Economic commentary

Towards the end of last year and early in 1977 there was a marked change of mood in UK financial markets. The completion of negotiations with the International Monetary Fund, the arrangement of a facility relating to the official sterling balances, and a $1½ billion loan raised through a syndicate of foreign banks, all contributed towards an improvement in confidence. The mood of confidence was reflected most clearly in the course of the exchange rate which rose from a low point of $1.56 in October to above $1.70 in late December, and remained close to this rate throughout the following two months – when the authorities were also buying dollars on a large scale.

Confidence was also helped by the recent behaviour of the monetary aggregates and domestic credit. Sterling M_3 (see the statistical note on page 39) fell in December – the first decline for many months – and again in January. DCE is now likely to be within its limit for 1976/77.

These developments were accompanied by a fall in interest rates, with minimum lending rate coming down in several stages from 15% in October to 12% in early February.

Turning to the real economy, output increased in the fourth quarter, after changing little in the previous six months. The rate of price inflation has accelerated – perhaps temporarily – in recent months, largely reflecting sterling's depreciation last year, and continues to be well above the rate in most other industrial countries. Domestic demand is likely to remain subdued this year, and output will be heavily dependent on external trade. UK export markets are not expected to expand very quickly, but an improvement in the current account is in prospect, largely because of North Sea oil.

The immediate and longer-term outlook for the UK economy is discussed in some detail in the concluding assessment on page 16.

International developments

In the fourth quarter of last year, output in the industrial countries had again expanded only slightly (see table) – in many cases probably more slowly than productive potential. In the OECD area as a whole, the margin of spare capacity appeared to be almost as large as it had been a year earlier. Unemployment had been falling in some countries, but by the end of the year it had either levelled off or turned up. The more expansionary policies now being adopted in varying degrees in the United States, Western Germany and Japan should help the growth of output to accelerate a little from now on in the OECD area as a whole: for reasons given below, GNP can be expected to rise by 5%–6% during 1977 and industrial production by perhaps 7%.

Industrial production [a]

In the final quarter of last year, production in the industrial countries as a whole again rose only slowly.

Percentage change on previous quarter: *seasonally adjusted*

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

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

In the United States, there had been signs of an underlying recovery in demand. Consumer spending began to rise much faster towards the end of last year, and investment intentions surveys suggested that private fixed investment by manufacturing and service industries would accelerate in the course of this year. The recovery was interrupted by the severe winter and the associated lay-offs which will have reduced personal incomes in the current quarter. But the effects of the adverse weather are likely to be largely temporary, and most of the loss of output should be made good fairly quickly. The first of the expansionary measures proposed by the new Administration – a tax rebate of $11.4 billion – is expected to be paid in the second quarter and should provide a boost to spending and output in that period. The effects of other elements of the package – an increase in public spending programmes of $9.2 billion and reductions in personal and

corporate taxes worth $10.6 billion – will be spread over two years. The Federal Reserve has indicated that its long-term money supply targets are consistent with the Administration's objectives for economic growth. All in all, the US economy may be expected to grow at an annual rate of around 5% during this year and next.

In Japan, a small reflationary package announced in November may generate demand equivalent to rather more than 1% of GNP, and a supplementary Budget for the present fiscal year perhaps a little less than this. The proposed Budget for the year to March 1978 provides for an increase in government spending of some 7% in real terms and for minor reductions in taxation. If these measures are approved, and with monetary policy at present broadly neutral, GNP can be expected to grow by between 6% and 7% both this year and next – in line with present official medium-term targets, but well below the average since the war. In Western Germany, policies remain rather more cautious. Public investment programmes have been increased by the equivalent of about ¼% of GNP in each of the next four years. But the Government plan to increase VAT next year in order to reduce their borrowing.

In most of the other large countries, continuing balance of payments problems have made for tighter government policies. In France, the Budget for this year provides for a much smaller rise in public spending than in 1976, and the official monetary targets suggest that monetary conditions will be tight. The Government's anti-inflation programme, designed to restrain both prices and incomes, is expected to slow down the growth of domestic demand this year. Altogether, GNP may grow by only about 3½% this year and next – well below medium-term targets. In Italy, more severe policies have been adopted: fiscal measures introduced last autumn were aimed at reducing demand by the equivalent of 3% of GNP this year, and plans for further increases in indirect taxation have since been announced. Even so, there may be a small increase in GNP both this year and next. Taking together the six main industrial countries other than the United Kingdom, GNP seems likely to grow by rather less than 5% this year and again in 1978 – less than in 1976 as a whole, but faster than in the second half of that year.

