Economic commentary

This commentary is mainly concerned with developments since the middle of the year. The period has been overshadowed by a further sharp depreciation of the exchange rate and a faster rise in the money supply.

Sterling's rapid decline began in March, when the rate fell below $2 on the 5th and has since been under recurrent, sometimes intense, downward pressure. The pound's effective depreciation widened fairly steadily from about 30% at the end of February to 39.6% at the end of May. The rate recovered somewhat after the announcement of the $5.3 billion short-term credit facility.

In the following four months to the end of October, sterling's effective depreciation widened even more sharply, to 48% (a devaluation of 15%). The rate was comparatively steady during July, before market sentiment again began to turn against the pound towards the end of August. The really steep fall began early in September, when pressure on sterling was such that it was no longer possible to maintain the rate around $1.77. The pound rallied briefly after the rise of 1½% in minimum lending rate announced on the 10th and the call for special deposits on the 16th; but by the 28th it had fallen to a low of $1.63. Subsequently, sterling again recovered for a time when it became known that an application was to be made to the International Monetary Fund for a stand-by credit. But the market remained unsettled throughout October and the pound fluctuated widely from day to day: the rate improved after the announcement of another increase of 2% in minimum lending rate and of a further call for special deposits, but on the 25th it fell by as much as five cents, reaching a low point of $1.55½ a few days later before recovering a little at the end of October.

During this four-month period, the need to conserve the official reserves became an increasingly important constraint on the amount of official intervention. Initially, the market appeared to regard a rate of $1.77 as appropriate, and only occasional official support was needed to prevent undue fluctuations in the rate. But after support at this rate had to be withdrawn early in September, official intervention in the spot exchange market was smaller than it had been earlier in the year, being designed largely to test the weight of market pressure or to smooth the impact of large orders. However, the authorities also intervened periodically in the sterling swap market in order to increase the cost of borrowing euro-sterling, thereby providing some support to the pound at little cost to the reserves.

The increases in minimum lending rate were appropriate not only for external reasons but also because the rate of growth in the money stock began to accelerate sharply after June. In the six months to mid-October, M_3 had risen by about 9%, which was clearly inconsistent with the 12% target for this financial year. Further measures were considered necessary in the light of monetary developments in October, and the supplementary special deposits scheme was reintroduced (see page 434).

Total output in the United Kingdom has been stagnant since the spring; all the components of domestic demand have been weak. The recent course of unemployment has been erratic, but the trend has remained upward. The rate of price inflation has failed to slow down further since the middle of the year and is unlikely to come down again for some time, largely because of the decline in the exchange rate. Pressure on personal incomes and expenditure is likely to continue. (There is a supplementary note on inflation, real incomes and taxation – see page 422.)

Industrial production[a]

In the third quarter, industrial production declined in some countries and for the group as a whole was little changed.

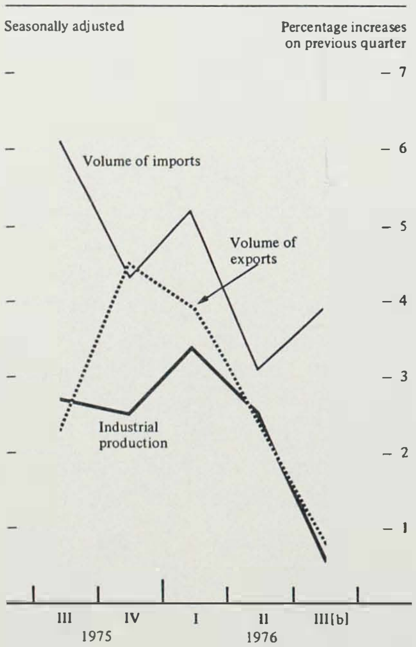
Percentage change on previous quarter; *seasonally adjusted*

	1975		1976		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr[b]
United States	+5·5	+2·4	+2·9	+1·8	+1·2
Canada	−0·5	+1·3	+3·0	+1·5	−0·1
Japan	+2·6	+0·3	+5·7	+5·3	+0·9
France	−0·4	+3·6	+5·5	+1·2	+2·7
Italy	−1·0	+4·6	+3·7	+5·7	−2·6
Western Germany	−	+3·9	+2·8	+2·7	−0·9
United Kingdom	−0·9	+1·1	+1·4	+1·0	−0·3
Other OECD	−1·0	+4·6	−1·3	+2·8	−1·7
Total OECD	+2·4	+2·6	+2·9	+2·5	+0·3

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

Output and trade in the main industrial countries [a]

In the group as a whole, industrial production and exports increased much more slowly in the third quarter, but imports went on rising strongly.



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

North Sea oil

In the third quarter, North Sea oil production is estimated to have reduced the import bill by £160 million.

£ millions

	1975	1976				1977
	Year	1st qtr	2nd qtr	3rd qtr	4th qtr (forecast)	Year
Production (million tonnes)	1·1	1·2	2·3	3·0	5·0	35–45
Saving on oil imports	50	60	120	160	300	..
Related imports[a]	870	215	320	320	275	..

[a] Estimated imports of goods and services related to the North Sea oil programme.

In the year ahead, output is likely to depend heavily on exports which should benefit from a prospective recovery in world trade. The negotiations with the International Monetary Fund – which were still in progress at the time of writing – provide the opportunity for establishing policy on a new basis which can remain in place until the economy recovers. The problems and prospects for the period ahead are discussed in the concluding assessment.

The balance of payments

The current account [1]

As mentioned above, sterling came under heavy pressure for much of the third quarter, resulting in further outflows of capital and a steep decline in the exchange rate. This pressure partly reflected a growing loss of confidence in the pound, but a deterioration in the current balance also contributed: in volume terms exports fell while imports were little changed. This set-back to exports (after nine months of rapid growth) in turn owed something to a marked (but probably temporary) slowdown in the growth of world trade.

After a strong recovery in the second half of 1975 and the early months of this year, output in the main industrial countries had been expected to rise rather less rapidly during the remainder of 1976. In the event, the slowdown has been very pronounced (see table) – partly, it appears, because of a smaller stimulus from stockbuilding (which had been expected), and partly because of a very much slower growth in personal consumption (which had not). Fixed investment has so far contributed little to world recovery, but is expected to grow more rapidly from the latter part of this year and to account for most of the prospective acceleration in output during the course of next year (either directly or indirectly through the extra consumption generated). There is, however, a danger that a faster rate of growth may not be sustained: policies remain cautious in most countries and, indeed, have recently been tightened in France, Italy and some of the smaller OECD members, which at present have large deficits on current account.

The volume of world trade, which had grown rapidly towards the end of 1975, increased more slowly in the first half of this year, and probably slowed down even further in the third quarter. The volume of exports by all OECD countries increased by some 8% in the last quarter of 1975, but by the third quarter had almost stopped rising, to judge by figures for the seven largest countries (see chart). Recent fluctuations in OECD exports have largely stemmed from trade within the OECD area. Exports to other countries have shown little growth – even to oil-exporting countries which earlier had been a rapidly expanding market. Looking ahead, OECD exports are expected to increase by some 8%–10% in the course of next year.

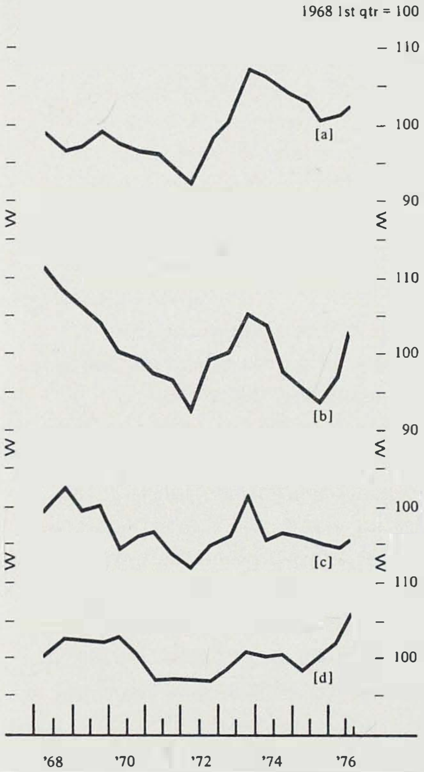
Against this background, the volume of UK exports rose by 14% between the third quarter of 1975 and the second quarter of 1976, only to decline by 3% in the third quarter. This decline probably owed something to the very slow growth in world trade during the quarter. However, exports rose sharply to a new peak in October.

The volume of UK imports has followed an uneven course this year – falling in the first quarter, rising sharply in the second, changing little on average in the third, and then (like exports) rising to a peak in October. Food imports have remained unusually large in recent months, partly because of the drought, while imports of industrial materials have fluctuated quite widely. More oil was imported in the third quarter than in the second, but the volume of imports fell back in October. North Sea production, which amounted to some 3 million tonnes (nearly 15% of domestic requirements) in the third quarter, will

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

Price ratios relevant to UK export performance

The depreciation of sterling this year has sharply improved the relative profitability of exporting and the cost-competitiveness of UK industry.



[a] Ratio of competitors' export prices of manufactures to those of the United Kingdom (in dollar terms); partly estimated.

[b] Ratio of competitors' unit labour costs in manufacturing to those of the United Kingdom (in dollar terms); partly estimated.

[c] Finished manufactures: ratio of UK import prices to UK export prices.

[d] Manufactures: ratio of UK export prices to UK wholesale prices.

Current account of the UK balance of payments

The current deficit widened in the third quarter: in volume terms, exports fell while imports were little changed.

