Economic commentary

Expansion continued in the second quarter, but possibly at a somewhat slower pace: the true rate of growth is, however, difficult to assess (page 289). The adjustment of stocks no longer provided, as earlier in the expansion, a strong stimulus to growth.

Though world industrial activity now seems to have slowed down to a more sustainable pace, the volume of world trade is still likely to rise strongly this year and next. In spite of a recent set-back, the prospects for UK exports thus remain favourable (page 295), and an upturn in productive investment throughout 1977 now seems more likely with signs of greater business confidence and some improvement – although from a low base – in profitability.

Inflation is still well above the rate in most other industrial countries and the year-on-year rise in retail prices is unlikely to be reduced to single figures by the end of the year. The current deficit on the balance of payments widened sharply in the second quarter; and there was heavy downward pressure on sterling (discussed in an article on page 308). This was the background (described more fully in the concluding assessment) to the Chancellor's July measures.

The money stock has increased at a faster rate in recent months, partly because of a sharp rise in bank lending to the private sector (page 296). In his July statement, the Chancellor referred to the future growth of the money supply in quantitative, as opposed to qualitative, terms (see the analysis of monetary developments and the assessment).

International developments[1]

When the recovery in the industrial countries began last year, expansion was initially almost as fast as in the previous upturn in 1972. But in the second quarter of this year, industrial production in some of the larger countries rose more slowly than before (see table); GNP in the United States increased (on provisional figures) at an annual rate of just under 4½% – only half as fast as in the previous quarter, when there had been a massive turn-round in stockbuilding.

Industrial production[a]

In the second quarter, industrial production increased more slowly in some of the main manufacturing countries.

1970 = 100: *seasonally adjusted*

	1975				1976	
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr[b]
United States	105	106	112	114	118	120
Canada	120	120	119	121	124	127
Japan	106	110	113	113	119	125
France	113	113	112	117	122	122
Italy	110	107	106	111	115	120
Western Germany	104	103	103	107	110	112
United Kingdom	107	101	100	102	103	104
Other OECD	117	115	114	119	118	118
Total OECD	108	108	110	113	116	119

[a] Excludes construction.
[b] Partly estimated.

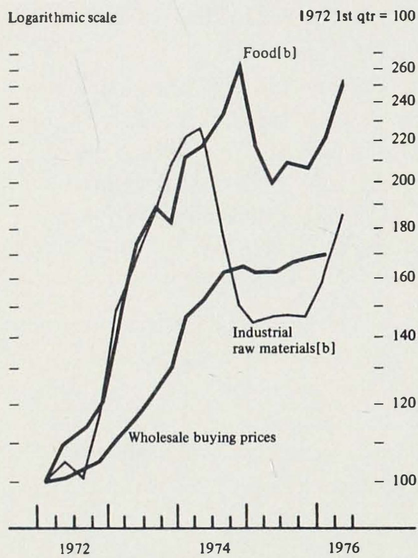
In its earlier stages, the recovery in output owed a good deal to the turn-round in stockbuilding. But in a number of countries, the adjustment of stocks now appears to have been largely completed, and the future course of output is likely to be stimulated primarily by other components of demand. Of these, private consumption has increased only slowly in recent quarters; and although it rose rather faster in the first quarter (particularly in Japan and the United States), the rate of growth appears to have slowed down again since. Private investment, however, has begun to improve in most countries, profits are rising, and a strong and sustained increase in capital spending is expected next year. Government spending has continued to rise in a number of countries, but this partly reflects a series of measures which were adopted last year to counteract the recession and which should now be having much less effect. All in all, GNP in the main industrial countries may well rise by around 5½% in the twelve months to the middle of next year – rather slower than the pace of recovery so far.

After a very sharp increase in the second half of last year, the volume of exports by the main industrial countries rose a little more slowly in the first quarter, with all the rise accounted for by trade among themselves: deliveries to oil exporters and to other developing countries continued to fall. In the same period, the volume of imports by the industrial countries rose at much the same rate as in the previous six

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

Commodity prices and wholesale buying prices in the main industrial countries[a]

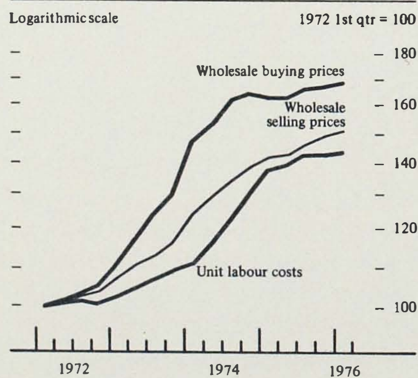
After the recent sharp increases in commodity prices, industry's buying prices should begin to rise more strongly later this year.



[a] Averages of prices, weighted by GNP, and expressed in national currencies.
[b] Based, with permission, on *The Economist* dollar index (excluding oil), but converted into national currencies, weighted by GNP.

Costs and prices in the main industrial countries[a]

Labour costs are now rising quite slowly; this should help to moderate future increases in wholesale selling prices.



[a] Averages of costs and prices, weighted by GNP.

months, and for the group as a whole there was probably a small switch of resources out of the trade balance with the rest of the world. Imports of oil declined during the quarter, but no doubt temporarily. Industrial countries' import prices and terms of trade were virtually unchanged, in spite of the rapid increase in commodity prices since the beginning of the year. But the impact of this rise seems bound to come through later this year, when the terms of trade must be expected to deteriorate.

Commodity prices are likely to rise rather more slowly in the second half of this year than in the first, when the increase was at least as fast as in the previous upturn in 1972 (see chart). The sharp rise in the price of metals and some tropical foodstuffs earlier this year has, in fact, already moderated. Although drought has badly affected the grain harvest in Western Europe, both the United States and the Soviet Union are expected to have good harvests.

The recent upturn in commodity prices will raise industrial costs later this year. But the effect on final prices (particularly consumer prices) should be moderated by a much slower rise in unit labour costs – the major element in total costs. Negotiated wage increases have been relatively moderate, either because unemployment was higher or because incomes policies were in force; and the present upswing has led to a fast rise in productivity which, in some countries, has already improved more than in the whole of the previous upturn. As a result, unit labour costs in the main industrial countries have now almost stopped rising (see chart below).

