly than in 1975 as a whole.

The current account deficit of developing countries (other than oil exporters) probably widened in the fourth quarter, and in 1975 as a whole amounted to some \$33 billion — about \$9 billion larger than in 1974. The volume and price of their exports each declined, while the value of imports continued to rise (although falling in volume terms — for the first time since 1958). These countries also had a larger deficit on invisibles, partly because of growing debt service. The fall in the volume of imports last year was concentrated among seventeen countries in this group with the highest *per capita* incomes, and which account for about half of the group's total trade. Nevertheless, the current account deficit of these seventeen countries in 1975 amounted to some \$20 billion, an increase of some \$5 billion over 1974. Some of them were able to borrow from banks in the developed countries (and in off-shore centres) to finance their deficits, and their reserves fell by only \$2½ billion. The deficits of the poorer developing countries were probably largely financed by aid: their reserves were little changed over the year.

Retail prices in the main industrial countries rose more slowly on average in the first quarter of this year than in the previous quarter. This reflected a very small increase in the United States and Canada, where food prices declined (though they are expected to begin rising again later this year). In Europe, retail prices rose much faster in the first quarter. The increase in the United Kingdom was only slightly faster in the first quarter than in the fourth, but remained much higher than in most of the other countries.

Over recent months the prospects of sustained world economic recovery have greatly improved. Consumer spending and stockbuilding have each revived faster than had been generally expected. Real GNP in the United States is now likely to be at least 6½% higher this year than in 1975, with growth in Western Germany and France possibly almost as fast. The volume of world trade may accordingly increase by at least 10% this year. Although the expansion of output may benefit less in 1977 than this year from stockbuilding and public expenditure, growth in both production and trade is likely to be sustained by a revival in fixed investment. There are as yet few signs of such a revival, but an improvement in company profits and cash flow is now under way.

The prospective growth in world activity should be accompanied by firm commodity prices, and the improvement in the terms of trade between commodities (excluding oil) and manufactures, which began in the middle of last year (see chart), is thus likely to be sustained. Indeed,

## Domestic activity

Output has increased in the last two quarters, largely because of a rapid growth in exports.

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

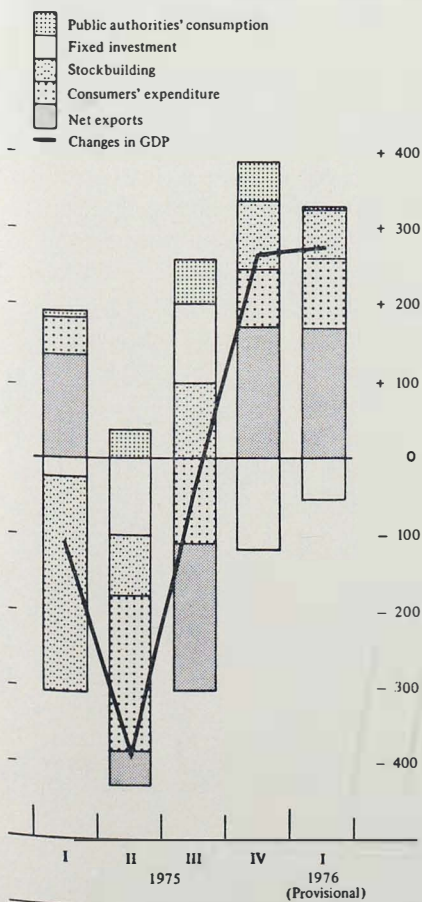
	1975			1976	
	2nd qtr	3rd qtr	4th qtr	1st qtr [a]	3rd qtr 1975 to 1st qtr 1976 [a]
Gross domestic product (output measure)	-2.5	-0.5	+0.7	+1.1	+1.8
of which, industrial production	-4.6	-0.3	+0.3	+1.3	+1.6
Consumers' expenditure	-2.2	-1.2	+0.9	+1.0	+1.9
of which, retail sales	-2.2	-3.1	+0.3	+1.4	+1.7
Exports of goods and services	-3.7	-1.8	+5.0	+2.6	+7.8
Imports of goods and services	-2.6	+3.9	-	-2.2	-2.2

[a] Provisional.

## Factors contributing to changes in GDP

The main stimulus to demand in the six months to March 1976 came from a marked shift of resources into the trade balance.

Seasonally adjusted  
Changes on previous quarter  
1970 £ millions at market prices



the prices of both foodstuffs and industrial materials rose faster than expected in the early months of this year, but in the short term any further rise may be quite modest, because there are substantial stocks of most industrial materials.

## The UK economy

### Output and demand [1]

In the first quarter of 1976 total output increased by just over 1%, making a rise of 1¼% since the third quarter of 1975 when the low point of the recession was reached; but this was so deep that output still remained 2¼% below the peak in the third quarter of 1974. Industrial production rose by 1¼% in the first quarter, and total manufacturing output by rather more. Most of the rise was in intermediate goods, reflecting the much slower rate of de-stocking in recent months. But production of consumer goods also improved: according to the most recent CBI quarterly surveys, the volume of export orders has been rising steadily, and there seem to be good prospects of a sustained export-led recovery in consumer goods. On the other hand, although export orders for capital goods are also reported to be improving, production in this sector remains depressed and is unlikely to revive significantly until the degree of surplus capacity in other industries has been reduced and company profits recover further.

A major stimulus to production in the second half of 1975 came from the marked slowdown in de-stocking, which contributed about 1% to output in that period. However, in the first quarter of 1976 provisional information for manufacturers and distributors (see page 159) suggests that the rate of de-stocking was about the same as in the previous quarter, and the stimulus to output from this source is thus likely to have been very much less than it was in the second half of 1975. But with the recovery in business confidence (foreshadowed by recent CBI surveys), there is likely to be a sustained recovery in stockbuilding throughout the rest of this year.

Although consumers' expenditure increased by about 1% in the first quarter, it was still more than 1½% lower than a year earlier. The latest rise suggests a decline in the saving ratio, because real personal disposable income is estimated to have fallen during the quarter. Assuming that the next stage of incomes policy continues to be strictly observed, any further growth in personal consumption will depend upon a continued decline in saving from its present high rate. Public consumption, which grew rapidly during the second half of 1975, is expected to rise at a progressively slower rate during the current financial year.

Fixed investment, apart from expenditure on the development of North Sea oil and gas resources, has been very depressed and fell a little further in the first quarter. In view of the present degree of spare capacity, investment is unlikely to rise very much until late in the year, by which time the continued growth in most other components of demand should provide a stronger incentive for capital expenditure.

As in the previous quarter, the main stimulus to growth in the first quarter came from another pronounced shift of resources into net exports of goods and services, which contributed about 1½% to output. The recent depreciation of sterling, while adding significantly to import costs, has improved the price-competitiveness of UK goods and the profitability of exports relative to home sales. This, together with the prospective recovery in world trade (see page 154), the present margin of spare capacity in industry and the improving trend of export orders, suggests that the growth of exports now under way is likely to be sustained.

[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, but the growth of unemployment has slowed down markedly.

Seasonally adjusted

	Previous 'low'	1975		1976	Latest
		3rd qtr	4th qtr	1st qtr	
Deviation of industrial output from trend [a] (percentage) (1st qtr 1972)	- 4	- 11	- 11	- 11	- 11 (1st qtr 1976)
Unemployment (thousands) [b] (March 1972)	917	1,000	1,132	1,223	1,250 (May)
Vacancies (thousands) (October 1971)	119	134	114	116	121 (May)
Short-time workers (thousands) [c] (January 1974)	1,137 [d]	130	160	151	133 (March)
Companies reporting below capacity working [e] (percentage) (January 1972)	71	75	73	78	76 (April)

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

[b] Excluding school-leavers and adult students.