£ millions: *seasonally adjusted*

	1975 Year	1976 1st qtr	1976 2nd qtr	1976 3rd qtr
Exports of goods	18,765	5,420	5,990	6,120
Imports of goods	21,970	5,900	6,995	7,325
Visible balance	− 3,205	− 480	−1,005	−1,205
Net invisibles	+ 1,550	+ 445	+ 470	+ 570
Current balance	− 1,655	− 35	− 535	− 635
Changes from preceding year/quarter:				
Visible balance	+ 2,015	+ 205	− 525	− 200
of which:				
Volume[a]	*+ 865*	*+ 270*	*− 370*	*− 200*
Price	*+ 1,150*	*− 65*	*− 155*	*–*
Volume of exports[b] (percentage)	− 4·0	+ 2·6	+ 4·2	− 2·9
Volume of imports[b] (percentage)	− 7·1	− 2·6	+ 10·1	+ 0·4

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

have reduced the import bill by an estimated £160 million (see table on opposite page). Next year, the saving is likely to rise substantially and further improve the current account, even though interest payments and profits due abroad will be larger. Inflows of capital for the development of the oil fields should remain substantial and continue to match the value of associated imports. Imports of finished manufactures have risen in recent months, in spite of a wide margin of spare capacity in most sectors of domestic industry and the price-competitiveness of UK goods. The rise may have included some precautionary buying and does not necessarily represent any underlying increase in import penetration.

The cost-competitiveness of UK industry [line (b) in the chart] has probably been much improved by sterling's depreciation this year of over 20%: prices of imported manufactures have risen much faster than those of comparable home-produced goods. However, export prices in sterling terms have also increased faster than domestic prices, perhaps partly because of a growing tendency to invoice in foreign currencies. So the relative profitability of exporting [line (d)] has improved during the year – at the expense of gains in the price-competitiveness of UK exports as conventionally measured [line (a)]. For this reason, the terms of trade in finished manufactures have changed little [line (c)]. This is a new pattern: in the past, exporters have been less prompt in raising their sterling prices when the exchange rate has weakened. Moreover, prices of other imports have risen no faster this year than those of finished goods, so the overall terms of trade have remained fairly stable – though they deteriorated markedly in October, when import prices rose steeply.

The surplus on invisibles rose sharply in the third quarter to £570 million, about £100 million larger than in the second. The rise mainly reflected higher net receipts from a wide range of services, especially tourism.

The balance of trade took fewer real resources in the third quarter than in the second. However, looking at the longer trend, and taking goods and services together, the proportion of national income devoted to the external balance (at 1970 prices) was larger in 1975 than in all but one of the preceding twenty years, and it rose further in the first half of 1976. In contrast, by historical standards the terms of trade are at present unfavourable to the United Kingdom, having only partly recovered after the sharp deterioration in 1973 and 1974 associated with soaring commodity prices (particularly of oil). The current account deficit has thus persisted: in the third quarter it amounted to some £635 million, making a deficit of about £1,200 million so far this year, compared with £1,360 million in the corresponding period of 1975. There could be a more substantial improvement in the course of next year as the shift of resources into the trade balance continues: weak domestic demand should restrain imports, while expansion in other industrial countries, together with the recent improvement in the relative profitability of exporting, is likely to benefit UK exports.

Financing the deficit[1]

The pressure on sterling, which began in March, persisted for much of the second half of the year. Between the end of June and the end of November, the exchange rate fell by 11% against other currencies weighted together, making a depreciation of 22% since the beginning of the year. One reason for this protracted period of pressure on the rate has been the continuing large current account deficit. Capital outflows were much smaller in the third quarter than in the second. The deficit for official financing, though more than halved, was still large. There was a small decline in the reserves.

[1] Movements in the exchange rate are described in more detail on page 429.

Summary of the balance of payments

In the third quarter, the current account deficit (before seasonal adjustment) was a little larger than in the second, but the deficit for official financing narrowed sharply.

£ millions: *not seasonally adjusted*

	1975 Year	1976 1st qtr	1976 2nd qtr	1976 3rd qtr
Current balance	–1,650	–260	– 480	–510
Sterling holdings of:				
Central monetary institutions in:				
Oil-exporting countries[a]	– 300	–220	– 660	–420
Other countries[b]	– 310	+130	– 250	+ 70
Other holders	+ 550	+ 10	– 10	+210
Increase (–) in UK banks' external sterling claims[c]	– 620	–470	– 440	–240
Other identified capital flows (net)	+1,010	+280	+ 100	– 20
Balancing item	– 160	–110	– 180	+ 60
Balance for official financing	–1,480	–640	–1,920	–850
Financed by:				
Drawings on the IMF	–	+570	+ 440	–
Drawings on other monetary authorities	–	–	+ 580	+310
Other borrowing[d]	+ 810	+280	+ 580	+490
Decrease (+) in reserves	+ 670	–210	+ 320	+ 50

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

[b] Including international organisations, but excluding the IMF.

[c] Includes export credit refinanced by the Export Credits Guarantee Department.

[d] Borrowing in foreign currencies by the central government, and by public sector bodies under the exchange cover scheme.

Domestic activity

Total output was little changed in the second and third quarters taken together, after recovering fairly rapidly in the previous six months.

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

	1975 4th qtr	1976 1st qtr	1976 2nd qtr	1976 3rd qtr
GDP output measure	+ ¼	+1½	+ ¼	+ ¼
Industrial production[a]	+1¼	+2	– ½	+ ¼
of which,				
Manufacturing production[a]	*+1*	*+2½*	*+ ½*	*+ ½*
GDP expenditure measure	+1¾	+2¼	–3½	+2½[b]
Consumers' expenditure	– ¼	+1¼	– ¾	+ ¾
of which,				
Retail sales	*+ ¼*	*+1½*	*– ½*	*+1¾*
Exports of goods and services	+4¼	+1¾	+3¾	–3 [c]
Imports of goods and services	– ½	– ¾	+8½	+ ¼[c]

[a] Adjusted to allow for the fact that some components are based on deliveries rather than output.

[b] Bank estimate.

[c] Goods only.

Within the aggregate decline in overseas holdings of sterling,[1] official holdings fell by a further £350 million. This latest fall, which was entirely in the holdings of central monetary institutions in the oil-exporting countries, reduced official balances outstanding to £2,760 million, compared with a peak of about £4,800 million early in 1975. Banking and money-market liabilities to other holders rose by £210 million in the third quarter to a record £3,430 million, partly because of an unusually large increase in the holdings of Irish residents (including banks) associated with a bank strike in the Republic. In contrast to official balances, private holdings have, in fact, remained stable or risen in recent quarters. Most of these balances are thought to be personal holdings, individually small and placed with a wide range of UK institutions; probably next in size are holdings in the names of banks overseas; and finally, there is a sizable element held mainly by companies.

Sterling lending overseas by UK banks rose again in the third quarter, but only by about half as much as in each of the previous two quarters. As before, most of the increase was probably associated with the finance of UK trade. Nevertheless, there has been a significant rise this year in sterling lending by UK banks to finance trade by members of the overseas sterling area (other than with the Scheduled Territories[2]). Such lending was brought under tighter exchange control rules in August before being prohibited entirely by further measures announced in November. The latter also prevent UK merchants from using official foreign exchange to finance trade between non-Scheduled Territories. No changes were made to the arrangements for trading by participants in exchange control commodity schemes. These measures are expected to generate a once-for-all inflow of funds amounting to several hundred millions of pounds.

Other identified capital transactions were almost in balance, and there was a small positive balancing item. In sum, the deficit for official financing amounted to £850 million. This was met largely by continued borrowing in foreign currencies by public sector bodies under the exchange cover scheme and by a further drawing under the $5.3 billion stand-by arrangement with other central monetary institutions, bringing total drawings under this facility to $1,545 million. The fall in the reserves was quite small. On 29th September, the Government announced that they were applying to the International Monetary Fund to draw the United Kingdom's remaining credit tranches.

Sterling remained under pressure for much of October and the reserves fell by £287 million; there was no new official borrowing during the month. However, in November £365 million was borrowed and the official reserves rose by £274 million.

The UK economy

Output and demand[3]

The recent expansionary phase started in the third quarter of last year, which constituted the trough of the recession. There were six months of fairly rapid growth, with GDP (on the average measure) rising at an annual rate of 4%. By the spring the recovery appeared well established; indeed, there was concern that momentum might build up too fast. But in the subsequent six months the rate of growth turned out to be minimal (see table). Monthly figures for

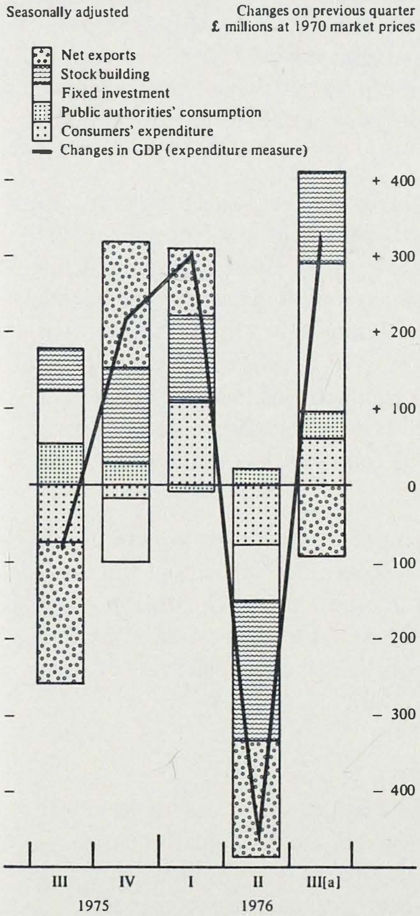
[1] See also Table 20 in the statistical annex.

[2] The Scheduled Territories at present comprise the United Kingdom, the Channel Islands, the Isle of Man, the Republic of Ireland, and Gibraltar.

[3] Figures in this section are seasonally adjusted and at constant prices.

Factors contributing to changes in GDP

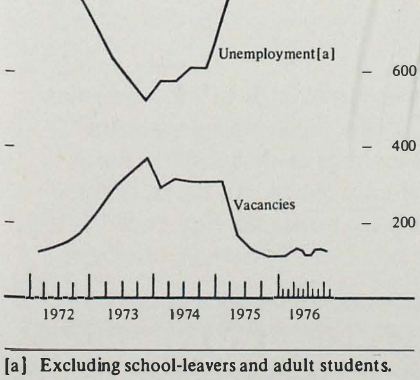
GDP rose in the third quarter, when there was probably a turn-round in stockbuilding and an increase in fixed investment.