The recovery in the industrial countries is now beginning to benefit the non-oil developing countries, whose exports increased in the first quarter, both in price and volume. Much of the rise will have been in commodities, but exports of manufactures are also likely to have increased. Manufacturing industries have grown very rapidly in these countries in recent years, and their products now account for about one third of total exports. On the other hand, imports by the developing countries continued to fall in the first quarter (both in volume and value), probably reflecting the restrictive measures they took last year, when they were in very heavy deficit on current account. In 1976 as a whole, these countries are expected to import more, but with exports still growing and the terms of trade moving in their favour, their aggregate current account deficit should be smaller.

The growth of demand in the industrial countries has led to an increase in oil production and hence in the current account surplus of oil-exporting countries. In the first quarter their aggregate surplus, at $10 billion, was slightly less than in the previous three months, but was still well above the quarterly average for 1975 ($8 billion). In 1976 as a whole, their current account surplus may amount to some $35 billion.

Within this group, most of the rise in oil output in the first quarter was by Saudi Arabia, which has a relatively low capacity to absorb imports. Countries with a high capacity to absorb imports have increased their oil exports only slightly during the recovery in world industrial production, although their revenues benefited from the increase in oil prices towards the end of last year. These countries continued to cut back their imports in the first quarter, but they have also found it necessary to borrow heavily in international capital markets, and arranged nearly $2 billion of medium-term credits during the first half of 1976 (almost as much as in the whole of 1975).

The rate of growth in world industrial activity is now slowing down to a more sustainable pace, after the rapid expansion stimulated largely by the turn-round in stockbuilding. The slowdown partly reflects the priority now being given to cautious demand management policies designed to avoid renewed price inflation at a time when, in many countries, prices are already rising fast. Nevertheless, the volume of

world trade is likely to rise by around 12%–14% this year and by not much less next year, so the prospects for countries aiming at export-led expansion remain favourable. At the same time, a steadier rate of growth should moderate the rise in commodity prices and hence the expected deterioration in the terms of trade of industrial countries.

The UK economy

Output and demand[1]

In the second quarter, provisional estimates suggest that total output continued to rise. Quarterly changes in the output and expenditure-based measures of GDP have varied widely since the recovery began (see table), and the true rate of expansion is therefore difficult to assess. However, the timing differences which cause these variations tend to cancel out over a longer period. Thus, in the December and March quarters the expenditure measure of GDP rose much faster than the output figure, but in the second quarter it appears to have fallen steeply while the output measure rose. Over the nine months to the second quarter of this year (i.e. since the low point of the recession), the average measure of GDP probably rose by about 5% at an annual rate; but this rate of growth was unlikely to be sustained even if the drought – which could adversely affect industrial production – had not occurred.

Domestic activity

The output and expenditure measures of GDP have varied widely since the recovery began.

Percentage changes on previous quarter at constant prices: *seasonally adjusted*

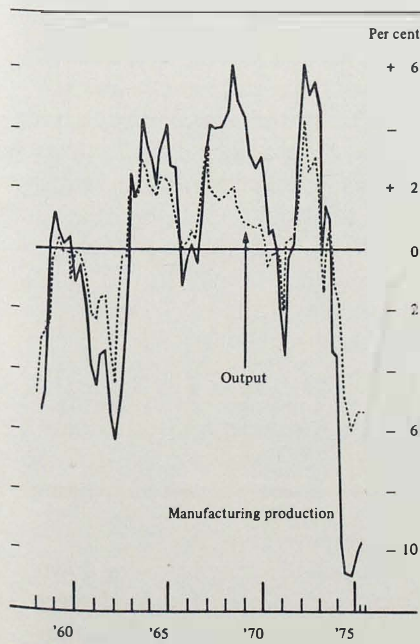
	1975 1st qtr	1975 2nd qtr	1975 3rd qtr	1975 4th qtr	1976 1st qtr	1976 2nd qtr (provisional)
Gross domestic product (output measure)	+0·2	–2·5	–0·6	+0·7	+1·0	+ 0·7
Industrial production	–0·4	–4·6	–0·5	+1·2	+0·9	+ 0·7
of which: Manufacturing production	*+0·2*	*–5·7*	*–0·5*	*+0·6*	*+1·6*	*+ 1·0*
Gross domestic product (expenditure measure)[a]	–	–2·8	–0·5	+2·5	+3·3	– 2·7
Consumers' expenditure	+0·5	–2·2	–1·2	+0·9	+1·2	– 0·9
of which: Retail sales	*–*	*–2·2*	*–3·1*	*+0·3*	*+1·4*	*– 0·6*
Exports of goods and services	–0·1	–3·9	–1·7	+4·6	+3·1	+ 4·2[b]
Imports of goods and services	–4·1	–2·5	+3·9	–0·6	–2·2	+10·6[b]

[a] Bank estimates, incorporating the latest provisional figures of stockbuilding by private industry.
[b] Goods only.

After rising by 1% in the first quarter, industrial production increased by a further ¾% in the second, in spite of a sharp decline recorded in June, when a change in the pattern of holidays had probably not been fully allowed for in the seasonal adjustment. In the same period, manufacturing output rose rather faster; but the recession was so deep that total output is still over 5% below trend and manufacturing output more than 9% below (see chart).

Deviation from trend of total output and manufacturing production[a]

In spite of the recent recovery, output remains well below trend and manufacturing production even more so.



[a] Percentage deviation from the exponential trends calculated over the period 1959 to 1975.

So far, all the main components of demand except fixed investment have contributed to the recovery, although the pattern has varied somewhat from quarter to quarter. Thus, the main stimulus in the December and March quarters came from a marked shift of resources into the balance of trade in goods and services, which contributed more than 3% to output during this period. The volume of exports continued to expand rapidly in the second quarter, but imports rose even faster. A further strong increase in the volume of exports seems likely in spite of the fall in June and July (see page 295); but after the sharp upturn in the second quarter, the rise in imports may slacken to a rate more closely in line with the prospective growth in total final expenditure. From now on, therefore, the shift of resources into the trade balance should be resumed.