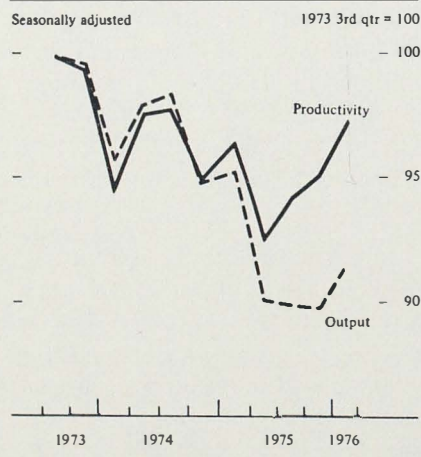
[c] Manufacturing industry in Great Britain only; not seasonally adjusted.

[d] Affected by the energy crisis.

[e] CBI survey, not seasonally adjusted: firms working 'below a satisfactory full rate of operation'.

## Output and productivity in manufacturing industry

In contrast to previous cycles, productivity began to rise six months earlier than output in 1975.



## Wage and salary settlements since July 1975 [a]

Settlements have been within the £6 limit.

	Cash increase (£ per week)	Percentage increase [b]	Numbers covered (thousands)
1975 3rd qtr	4.37	14.0	113
4th ,,	5.90	17.2	1,865
1976 1st qtr	5.81	16.3	1,634
2nd ,, [a]	6.00	13.0	3,175
<b>Weighted average</b>	<b>5.90</b>	<b>15.0</b>	<b>6,787</b>

[a] Confined to settlements up to the end of May, for which reliable published information could be found.

[b] Average of percentage increases for the highest and lowest paid in each wage-bargaining group, weighted by the numbers in each group.

## Capacity and unemployment [1]

Unemployment in the United Kingdom (excluding school-leavers and adult students) rose in April and May after falling in March, but at 1,250,000 was still only 18,000 above February. In recent months unemployment has been somewhat lower than had earlier been expected. After increasing by an average of 46,000 a month over the last nine months of 1975, unemployment rose by only 6,000 in the three months to May. The number of notified vacancies, which fell by an average of 7,000 a month in the fourth quarter of 1975, rose by an average of 4,000 a month in the first quarter before subsequently falling back a little. The numbers on short-time working or temporarily laid off have also fallen steadily so far this year, so that the overall position in the labour market is better now than it was expected to be at the beginning of the year.

The experience of earlier cycles suggested that, after industrial production had levelled out in the second and third quarters of 1975, unemployment would grow much more slowly early in 1976. In the event, the slowdown proved to be even sharper than expected. The reasons for this are not entirely clear, although there is some evidence to suggest that labour-shedding earlier in the cycle may have been more extensive than previously realised. In previous cycles, the turning points in productivity and output in manufacturing have roughly coincided. But in the present cycle, productivity turned up two quarters before the corresponding rise in output (see chart), suggesting that employment may have responded more rapidly than usual to falling output in 1975. This may be one reason why the rise in unemployment slowed down so markedly early this year. Another factor has been the Government's job creation schemes and temporary employment subsidy programmes, introduced last September. The working population is now increasing after a period of decline, so that employment will need to rise correspondingly faster in future in order to bring down the number of registered unemployed.

In spite of the rise in output in the past two quarters, the degree of surplus capacity, as indicated by the deviation of output from trend, has been little changed. This is confirmed by the latest CBI quarterly survey which continues to report a large proportion of companies with surplus capacity. However, this may not be a reliable guide (at least in the short term) to the potential for increasing output as demand recovers: the run-down in stocks throughout 1975 may lead to bottlenecks as demand for raw materials and components grows more rapidly in the next year or so. Also, in the medium term the low volume of fixed investment in recent years, which has increased the average age of the capital stock, may inhibit the underlying growth of productive potential. If so, capacity constraints will emerge earlier than the unemployment figures might suggest, unless existing plant can be used much more effectively and intensively than in the past.

## Costs and prices

The first stage of the Government's incomes policy has proved to be successful: there have been no reported breaches of the policy, and the increase in basic wages and salaries in the settlements for which reliable information could be found has averaged £5.90 per week (or about 15%), i.e. within the £6 limit (see table). However, although the policy itself would have brought about a distinctly slower rise, of about 10½% per annum, in average earnings over the year (because overtime and bonus rates of pay were held constant), in the event they have risen almost as fast as the basic wages covered in the table in the eight months since the introduction of the policy. The difference can be largely explained by the final implementation of the Equal Pay Act (which may have added as much as 1% to average earnings – see first table opposite), by an increase in average hours worked, and by transitional arrangements. The increase in average

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

## Increases in wage rates

*The Equal Pay Act, which had to be fully implemented by the end of 1975, apparently added about 1% to basic wage rates; the increase in wage rates has nevertheless slowed down.*

### Percentage increases

	July 1975 to December 1975	December 1975 to April 1976
Men	6.3	5.4
Women	12.1	5.3
All workers	7.3	5.4

## Retail prices

*Up to April progress had been made towards the Government's target for reducing inflation.*

	July 1975 to April 1976 Percentage increase at annual rate	Percentage weight in retail price index
All items	14.7	100
of which, seasonal food	49.7	5
All except seasonal food	13.4	95
of which, nationalised industries	22.3	8
Other	12.6	87

## Factors contributing to inflation<sup>[a]</sup>

*The moderation in the growth of labour costs has been partly offset by an increase in import and other costs.*

	Average share in total final expendi- ture	Percentage changes at annual rate			
		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 4th qtr 1975
Labour costs	50	+ 8.5	+16.0	+18.1	+ 7.8
Import costs	23	+12.1	+ 3.1	+ 0.6	+ 3.9
Indirect taxes less subsidies	8	- 0.4	- 0.7	+ 1.8	+ 1.7
Other costs <sup>[b]</sup>	19	- 0.1	+ 3.0	+ 4.0	+ 4.7
Total <sup>[c]</sup>	100	+20.6	+21.8	+25.0	+18.7

[a] The value of each component of costs was divided by an index of total final output to derive changes in costs per unit of output. The latter were then weighted according to their share in output in each base period to estimate their contribution to total costs. No lags were used.

[b] A residual category which includes profits net of stock appreciation, income from property, self-employment, and the residual error in the national accounts.

[c] Implicit price index of total final expenditure. Components do not add to totals because each is converted separately to an annual rate.

earnings on a year ago was reduced to 19% in March, compared with a rise of 28% in the twelve months to March 1975.

The slower rate of growth in retail and wholesale prices in the second half of 1975 continued in the early part of this year. Comparing February to April with the previous three months, retail prices rose by about 15% at an annual rate. Although the price of seasonal foods and of services provided by the nationalised industries increased sharply (second table), progress had been made up to April towards achieving the Government's target of reducing the annual rate of inflation to single figures by the end of 1976.

The rise in food prices which might have been expected from the depreciation of sterling has been held back by an increase in payments from the EEC Agricultural Fund. Import and domestic producer prices for certain foodstuffs in the United Kingdom are set in terms of an EEC representative sterling rate of exchange (the 'green pound'), which does not automatically follow the market rate. Because of these payments, food prices may be about 2% (and retail prices ½%) lower than they would otherwise have been.

Following the upturn in world activity, commodity prices (as measured by *The Economist* dollar index) increased by 6½% in the first quarter compared with the fourth, and by the end of May were a further 12½% higher. Because of the depreciation of the pound, the rise in sterling terms was much faster, and by the end of May commodity prices were 23% higher than in the first quarter (and nearly 60% higher than a year earlier). The increase in commodity prices in sterling terms was partly responsible for a rise of 4% in wholesale buying prices in the first quarter.