[a] Provisional.

Unemployment and vacancies

The trend of unemployment has remained upward.



[a] Excluding school-leavers and adult students.

industrial production have been distorted by changes in the pattern of holidays, making comparisons over short periods uncertain, but the run of figures shows little growth from March to September. Manufacturing output has held up a little better than industrial production.

In the early stages of the recovery, the stimulus to output came from external trade – exports rose more quickly than imports – together with a turn-round from heavy destocking to a small amount of restocking. But stocks appear to have been run down in the second and third quarters taken together; and in the same period, imports rose much faster than exports. Consumers' expenditure was little changed while public consumption and fixed investment made only small contributions to the growth of demand.

Given the expected expansion of world trade, exports should now begin to rise faster than imports and thus provide a continuing stimulus to output. Stockbuilding should also contribute to growth, especially in the early part of next year. But other elements of demand are likely to remain subdued. Consumers' expenditure is expected to fall throughout next year in spite of a decline in the saving ratio; public consumption may be little changed; and total fixed investment is likely to go on declining. The optimistic investment intentions survey by the Department of Industry, which relates only to manufacturing and the distributive and service industries, was carried out before the rise in minimum lending rate in October: this has weakened business confidence as well as increasing the cost of borrowed funds. Moreover, manufacturing investment (where the largest rise was expected) accounts for only about one sixth of total fixed investment. The other elements of investment – mainly housing, and expenditure by the nationalised industries – are expected to weaken next year.

All in all, growth during the year ahead is now likely to be heavily dependent on exports and, to a much smaller extent, on stockbuilding and manufacturing investment; output can thus be expected to expand fairly slowly.

Unemployment[1]

The sharp rise in output in the six months following the low point of the recession last year suggested that unemployment might before very long reach a turning point and start to fall. But with the pace of recovery subsequently slackening, the rise in output (about 2¼% in the year to the third quarter of 1976) fell below the growth of productive potential (some 3%). Against this background, the course of unemployment, though erratic, has remained upward (see chart). After falling in March, unemployment in the United Kingdom (excluding school-leavers and adult students) rose slowly in the second quarter and more rapidly in the third, before declining in October. (Figures for November have not been collected because of an industrial dispute.)

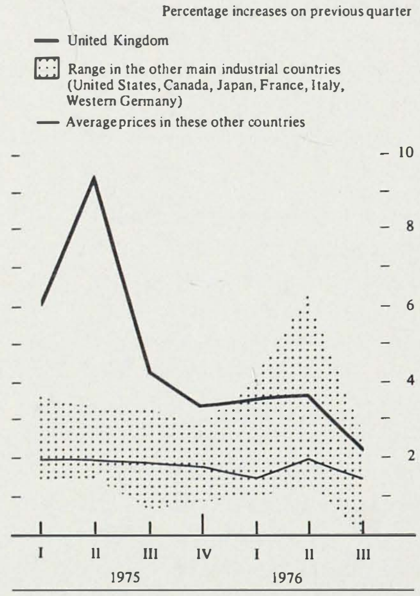
Among other indicators of demand in the labour market, unfilled vacancies have risen a little in recent months but the numbers are relatively small. Overtime working has not increased significantly this year.

The prospect that total demand will grow only slowly in the months ahead suggests that unemployment is likely to go on rising, especially as a higher proportion of the population – in particular of women – is registering for employment, and because a demographic increase in the labour force is now taking place.

[1] Figures for unemployment and vacancies are seasonally adjusted.

Consumer prices in the main industrial countries

In the third quarter, UK consumer prices rose more in line with prices in other main industrial countries.



Costs and prices [1]

Up to the middle of this year, the rise in retail prices was slowing down markedly; but it has since remained fairly steady at an annual rate of about 14%. However, food prices rose by as much as 10½% in the three months to October, partly for seasonal reasons but also because of the depreciation of sterling, reductions in subsidies and, perhaps, the delayed effects of the drought. The increase would have been even larger but for the stability of the 'green pound', which has moderated the effect of depreciation on the prices of certain foodstuffs imported from the EEC.

After rising steeply in dollar terms in the first half of the year, prices of many commodities have since fallen back: at mid-November, *The Economist* all-items index was 4% lower than at the beginning of July. Metal prices in particular have declined sharply. However, the beneficial effect on domestic inflation has been outweighed by sterling's recent depreciation which accounted for most of the rise of 8% in the price of raw materials and fuel bought by manufacturing industry between July and October. [2] UK consumer prices are still going up faster than the average rate in other main industrial countries, but the gap has narrowed recently (see chart).

The rise in prices has been moderated by the slower growth of unit labour costs, partly reflecting the success of the current incomes policy, and partly a cyclical improvement in productivity. The present stage of the incomes policy could restrict the rise in average earnings to about 7%–8% over the full year of the policy, thus halving the rate of wage inflation for the second successive year.

Personal incomes and spending [3]

After being depressed during the first half of the year, real personal incomes and expenditure were boosted in the third quarter by tax reliefs; spending may also have been inflated in the fourth quarter by buying in anticipation of indirect tax increases. But incomes and expenditure are likely to come under pressure again from now on.

Average weekly earnings and total personal incomes probably rose by about 3½% in the third quarter. Retail prices went up by only 2¼%; and, with the once-for-all benefit of the back-payment of tax reliefs, real personal disposable income rose by almost 2%. Consumers appear to have spent less than half of the rise in real disposable income during the quarter. The volume of retail sales (which account for about half of consumers' expenditure) was up by nearly 2%, but new car registrations fell sharply. Consumers' expenditure as a whole is provisionally estimated to have been only ¾% higher than in the second quarter, and the saving ratio appears to have increased – perhaps only temporarily – by nearly one percentage point to about 14%.

The nominal value of new credit has risen in recent months; and instalment credit outstanding at the end of September was higher in nominal terms than at any time since controls were reimposed in 1973. However, in real terms debt outstanding has been falling steadily, and the recent rise in the volume of retail sales – particularly of durable goods – seems to have been financed largely out of the tax rebates.

Real personal disposable incomes seem likely to fall for some time, and more rapidly than in the past. Under the second stage of the incomes policy, the rise in average earnings could be restricted to around 7%–8%; but (for reasons already indicated), the rise in retail prices is unlikely to fall much below the present rate of around 14% per annum in the months ahead.

[1] See also a supplementary note on inflation, real incomes and taxation on page 422.
[2] In this period sterling's depreciation was more than enough to offset the relatively fast rate of domestic inflation (see page 422).
[3] This section is in seasonally-adjusted terms.

Consumers' expenditure will probably fall less fast than real incomes in the current quarter and early next year, when the final effects of the tax relief will still be working through, and when consumers may cushion the prospective decline in their real incomes by saving less. But the saving ratio is unlikely to decline substantially until prospects for inflation and employment improve.

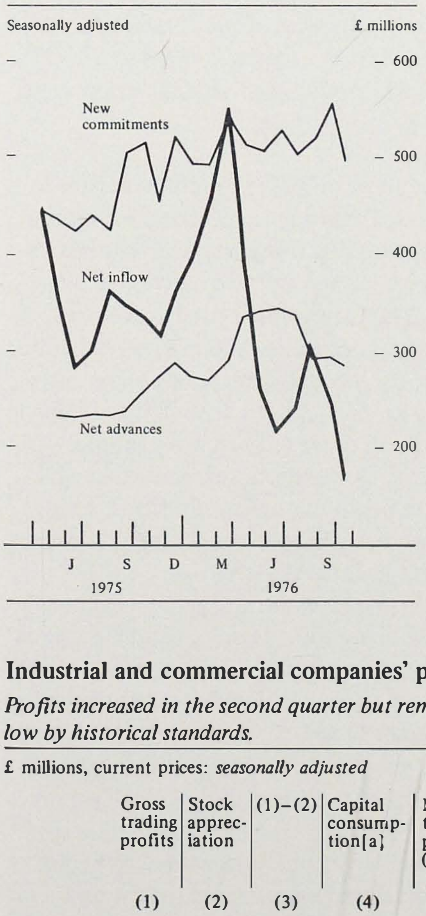
Housebuilding[1]

The number of houses started in Great Britain was little changed in the third quarter. Public sector starts rose slightly, but were 12% below the peak reached in the first quarter. On provisional estimates, starts fell back in October, and a further decline in activity is in prospect if the controls on the rate of local authority approvals, introduced in July with the aim of reducing public expenditure on housing up to the end of 1977, prove effective.

After rising steadily since the beginning of 1975, the number of private sector starts fell by 5% in the third quarter. The total for 1976 is still likely to be larger than last year, though considerably less than the 170,000 forecast in the July Private Enterprise Housing Enquiry. The prospects for 1977 are now much less favourable. Firstly, the increase in the mortgage rate to 12¼% is likely to limit the rise in prices which buyers are prepared to accept. If so, the building industry – where costs have already risen almost twice as fast as new house prices over the past twelve months – will face a further squeeze on profit margins. Secondly, any reduction in lending (see below) would depress demand for new houses at a time when the number of houses under construction is already large in relation to the rate of completions.

Building society funds

The net inflow has been much reduced since competing rates became more attractive.



The net inflow[2] into building societies has fallen sharply since March (see chart), when the rate offered to investors became less attractive than some competing rates; in October the inflow was the lowest for more than two years and in November it was probably lower still. The recent increase to 7.8% in the share rate recommended by the Building Societies Association merely restored the differentials prevailing before minimum lending rate was raised to 15% in October. Meanwhile, the societies have maintained a steady rate of lending, but at the expense of their liquidity which fell from a peak of 22% in April to 19% in October. However, they are already showing signs of adopting a more restrictive attitude to lending and are likely to be reluctant to see their liquidity fall too far without considering further action on interest rates.