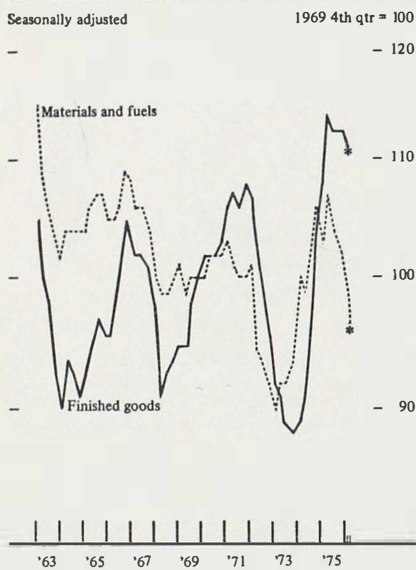
Consumers' expenditure fell by nearly 1% in the second quarter, after rising by 2% in the previous six months. The recent reductions in income tax – six months of tax relief will be paid in the third quarter – should boost spending, but real incomes are likely to continue to decline slowly during the second stage of pay restraint. Over the next twelve months, the course of consumers' expenditure will thus depend heavily on the behaviour of personal saving. The Bank's forecast suggests that the rate of personal saving will fall, but not sharply enough to prevent a small decline in consumer spending during 1977.

After running down stocks for four successive quarters, some sectors restocked on a modest scale in the first quarter. In the second quarter, however, manufacturers and distributors are provisionally estimated to have run down stocks heavily again (see page 293). Although the ratio of total stocks to output is generally still high, stocks of raw materials are at present quite low in relation to output (see chart overleaf).

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

Ratio of manufacturers' stocks to production

In contrast to finished goods, stocks of raw materials are at present quite low in relation to output.



*1976 2nd quarter, based on provisional figures.

Imports of industrial materials, though probably not of finished goods, are therefore likely to go on rising quite fast. The costs of holding such materials are considerable, but there could be some extra buying in anticipation of a further rise in commodity prices during the coming year (see page 288). On balance, stock rebuilding should add to demand over the next year.

Of the remaining components of demand, private fixed investment has been depressed for eighteen months. However, manufacturing investment should recover slowly in the second half of this year, and more rapidly next, according to the Department of Industry's latest investment intentions survey in June and the more recent CBI survey. In contrast, capital spending by nationalised industries, which rose in the first half of the year, is now expected to decline. Investment in dwellings also rose a little in the first half of this year, in both the public and private sectors. Local authorities' housing expenditure is expected to decline from now on, but should still be higher in 1976 as a whole than in 1975. Private sector housing investment may continue to rise before falling back a little in the course of 1977. Although the building societies' net receipts have declined since May, their present high liquidity ratio should ensure that lending will remain adequate to support the prospective growth in housebuilding during the remainder of this year.

Current expenditure by the public sector on goods and services has been growing much less rapidly recently – in the first quarter it appears to have been little changed – and now that recovery is under way, there will be little scope for any further increase if the Government's aim of sustained growth based on higher exports and investment is to be achieved.

Capacity and unemployment

After seasonal adjustment, unemployment in the United Kingdom (excluding school-leavers and adult students) rose by 15,000 in August to 1,309,000. This increase is probably more in line with the underlying trend of recent months than the sharp rise of over 38,000 in July – the largest monthly increase since December 1975. Earlier in the year, unemployment had risen much more slowly than might have been expected from previous experience. On this occasion the Government had, of course, taken special steps to protect or create employment.

Unfilled vacancies rose quite sharply in August, and the numbers on short-time working or temporarily laid off continued to fall. So recent indicators of the labour market are somewhat contradictory and, together with some uncertainty about the underlying course of output and demand in recent months (see page 289), make it difficult to assess when unemployment may begin to decline. A number of factors suggest that a marked fall in unemployment is unlikely: the Employment Protection Act, while acting as a constraint on dismissals, also appears at present to be discouraging firms from hiring labour; the cuts in public expenditure and public sector employment, which should release labour for manufacturing industry in the medium term, may also produce short-term transitional problems; and the July measures will slow down a recovery in the labour market next year. Also, demographic factors are expected to increase the population of working age by 100,000–150,000 a year for the rest of the decade, after several years of relative stability.

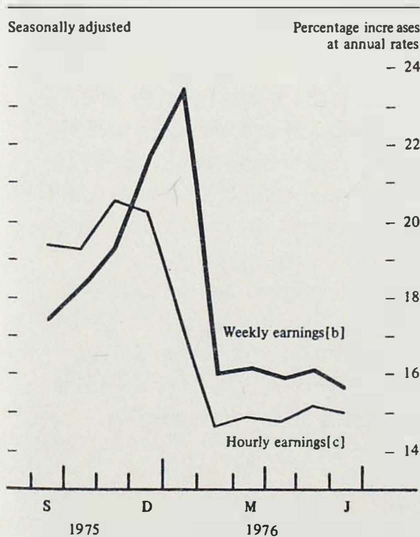
Nevertheless, unemployment fell rapidly after the recession in 1971–72 as confidence and demand recovered, even though it was widely believed beforehand that a once-for-all shake-out of labour had taken place. Also, much of the increase in unemployment during 1975 occurred in the manufacturing sector: the prospective rise in exports and in manufacturing investment should re-create employment opportunities there.

In spite of the rise in industrial production since the third quarter of last year, the latest CBI survey shows that 72% of firms are still operating below full capacity. Although an improvement on the January survey, this is no better than in January 1972 – the low point of the previous recession. When introducing the July measures, the Chancellor forecast that manufacturing production would rise at an annual rate of 8½% over the eighteen months from the first half of 1976; even so, it would still be not much higher at the end of 1977 than four years earlier, and would remain well below trend. Industrial capacity in most sectors is thus likely to remain more than adequate over the next eighteen months or so.

Nevertheless, in previous phases of recovery bottlenecks have often tended to develop in key sectors of the economy, inducing a rapid increase in imports. Shortages of steel and aluminium strip, some electrical engineering products and skilled labour have, in fact, already been reported in the present upturn, though on a very limited scale. The July measures were designed partly to counter such developments in a period when the expansion of exports and the prospective recovery of fixed investment are expected to make heavy demands on industry.

Cumulative increase in average weekly and hourly earnings in manufacturing industry[a]

Hourly earnings have risen by 15% at an annual rate since the first stage of the present incomes policy was introduced.



[a] Percentage increases since July/August 1975 in two-month moving averages, expressed at annual rates.

[b] Index of average earnings.

[c] Index of average earnings divided by index of average weekly hours per operative.