By the end of last year, consumer prices in the OECD area as a whole were rising on average at an annual rate of around 8% – almost as fast as a year earlier (see table). The pressures on industrial costs from higher commodity prices eased off in the fourth quarter, though signs of recovery in industrial activity around the turn of the year have since led to a further revival in the prices of some raw materials (see below). In Italy and the United Kingdom, a sharp decline in the exchange rate last year added to price inflation, and in the fourth quarter their consumer prices were rising more strongly than elsewhere.

The current account balances of the main industrial countries deteriorated sharply in the second half of last year (see table). In volume terms, their exports rose by less than 1% in the third quarter, largely because trade between themselves was little changed. On the other hand, oil imports were much higher than in the previous quarter and the volume of total imports rose by some 4%. On the evidence so far available, the pattern was much the same in the fourth quarter, with exports increasing only slowly while imports went on rising almost as fast as in the previous quarter.

In the recent past, as in the whole period since the oil crisis, the counterpart of the oil exporters' current account surpluses has been very unevenly spread among the oil-importing countries. Most countries which ran up large deficits after the oil crisis remain in heavy deficit. Indeed, France's current account deficit widened in the second half of last year, partly reflecting extra oil imports and a significant fall in

Consumer prices

In the fourth quarter prices generally rose at about the same rate as a year earlier, but variations among individual countries were more pronounced.

Percentage increase on previous quarter: *not seasonally adjusted*

	1975	1976				Year to
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr	4th qtr 1976
United States	1·6	1·0	1·3	1·6	1·1	5·0
Canada	2·1	1·3	1·5	1·4	1·5	5·9
Japan	2·7	2·3	3·2	1·1	2·5	9·4
France	2·2	2·4	2·3	2·3	2·6	9·9
Italy	2·8	4·2	6·3	2·7	6·4	21·2
Western Germany	0·9	1·7	1·5	0·1	0·5	3·8
United Kingdom	3·4	3·6	3·7	2·3	4·6	15·0
Weighted average of above	*1·9*	*1·7*	*2·0*	*1·5*	*1·8*	*7·3*
Other OECD	4·2	5·5	1·2	4·6	3·3	14·2
Weighted average of all OECD countries	*2·2*	*2·2*	*1·9*	*1·9*	*2·0*	*8·2*

Current account balances

In the second half of last year, the main industrial countries had a much larger current account deficit.

$ billions: *seasonally adjusted*

Surplus +/deficit –

	1975		1976		Total
	1st half	2nd half	1st half	2nd half [a]	1974–1976
United States	+ 5	+ 6	+ 1	– 2	+ 7
Canada	– 3	– 2	– 3	– 2	– 11
Japan	+ 1	– 2	+ 4	–	– 2
France	+ 1	– 1	– 2	– 5	– 12
Italy	–	– 1	– 2	– 1	– 12
Western Germany	+ 3	+ 1	+ 2	+ 2	+ 18
United Kingdom	– 2	– 2	– 1	– 2	– 16
Total	+ 5	– 1	– 1	–10	– 28
Other OECD countries	– 7	– 5	– 6	– 6	– 37
Total OECD countries	– 2	– 6	– 7	–16	– 65
Oil-exporting countries [b]	+13	+19	+17	+20	+138
Other developing countries	–17	–15	–11	–11	– 79

[a] Partly estimated.

[b] As listed in the footnote to Table 19 in the statistical annex.

exports of foodstuffs following the drought, but also because domestic demand remained stronger than in other countries. The smaller OECD countries as a group, together with the non-oil developing countries, continue to run current deficits which are very large in relation to the size of their economies. The position of three of the larger OECD countries – Western Germany, the United States and Japan – has, however, been quite different. Western Germany's current account surplus has narrowed only slightly. On the other hand, the United States moved from a substantial surplus in 1975 to a small deficit in the second half of last year: this change was partly because it led the way out of the world recession, but also because oil imports were swollen by an increase in energy consumption while domestic oil production continued to fall. In Japan a very rapid growth in exports had produced a large current account surplus in the first half of last year, but imports subsequently began to expand and the current account was once again close to balance in the second half.