Company spending and finance[1]

Substantial upward revisions have been made to estimated company profits in the national income accounts in each of the years from 1969 onwards;[3] and their recent quarterly path has also been amended. The picture remains one of slow recovery from the difficulties of early 1975, but there now appears to have been a modest set-back in the first quarter, followed by a marked improvement in the second. Even so, by historical standards the share of profits in domestic income remains extremely depressed (see table). The extent to which recovery continues will depend partly on the performance of exports which have recently been more profitable relative to domestic sales (see page 411). Profits earned by firms engaged in North Sea oil activities will also increasingly swell the total – gross trading profits from such operations are expected to rise from around £¾ billion this year to perhaps £3 billion in 1977. Profits recorded by other companies will thus be less buoyant than the overall figures suggest.

Industrial and commercial companies' profits

Profits increased in the second quarter but remained very low by historical standards.

£ millions, current prices: *seasonally adjusted*

	Gross trading profits	Stock apprec-iation	(1)–(2)	Capital consump-tion[a]	Net trading profits (3)–(4)	Share of net profits in net domestic income[b]
	(1)	(2)	(3)	(4)	(5)	(6)
						Per cent
1965[c]	5,051	252	4,799	1,147	3,652	*12·9*
1969[c]	5,801	590	5,211	1,514	3,697	*10·4*
1972[c]	8,427	1,067	7,360	2,208	5,152	*10·4*
1974	12,333	4,908	7,425	3,135	4,290	*6·6*
1975 1st qtr	3,115	1,269	1,846	947	899	*4·7*
2nd qtr	2,921	984	1,937	1,019	918	*4·6*
3rd qtr	2,911	911	2,000	1,083	917	*4·4*
4th qtr	3,218	943	2,275	1,139	1,136	*5·2*
1976 1st qtr	3,365	1,143	2,222	1,186	1,036	*4·7*
2nd qtr	3,684	1,201	2,483	1,228	1,255	*5·4*

[a] Quarterly figures have been estimated by the Bank.

[b] Total domestic income less stock appreciation and capital consumption.

[c] These years correspond broadly to earlier cyclical peaks.

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

[2] Net receipts plus interest credited.

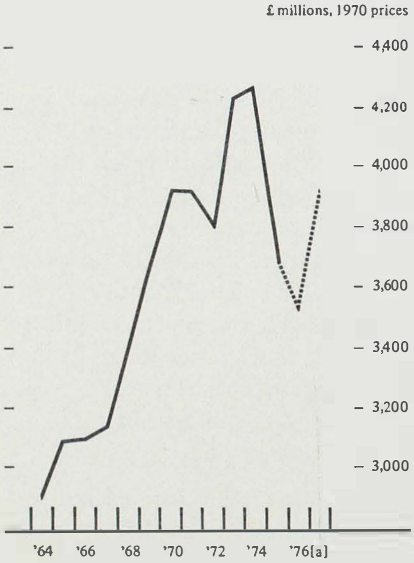
[3] The reasons for the revisions are discussed on page 114 of *National Income and Expenditure 1965-1975* (the 'Blue Book').

The recent revival of profits has been accompanied by an improvement in companies' cash flow:[1] together with low fixed investment and further destocking, this has enabled companies to go some way towards restoring their net liquidity after the massive accumulation of liquid liabilities (mainly bank borrowing) during 1974.

The volume of private industrial fixed investment,[2] which in the first quarter had been smaller than at any time since 1968, is estimated to have risen by 2½% in the second quarter and by a further ¾% in the third. The Department of Industry's latest investment intentions survey (carried out in August and September) predicted a year-on-year fall of 5% in 1976 (see chart). This projection now looks rather pessimistic. On the other hand, manufacturing investment next year may be less buoyant than suggested by the survey which predicted a recovery of 15%–20%. Since the survey, there has been a sharp rise in interest rates and, with the prospect of weaker demand, a deterioration in business confidence.

Fixed investment by manufacturing, distributive and service industries

The volume of investment is expected to recover next year, but would still be well below the previous peak in 1974.



[a] 1976 and 1977 figures are taken from the Department of Industry's investment intentions survey.

Private industry[2] ran down stocks quite sharply in the first half of the year (by £126 million at 1970 prices), but added to them on a small scale (£33 million) in the third quarter. The marked increase in interest rates in September and October, and the subdued outlook for demand, suggest that any further restocking during the current quarter is likely to be small.

After five quarters in which capital issues had averaged as much as £330 million, industrial and commercial companies raised only £130 million net in the third quarter, mainly by way of rights issues. In September and October capital issues were negligible, and by November the queue of prospective borrowers had almost disappeared.

The public sector

The stricter controls now operating over public expenditure appear to have been successful so far this year. Total public spending in the June quarter was broadly in line with the official forecasts, which implied a slower rate of growth in both costs and the volume of spending compared with the previous year. The Government have announced that there will be no general increase in cash limits for 1976/77. Labour costs continue to be restrained by the incomes policy; but other costs are now likely to rise faster than originally expected, so that the volume of spending may be reduced slightly in order to keep programmes within the limits. On the other hand, slower economic growth can be expected to increase government expenditure on certain items, such as social security payments, which are not subject to cash limits. Local authority spending plans, which are not directly controlled by the central government, are still thought to be above the guidelines for 1976/77, though the excess is now likely to be less than half as large as the earlier estimate of £400 million (at November 1975 prices). Increases in total public expenditure above forecast have so far been accommodated within the contingency reserve.

The impact on revenue of the recent changes in the economic outlook is difficult to assess. Income tax receipts and national insurance contributions will be smaller than forecast to the extent that slower growth reduces employment. If the rate of inflation proved to be higher than forecast, real disposable incomes and consumer spending would be correspondingly lower: *ad valorem* taxes on expenditure might be little changed, but receipts from specific taxes would be less than forecast.

The public sector borrowing requirement in the first six months of the present financial year amounted to £5,150 million (seasonally adjusted) – rather less than implied by the Chancellor's July forecast of £11,500 million. But the borrowing requirement in the second half of the year is likely to be higher, largely because social security benefits were uprated in November. The central government borrowing

[1] Defined as undistributed income before providing for depreciation, plus net capital transfers, less stock appreciation.

[2] Manufacturing and the distributive and service industries (excluding shipping).

requirement in the first half of 1976/77 was £3,800 million (seasonally adjusted), much less than in the same period last year. However, this reduction arose partly because public sector bodies borrowed more from domestic markets and from abroad instead of from the central government, and the public sector borrowing requirement was not correspondingly reduced.

The Government have indicated that two changes are to be made in the next White Paper on public expenditure. Firstly, the nationalised industries are to be treated as a separate sector, and will form part of the public expenditure totals only to the extent that their activities are financed by subsidies, grants, equity capital or loans from the central government. (In the past the totals for expenditure excluded loans and capital transfers but included all capital spending by nationalised industries.) Secondly, receipts of debt interest by the Government (including provisions for interest from rent and trading surpluses) will be offset against interest payments. The figure for total public expenditure will then correspond more closely to the amount which has to be financed by taxation, or borrowing by public authorities. The table shows the effects of these adjustments, expressed as percentages of GDP, for the years 1971 to 1975.

Old and new measures of total public expenditure[a]

Percentages of GDP at factor cost

	1971	1972	1973	1974	1975
Total public expenditure (old style)	49·6	49·8	50·9	57·0	58·5
Effects of:					
New treatment of debt interest	– 2·0	– 1·5	– 2·6	– 3·7	– 3·3
Separate treatment of nationalised industries	– 3·3	– 3·3	– 3·2	– 3·6	– 3·4
Total public expenditure (new style)	44·2	45·0	45·1	49·7	51·8

[a] Components may not add to totals because of rounding.

The public sector borrowing requirement is unaffected by this change in presentation. But one of the effects of the new format is to reduce public expenditure measured as a percentage of GDP by 5%–7%, compared with the previous presentation. A second effect is to include within public expenditure lending to nationalised industries by the central government but not their borrowing from the private and overseas sectors – even though the nationalised industries often switch their sources of funds: the table shows the extent to which this has happened between 1965 and 1975.

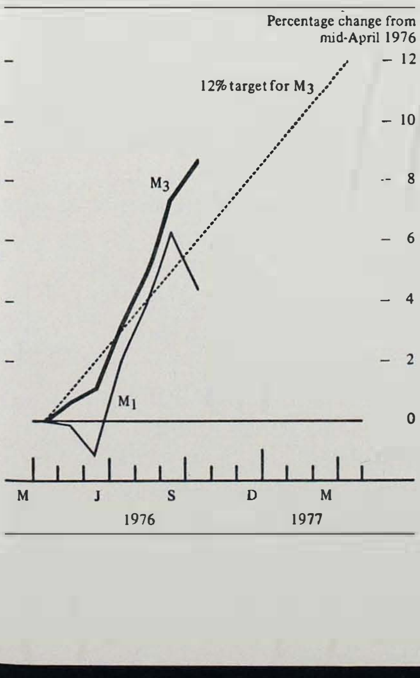
Capital expenditure by nationalised industries: sources of financing

Percentages

	1965–1968	1969–1972	1973	1974	1975
Proportion of capital spending financed by:					
Borrowing from central government	57	50	25	5	31
Borrowing from private and overseas sectors	–	– 1	25	23	12
Other (including undistributed income)	43	51	50	72	57

Cumulative growth in the money stock

Since the middle of the year M_3 has been increasing quickly.



Monetary developments[1]

Domestic credit expansion, at nearly £3,000 million, was very large in the third quarter. The outflow of funds abroad had a smaller contractionary influence on the money stock than in the previous quarter, and M_3 rose quite rapidly, by 5¼% – making a rise of 9% in the first half of 1976/77. This rate of expansion was clearly inconsistent with the authorities' aim of containing the rise in M_3 to about 12% in the financial year as a whole (see chart). A series of restrictive measures was accordingly introduced.