Costs and prices

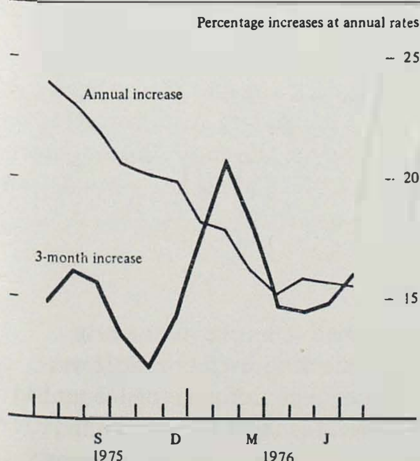
The second stage of the current incomes policy began on 1st August (for details, see June *Bulletin* page 157). In the first stage, the growth of hourly earnings in manufacturing industry appeared to stabilise at an annual rate of 14%–15% midway through the year of the policy (see chart). The £6 increase, together with the final implementation of the Equal Pay Act, should have added just under 12% to average hourly earnings in manufacturing industry. This leaves a margin of 2%–3% to be explained by certain long-term settlements (mostly tied to the retail price index) which were allowed under the policy, by a rise in piecework payments as production expanded and also, perhaps, by changes in the composition of the work force. The policy appears to have been well observed, and hourly earnings have been rising only about half as fast as they were before the policy was introduced.

With an increase in overtime and a reduction in short-time working, average weekly earnings rose at an annual rate of just under 16% in the ten months covered by the chart – about 1% faster than hourly earnings.

The rise in unit labour costs has also been moderated by the cyclical improvement in productivity. In the nine months from the third quarter of 1975, unit labour costs in manufacturing industry rose by only 5%, compared with 31% during the previous year. The rate of price inflation would therefore have tended to slow down further towards the end of this year, but for the rise in commodity prices and the depreciation of sterling (which partly reflected the earlier sharp rise in unit costs relative to those abroad). For these two reasons, the price of materials bought by manufacturing industry went up by 10% in the second quarter, to 30% above a year earlier. Over the first year of the incomes policy, wholesale selling prices rose by just over 14½%, and by a little more if food, drink and tobacco are excluded (see chart): apart from seasonal fluctuations, the rate of increase was fairly steady during the year. In the same period, retail prices rose by 13%, of which nearly two percentage points were accounted for by a reduction in subsidies to the nationalised industries and an increase in indirect taxes. In the three months to July, retail prices rose by only 2% – rather less than during the previous three months – largely because of a fall (of over 20%) in seasonal food prices which were not at that time significantly affected by the drought. Excluding seasonal foods, the index rose by 3%.

Increase in wholesale prices[a]

Apart from seasonal fluctuations, wholesale prices have risen steadily during the year to July, at around 15%.



[a] Index of the products of manufacturing industries other than food, drink and tobacco.

The much slower rise in retail prices in the latter half of 1975 makes it most unlikely that the year-on-year increase will be reduced to single figures by the end of this year. Progress will also be delayed by the

drought, although its overall effect is unlikely to be large. The US grain harvest is expected to be more than adequate to meet world requirements this year, and heavy buying in Europe may do no more than prevent prices from actually declining. Fruit and vegetable prices, however, are likely to rise steeply – anticipatory stockpiling has already been reported – but these have a small weight (4%) in the retail price index.

Looking further ahead, the containment of inflation will depend heavily on future trends in productivity and on the degree of adherence to the second stage of incomes policy. But stronger demand should enable allowable cost increases – including the rise in employers' national insurance contributions next April – to be more easily passed on to consumers, though the effects on the retail price index will be spread over a considerable period.

The second stage of the incomes policy is expected to add an average of about 4½% to wages and salaries, but after allowing for the likely increase in overtime, for piecework payments and for changes in the distribution of the work force as recovery proceeds, the rise may turn out to be about 7%–8% over the full year. This would represent a halving of wage inflation for the second successive year.

Personal incomes and spending[1]

The continued recovery in output during the second quarter was accompanied by an increase in hours worked, and average weekly earnings rose by 2½%: total personal incomes increased at about the same rate. However, retail prices rose by around 3½% between the first and second quarters and, with income tax and national insurance contributions rising faster than nominal incomes, real personal disposable income again declined. But consumers did not react by saving significantly less or by drawing on their savings: although new instalment credit and debt outstanding (mainly for cars and other vehicles) rose during the quarter, the volume of consumer spending as a whole fell by nearly 1%, implying that the saving ratio may have been little changed, at around 13%.

Retail sales had been depressed in May and June, but rose by 2% in July. Consumer spending as a whole probably recovered somewhat in the present quarter, because of the back-payment of conditional tax reliefs announced in April (which, together with monthly tax relief paid in the third quarter, will add more than 1½% to disposable income). There is normally a delay before spending adjusts fully to changes in income, so that the saving ratio is also likely to have risen during the quarter.

However, there is little prospect of a sustained revival in consumer spending, even though the saving ratio may subsequently decline slowly. Provided that the second stage of the incomes policy is strictly observed, disposable income is likely to rise more slowly than retail prices up to the middle of next year, even when allowance is made for increased overtime and piecework payments, and for the benefit to personal incomes from the tax reliefs in the Budget. Also, borrowing to finance consumption will be restricted by the Governor's recent request to banks to maintain existing restraints on lending for this purpose (see page 307).

Company spending and finance[1]

Companies' gross trading profits continued to recover in the first quarter, rising by 12% or by 7% net of stock appreciation. With other incomes rising more slowly, the share of gross profits in total domestic income also increased, but was still lower than a year ago, even though profits (both including and excluding stock appreciation) rose by as

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

Company sector profits

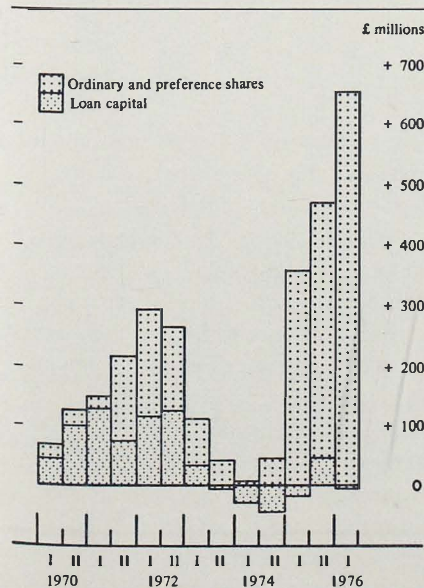
Although profits have increased recently, the share of gross trading profits in total domestic income in the first quarter was still smaller than a year earlier.