The oil-exporting countries' surpluses seem likely to increase again this year, though forecasts have been made unusually difficult by the two-tier price increase at the OPEC meeting last December – 5% by Saudi Arabia and the United Arab Emirates, and 10% by the other members of OPEC – and by the declared intention of the two former countries to raise their production. It is also too early to assess the effect of these decisions on imports into the oil-exporting countries; but a rise of some 12% in the volume of imports last year will probably be slightly exceeded in 1977.

The current account deficit of the developing countries (other than oil exporters) is estimated to have changed little between the two halves of last year, with exports and imports each rising faster. Nevertheless, the reserves of these countries continued to rise (by some $3 billion in the second half of 1976), implying that capital inflows remained at about the same rate as in the first half ($14–15 billion). But even if capital inflows continue on this scale this year the developing countries will probably not be able to increase the volume of their imports much more. Their export receipts should benefit from renewed expansion in the industrial countries and from a rise in commodity prices (see below), but this is likely to be largely offset by dearer imports (both of oil and manufactures).

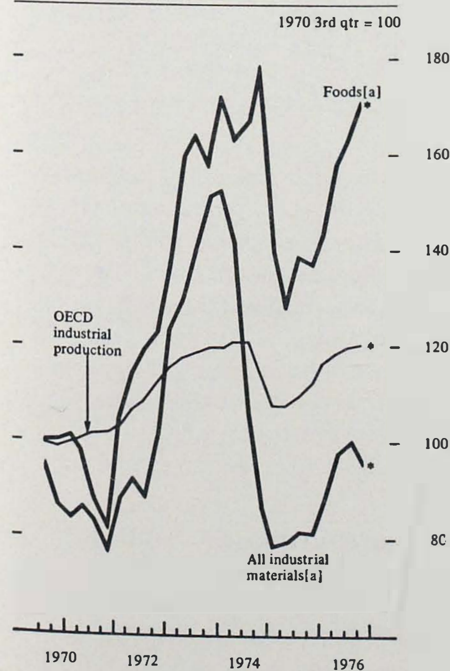
In the first half of last year, raw material prices had risen steeply in anticipation of a strong recovery in industrial demand. But during July to October many of these prices – particularly of metals – fell back as the increase in demand was not sustained. In the same period, clearer signs of record grain harvests and ample sugar supplies slowed down the rise in food prices as a whole, though coffee and cocoa prices went on rising sharply. However, during November prices of raw materials began to turn up again in dollar terms, and more recently certain prices – notably lead and tin – rose very sharply, because of supply shortages. By the beginning of March, *The Economist* all-items index was 17% above its previous peak in July last year.

Raw material prices as a whole tend to move broadly in line with changes in industrial output (see chart), and are thus likely to go on rising in the months ahead. The increase in food prices (which, in real terms, are now close to the peak reached in 1973/74) should moderate as the price of coffee and cocoa levels off.

World trade as a whole is likely to grow much faster during 1977 than last year, with UK export markets expanding by about 8%, compared with about 6% during 1976. The oil-exporting countries are expected to have a larger current account surplus this year while the deficit of the non-oil developing countries remains virtually unchanged, so the aggregate current account deficit of the OECD countries is likely to increase, and associated financing problems to worsen.

Commodity prices

In the second half of 1976, raw material prices stopped rising, but food prices approached their previous peak.



* Estimated for the 4th quarter of 1976.

[a] Based, with permission, on *The Economist* index (in dollar terms), deflated by UN index of prices of manufactured exports.

Current account of the balance of payments

The visible deficit was a little smaller in the fourth quarter, mainly because of a recovery in the volume of exports.