Wholesale selling prices also rose by 4% in the first quarter, but unit labour costs increased much less than this and profits net of stock appreciation must therefore have recovered further, after increasing by 14% in the previous quarter. With companies generally maintaining historic cost pricing, this improvement (which partly reversed the sharp fall in profits since 1973) was not unexpected in the present phase.

The next stage of the incomes policy (which begins on 1st August) has been agreed with the TUC leaders. Increases in earnings are to be limited to 5%, with a maximum of £4 per week. Those earning less than £50 per week may negotiate an increase of up to £2.50 per week. Assuming that all workers receive their full allowance, the direct impact will be to raise average earnings by at least 4½%. However, after allowing for the effects of the likely increase in overtime working over the year of the policy, and of piece-work payments, the final increase in average earnings will be one or two percentage points higher than 4½%.

The depreciation of sterling, the recent rise in world commodity prices, and the impact of the Budget, all make it unlikely that the monthly rise in retail prices will slow down much more until the growth of earnings moderates further this autumn following the agreement on the second stage of the incomes policy; and it is now clear that the annual rate of inflation will not, as was earlier hoped, be reduced to single figures by the end of the year. Meanwhile, the year on year increase, which by April had fallen to 19%, should continue to decline as the rapid rise in prices in the first half of 1975 ceases to affect the comparison.

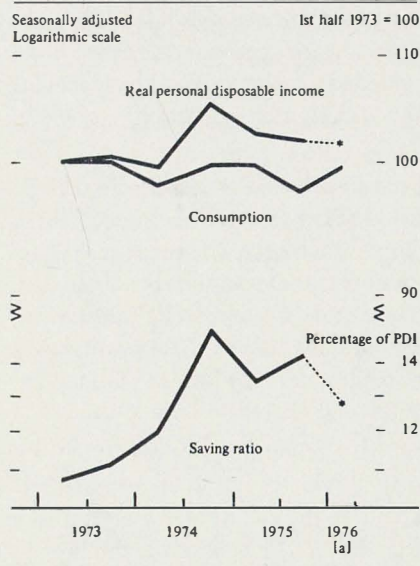
## Personal incomes and spending<sup>[1]</sup>

In the first quarter, average earnings rose by 2¾%. Although employment fell during the quarter, total personal incomes increased slightly more than earnings, partly because of larger current grants from the public sector. However, retail prices rose by 3½%, and with income taxes and national insurance contributions growing faster than nominal incomes, real personal disposable income is estimated to have fallen. At the same

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

## Personal income, consumption and saving

*In the first quarter consumers' expenditure rose while real incomes probably fell: the saving ratio thus declined.*



\*Estimated.

[a] 1976 1st quarter at half-yearly rate.

time, real consumers' expenditure rose slightly, so that the saving ratio at present appears to have declined to under 13% in the first quarter of 1976 (see chart). Nevertheless, the ratio was still very high compared with the average of just over 8% in the 1960s.

The increase in real consumer spending in the first quarter reflected very buoyant January 'sales', a recovery in new car registrations and the easing of hire-purchase restrictions in December. New instalment credit extended rose in the first quarter, but the resulting increase in debt outstanding was almost entirely with retailers — debt outstanding with finance houses was little changed. Bank lending to persons other than for house purchase recovered in April.

The volume of retail sales declined by 1½% in March to below the average of the fourth quarter, perhaps because purchases were delayed in advance of the Budget, but then recovered in April.

The outlook for personal incomes depends crucially on the success of the next stage of the incomes policy. Provided that the policy is strictly observed, personal disposable income will not grow quite as rapidly as prices during 1976 in spite of the conditional tax reliefs announced in the Budget, which are to be granted in full. However, consumer spending could increase if the saving ratio continues to decline.

The links between inflation and personal saving in recent years were discussed in some detail in an article in the March *Bulletin* (page 53). It was concluded that the real value of liquid assets has a significant influence on saving, and that a slowdown in the rate of inflation should eventually reduce the saving ratio. Among a number of other possible explanations, uncertainty about employment prospects may have had an impact on saving (although this could not be tested econometrically because the data are not adequate for the purpose). If this is so, the marked slowdown in the growth of unemployment in recent months might lead to some reduction in precautionary saving. The agreement on the next stage of the incomes policy, and the implementation of the conditional tax cuts, could also have a marked impact on consumers' expectations about inflation and employment, and hence on the volume of spending.

### Housebuilding[1]

There was a further upturn in housebuilding in the first quarter. In the public sector, the number of new houses started was 2% higher than in the previous quarter, but the number of completions fell by 5%. The private sector continued to recover from the exceptionally depressed activity of 1974, with starts and completions each rising by 5%. This was the third successive quarter in which private starts exceeded completions, and the stock of houses under construction has thus increased steadily, though slowly. The Private Enterprise Housing Enquiry, conducted in March, indicated that starts would average about 13,300 a month this year (implying that builders' intentions were unchanged from the previous enquiry in November). But this rate was already exceeded in the first quarter, so the average for the year as a whole is likely to be higher than expected, though it will probably not be higher than in the previous housebuilding recession of 1969–70, when starts averaged more than 13,800 a month.

Although the rise in house prices has recently been modest, builders should have been encouraged by the much slower growth in their costs over the past year and by the continuing prospect of a steady flow of mortgage finance. The cost of labour and materials in the first quarter was about 14% higher than a year earlier, after rising twice as fast during the previous twelve months;[2] and land prices have fallen back to around the average of 1972. In spite of the increase in banks' lending rates in May, interest charges are probably no higher than they were a year earlier, because of the fall in the stock of unsold houses. In recent

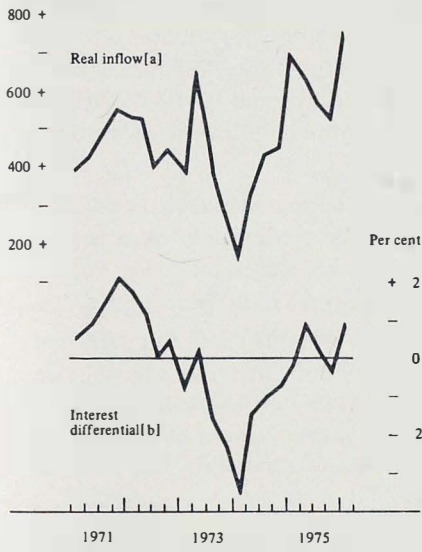
[1] Apart from references to prices and interest rates, this section is in seasonally-adjusted terms.

[2] Nationwide Building Society index of housebuilding costs.

## Building societies' inflow and relative interest rates

*Building society rates became relatively more attractive in the first quarter; net receipts rose sharply.*

£ millions at 1970 prices

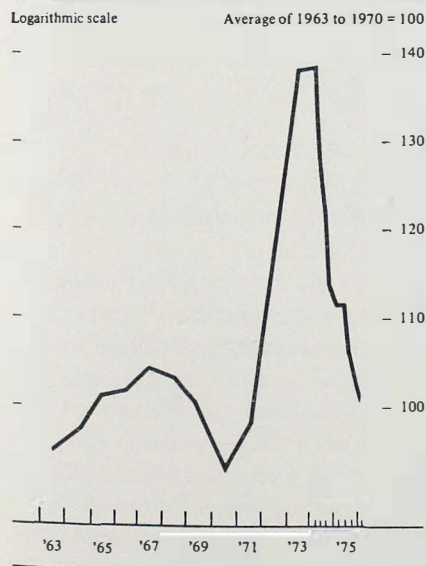


[a] Building societies' net receipts including interest credited (seasonally adjusted), deflated by an index of consumer prices.