£ millions: *seasonally adjusted*

	1974	1975				1976
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Gross trading profits	2,490	2,465	2,315	2,245	2,485	2,785
less Stock appreciation	955	1,245	960	880	905	1,095
'Net trading profits'	1,535	1,220	1,355	1,365	1,580	1,690
Gross trading profits as a percentage of total domestic income	11·6	10·9	10·0	9·2	9·8	10·6
'Net trading profits' as a percentage of total domestic income *less* stock appreciation	7·6	5·8	6·2	5·9	6·5	6·8

Net capital issues by listed industrial and commercial companies[a]

In the first half of 1976 capital issues were even larger than in the previous six months.



[a] Excluding a rights issue of £214 million by British Leyland Limited in October 1975, nearly all of which was taken up by the Government.

much as 24% between the third quarter of 1975 and the first quarter of this year (see table).

With the increase in profits, industrial and commercial companies' cash flow[1] improved by around £400 million to £1,730 million in the first quarter. However, part of this improvement stemmed from a change in the seasonal pattern of tax payments: the rules governing late payment of company taxation were tightened in the April 1975 Budget, and many payments were accordingly brought forward from February to December. This effect can be smoothed out by taking the December and March quarters together, when cash flow was £560 million higher than in the previous six months, and the financial deficit was almost eliminated.

But the improvement in companies' financial position was small in relation to the accumulated deficit of some £3½ billion during 1974 and 1975; and it owed a good deal to the run-down in stocks and low capital investment. In the second quarter, the volume of private fixed investment (excluding shipping) is provisionally estimated to have risen by about 2%: manufacturing investment was unchanged but investment by the distributive and service industries rose by 3½%, after a similar decline in the previous quarter. The Department of Industry's investment intentions survey in June suggests little further recovery in investment in the distributive and service industries, even in 1977, but the volume of manufacturing investment is forecast to rise by 15% next year. The CBI also expect a sharp recovery in manufacturing investment.

After rebuilding stocks in the first quarter by £66 million (at 1970 prices), private industry appears on provisional figures to have reduced stocks considerably in the second – distributors by £80 million and manufacturers by £118 million (making a reduction of nearly £500 million in manufacturers' stocks since early in 1975). The rise in bank lending to companies in the second quarter thus appears to owe little, if anything, to a higher volume of stockbuilding or fixed investment.

Capital issues by industrial and commercial companies were even larger in the first six months of the year than in each of the two previous half-years (see chart), amounting to over £1,000 million[2] during the twelve months to June 1976, of which about two thirds was by manufacturing companies. However, equity issues are beginning to tail off, with the queue of prospective borrowers now much shorter. The market for loan capital remains dull, no doubt largely reflecting the riskiness to borrowers of long-term fixed-interest debt at a time of high interest rates and uncertainties about prospective rates of inflation (see June *Bulletin*, page 193).

The public sector

Total public spending (excluding debt interest) is planned to increase by less than ½% in real terms in the current financial year. A further rise is projected in current grants to persons, but with investment expected to decline, direct spending on goods and services should fall by ½%. It is not yet possible to assess how the actual course of spending so far this year compares with the forecasts in the White Paper on public expenditure published in February and in the *Financial Statement and Budget Report* published in April. All the unforeseen items of central government spending – e.g. on further schemes to create employment – have been accommodated within the contingency reserve, which amounts to about 1½% of total planned expenditure. The Government have strengthened the controls over public spending through the introduction of cash limits, better monitoring procedures, and the need to obtain specific Cabinet authority for all spending from the contingency reserve. However, local authority spending plans are now thought to be higher than was agreed during the last rate support

[1] Cash flow is defined as undistributed income before providing for depreciation, plus net capital transfers, less stock appreciation.

[2] Excludes a rights issue by British Leyland Limited (see footnote to chart).

grant negotiations; following the Layfield Report on local government finance, the arrangements for the control of local authority spending are now under review.

As regards the public sector borrowing requirement, the evidence so far suggests that it will fall short of the Budget forecast. The main component – the central government borrowing requirement – amounted to £1,700 million (seasonally adjusted) in the first quarter of the financial year, well below the average quarterly rate implied in the Budget forecast of £10,425 million for the year as a whole. However, this was partly because income tax receipts had yet to be reduced by the implementation of the tax reliefs, and partly because public sector bodies borrowed less than expected from the central government. All the same, the improved trading profits of some of the nationalised industries should reduce their need for government finance; and on the spending side, the outlook for public sector costs has been improved not only by the new system of cash control, but also by the incomes policy. The official forecast of the public sector borrowing requirement was accordingly revised downwards in July from an estimated £12,000 million last April to about £11,500 million. This would be equivalent to around 9% of GDP at market prices, compared with 10% last year.

The public sector borrowing requirement might have fallen further to around £10,500 million in 1977/78. However, there appeared to be a risk that the claims of the public sector would impose a strain on productive capacity as well as pre-empting savings which private industry will require to finance investment and stockbuilding; and a borrowing requirement of this size would make it harder to prevent an excessive growth in the money supply. For these reasons, together with the need to maintain confidence at home and abroad, the Chancellor announced additional measures in July, designed to reduce the forecast public sector borrowing requirement for 1977/78 to £9,000 million, or about 6% of GDP at market prices. Spending is to be cut by about £1,000 million, of which two fifths will be accounted for by a reduction in gross fixed investment. Total expenditure (excluding debt interest) is now planned to fall by almost 3% in real terms between this financial year and next. Over £900 million of additional revenue is to be raised by an increase of two percentage points in employers' national insurance contributions from next April.

Current account of the UK balance of payments

In the second quarter, imports rose faster than exports in both volume and price, and the current account deficit widened sharply.