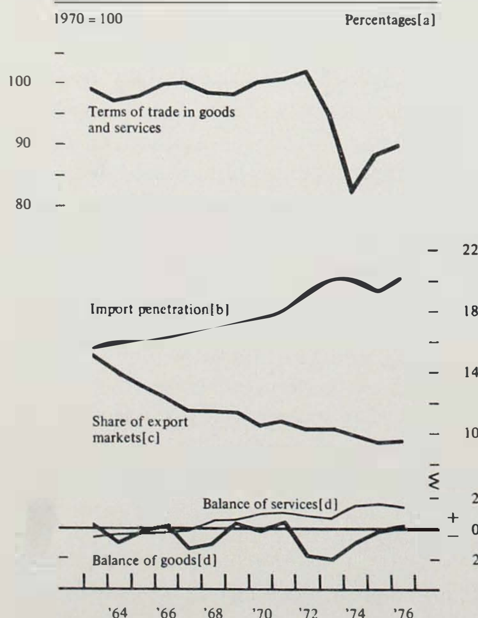
£ millions: *seasonally adjusted*

	1975	1976			
	Year	Year	2nd qtr	3rd qtr	4th qtr
Exports of goods	19,380	25,290	6,210	6,400	7,070
Imports of goods	22,580	28,880	7,130	7,550	8,060
Visible balance	– 3,200	– 3,590	– 920	–1,150	– 990
Net invisibles	+ 1,560	+ 2,170	+ 480	+ 610	+ 620
Current balance	– 1,640	– 1,420	– 440	– 540	– 370
Changes in visible trade from preceding year/quarter:					
Volume of exports[a] (percentage)	– 4·3	+ 8·2	+ 4·3	– 2·1	+ 4·9
Volume of imports[a] (percentage)	– 7·2	+ 6·2	+ 6·7	+ 2·5	+ 0·1
Terms of trade	+ 7·9	– 0·7	– 1·6	+ 0·2	– 1·5

[a] Measured at 1970 prices.

Some aspects of UK external trade

In recent years, more resources have gone into the balance of trade in goods and services, while the terms of trade have been particularly unfavourable.



[a] Derived throughout from series at 1970 prices.
[b] Imports of goods and services as a percentage of total final expenditure.
[c] UK exports of manufactures as a percentage of similar exports by the main manufacturing countries.
[d] Exports minus imports, expressed as percentages of gross domestic product, all in real terms.

The balance of payments

Most of last year was dominated by a crisis of confidence in sterling, but a distinct change of pattern occurred in the balance of payments during the fourth quarter. There was a marked improvement in confidence by the end of this period, which was reflected in a sharp turn-round in capital flows and a much stronger exchange rate; at the same time, the volume of exports turned up again after several months of little growth.

In 1976 as a whole, the current account deficit narrowed only slightly. In volume terms, exports of goods rose by about 8%, but imports increased by not much less, even though domestic output expanded very little during the year. With the terms of trade deteriorating slightly – in sterling terms import prices rose by 22½% and export prices by 21% – the current account deficit would have widened but for a much larger surplus on invisibles. However, capital outflows were so heavy that the deficit for official financing – met by drawing on the reserves or through official borrowing abroad – was larger than in the two previous years together. During the year, the exchange rate depreciated by around 20% against other leading currencies taken together.

Current account[1]

In the fourth quarter, the volume of exports rose by 5%, more than reversing the decline in the previous three months (see table). World trade may have grown rather faster than in the third quarter, and UK exports probably benefited from sterling's earlier depreciation. Manufactured goods accounted for almost all the growth in the volume of exports in 1976, though some of the other (much smaller) categories rose steeply. The volume of imports rose only slightly in the fourth quarter; the rise over the year as a whole (6%) was mainly in industrial materials (i.e. basic materials and semi-manufactures), but finished manufactures also increased fairly sharply. The net increase in resources absorbed by the trade balance in the fourth quarter was only partly offset by a small deterioration in the terms of trade, and the deficit on visible trade narrowed by £160 million.

However, in January the visible deficit widened sharply, because of a huge recorded rise in the volume of imports. This was in sharp contrast to a very favourable outturn in December, and it is possible that the seasonal adjustment for imports may not have allowed fully for the impact of the end-year holiday period. (The export figures relate broadly to shipments in the month to mid-January and would thus be less affected.)

The amount of resources taken by the trade balance increased in 1976. The chart shows that the balance of trade in goods alone (at 1970 prices) is much as it was a decade or so ago, while the first table on the opposite page suggests that its broad composition has also not changed very much. The share of UK exports in world trade has fallen steadily while import penetration into the United Kingdom has tended to increase (see chart). With the balance of trade in services improving in real terms over the years, the resources devoted to the balance of trade in goods and services together have been historically very large. But the terms of trade have been much worse in recent years, mainly because of dearer oil.