[b] Quarterly average of Building Societies Association recommended ordinary share rate (tax-paid) minus the interest rate on 3-month local authority deposits (net of tax at the basic rate).

## Ratio of new house prices to average earnings

*By the beginning of 1976, the ratio had fallen back almost to the average of 1963-70.*



months, sales of new houses have probably continued to keep pace with, if not exceed, the volume of completions, and building society loans and commitments have risen further (both in nominal and real terms), supported by heavy inflows of funds which reached a peak in the first quarter.

These inflows reflected the attraction of interest rates on building society shares and deposits as competing rates generally declined in the first three months of the year. (The chart shows the relationship in recent years between inflows on the one hand and the differential between building society and competing rates on the other, with the latter represented by the rate on three-month local authority deposits.) Thus, net receipts (including interest credited to accounts) rose to a record £575 million in March when the differential was particularly large. This inflow was well above the amount required to finance current lending, and the societies' liquidity ratio rose to a record 22% at the end of that month. After the Budget, the Building Societies Association decided to bring their members' rates more closely into line with other rates by lowering the interest rate recommended for ordinary share accounts from 7% to 6.5% (or from 10.77% to 10% when grossed up at the basic rate of tax). This enabled them also to reduce the recommended mortgage rate from 11% (where it had stood since September 1973) to 10.5%. Although these changes did not take effect until 1st May, net receipts fell back to around £390 million in April, perhaps partly in anticipation of the fall in rates, and also because various other rates began to turn up towards the end of the month after the rise in minimum lending rate on the 23rd. The attraction of building societies' shares and deposits will have been further reduced by the increase in interest rates (including bank deposit rates) which followed the rise in minimum lending rate on 21st May. Nevertheless, although net receipts may have declined further since April, the societies' liquidity ratio is high enough to ensure that, in the months ahead, mortgage lending will remain adequate to support the recovery in housebuilding.

Although demand for housing was quite high in the first quarter, prices again rose only moderately, by 1½%. [1] In the last two years house prices have increased much less than the general rate of inflation; and the ratio of new house prices to average earnings, which rose to a peak at the beginning of 1974, has subsequently fallen back to not much higher than the average in the eight years up to 1970 (see chart).

## Company spending and finance [2]

Gross trading profits of industrial and commercial companies turned up in the fourth quarter, and probably continued to improve in the following three months. As a proportion of gross domestic income, however, profits remain very low (see chart overleaf). Fixed investment (other than on the development of North Sea oil and gas resources) remained depressed by lack of confidence and weak demand. During 1975 as a whole, bank borrowing increased much more slowly than in 1974 while substantial funds were raised on the equity market, so that net liquidity improved.

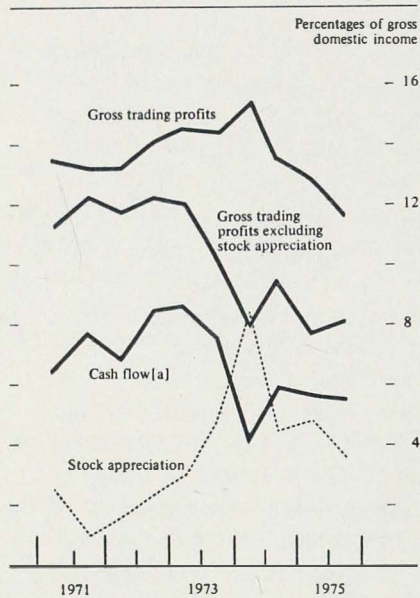
In the fourth quarter, gross trading profits of industrial and commercial companies rose by 11%, and by 14% net of stock appreciation. The slower rate of growth in commodity and other prices meant that stock appreciation in the second half of last year, at £1,800 million, was 18% less than in the first half. In the first quarter, manufacturers are provisionally estimated to have run down their stocks further, but much more slowly – by only £5 million (at 1970 prices): a large fall in stocks of raw materials and fuel was offset by a rise in work in progress and in stocks of finished goods. Any expectations of a further rise in commodity prices following the sharp increase earlier this year

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

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

## Company profits and cash flow

In the second half of 1975, companies' profits continued to fall, but net of stock appreciation they rose slightly.



[a] As defined in footnote to text.

## Main components of public expenditure<sup>[a]</sup>

In 1975/76 public spending grew more slowly than in the previous year, and a further reduction in growth is planned for 1976/77.

	1975/76 <sup>[b]</sup> (£ billions)	Percentage changes		
		1973/74 to 1974/75	1974/75 to 1975/76 <sup>[b]</sup>	1975/76 to 1976/77 <sup>[c]</sup>
Goods and services:				
Current	23.8	31½	30	15
of which:				
Volume		2	4½	
Price		29	24½	
Capital (excluding stocks)	9.0	23½	22½	15½
of which:				
Volume		—	1½	
Price		23½	20½	
Current transfers:				
Subsidies	3.6	83½	2	-11½
Grants	11.5	22	36	22½
Debt interest	4.8	21½	23½	33½
Total (including stocks and capital transfers)	54.4	31	26	16½
of which:				
Volume		6	1	
Price		24	24	

[a] Excluding net lending.

[b] Provisional.

[c] Forecast derived from *Financial Statement and Budget Report, 1976-77*.

could provide a new stimulus to stockbuilding. Distributors' stocks were virtually unchanged during the quarter.

The volume of gross fixed investment by the private sector (apart from expenditure associated with North Sea oil and gas) continued to fall in the first quarter, but at a much slower rate: indeed, manufacturing investment rose by 2% after a similar decline in the previous quarter, but investment by the distributive and service industries fell by 3%. Recent surveys report an improvement in investment intentions among manufacturers, suggesting that the slow recovery in the first quarter could continue. However, a more pronounced upturn will probably not occur until later in the year.

The value of capital spending<sup>[1]</sup> rose a little in the fourth quarter but cash flow<sup>[2]</sup> increased rather more, so that companies' financial deficit narrowed slightly. However, after a surplus of £230 million in the first half of the year, companies had a deficit of £570 million in the second, largely because of increased capital expenditure at current prices (particularly on North Sea oil and gas installations).

Industrial and commercial companies continued to adjust their gearing ratios in the fourth quarter by raising a substantial amount of new equity funds, and in the first quarter they raised a further £200 million by way of rights issues.

Although the worst of the recession is over, and many companies have improved their liquidity and gearing, profitability has declined steadily over a period of years, and was particularly low in 1974 and 1975 (see the March *Bulletin*, page 36). An article on page 193 shows how this fall in profitability has reduced the incentive to invest and created other problems for companies. Profitability will need to improve further before companies will be in a position to embark upon sustained investment programmes: economic recovery and diminishing inflation will help to bring this about, and the Government have announced their intention of reviewing the price code in the light of its effects on investment and employment.

## The public sector<sup>[3]</sup>

Public spending grew rather more slowly in money terms in 1975/76 than in the previous financial year, and slower still in real terms (see table). This was largely because of a much smaller rise in subsidies and a fall in capital transfers.

The increase in real spending on goods and services was broadly in line with the Budget forecast in April 1975. On the other hand, the rise in costs proved to be higher than expected, so that expenditure on goods and services in money terms was about 8% above forecast. Transfer payments were only slightly higher than expected; and within the total, subsidies were well below forecast (in contrast to the previous financial year). In spite of the recession, tax revenues were also unexpectedly high because the rate of inflation had been underpredicted. On the other hand, expenditure was raised partly by the unforeseen depth of the recession, but mainly by the unexpectedly fast rate of inflation; and the public sector borrowing requirement, at £10,800 million, exceeded the Budget forecast by £1,700 million.