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

Monetary expansion will tend to accelerate during periods when the authorities do not sell sizable amounts of public sector debt outside the banking system, to help to finance the large public sector borrowing requirement. Such a pause in official sales occurred last summer. It was followed by a rise in interest rates, with minimum lending rate going up from 11½% to 13% on 10th September; and on the 16th calls were announced for special deposits equivalent to 1% of the banks' eligible liabilities. For a time this action successfully stimulated renewed sales of gilt-edged. A substantial amount of stock was sold in the second half of the month when, unusually, one long-dated issue was oversubscribed on the day of issue and thus never became a tap stock. However, shortly afterwards another sharp decline in the exchange rate led to fears that interest rates might rise again, and this impaired the prospects for further sales. When it became known that bank lending to the private sector and the money stock had expanded rapidly in the month to mid-September, further measures appeared necessary: on 7th October the Bank raised minimum lending rate to a record 15%, and calls were announced for special deposits equivalent to 2% of the banks' eligible liabilities. These measures showed the authorities' determination to prevent excessive monetary expansion; and with long-dated gilt-edged yielding over 16%, the authorities were again able to sell a sizable amount of stock around the middle of October. Subsequently, yields fell a little and further official sales were made.

In the third quarter, the central government's borrowing requirement, at £1,800 million, was smaller than in recent quarters and rather less than had been predicted earlier in the year. However, little more than one third was financed by domestic investors (other than banks): finance from other sources thus contributed over £1,100 million to domestic credit expansion (DCE), compared with around £700 million and £900 million in the two previous quarters. Bank lending to the private sector has also increased more rapidly this year, from a rise of only £100 million in the first quarter to £900 million in the second, and over £1,100 million in the third.

According to the monthly banking statistics, such lending in sterling has risen particularly fast in the months to mid-July, mid-September and mid-October: in the six months to mid-October, it rose by over £2,200 million. The broader version of the money stock (M_3) also rose rapidly in the same period – by nearly 9%. This was about twice as fast as the increase in the narrower version (M_1), which was checked by rising interest rates.

In the month to mid-October, bank lending in sterling to the private sector rose by as much as £650 million. Part of the rise was probably exceptional – there may have been some borrowing in anticipation of tighter credit restrictions; and a temporary shortage of reserve assets (see page 428) would have encouraged a number of borrowers to seek bank finance at rates related to base rates rather than borrow in the money markets. Nevertheless, the authorities could not run the risk that increases on such a scale might be repeated in subsequent months. Accordingly, the Bank announced on 18th November that the supplementary special deposits scheme was to be reintroduced (see page 434): this will considerably reduce the risk of further rapid growth in the money supply stemming from an excessive rise in bank lending either to the private or to the public sector. New exchange control restrictions on sterling finance of third country trade were also announced in November (see page 412). As such lending is run down over the next six months, the banks should find it less difficult to accommodate domestic customers. Lending remains subject to directional guidance and, provided that the public sector's demand for bank finance is contained, banks should be able to meet reasonable demands for borrowing by priority categories.

Influences on the money stock (M_3)

A higher rate of domestic credit expansion led to a faster rise in M_3 in the third quarter.

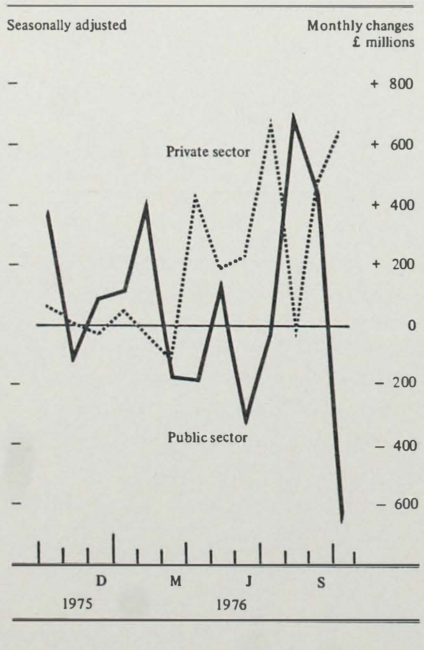
£ millions: *seasonally adjusted*

	1975		1976		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Central government borrowing requirement	+2,405	+1,915	+2,135	+1,985	+1,790
Purchases (–) of central government debt by non-bank private sector	–1,230	–1,895	–1,420	–1,105	– 665
Other public sector borrowing requirement	+ 145	+ 765	+ 285	+ 795	+ 640
Purchases (–) of other public sector debt by non-bank private sector	+ 140	– 90	– 40	– 235	– 115
Lending to private sector:					
In sterling	– 480	– 60	+ 130	+ 950	+ 920
In foreign currencies	+ 315	+ 15	– 25	– 40	+ 220
DCE [a]	*+1,195*	*+ 525*	*+1,365*	*+2,585*	*+2,955*
External items	+ 215	– 245	– 285	– 835	– 560
Other	+ 25	– 215	– 45	+ 35	– 110
Money stock (M_3)	+1,535	+ 190	+ 735	+1,550	+2,120

[a] 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

In recent months, most of the rise in bank lending in sterling went to the private sector.



Assessment

At the time of writing (8th December), the reaction of the Government to the present situation is still under consideration. But in general it is clear that circumstances limit the room in which economic policy can manoeuvre; and, whatever the choice of measures, there will be no escape from the conclusion that we face a year more of restraint and retrenchment. The recent malaise of the economy has patently been greater than the difficulties of previous post-war years: it would accordingly be wrong to expect that prosperity can be rebuilt immediately.

This year has been a year of crisis, exemplified most dramatically by the fall in the exchange rate. Between early March and early December the value of sterling in terms of other currencies fell by about 20%. This depreciation, spread over nine months, has been considerably greater than either the devaluation of sterling in 1949 or that in 1967, neither of which was more than 15% (on a trade-weighted basis).

Among the underlying reasons for sterling's decline, there can be no doubt that three aspects of UK economic performance were important. First, despite the slowing down in the rate of inflation, prices in this country have still been rising more rapidly than in most other industrial countries – as they have done for five or six years. Second, there has been widespread unease at the size of the public sector borrowing requirement and, since mid-year, the faster pace of monetary growth. And third, the balance of payments has remained in large deficit on current account – as it has been for four years.

It was natural for this country, given the size of the adjustment required when oil prices rose three years ago, to aim to correct the balance of payments only over a term of years. Policy has sought to restrain the growth of consumption, both public and private, in order to leave room for the required expansion of exports. This gradualist strategy rested heavily on the maintenance of confidence in sterling, which events might place at risk. These risks were the greater in that, even before the 1973 increase in the price of oil, the current account of this country was already in substantial deficit, and that since then the deficit has remained disproportionately large in relation to the collective deficit of industrial countries.

It must now be an urgent aim of policy that the balance of payments deficit should be eliminated quickly. This year the deficit, after falling in the first quarter, has since increased again, and at an annual rate has recently been larger than last year. This was partly because the growth of exports was, for a time, reversed; and partly because of the growth of imports. The terms of trade showed no worsening, despite the rise in commodity prices and despite the depreciation of sterling: on past experience with the so-called J-curve, depreciation would have worsened them. The prospects now appear more favourable. If, as expected, there is a moderately fast expansion of world trade, the highly competitive exchange rate should enable a stronger growth of exports to be resumed. The growth of imports ought to be slowed down by weak domestic demand; invisible receipts should continue to rise; and North Sea output is now beginning to produce appreciable savings on imported oil. While it is not possible to forecast the future development of the balance of payments with great accuracy, it may be hoped that a change of trend in external payments will become apparent in the first half of 1977, which could lead to the prospect of a balance on current account by the end of the year.

This prospect depends, however, on keeping a tight hold on demand. To achieve the result, most of the stimulus to output will have to come from exports. Home demand is likely to show little growth; personal consumption is more likely to fall somewhat; and though some growth of output is possible, the pace is likely to be decidedly slow – unfortunately, less for a while than the growth of capacity. But if the domestic economy can next year be kept within this degree of restraint, the economic situation might look very different by the end of the year. High profits in exporting should encourage exports and related investment. Depending on the success of policy in this direction and notably also in slowing down inflation, there should in a year's time be a prospect of a shift towards faster economic expansion.

It is, however, already clear that there will be difficulties in the way of controlling inflationary trends. The success of the present incomes policy has helped to halve the rate of price inflation, and after the present pause it will have to be reduced further. The rapid increase in real wages obtained earlier is being succeeded by a period in which this trend is having to be reversed. Whatever arrangements follow the present policy, this fall in living standards will make restraint more difficult. At the same time, there will be need to provide greater flexibility, and there will be pressure to restore differentials and to correct anomalies. This includes pressure for 'consolidation'; for, as a result of wage restraint, bonuses and overtime pay have been depressed in comparison with pay for standard hours. In some key sectors, too, a recasting of pay policies may now be urgent for the sake of securing agreement on manning levels.

Even if there were no normal across-the-board wage increase at all, adjustments of this sort could increase wage costs by more than can be afforded at present. Some of the pressures could be relieved if there were scope for an easing of the burden of direct taxation. Even so, it appears questionable whether all the needed wage adjustments can be made in one year, and whether it would not be more realistic to envisage a two-year period for the next phase of pay policy. This might appear a hard remedy. But in present circumstances it is likely to prove hard to maintain employment; and prospects of success will be greater if the pace of cost and price increases is being effectively contained. What pace of expansion can be aimed at will turn on how quickly inflation can be overcome. Only continued collaborative effort can bring together these two imperatives – less inflation, but more employment.

It will remain important to keep the pace of monetary expansion under close restraint. This will be easier if the public sector borrowing requirement can be seen to be falling in money terms as well as in proportion to GDP. Up to the middle of the year, the growth of the monetary aggregates had been moderate; but in July the growth accelerated, and subsequently continued to be uncomfortably fast. Domestic credit expansion, correspondingly, remained above the expected rate indicated a year ago to the International Monetary Fund (£9 billion in this financial year). Monetary expansion tends to be rapid when sales of government stock fall off – as they did from the latter part of July until the first part of September: since then, however, there have been very large sales of gilt-edged. A second reason for faster expansion has been higher bank lending to the private sector. The earlier rise in interest rates and calls for special deposits have now been reinforced by the reimposition of supplementary special deposits. These measures are likely to bring bank lending, and the growth of the monetary aggregates, back to an acceptable pace. Quantitative monetary targets for 1977/78 have not at the time of writing been announced: in view of the overriding need to bring about a rapid recovery in the balance of payments, it may be appropriate to place chief emphasis on the domestic component of monetary expansion.