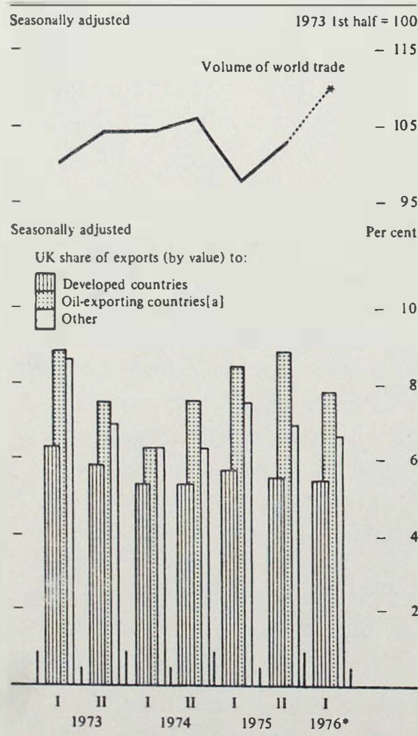
£ millions: *seasonally adjusted*

	1974	1975		1976	
	Year	Year	4th qtr	1st qtr	2nd qtr
Exports of goods	15,900	18,770	5,125	5,420	5,990
Imports of goods	21,120	21,970	5,810	5,895	7,030
Visible balance	– 5,220	– 3,200	– 685	– 475	–1,040
Net invisibles	+ 1,875	+ 1,530	+ 390	+ 435	+ 485
Current balance	– 3,345	– 1,670	– 295	– 40	– 555
Changes from preceding year/quarter:					
Visible balance	– 2,885	+ 2,020	+ 305	+ 210	– 565
of which:					
Volume[a]	*+ 665*	*+ 865*	*+ 330*	*+ 280*	*– 395*
Price	*– 3,550*	*+ 1,155*	*– 25*	*– 70*	*– 170*
Volume of exports[b] (percentage)	+ 6·8	– 4·0	+ 6·9	+ 2·6	+ 4·2
Volume of imports[b] (percentage)	+ 1·0	– 7·1	– 0·2	– 2·5	+ 10·6

[a] Measured for each period at the prices of the preceding period.
[b] Measured in 1970 prices.

World trade and the UK share

World trade expanded rapidly in the first half of this year; the share of UK exports is estimated to have fallen slightly.



*1976 1st half, estimated.
[a] Listed in the footnote to Table 20 in the statistical annex.

The balance of payments

The current account[1]

The volume of UK exports of goods rose by 4% in the second quarter, after an increase of 2½% in the first (see table). Nevertheless, it is estimated that the share of UK exports in world trade fell slightly during the first six months of the year (see chart). The rise in exports in the second quarter appears to have been concentrated in Western European and North American markets: shipments to oil-exporting countries were probably little changed in volume while those to the rest of the world declined. The volume of UK imports of goods rose by as much as 10½%, with foodstuffs (which had been unusually low in the previous quarter) and North Sea installations accounting for much of the increase. Imports of industrial materials – which began to pick up last autumn – continued to rise, reflecting the recovery of industrial output. On the other hand, imports of finished goods (excluding equipment for North Sea activities) increased only slightly.

Export prices rose by 7% between the first and second quarters – quite a sharp increase when compared with the estimated change in the prices of comparable goods sold on the home market, and in a period when the rise in domestic costs was slowing down. This suggests that a depreciation in the exchange rate is now being reflected more quickly

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

in the sterling price of exports – perhaps because of a greater tendency towards invoicing in foreign currencies. Thus, the depreciation of the pound will have produced a mixture of more attractive prices to customers abroad and more attractive profits to exporters. Import prices rose by 8½% in the second quarter. The increase would have been even larger if the full effect of sterling's depreciation and of rising world commodity prices during the period had worked through to imports: a further increase in import prices on this account may therefore be in prospect.

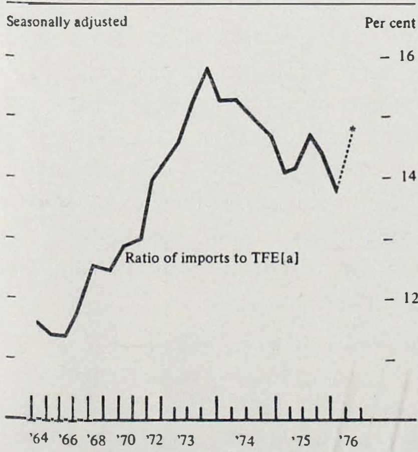
With imports rising faster than exports in both price and volume, the deficit on visible trade widened to over £1,000 million in the second quarter – more than twice as large as in the first. After a small decline in June, the volume of exports fell steeply in July. This latest decline may have been associated with the sharp fall in industrial production in June (see page 289). Although imports of industrial materials declined, the volume of total imports rose steeply in July, but partly because deliveries of ships abroad to UK owners were unusually large. Imports of North Sea oil installations amounted to over £100 million for the second successive month. The terms of trade also deteriorated during the month, and the visible deficit widened to £524 million.

In spite of the recent set-back, the prospects for exports still appear favourable. The decline in the exchange rate and the likelihood of a further reduction in the rate of domestic cost inflation should ensure that exports remain both competitive and profitable. Exporters also have the advantage at present of a large margin of spare capacity in industry as a whole. On the demand side, the volume of world trade in manufactures is likely to expand strongly this year and next.

However, as long as productive capacity continues to grow more slowly in the United Kingdom than in other industrial countries the secular decline in our share of world exports seems likely to continue, even though the trend may be checked in particular cyclical circumstances. A more important yardstick for exports is that they should sustain a satisfactory rate of growth in relation to imports. The fact that exports have risen faster than imports (in volume terms) for much of the last three years is largely explained by the recession.

Imports and expenditure

The ratio of imports to total spending rose in the second quarter, but partly because of imports of North Sea oil installations.



*1976 2nd quarter, estimated.

[a] Imports of goods as a percentage of total final expenditure on goods and services, both measured at 1970 prices.

The chart shows that the ratio of imports to total spending in the United Kingdom fell during the recession. The rise in the second quarter was partly because of imports of North Sea oil installations. In previous phases of expansion, the increase in the ratio owed much to a sharp upturn in imports of finished goods; but during the current recovery this may not, perhaps, recur for some time, partly because of the present wide margin of spare capacity in industry and partly because of competitive prices: in the year to mid-1976 domestic wholesale prices of manufactures (excluding food, drink and tobacco) rose by some 15%, whereas the price of imported finished manufactures rose by about 25%. Thus, although imports of industrial materials are likely to rise again as output grows – and especially if there is restocking – the aggregate ratio of imports to spending should increase more slowly than during the last expansion.

The surplus on invisibles in the second quarter, at £485 million, was some £50 million more than in the first, largely because of higher receipts from a wide range of services (particularly tourism and travel).

The current account, which was almost in balance in the first quarter, reverted to substantial deficit in the second.