This illustrates the need for tighter control over public sector costs, but also the difficulties of forecasting public spending at a time when the rate of inflation is both rapid and variable. The new system of cash limits, set out in a recent White Paper, will introduce an additional element of stability. But the White Paper stated that the Government would need to reassess the position in the light of the prevailing circumstances if the rate of inflation turned out to be very much faster or slower than expected.

[1] Capital spending is defined as expenditure on fixed capital and stocks after deducting stock appreciation.

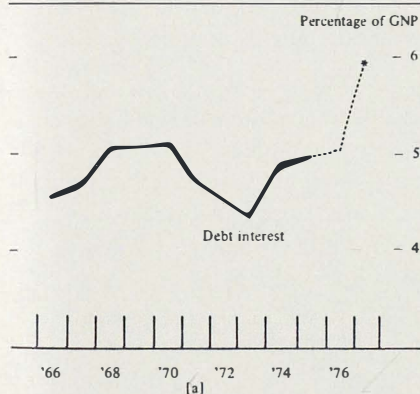
[2] Cash flow is defined as retained profits (including depreciation) plus investment grants and other capital transfers, but excluding stock appreciation.

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



### Debt interest as a percentage of GNP

As a proportion of GNP, public sector debt interest payments were probably little higher in 1975/76 than the average for the previous decade, but are likely to increase sharply in 1976/77.



\*Forecast, with debt interest derived from *Financial Statement and Budget Report 1976-77*.

[a] Financial years ending 31 March.

In spite of the slow growth of real expenditure planned for 1976/77, the public sector financial deficit is expected to rise further as a proportion of GNP; but this is unlikely to be true of the borrowing requirement because of the planned reduction in net lending by the public sector.

The increase in the size of the public sector borrowing requirement, together with the rise in nominal interest rates, has substantially raised the nominal cost of debt service during recent years. But this has been offset by the effects of accelerating inflation: the real value of interest payments on outstanding debt was reduced rapidly, and the real rate of interest on new issues declined. Indeed, the ratio of debt interest to GNP in 1975/76 was probably little higher than the average for the previous decade (see chart). But as inflation slows down, these effects are likely to be reversed, and the real cost of debt service should rise: in the White Paper on public expenditure, debt interest is forecast to increase by 50% (at constant prices) between 1975/76 and 1978/79.

The implications of the above for economic management depend on the extent to which interest receipts are used to finance private spending. The immediate effect on demand for goods and services is almost certainly much less than with other types of public spending, because a large part of the funds is returned to the Government in income tax, and a further sizable proportion is saved. But the longer-term effects are likely to be almost as large as with many other forms of expenditure. In the first place, public sector debt held abroad has risen sharply, and payments abroad must ultimately be matched by additional exports. Secondly, a large proportion of interest payments accrues to financial institutions such as life assurance and pension funds, and will eventually be passed on in the form of higher pensions and benefits. Even though a good deal of the interest paid direct to individuals goes to those in the higher income brackets whose propensity to save is generally above average (in spite of high tax rates), their consumption may eventually respond when they reach retirement age.

### The Budget

The April Budget was introduced against a background which allowed little room for expansionary action even though spare capacity had risen over the previous year. First, the growth in exports and stockbuilding was generally expected to be large enough to generate a fairly strong recovery in output this year; and a fiscal stimulus to demand would be likely to increase the pressure on costs and prices and so put the Government's counter-inflation policy at risk. Secondly, the task of shifting resources into investment and the balance of trade made it necessary to avoid a substantial boost to consumption. Finally, the prospective public sector borrowing requirement was already unprecedentedly high as a proportion of GNP, and further increases could create growing financial pressures, especially as the economy continued to recover.

The unconditional measures introduced in the Budget – i.e. rises in excise taxes offset by reductions in VAT, by increased spending on aid to industry and by short-term employment subsidies – are likely to add little to demand. But the reduction of £900 million in direct taxation – which will be made following acceptance of the TUC General Council's recommendation on pay – will partly offset the effects of continuing wage restraint on consumer demand, and should by itself raise output by about ½% from the first half of 1977 onwards.

The public sector financial deficit is expected to amount to about £10½ billion in 1976/77, in spite of some recovery from the recession. The Chancellor indicated his aim that the growth of the money supply should be consistent with plans for the growth of demand in current prices. If monetary growth began to appear excessive, the Chancellor stated his readiness to take steps (not necessarily of a monetary nature) to redress the situation.

## The balance of payments

### The current account [1]

Helped by an unusually favourable result in March, the current account deficit narrowed appreciably in the first quarter to £60 million, compared with £305 million in the fourth quarter and £570 million in the third.

The volume of exports of goods rose by 3% in the first quarter, and was only slightly below the previous peak reached around the middle of 1974. Sales of chemicals, metals, and metal goods were particularly buoyant. The price of exports (measured by unit values) rose by about 4% in the same period; within the total, prices of machinery, which accounts for over a quarter of UK exports, rose rather faster than this. By value, exports to oil-exporting countries increased by as much as 15% (after growing relatively slowly in the second half of 1975). There was also a large rise in exports to other developing countries and to North America.

Despite a sharp growth in imports of some industrial materials, of cars and of other transport equipment, the volume of total imports fell by nearly 3% in the first quarter, with food, drink and tobacco (which account for nearly one quarter of the total) well below the exceptionally high average for the second half of last year. Imports of fuel were again little changed. Import prices rose by some 3½% in the quarter, with fuel up by twice as much, following the rise in oil prices during the previous quarter. The price of finished goods rose by 4% – rather less than comparable export prices – but foodstuffs and industrial materials increased by only 2% – surprisingly little, considering the the sharp rises in most indices of commodity prices.

The deficit on visible trade in the first quarter was £470 million, about £215 million less than in the previous quarter. The surplus on invisibles increased to £410 million, entirely because of a rise in net receipts from services: there was a larger deficit on transfers, mainly reflecting an increase in aid and in the United Kingdom's net contribution to the EEC Budget; and higher earnings by foreign companies in this country reduced net investment income.

After a large deterioration between 1971 and 1974, the current balance has improved substantially in the last two years. A surplus on trade in goods and services (i.e. excluding transfers and interest, profits and dividends) of some £200 million per quarter in 1971 was rapidly eroded by a sharp expansion of domestic demand followed by a rise in commodity and oil prices, and by 1974 there was an average quarterly deficit of £1,150 million. However, by the first quarter of this year, the deficit on goods and services had been reduced to some £205 million. The United Kingdom's improvement over the last year contrasts with the general experience of the other main industrial countries (see table on page 154).

Part of the improvement in the trade balance since 1974 has come from a reduction in the volume of fuel imports, which in the first quarter of this year was 15% below the average of 1974. This can be largely explained by the recession and by economies in the use of fuel after the steep increases in price. But the contribution of North Sea gas to the United Kingdom's energy needs has also grown in recent years, to the equivalent of some thirty million tons of oil – about 15% of UK energy consumption last year. Some of the increase will have displaced domestic coal production, but some will also have replaced imports of oil or liquefied gas. Fuel imports will be further reduced this year by the continued development of gas resources, combined with the first significant supplies of North Sea oil.