The achievement of a more stable basis for recovery in the United Kingdom is closely dependent on the continuation of a satisfactory rate of expansion among this country's trading partners. Without this, it will be difficult to achieve either the necessary correction of the balance of payments, or to look forward to a faster rate of domestic growth. Countries such as the United Kingdom, with particularly severe problems of inflation or external deficit, must give priority to bringing their external position into balance. The reverse is also true: countries in a strong external position need to be willing to adopt policies which will bring them nearer to balance. If the burden of adjustment is laid only on the deficit countries, there is a danger of the world returning to unintended and unnecessary recession. There have been signs that world economic recovery is faltering; but any such tendency is not beyond the reach of corrective action by governments.

The importance of maintaining the momentum of economic recovery is particularly great at the present juncture. The world is still in course of adjusting to the increase in the price of oil three years ago. The effects experienced so far on countries' balance of payments and on internal prices are evident enough. But much of the diversion of real resources required to complete the adjustment has still to be made. Such an adjustment is liable to increase the economic and social tensions inside each country, and strain its resources of economic management. These tasks should be much less difficult for the United Kingdom than for many other countries which are not able to look forward to the development of domestic sources of oil.

Supplementary note to the economic commentary

Table A

Increase in consumer prices in main industrial countries[a]

Percentage increases on previous year

	1966–1973[b]	1973	1974	1975	1976 1st half (annual rate)
United States	4·2	5·5	10·8	8·0	4·9
Canada	4·0	6·5	10·6	10·4	7·9
Japan	6·2	11·0	21·5	11·0	9·5
France	5·5	7·0	13·6	11·4	9·5
Italy	5·3	11·6	19·7	17·4	15·1
Western Germany	3·9	6·9	7·2	6·0	4·9
United Kingdom	6·1	8·6	16·1	23·1	17·3

[a] Up to and including 1975, deflators of consumers' expenditure have been used. Estimates for the first half of 1976 were based mainly on consumer price indices, which are broadly similar to the UK retail price index.

[b] Increase in this seven-year period, expressed at an annual rate.

Inflation, real incomes and taxation

This note describes factors contributing to the general rise in prices in the United Kingdom over the last few years, particularly import prices and earnings; it also examines trends in real personal income, taxation, and the distribution of post-tax earnings. Some international comparisons are included.

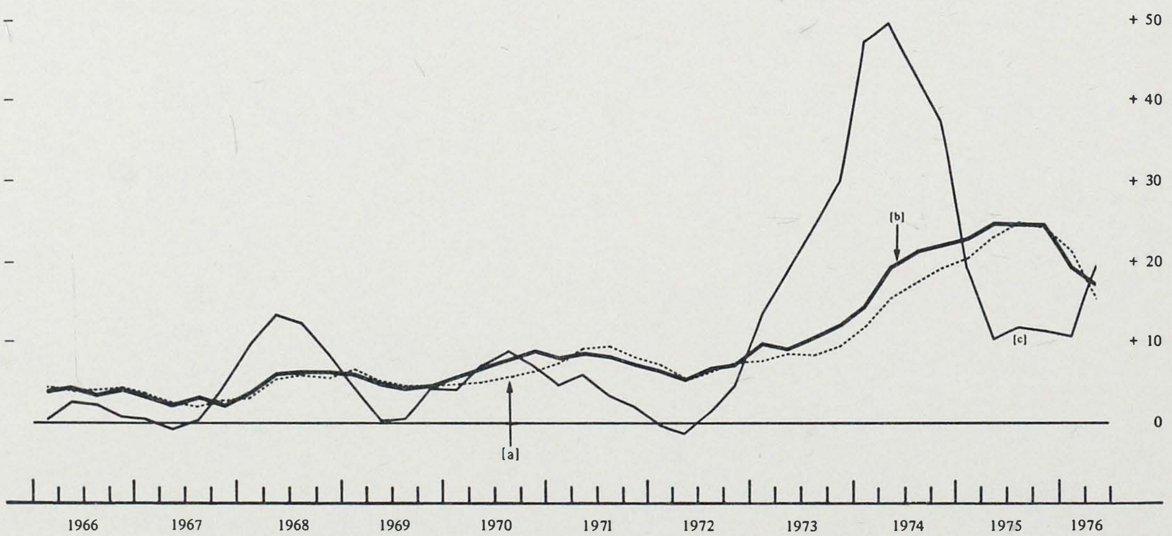
Factors contributing to inflation

In the last few years, inflation in the United Kingdom has been faster than in most other OECD countries; but other countries have also suffered from accelerating inflation, though to widely varying degrees (see Table A).

Price inflation increased in the United Kingdom during the ten years to 1975; the rise was only checked in years following low points in economic activity, namely 1967, 1972 and 1976 (see chart). Import prices rose especially quickly in the two years to the end of 1974.

UK price inflation

Percentage changes on a year earlier



[a], [b] and [c] represent implicit deflators of consumers' expenditure, total final expenditure, and imports of goods and services respectively.

Table B

Factors contributing to the general rise in UK prices[a]

Percentage increases on previous year

	General prices[b]	of which, attributable to: Labour costs[c]	Other factor incomes[d]	Net taxes on expenditure	Import costs
1970	7·3	4·3	0·7	0·7	1·6
1971	8·0	3·5	3·3	0·2	1·0
1972	6·7	3·7	1·6	–0·1	1·5
1973	10·4	3·6	1·8	–0·1	5·1
1974	19·5	10·0	0·9	–0·3	8·9
1975	24·1	16·0	4·2	1·9	2·0
1976 1st half (annual rate)	16·1	6·3	3·7	1·7	4·4
Shares of total final expenditure in 1975 (per cent)		51·8	19·0	7·7	21·5

[a] The values of the various cost components were each divided by total final output to give costs per unit of output. Unit cost increases for the various components were then expressed as percentages of the implicit deflator of total final expenditure in the preceding year to give increases in total costs attributable to particular components. No lags were incorporated.

[b] The implicit price index of total final expenditure.

[c] Incomes from employment per unit of TFE at 1970 market prices.

[d] Self-employment incomes, profits and trading surpluses of public corporations (all net of stock appreciation), rent and the residual error – all per unit of total final expenditure at 1970 prices.

Sources: derived from *National Income and Expenditure 1965–1975*, *Economic Trends*, October 1976 and *Monthly Digest of Statistics*, October 1976.

The general rise in prices can be separated into its main components by using the identity that total final expenditure at market prices equals total income from employment plus profits, rent and self-employment income (all net of stock appreciation), plus imports and taxes on expenditure (net of subsidies). In Table B, general price inflation is represented by the rise in the price of total final expenditure; and the contribution of, say, imports is calculated from the rise in import costs per unit of total final output. It should be stressed that such an analysis in itself reveals little about the causes of inflation or about the interaction of the various price movements. For example, a rise in UK import prices may not necessarily originate abroad: it may stem entirely from a depreciation of sterling brought about by a faster rate of inflation in the United Kingdom compared with other main industrial countries. Nevertheless, this type of statistical analysis is useful, provided it is interpreted with care.

The figures show that import costs contributed substantially to price inflation between 1972 and 1974. Import prices (for both goods and services) rose by 44% in sterling terms between 1973 and 1974, and there was effectively no replacement of imports by cheaper domestic goods until 1975. Indeed, import penetration rose faster than usual in 1972 and 1973 with the upturn in activity, and in 1974 was around

Table C
Import penetration

Imports of goods and services as a percentage of total final expenditure, all at 1970 prices

	1970	1971	1972	1973	1974	1975	1976 1st half
United States	5·6	5·7	5·9	5·9	6·1	5·3	5·8
Canada	19·1	19·2	19·9	20·9	21·8	21·3	22·1
Japan	9·6	9·6	9·2	10·2	11·5	10·5	10·3
France	12·9	13·2	14·4	15·7	15·3	14·5	15·5[a]
Italy	15·2	15·4	16·4	16·9	16·7	15·7	16·5
Western Germany	17·7	18·6	19·4	20·1	20·8	21·5	22·3
United Kingdom	17·7	17·9	19·3	20·4	20·2	19·4	19·9

[a] First quarter only.

Table D
Contribution of imports to the general rise in prices

Percentage increases on previous year

	Total contribution of imports to the general rise in prices[a]	Attributable to: Import prices in sterling	*of which:* *Import prices in US dollars* [b]	*Change in exchange rate*	Change in import penetration [c]
1970	1·6	1·2	*1·2*	*–0·0*	0·4
1971	1·0	0·7	*1·0*	*–0·3*	0·3
1972	1·5	0·2	*0·7*	*–0·4*	1·3
1973	5·1	3·9	*3·6*	*0·3*	1·2
1974	8·9	8·9	*7·8*	*1·1*	–
1975	2·0	3·2	*1·8*	*1·4*	–1·2
1976 1st half (annual rate)	4·4	3·5	*–1·0*	*4·5*	0·9

[a] Table B, final column.

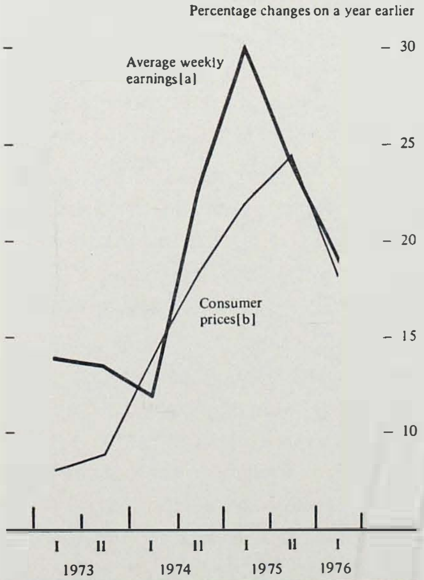
[b] Changes in dollar prices were obtained by dividing the deflator for UK imports of goods and services by an index of the dollar/sterling exchange rate, i.e. prices in US dollars were taken to be independent of movements in sterling.