Financing the deficit

Before seasonal adjustment, the current account was in deficit by £500 million in the second quarter. Identified investment and other capital flows produced an outflow of £1,190 million and there was a negative balancing item of £240 million. The deficit for official financing

amounted to £1,920 million. Sterling depreciated by 7% during the quarter. An article on page 308 discusses in more detail the composition of the deficit and how it was financed, and some of the factors leading to pressure on the exchange rate.

During July and August the reserves fell by a further £160 million, after public sector borrowing of £290 million under the exchange cover scheme. Sterling was quite steady throughout this period.

Monetary developments [1]

In the twelve months to mid-March – which correspond broadly to the financial year 1975/76 – M_3 rose by 9% and M_1 by about 17%. In the following three months (to mid-June), M_3 continued to grow at much the same rate, although the counterparts to the increase changed considerably as bank lending to the private sector began to recover. Such lending was erratically large in the following month, and the growth in M_3 over the four months from mid-March rose to 4½% – an annual rate of 14% (see chart). During the same period, the rise in M_1 slowed down to around 13% at an annual rate.

During the second quarter, the growth of M_3 was moderated by 'external items' (see table), which showed a large outflow associated with the pressure on sterling. In this period, companies may have been protecting themselves as far as possible from any further depreciation of sterling by accelerating payments for imports and by delaying foreign currency receipts from abroad (see article on page 308). The consequent drain on corporate finances will have been partly reflected in heavier bank borrowing by companies.

With M_3 rising rather more quickly than in the previous quarter, the growth of the domestic counterparts was considerably faster. The central government borrowing requirement, at around £1,700 million, was over £600 million less than in the previous three months; but sales of gilt-edged and of other government debt to the non-bank private sector were not as large as earlier in the year, when interest rates had been declining. Moreover, the central government's total borrowing would have been much higher if public corporations had not borrowed £500 million abroad: the public sector as a whole took £1,150 million from the banking and overseas sectors in the second quarter – £150 million more than in the first. This borrowing accounted for about one half of the expansion of domestic credit in the second quarter.

However, the main reason for the faster growth in domestic credit was a marked increase in bank lending in sterling to the private sector, which had remained subdued during the previous twelve months (see first chart on opposite page). After rising by less than £100 million in the March quarter, such lending increased by nearly £1,100 million in the following three months. This upturn in bank lending has so far been rather stronger than usual at this stage of the recovery and, as mentioned above, part of the rise no doubt reflected leads and lags in commercial payments and receipts from abroad.

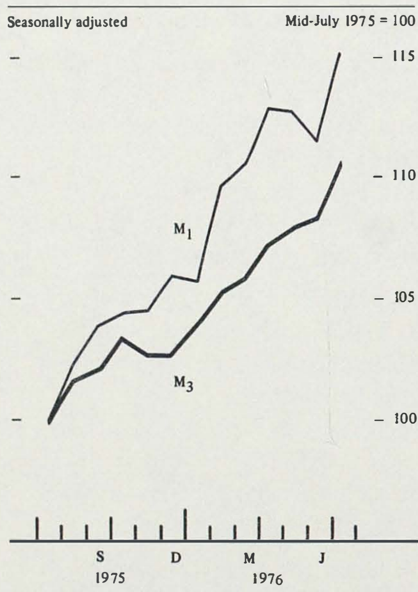
In his Budget statement the Chancellor indicated that after two years in which M_3 had increased much more slowly than money GDP, he expected their growth rates to come more into line in the financial year 1976/77. It was still the Government's objective that the growth of the money supply should remain moderate. In his announcement of 22nd July, the Chancellor stated that, for the financial year as a whole, the growth of the money supply should amount to about 12%. The figures can, of course, fluctuate widely from month to month and, indeed, from quarter to quarter (see March *Bulletin*, page 13).

Before the July measures, the size of the prospective public sector borrowing requirement for the financial year 1977/78 – when bank

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

Money stock

M_3 has risen more rapidly in recent months, largely because of heavier bank lending to the private sector.



Influences on the money stock (M_3)

In the second quarter, the growth of M_3 was moderated partly by a large outflow of funds.

£ millions: *seasonally adjusted*

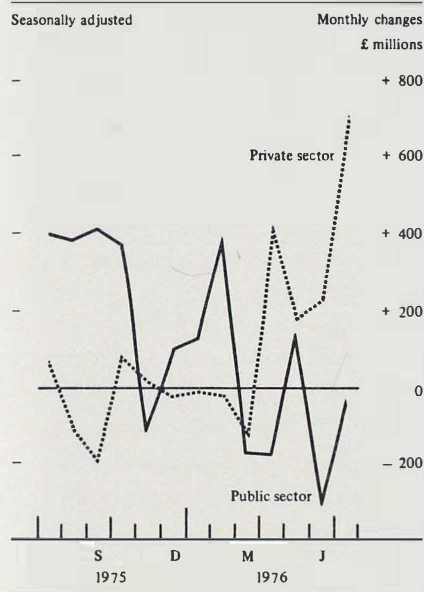
	1975			1976	
	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr
Central government borrowing requirement	+1,944	+2,724	+1,744	+2,331	+1,725
Purchases (–) of central government debt by non-bank private sector	– 550	–1,235	–1,892	–1,420	–1,078
Other public sector borrowing requirement[a]	+ 746	+ 121	+ 757	+ 174	+ 777
Purchases (–) of other public sector debt by non-bank private sector[a]	– 233	+ 136	– 70	– 77	– 266
Lending to private sector:					
In sterling	– 147	– 563	– 14	+ 79	+1,094
In foreign currencies	+ 239	+ 314	+ 13	+ 52	– 121
DCE[b]	*+2,067*	*+1,400*	*+ 416*	*+1,451*	*+2,257*
External items	–1,603	+ 212	– 246	– 333	– 826
Other	+ 10	– 53	– 165	– 15	+ 85
Money stock (M_3)	+ 406	+1,656	+ 127	+ 791	+1,390

[a] These figures include some recent revisions which have not yet been incorporated in 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.