### Current account of the UK balance of payments

*The current balance improved further in the first quarter, with exports rising and imports falling in volume terms.*

£ millions: seasonally adjusted

	1974		1975		1976
	Year	Year	3rd qtr	4th qtr	1st qtr
Exports of goods	15,895	18,770	4,635	5,125	5,440
Imports of goods	21,160	21,970	5,620	5,810	5,910
Visible balance	- 5,265	- 3,200	- 985	- 685	- 470
Net invisibles	+ 1,655	+ 1,500	+ 415	+ 380	+ 410
Current balance	- 3,610	- 1,700	- 570	- 305	- 60
Changes from preceding year/quarter:					
Visible balance	- 2,930	+ 2,065	- 305	+ 300	+ 215
of which:					
Volume [a]	+ 665	+ 870	- 315	+ 330	+ 310
Price	- 3,595	+ 1,195	+ 10	- 30	- 95
Volume of exports [b] (percentage)	+ 6%	- 4	- 2	+ 7	+ 3
Volume of imports [b] (percentage)	+ 1	- 7	+ 4%	- ¼	- 2%

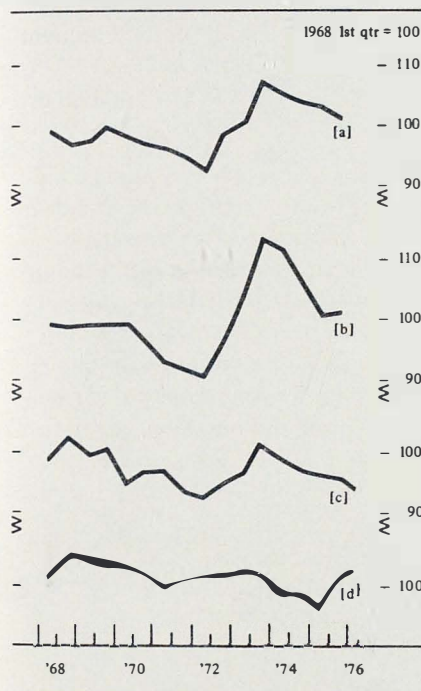
[a] Measured for each period at the prices of the preceding period.

[b] Measured in 1970 prices.

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

## Price ratios relevant to UK export performance

The depreciation of sterling has broadly matched the faster rise in UK prices since 1968.



- [a] Ratio of competitors' export prices of manufactures to those of the United Kingdom; partly estimated.  
 [b] Ratio of competitors' wholesale prices of manufactures to those of the United Kingdom.  
 [c] Finished manufactures: ratio of UK import prices to UK export prices.  
 [d] Manufactures: ratio of UK export prices to UK wholesale prices.

## Financing of the current account deficit

Before seasonal adjustment, the current deficit widened in the first quarter but the reserves rose, largely because of a drawing on the IMF.

£ millions: not seasonally adjusted

	1974		1975		1976
	Year	Year	3rd qtr	4th qtr	1st qtr
Current balance	-3,610	-1,700	-520	-130	-280
Capital transfers	70	-	-	-	-
	-3,680	-1,700	-520	-130	-280
Financed by:					
Increase (+) in sterling holdings of:					
Oil-exporting countries [a]	+2,220	-180	-260	-80	-210
Other	-660	+110	-120	+160	+130
Increase (-) in UK banks' external claims in sterling	-560	-690	-100	-30	-460
Other identified capital flows (net)	+650	-50	+500	-570	+100
Balancing item	+360	+930	+280	+290	+80
Official financing:					
Decrease (+) in reserves	-80	+670	+170	+220	-210
Foreign currency borrowing by:					
Central government	+640	+420	-	-	-
UK public sector under the exchange cover schemes	+1,110	+390	+50	+140	+280
Drawings on the IMF	-	-	-	-	+570

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

Sterling's effective depreciation widened by 5¼% in the first quarter, mostly in March (see page 171), and by a further 8¼% in the following two months. Although domestic price inflation has slowed down considerably since the middle of last year, on most measures the rate of inflation is still above that in other industrial countries. No single indicator provides an ideal measure of competitiveness. But to judge by a comparison of wholesale prices of manufactured goods at home and abroad, and of UK and competitors' export prices of manufactured goods [1] (the most widely used measures), the United Kingdom's price-competitiveness deteriorated last year (see chart – this does not, however, capture much of the effect of sterling's depreciation this year, which probably made good the loss in competitiveness in 1975). On the other hand, the rise in the price of UK exports of manufactures relative to wholesale prices suggests that exporting was becoming more profitable even before the pound's recent sharp depreciation. On a longer view – for example, since devaluation in November 1967 – most measures show that the depreciation of sterling has broadly matched the faster rate of growth in UK prices.

After the very favourable outturn in March, the deficit on visible trade widened to £255 million in April. In volume terms, exports rose by less than 1% but imports were up sharply, by 10½%, after being very low in March: the arrival of an oil rig and very large imports of diamonds (an erratic category) accounted for part of the rise, but the remainder was widely spread. The terms of trade worsened by nearly 1½%, partly because of the continued depreciation of sterling but also because of a general rise in commodity prices.

## Financing the deficit

Before seasonal adjustment, the current account deficit in the first quarter was £285 million. Among identified capital flows, there was a reduction of £80 million in total sterling holdings: oil-exporting countries ran down their balances by £210 million but other holdings increased by £130 million. UK banks' external claims in sterling rose sharply, by £460 million, a large part of which was probably associated with the finance of UK exports. But there was also a rise in UK banks' net external liabilities in foreign currencies, after a large fall in the previous quarter: this partly reflected borrowing by other UK residents to finance investment abroad, and partly a fall in the foreign currency balances of UK residents, particularly oil companies. The 'balance for official financing' [2] amounted to a deficit of some £640 million: a drawing on the IMF oil facility provided over £570 million, and public sector borrowing under the exchange cover schemes a further £280 million; the reserves rose by £210 million.

With sterling under pressure for most of April, the official reserves fell by £570 million during the month. In May, £440 million was drawn on the United Kingdom's first credit tranche with the IMF, and public sector bodies borrowed a further £130 million under the exchange cover schemes; the reserves rose by £320 million.

The Bank announced on 7th June that 'the financial authorities from the Group of Ten countries and Switzerland, together with the Bank for International Settlements, noting that the recent fall in the value of sterling under exchange market pressure had led to disorderly market conditions which carried sterling to an unjustified level, today agreed, in the common interest of the stability and efficient functioning of the international monetary system, to make available to the Bank of England a standby credit in excess of \$5 billion.' The facility is for three months, which could be extended by mutual agreement for a further three months.

[1] This particular measure may, however, be distorted by the inclusion of semi-manufactured goods: these are influenced by commodity prices which may affect UK prices differently from those of other industrial countries.

[2] Previously known as the 'currency flow' – see Table 19 in the statistical annex.

Referring to this announcement, the Chancellor said 'this is a short-term facility made up of \$2 billion from the US authorities and of \$3.3 billion from central banks in other Group of Ten countries and Switzerland, and from the Bank for International Settlements. My hope and expectation is that any drawing on these funds will be only temporary. But if any drawing on them could not otherwise be paid on the due date, Her Majesty's Government would be prepared to seek further drawing from the International Monetary Fund.'

## Monetary developments

The money stock, on both the wider and narrower versions ( $M_3$  and  $M_1$ ), grew at a faster rate in the early months of 1976. During the three 'banking' months to mid-April,  $M_1$  rose by nearly 7% (after seasonal adjustment), following a rise of only 1% in the previous three, while  $M_3$ , which had been little changed in the earlier period, increased by about 3% (see chart). There had been a period of unusually heavy sales of gilt-edged towards the end of 1975 and in January; but this was followed by a period of consolidation, when initially the authorities did not seek to press further sales, and when a number of developments subsequently weakened the gilt-edged market (see page 170).