[c] Obtained by subtracting the change in general prices stemming from movements in import prices in sterling terms from the change arising from total import costs.

Source: See Table B.

Average earnings and consumer prices

Percentage changes on a year earlier



[a] Great Britain: all industries, seasonally adjusted, July 1970 = 100.

[b] Implicit deflator of consumers' expenditure, 1970 = 100.

20% of total final expenditure: the rise in import prices in that year accordingly added about 9% to UK general inflation. The United Kingdom relies more on imports than many countries, but not much more than the main European industrial countries – indeed, slightly less than Western Germany (see Table C). Nevertheless, import costs appear to have been more inflationary here than in Western Germany between 1972 and 1974. Changes in the exchange rate had little effect on the import bill in either country (though sterling's decline has since raised UK import costs substantially – see Table D). But in dollar terms, UK import prices rose by 38% between 1973 and 1974 and West German prices by 26%. The reasons for this discrepancy are not clear but they probably include variations in the commodity composition of imports, in the proportion supplied on long-term contracts, and in the rate of inflation in the two countries.

Labour costs represent about 50% of total costs; but in 1974, and even more in 1975, they were the largest element in inflation, directly accounting in both years for more than half of the general rise in prices. In 1974 stage three of the previous Government's statutory pay policy was replaced by the present Government's voluntary incomes policy, while threshold payments permitted under the former policy continued to be payable in respect of increases in the retail price index up to and including November 1974. Average earnings in 1974 were about 18% higher than in 1973, and a further 27% higher in 1975. In the year to the middle of 1975, average earnings rose much faster than consumer prices (see chart) and real earnings increased accordingly. The deepening recession early in 1975, together with the £6 pay limit introduced in August, led to a much smaller rise in average earnings through the year; with productivity rising cyclically, the contribution of labour costs to inflation has been much less this year than last.

Profits, rent and earnings of the self-employed (as well as the residual error in the national income accounts) contributed little to the general rise in prices until 1975, but have since accounted for more. Profit margins on current costs have recently benefited from the slower rate of inflation – reflected for example in smaller stock appreciation – and from rising export prices, although the recovery of profits has been limited by weak domestic demand and low output.

The limitations of this type of analysis were outlined earlier, but the following points can be made. Firstly, the rise in commodity prices between 1972 and 1974 was unprecedented in UK post-war experience.[1] The reasons for the increase are various, but include successful collective action by oil exporters in 1973 as well as heavy demand in commodity markets associated with the cyclical peak in economic activity in many industrial countries before 1974. The rise came at the start of the period of rapid inflation and made a large direct contribution to price increases; and although the steep rise was fairly short-lived, it must also have had important indirect consequences through induced adjustments to wage rates and profit margins.[2]

Secondly, much of the increase in average earnings must have been a reaction to the earlier sharp rise in import prices, in particular because the earnings of perhaps two thirds of employees in 1974/75 were

[1] As measured by *The Economist* all-items dollar index, commodity prices rose almost as fast between 1950 and 1951 (i.e. during the Korean War); but by the middle of 1953 the rise had been reversed. In contrast, by the middle of 1975 prices were still about twice as high as in 1970 and have since risen further.

[2] If persons and companies were able to maintain their real incomes in the face of price increases by raising their nominal incomes, a once-for-all rise in import prices would, in the absence of changes in productivity, sooner or later spread throughout the economy, with powerful effects on prices as a whole. In theory, the latter would increase by the same percentage as import prices if all domestic prices were fixed by applying constant percentage mark-ups to input costs. In fact, some sectors of the economy will be unable to pass on price increases fully because of market conditions or restraints on wages or prices. The eventual increase in general prices will therefore be somewhere between the 'direct contribution' of import prices (as shown in Table B) and the full percentage change in import prices.

Further inflationary pressure will emerge in time if domestic resistance to cuts in real income leads to a balance of payments deficit and hence to a decline in the exchange rate; or if domestic incomes rise in anticipation of further price increases.

Table E

Increase in real average earnings in manufacturing in main industrial countries[a]

Percentage increases on previous year

	1966–1973[b]	1973	1974	1975	1976 1st half (annual rate)
United States	1·7	1·5	–2·7	0·9	0·9
Canada	3·8	1·9	2·5	4·9	3·9
Japan	10·6	12·1	9·3	3·9	..
France[c]	5·2	7·1	5·0	4·9	..
Italy	7·6	10·0	6·2	..	..
Western Germany	4·8	3·6	3·0	2·0	–0·7
United Kingdom	3·8	2·3	3·4	3·1	1·3

.. not available.

[a] Average hourly earnings in manufacturing, deflated by the consumer price indices used in Table A.

[b] Increase in this seven-year period, expressed at an annual rate.

[c] Based on wage rates.

Table F

UK personal income before and after tax

£ billions: *percentages in italics*

	1968–1970 [a] (annual averages)	1971–1973 [a] (annual averages)	1974	1975	1976 1st half[b]
Total personal income[c]	39·6	54·9	75·9	95·7	107·2
Increase on previous year	*+ 9·0*	*+14·7*	*+20·8*	*+26·2*	*+ 16·3*
Shares in total personal income:					
Employment income[d]	*69·9*	*69·4*	*69·2*	*71·2*	*70·2*
State pensions and other social security benefits	*10·1*	*10·4*	*10·4*	*10·7*	*11·8*
Other income[e]	*20·1*	*20·1*	*20·4*	*18·1*	*18·0*
UK taxes and national insurance contributions	7·5	10·3	15·4	21·9	25·6
Tax and national insurance as percentage of total personal income	*19·0*	*18·8*	*20·4*	*22·8*	*23·9*
Personal disposable income	32·0	44·5	60·3	73·7	81·5
Increase on previous year	*+ 8·2*	*+15·1*	*+18·3*	*+22·3*	*+ 14·3*
Real personal disposable income:					
£ billions at 1970 prices	33·9	38·2	41·4	41·2	40·6
Increase on previous year	*+ 2·2*	*+ 6·9*	*+ 1·9*	*– 0·7*	*– 1·2*

[a] Percentage increases relate to 1970 on 1968 and 1973 on 1971 at annual rates

[b] At annual rate.

[c] Before deducting stock appreciation and depreciation. Includes income of unincorporated businesses and private non-profit-making bodies and net interest received by life assurance and pension funds. Also includes employers' national insurance and other contributions.

[d] Including employers' contributions and forces pay.

[e] Income from self-employment and rent, dividends and net interest receipts.

Source: See Table B.

automatically, if partially, linked to the retail price index through the mechanism of threshold payments. Nevertheless, wage settlements during that wage round were much larger than required to maintain real earnings or to anticipate the continuation of prevailing price increases (see also the March 1975 *Bulletin*, page 11). They were thus apparently in part an independent source of inflation.

The impact on costs of these high wage settlements was partly offset from early in 1975 by the slower growth in average earnings associated with the recession. Earnings have continued to rise more slowly – even this year when import costs have risen sharply; this must be seen as a necessary step back from the rapid inflation in 1974 and 1975. Such a phase, which entails the temporary acceptance of unusually small increases in living standards, or actual falls, has been characteristic of countries which have been able either to avoid the inflationary excesses of the last few years or, having suffered them, to return to stability (see Table E).

Disposable incomes[1]

Before tax, total personal income has risen at broadly the same rate as income from employment over the last few years (see Table F). However, since 1973 both earnings and social security benefits (mainly pensions) have increased faster than other sources of income (self-employment income, rent, dividends and interest, and private pensions). The increase in the share of income from employment was particularly marked in 1975, though this was partly because of the steep rise in employers' contributions in that year.

This growth in total income has been accompanied by a more than proportionate rise in personal income tax and national insurance contributions. Taken together, such payments rose from 19% of total personal incomes in 1971–73 to 24% in the first half of 1976. This increase was essentially due to rapidly rising incomes and the progressiveness of the tax system in automatically raising average tax rates ('fiscal drag').[2] Tax thresholds were not raised sufficiently to offset this fiscal drag. If tax bands and allowances had been the same in real terms as in 1973, with growth of pre-tax income unaffected, personal disposable income in 1975 would have been over 5% higher than it actually was. However, because it is hard to assess how far the actual rise in nominal pre-tax income was a reaction to fiscal drag, or how far tax rates would have been raised to compensate for the absence of fiscal drag, there is no means of knowing how taxation would have developed if the tax system had actually been indexed.

Ignoring tax which may be paid on retirement benefits, the share of social security benefits in personal income after tax has risen from 12½% in 1970 and 1971 to 15½% in the first half of 1976 (and will almost certainly rise further as a result of the uprating of social security benefits in November).

The rise in personal disposable income naturally becomes much smaller when account is taken of the falling value of money. Nevertheless, an unusually large increase in real terms (about 7% per annum) took place between 1971 and 1973, a period when output and the pressure of demand were each rising rapidly and when rates of personal income tax were reduced. Increases in real personal disposable income since 1973 have been much smaller as higher taxation and inflation have combined to offset the steep increases in nominal income in 1974 and 1975, and pay restraint since August 1975 has helped to keep increases in wages and salaries at or below the prevailing rise in consumer prices.

[1] For definitions, see the notes to Table F.

[2] If tax bands and allowances had been fully adjusted to eliminate the effect of price inflation between 1973 and 1975, pre-tax incomes being unaffected, personal income tax and national insurance contributions in 1975 would have been about £4 billion less than the amounts actually paid. This assumes an income tax elasticity of 1.8 with respect to the tax base, and an elasticity of unity for national insurance contributions with respect to the tax base.