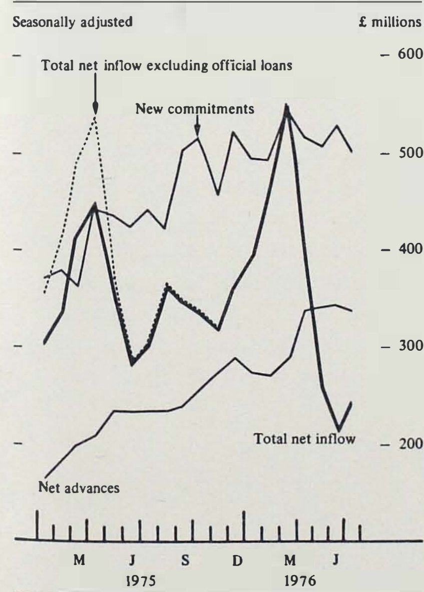
Bank lending in sterling

Bank lending to the private sector has risen sharply in recent months, after changing little during 1975/76.



Building society funds

The societies' inflows fell after interest rates on competing assets became more attractive.



lending to the private sector could be expected to rise as economic recovery continued – was such that very heavy sales of public sector debt would have been necessary to avoid excessive monetary growth. Such sales might well have proved difficult without a sharp rise in real interest rates and the implied damage to the recovery of fixed investment. With the planned reduction in the public sector borrowing requirement to £9,000 million, this danger will have been reduced. Also, in order to provide further help in achieving restraint in the growth of the money supply without depriving industry of essential finance, the Governor has asked the banks and finance houses to ensure that, by exercising strict restraint on lending or provision of facilities for other purposes, sufficient funds would be available for both working capital and fixed investment by manufacturing industry, and for the expansion of exports and import saving (see page 307).

As a proportion of total final expenditure, private sector liquidity continued to fall in the second quarter. The decline was again concentrated in the personal sector, even though persons' money balances rose sharply in nominal terms – the largest increase for over a year. Among other liquid assets, investment in building society shares and deposits increased much less than in the previous three months, as rates on competing assets became more attractive. Although the personal sector's total short-term borrowing fell as a proportion of income, borrowing from banks rose slightly for the second successive quarter, after remaining virtually unchanged throughout 1975. With companies borrowing heavily from banks during the period, the private sector's net liquidity declined rather more sharply than in earlier quarters.

The marked reduction in net receipts by building societies (see chart) lowered their combined liquidity ratio from around 22% at the end of April to 20% at the end of July. If the societies continue to lend at the present high rate while inflows do not recover further from the low figure in June, their liquidity ratio will come under further pressure but will probably remain high by past standards, at least during the remainder of this year.

Assessment

In the early months of this year the recovery in world demand and output was very strong; the pace of expansion now seems to have slowed down. The slowdown in part reflects an end to the initial adjustment in stocks, which earlier had been a strong stimulus to growth. It also reflects the effect of governmental policies, which have remained cautious out of concern for inflation. The trend of prices is, indeed, likely to remain a problem.

The problems faced by this country with regard to inflation and the balance of payments are especially severe. The agreement to continue pay restraint for a second year provides an invaluable opportunity to consolidate the achievements of the first phase. Commodity prices have recently risen more slowly, and the greater stability of sterling since the middle of the year will also help to contain the rise in import prices. But further progress needs to be made in bringing down the rate of inflation. Over the next few years the possibility of maintaining a reasonable rate of economic expansion, and thus of reducing unemployment, will depend very directly on success in dealing with inflation.

Recent indicators are difficult to interpret; they seem to point to some slackening in the rate of expansion, but probably for temporary reasons. In the second quarter, stocks appear to have been drawn down for a time, thus reversing the earlier stimulus to output from changes in stocks. Exports of goods were only 1%

higher in volume in the three months from May to July than in the preceding three months; and imports increased sharply, though much of the rise was accounted for by North Sea installations. Consumer spending fell in the second quarter; but in July retail sales recovered, and from August onwards spending should be stimulated by the income tax rebates. Impressionistic information, such as the CBI survey (taken just before the July measures), presents a more confident picture of the economy than earlier, in particular by suggesting that a big increase in productive investment may begin later this year.

There are good reasons for thinking that any temporary slowdown will be followed by faster expansion. World trade seems likely to go on rising fairly rapidly: the recent improvement in the competitiveness of UK exports should mean that, in spite of the recent pause, they resume their fast growth. In addition, there should be a recovery in industrial fixed investment, and renewed investment in stocks. For these reasons, the prospects are that output will continue to expand, though possibly at a somewhat more moderate pace than earlier this year.

Economic recovery to date has brought with it a limited recovery, albeit from a low base, in profits. This has improved the prospect for private investment – as has, in the longer term, the relaxation earlier this year of the price code, which was a timely recognition of the need for higher real profitability. But further improvement in profitability is likely to be only gradual. The new higher rate of employers' national insurance contributions from next April is likely to reduce profits in the early stages – but it is an allowable cost increase and, to the extent that it can be passed on in higher prices as the economy becomes more buoyant, the effect on profitability need only be temporary. To encourage investment, the prospect of improved returns is needed.

The improvement so far in company profits, together with low capital investment, is helping to bring the company sector back to financial balance after the heavy deficits of recent years. As the expected recovery in private fixed investment gets under way, the sector's improving financial balance may be partly reversed next year. In the personal sector, the large and growing financial surpluses of recent years have mainly reflected the unusually high rate of personal saving, which may now begin to show some fall. All in all, the financial surplus of the private sector in 1977/78, though still big, could well begin to decline.

The measures announced in July to reduce the public sector borrowing requirement and to restrain demand comprised cuts in public spending in 1977/78 of about £1 billion and an increase in the rate of employers' national insurance contributions estimated to raise government revenue by just over £1 billion. The borrowing requirement should also be reduced by continued economic expansion, due in part to a lower rate of saving and increased capital expenditure by the private sector. As a result, the public sector's financing needs are expected to be £9 billion in the next financial year. This would represent about 6% of GDP at market prices; for the purpose of external comparison, the general government deficit (which excludes on-lending to public corporations and to the private sector) would be 3%, as compared with just under 6% expected for this financial year.

The July announcement also included a quantification of the expected growth in the money stock. It was envisaged that the growth of the money supply in the present financial year should be about 12%.

Fluctuations are to be expected in the money supply figures as a result of month-by-month variations in borrowing needs and sales of gilt-edged. In the first three months of this financial year M_3 grew

at a rate of under 1% a month. In July it rose by over 2%. This sharp rise was associated with an increase in bank lending to the private sector which seems, at this stage of economic recovery, to have been erratically high. In August there was a lull in the gilt-edged market but there was probably little increase in lending to the private sector. The rate of monetary expansion in future months will need to be carefully watched.