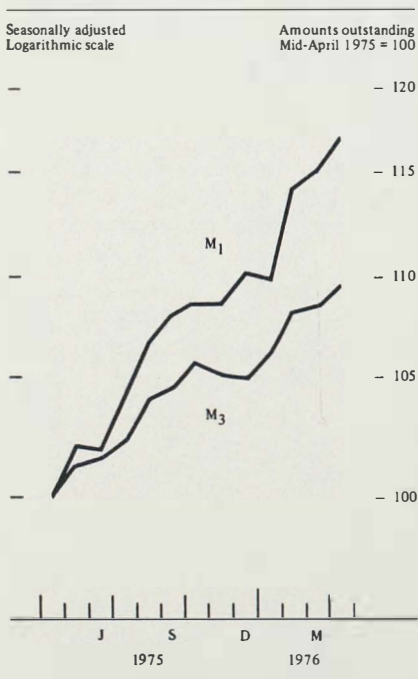
Meanwhile, the central government's borrowing requirement, which had been temporarily lower in the last few months of 1975, increased again in the remainder of the financial year. In contrast to the latest monthly figures, the statistics for the March calendar quarter show a continued slower rate of monetary expansion. During the last financial year as a whole,  $M_1$  rose by 16% and  $M_3$  by 8%, both well below the growth in nominal incomes.

Recent monetary developments indicate some of the difficulties involved in interpreting the movements of the various alternative aggregates. The narrow definition of the money supply ( $M_1$ ) covers those funds, held by the UK private sector, which are immediately available for transfer, whether interest-bearing or not. In the last few months there appears to have been a significant increase in private sector funds placed at call or overnight with the banking system, and the interest-bearing element in  $M_1$  has grown relatively fast, though it remains a small proportion of the total. (Figures of the interest-bearing element are given in the additional notes to Table 11 in the statistical annex.) This fairly rapid growth may indicate that part of the recent rise in  $M_1$  reflected changes in institutional behaviour rather than an increase in demand for transactions balances. On the other hand,  $M_3$  includes all UK residents' deposits with the banking system, whether long or short-term, and in both sterling and foreign currencies. Thus, the money stock can alter simply by a change in the sterling valuation of these foreign currency deposits. The effect of this is usually negligible, but becomes a little more pronounced when exchange rates fluctuate widely: over the last three banking months, changes in valuation raised  $M_3$  by slightly more than half of one per cent.

Furthermore, these concepts are by no means exclusive, although the study of aggregates based on particular categories of bank deposits or other short-term forms of investment is, in practice, limited by the availability of consistent statistics. The pattern of short-term interest rates can vary, and market conditions may encourage companies and persons to switch surplus funds from one form of asset to another without any apparent gain or loss of liquidity or ability to spend. In such circumstances, different measures of the money stock may grow at very different rates, particularly during short periods, and it has yet to be shown that any one measure is inherently a more stable indicator of monetary conditions than any other. But the ability to relate changes in  $M_3$  to the main areas where the authorities can bring their influence to bear, namely, the public sector borrowing requirement, private sector demand for government debt, the growth of bank lending to the private

## Money stock

The monthly figures of the money stock show a faster rise in the first few months of 1976.



## Influences on the money stock (M<sub>3</sub>)[a]

The public sector borrowing requirement was the main expansionary influence on M<sub>3</sub> in 1975/76.

£ millions	Financial years	
	1974/75	1975/76
Public sector borrowing requirement	+7,922	+10,546
Purchases (-) of public sector debt by non-bank private sector	-4,157	- 5,348
Lending to private sector:		
In sterling	+2,542	- 579
In foreign currencies	+ 573	+ 625
DCE[b]	+6,925	+ 5,297
External items	-2,770	- 1,788
Other	- 626	- 402
<b>Money stock (M<sub>3</sub>)</b>	<b>+3,484</b>	<b>+ 3,054</b>

[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.

sector, and the external deficit, makes it convenient to concentrate on M<sub>3</sub>, provided that movements over short periods are treated with caution.

As the table shows, the continuing external deficit meant that domestic credit grew much more than M<sub>3</sub> during 1975/76. Thus, domestic credit increased by about £5,300 million during the year, while M<sub>3</sub> went up by just over £3,000 million. External items, which reduced the growth in the money stock by some £1,800 million, accounted for most of the difference.

Among the domestic counterparts of M<sub>3</sub> (i.e. the components of DCE), the public sector borrowing requirement was the dominant expansionary influence: at around £10,500 million, it was more than three times as large as the increase in the money stock, and about twice the amount of domestic credit expansion. Roughly half of the borrowing requirement was offset by purchases of public sector debt by the UK private sector other than banks (including about £800 million of Treasury bills). Bank lending to the private sector was little changed during the year, implying a substantial fall in real terms.

Looking ahead, the public sector borrowing requirement in 1976/77 will again be very large and is likely to remain the most important potential expansionary influence on the money stock. But if the rate of inflation is seen to be moderating, gilt-edged stocks should be an attractive form of investment, and it may well be possible again to finance a large part of the requirement outside the banking system.

Bank lending to the private sector, which has been very subdued for a long period, can be expected to recover somewhat as corporate expenditures revive. On the other hand, companies' financial position should be improving, with profits rising as demand recovers, and with a large number of new capital issues having taken place. The timing and extent of companies' need for recourse to bank finance is therefore difficult to predict.

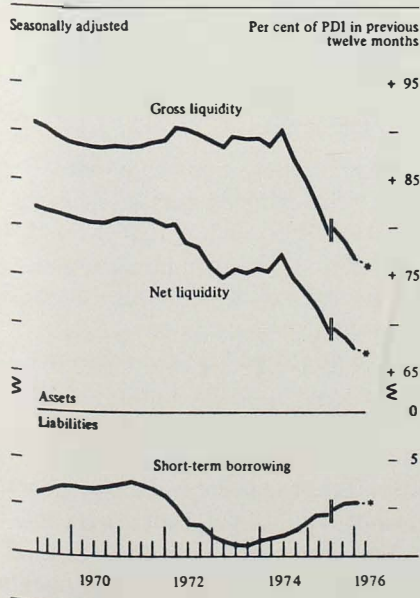
During the March quarter – formerly a period when the Government were seasonally in surplus – the central government had a borrowing requirement (before seasonal adjustment) of some £1,400 million. Purchases of gilt-edged stocks by the private sector were very heavy in early January when interest rates were declining. Subsequently, demand fell away sharply and yields on gilt-edged, which reached a low point for the quarter in February, began to rise gently. Minimum lending rate continued to fall, reaching 9% on 5th March, but then remained steady until 23rd April when, with sterling markedly weak after Easter, it rose to 10½%; the rate rose again to 11½% on 21st May.

With the banks not bidding for funds because of the slack demand for credit, there was a further increase in non-bank holdings of Treasury bills. Finance was also provided by receipts of sterling through the Exchange Equalisation Account, and the Government's need for bank finance was relatively small. The banks' combined reserve ratio remained fairly steady at around 15½%.

During the December and March quarters, the personal sector's holdings of money increased only slightly, no doubt largely because of the greater attractions offered by higher-yielding building society shares and deposits: net receipts by the societies amounted to a record of almost £1,500 million (seasonally adjusted) during the first quarter, much of which was invested in public sector debt. Nevertheless, the ratio of persons' gross liquid assets to personal disposable income continued to fall. With their borrowing from banks increasing (so that, unusually, the personal sector on balance drew funds from the banking sector during the March quarter), persons' net liquid assets again fell sharply as a proportion of personal disposable income (see chart). As discussed in the article on the personal saving ratio in the March *Bulletin* (page 53), this decline in personal liquidity may have contributed to the continued weakness of consumers' expenditure.