International comparisons of changes in real personal disposable income (RPDI) should be treated with caution because some countries normally experience a much faster rise in RPDI than others, and the United Kingdom has in recent years come fairly low in comparisons with main industrial countries. Moreover, comparisons are affected by the differing importance of farm or other small business incomes. However, RPDI appears to have risen much more slowly since 1973 than before in all the main OECD countries, particularly in the United States, Western Germany and (in 1974) Japan, as well as in the United Kingdom (see Table G); but whereas RPDI accelerated again last year in a number of countries, it has not done so in the United Kingdom.

The pressure on real personal income in the United Kingdom should be viewed in the light of changes in recent years in real national disposable income, i.e. real GNP at market prices adjusted for changes in the terms of trade. Whereas real GNP at market prices, but not so adjusted, fell very slightly in 1974 (partly because of the energy crisis early in that year) and by 1¾% in 1975, real national disposable income fell by almost 5% in 1974 and by ½% in 1975, before recovering slightly in the first half of 1976. It was then, however, only about 6% higher than in 1970 (see Table H). In contrast, real personal disposable income (net of stock appreciation) was 15½% higher in the first half of 1976 than in 1970. The counterpart was a substantial fall in the real disposable income of companies and of the public sector.[1] This was reflected in a fall in the real profitability of companies[2] and, in the case of the public sector, in the relatively slow growth of revenue in real terms (associated with the recession), together with a rapid rise in transfer payments directly or indirectly to the personal sector. To achieve a better balance in the economy, the real disposable income of these sectors will need to be restored to a more normal relationship with national disposable income.

Table G

Real disposable household income in main industrial countries[a]

Percentage increases on previous year

	1966–1973 [b]	1973	1974	1975	1976 1st half (annual rate)
United States[c]	4·2	6·7	−1·6	1·8	4·7
Canada	5·5	7·4	4·7	5·6	
Japan	10·4	11·9	1·9	5·2	
France	6·1[d]	6·9	3·0	3·5	
Italy	5·9	5·3	3·1	−0·4	
Western Germany	4·4	1·4	1·0	3·1	2·5
United Kingdom	3·1	5·5	–	−0·9	

[a] Household income here differs from total personal income in Table F mainly in excluding net interest received by life assurance and pension funds.

[b] Increase in this seven-year period, expressed at an annual rate.

[c] Personal sector's disposable income.

[d] 1970–1973.

Sources: derived mainly from *National Accounts of OECD Countries* and *Economic Outlook* (OECD), supplemented by national publications. US data are from the *Survey of Current Business.*

Table H

UK real national and personal disposable incomes

	Real gross national product at 1970 market prices[a]	Real national disposable income[b]	Real personal disposable income[c]
Average annual percentage increase, 1966–71	*2·2*	*2·5*	*1·9*
Index numbers, 1970=100			
1971	101·8	101·9	102·3
1972	105·0	105·4	110·2
1973	111·8	110·2	116·4
1974	111·6	105·1	118·1
1975 1st half	109·6	104·8	118·8
2nd „	108·3	104·5	117·2
1976 1st „	109·4	105·9	115·5

[a] Based on average estimate of GDP.

[b] Real GNP at 1970 market prices adjusted for net current transfers abroad and for the effect of changes in the terms of trade on the purchasing power of income derived from domestic output (see *Economic Trends*, January 1975, page xxviii).

[c] Net of stock appreciation.

Source: See Table B.

Distribution of personal incomes

The combination of pay restraint in the form of uniform limits for increases in earned income and rapid inflation working through a non-indexed and progressive tax system is likely to have a significant effect on the distribution of post-tax income between individuals with different earnings. The main influence recently has probably been the incomes policy: tax changes this year have partly offset the effect of fiscal drag. To show this impact since the beginning of the present pay policy in August 1975, Table J (on the following page) gives estimates of the pre and post-tax pay of individuals with different earnings before and after the first and second stages of the policy.[3] The incomes chosen span the great majority of income earners, with group 3 broadly representing the median wage and salary earner in the pay year August 1974 to July 1975, and group 4, the average earner. All the individuals shown are assumed to be married men with two dependent children, receiving only the standard tax and family allowances; family income supplements and other welfare benefits are excluded. For illustrative purposes, all are assumed to receive the maximum permitted pay increases at the start of each stage of the policy. On these assumptions, the dispersion of post-tax pay, as measured for example by percentage differentials from group 3, narrows quite appreciably between the pay years 1974/75 and 1976/77; and the ratio of post-tax pay between the highest and lowest groups shown falls from about 3⅔ to 3. The main influence in this period is the narrowing of pre-tax differentials brought about by the incomes policy (particularly the first stage); the change in the tax burden is relatively unimportant.

[1] The public sector's real disposable income is, in principle, equal to current receipts of taxes, trading surpluses, rent and interest, less current transfers to other sectors, and deflated by the price of public expenditure on goods and services.

[2] See March *Bulletin*, page 36.

[3] Data for earlier years have been published by the Diamond Commission.

Table J
Change in pay distribution under the counter-inflation policy

Group	Approximate position in earnings distribution[a]	Pay year 1974/1975[b] Pre-tax pay[a] £	Post-tax pay[c] £	Post-tax pay[c] Percentage of pre-tax pay	Post-tax pay[c] Percentage of group 3	Pay year 1976/1977[b] Pre-tax pay[d] £	Post-tax pay £	Post-tax pay Percentage of pre-tax pay	Post-tax pay Percentage of group 3	Fall in real post-tax pay since 1974/1975[e] *percentage*
1	Lowest decile	1,870	1,650	88	75	2,540	2,160	85	78	0–5
2	Lower quartile	2,260	1,880	83	85	2,970	2,420	81	87	3–7
3	Median	2,790	2,200	78	100	3,590	2,790	78	100	4–8
4	Mean	3,040	2,350	77	107	3,880	2,960	76	106	5–9
5	Upper quartile	3,500	2,650	76	120	4,430	3,280	74	118	6–10
6	Highest decile	4,410	3,240	73	147	5,450	3,920	72	141	9–13
7	Twice mean	6,080	4,340	71	197	7,320	5,080	69	182	11–15
8	Three times mean	9,110	5,940	65	269	10,400	6,590	63	236	16–20

[a] Based on new earnings survey, 1975. Refers to men on full time, aged twenty-one and over, whose pay for the survey period was not affected by absence. Earnings have been adjusted to reflect the difference between average earnings in the survey (April 1975) and those throughout the pay year.

[b] Incomes policy years, beginning 1 August.

[c] Post-tax pay has been estimated by applying a weighted average of tax rates and allowances ruling in the years 1974/75 and 1975/76. It includes family allowances and, in 1976/77, child benefits, with appropriate deductions for tax claw-back.

[d] Pre-tax pay has been estimated by adjusting the estimates for 1974/75 to allow for the increase in average earnings up to July 1975 and by adding the increases allowed under the incomes policy. It was assumed that the latter were received at the beginning of each stage of the policy.

[e] Change in nominal post-tax pay divided by the change in the deflator of consumers' expenditure (1970=100). The estimates vary in accordance with the rate of inflation assumed for the second year of the policy.

It can also be seen that all individuals shown suffer falls in real post-tax pay, particularly in the higher groups. The extent of the decline will depend among other things on the rate of inflation during the remainder of the current pay year. For present purposes, alternative year-on-year increases of 10% and 15% have been assumed.

These various assumptions are, of course, hypothetical and the results are unlikely to correspond exactly with actual changes in earnings or taxation. For example, no allowance is made for the effects on pay of overtime or short-time working, back-payments, progress towards equal pay or promotion; or for increases in social security benefits. Similarly, no account is taken of tax reliefs available in respect of mortgage interest or life insurance premiums, or of welfare benefits, although the incidence of each of these will not be the same for different income groups. For example, much of the benefit of the incomes policy to some families on low incomes will have been lost through the associated reduction in means-tested welfare benefits. Accordingly, the post-tax differentials may not be an accurate guide to differences in living standards. The table merely shows how the various individuals would have fared if they each received the maximum permitted increases, if their earnings were otherwise unaffected, if tax rates and allowances remained unchanged for the rest of stage two, and they received only the standard allowances.[1] In fact, the falls in real post-tax earnings shown here are somewhat heavier than the decline in total real personal disposable income up to the first half of the year shown in Table F. While these illustrative figures perhaps overestimate the fall in an individual's real earnings, they are unlikely seriously to misrepresent the scale of the general squeeze of pay differentials currently taking place.

[1] When compared with the results of the new earnings surveys in 1975 and 1976, these estimates appear to overstate the contraction in the range of earnings. However, some individuals may have been at the lower end of the range partly because they had not by then received any, or all, of the £6 increase. Those with higher earnings may have been promoted, or have received an annual salary increment. Individuals receiving exactly £6 a week may have changed groups, and the differences between their particular earnings may have narrowed sharply – but not the earnings of the groups as a whole. The estimates presented here are thus not necessarily incompatible with the results of the surveys.

CORRECTION

Bank of England Quarterly Bulletin

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Supplementary note to the economic commentary

Table J on page 426 should read as follows:

	Approximate position in earnings distribution[a]	Pay year 1974/1975[b]				Pay year 1976/1977[b]				
		Pre-tax pay[a]	Post-tax pay[c]			Pre-tax pay[d]	Post-tax pay			Fall in real post-tax pay since 1974/1975[e]
				Percentage of pre-tax pay	Percentage of group 3			Percentage of pre-tax pay	Percentage of group 3	
		£	£			£	£			*percentage*
Group										
1	Lowest decile	1,870	1,630	87	74	2,540	2,140	84	77	0–5
2	Lower quartile	2,260	1,860	82	85	2,970	2,400	81	87	2–7
3	Median	2,790	2,190	78	100	3,590	2,770	77	100	4–8
4	Mean	3,040	2,330	77	107	3,880	2,940	76	106	5–9
5	Upper quartile	3,500	2,630	75	120	4,430	3,260	74	118	6–10
6	Highest decile	4,410	3,230	73	148	5,450	3,900	72	141	8–12
7	Twice mean	6,080	4,320	71	198	7,320	5,060	69	183	11–15
8	Three times mean	9,110	5,910	65	270	10,400	6,560	63	236	16–20

Footnotes remain unchanged.