## Personal sector liquidity – gross and net [a]

Personal sector liquidity is estimated to have fallen further in the first quarter.



\* Estimated.

[a] The break in the series in the 2nd quarter of 1975 reflects the introduction of new reporting forms by banks (see December 1975 *Bulletin*, page 344).

In contrast, the net liquidity of the company sector continued to recover in the first quarter: demand for credit remained weak while money balances rose a little.

## Assessment

The economy has in several ways developed favourably in recent months. The expansionary trend has been confirmed; unemployment has risen little, though it is still high; and the current account deficit has been unexpectedly small so far this year. Good progress has been made in reducing the rate of price inflation, but it still remains too high. This was one factor underlying the rapid depreciation of sterling from the beginning of March.

Inflation remains the country's major problem. The general support for the current agreement on pay between the Government and the TUC has been an invaluable feature of economic developments since last summer; and the agreement on another year of pay restraint on stricter terms has been a further encouraging step. By the end of this year, the rise in retail prices over the same date twelve months earlier, though likely to be more than the 10% which had earlier been the aim, will be less than half the increase during 1975. The new agreement on pay opens up the prospect that the rate of rise of retail prices can be approximately halved again by the end of 1977, and brought more closely in line with the performance of this country's main competitors.

Looking further ahead, while it is too soon to discuss in detail what policies on pay will be needed in the coming years, it will be important to maintain and consolidate the gains made in controlling inflation, though a broader and more flexible approach may be necessary. The recent agreements between the Government and the TUC have been valuable not only because the size of pay settlements has a major influence on the course of prices, but also because the implications of this influence have been widely accepted. This greater general awareness could prove a permanent gain.

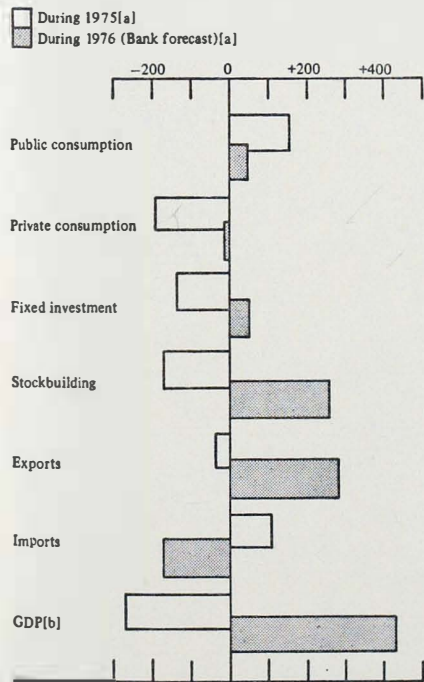
Unless inflation continues to be severely restricted, prospects for employment cannot be assured; and this may have implications for policy in future years which are already discernible. It is likely that the rate of expansion of the economy will have to depend on the degree of success in dealing with inflation; and there may be a case for expressing the rate of expansion to be aimed at in terms not of the increase of real output but of the growth in money national income. Other conditions for future expansion are likely to be favourable but the opportunity cannot be seized unless inflation is contained.

Though the announcement of the new agreement on pay provided some response to the more proximate inflationary dangers, sterling continued to fall in the exchange market. Despite substantial official support, particularly in March and April, and the rise in interest rates, its external value fell by some 15% in the three months up to early June. During the period since the general adoption of floating rates, the exchange rates of most countries have tended to reflect the movement of internal prices relative to those of their competitors. Exact international comparisons of cost and price changes are difficult to draw, and the different bases on which comparisons can be made typically yield different results. But it is clear that the recent depreciation of sterling had gone well beyond the point that could be justified on such grounds. This was fully recognised by financial authorities abroad; and the pound recovered quite strongly after the announcement of the standby credit of over \$5 billion (see page 163), reinforced by the miners' decision to support the next stage of incomes policy.

## Factors contributing to changes in GDP

The main stimulus to output in 1976 is likely to come from exports and stockbuilding.

Seasonally adjusted 1970 £ millions at market prices



[a] Change between fourth quarter and previous fourth quarter.  
[b] Expenditure measure.

Even allowing for some reversal of sterling's earlier depreciation, this country's exports could well remain more competitive than in previous experience. The volume of exports was already expanding rapidly in the early part of this year: the increase between the second half of last year and the first four months of this was, in fact, at an annual rate of nearly 20% — probably fully in line with the growth of world trade over this period, which was abnormally fast. The current account deficit in these same four months was some £600 million at an annual rate — little more than one third of the figure for last year as a whole. The deficit for the rest of the year is likely to be at a higher rate. Given the inexactitude of forecasting, it is hardly useful to put forward precise forecasts of the balance of payments, but the deficit might well be of the same order as last year.

Since the autumn there has been a good start to economic recovery. Largely because of the prospects of a continuing growth of exports, expansion seems likely to continue (see chart) at a rate above the rate of growth of capacity, thus promising a gradual reduction of unemployment. While present Bank forecasts for the next two years suggest that the expansion should proceed at a moderate pace, on previous occasions an economic expansion has often proved to be faster than expected.

The logic underlying the Budget was that the agreement on pay, taken by itself, would bring about a reduction of purchasing power; and the conditional remissions of taxation were designed to offset this erosion of demand. Despite the increase in the public sector borrowing requirement, the Budget and the pay agreement can thus, in combination, be regarded as broadly neutral in their impact on demand.

A forecast of the real economy, if built up from a picture of the income and expenditure of the principal sectors of the economy, provides a view about the prospective financial surpluses and deficits of the different sectors. With a public sector deficit larger than last year, and a balance of payments deficit perhaps little, if any, smaller than in 1975, the surplus of the private sector should be larger even than last year. This appears probable because companies are likely to be able to make some progress towards rebuilding profits from their extremely low level: this would only later be fully reflected in higher investment. If demand were to revive more rapidly than expected, government revenue would probably be more buoyant, and the public sector deficit smaller, than now forecast. If the source of the greater expansion were export demand, the balance of payments deficit would also be less than forecast. If the source were a fall in the rate of personal saving, the private sector surplus would be reduced, but the overseas deficit increased. It is useful to bear these possibilities in mind in watching for signs that demand might begin to revive more rapidly than now seems likely.

Looking further ahead, the public sector deficit should fall as part of the process of economic recovery. But it may turn out that positive steps of a budgetary nature will be needed to keep demand — and, by the same process, the public sector deficit — within the bounds that the economy can accommodate. At the very least, it will be necessary to keep a firm control on government spending so as to leave room for the revival of private demand. The improved control arrangements which have been introduced, and the Government's firmly expressed determination to use them, are therefore to be welcomed. A renewed unplanned rise in government spending, as compared with the agreed programmes, would have unfortunate consequences for the economy in future and for confidence now.

There will continue to be the problem of ensuring that the public sector borrowing requirement is financed in a way which does not involve excessive monetary expansion. The private sector is now running a financial surplus of unprecedented size, and it is probable

that this will continue for a time; thus, the public's desire to acquire financial assets is, and will remain, large. This does not mean — as fluctuations in sales of gilt-edged and in the rate of monetary expansion show — that the demand for government debt must also be large. Granted, however, that there continue to be good prospects that the rate of inflation can be progressively reduced, government debt should become more attractive and continuing large sales of gilt-edged should be possible. Policy must continue strictly to restrain the expansion of the money supply in relation to the growth of money national income.