The surplus on invisibles was virtually unchanged in the fourth quarter. Net earnings for the year as a whole, at £2,170 million, were some £610 million higher than in 1975. Much of this improvement stemmed from the travel sector, where earnings were quick to respond to sterling's depreciation. The relative cheapness of UK goods and services led to a sharp rise both in the number of visitors to the United Kingdom and in their average expenditure per head. Prospects for this

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

Exports less imports in real terms

In real terms, there has been a marked improvement since 1963 in the balance of trade in services, but not in goods.

£ millions at 1970 prices

	1963	1975	1976
Overseas trade statistics basis[a]			
Food, beverages and tobacco	−1,700	−1,200	−1,300
Basic materials	−1,000	− 750	− 950
Fuels	− 350	− 650	− 600
Semi-manufactures	350	150	350
Finished manufactures	1,950	1,650	1,500
All goods[b]	− 600	− 750	− 850
Balance of payments basis[a]			
Goods	100	− 100	50
Services	− 200	750	700
	− 100	650	750

[a] Various valuation and coverage adjustments (such as the exclusion of freight and insurance from the import figures) are made to convert the overseas trade statistics to a balance of payments basis.

[b] Includes a small miscellaneous category.

Summary of the balance of payments

In the fourth quarter the deficit for official financing was much smaller, mainly because of an inflow of capital.

£ millions: *not seasonally adjusted*

	1975	1976			
	Year	Year	2nd qtr	3rd qtr	4th qtr
Current balance	−1,640	−1,420	− 480	−370	−340
Sterling holdings of:					
Central monetary institutions in:					
Oil-exporting countries[a]	− 300	−1,390	− 660	−420	− 90
Other countries	− 360	− 80	− 260	+ 90	− 40
Other holders[b]	+ 590	+ 320	− 10	+190	+120
Increase (−) in UK banks' external sterling claims[c]	− 590	−1,170	− 440	−270	+ 10
Increase (+) in UK banks' net external liabilities in foreign currencies	+ 240	+ 110	− 10	−170	+130
Other capital flows and the balancing item	+ 590	−	− 100	+ 90	+ 80
Balance for official financing	−1,470	−3,630	−1,960	−860	−130
Financed by:					
Drawings on the IMF	−	+1,020	+ 440	−	−
Drawings on other monetary authorities (+)	−	− 30	+ 580	+310	−920
Other borrowing[d]	+ 810	+1,790	+ 580	+490	+440
Decrease (+) in reserves	+ 660	+ 850	+ 350	+ 60	+620

Components may not add to totals because of rounding.

[a] As listed in the footnote to Table 19 in the statistical annex.

[b] Includes international organisations.

[c] Also includes lending by a few financial institutions other than banks, and 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.

sector in 1977 are also encouraging: rising incomes overseas should lead to a further expansion in tourism to this country, while UK tourism abroad may even decline.

Elsewhere in the invisibles account, earnings from construction work overseas rose strongly in 1976, largely because of an expansion of business in the Middle East. Merchanting profits were also higher as world trade recovered, while earnings from civil aviation benefited from the rise in tourism. In spite of heavier interest payments associated with a further rise in official borrowing, net receipts of interest, profits and dividends were larger in 1976. This was partly because a higher proportion of receipts than of payments is denominated in foreign currencies, so that sterling's devaluation inflated receipts more than payments. Another reason was that UK banks earned more on their euro-currency business.

In sum, the current account deficit for 1976 was around £1½ billion. There should be an improvement this year, mainly because of North Sea oil. In 1976, domestic production of oil was worth about £600 million, but this was more than offset by imports connected with development expenditure and by interest due abroad.[1] This year, there should be a sizable net benefit to the current account. Apart from oil, the current account in 1977 is also likely to benefit from an expansion of world trade, which should again outweigh the effects of any growth in domestic demand. UK firms appear to remain well placed in terms of competitiveness and the relative profitability of exporting, even though part of the exceptional gains up to last November has latterly tended to be reversed by the higher rate for sterling; and there is probably ample spare capacity in most sectors of industry.

Capital flows and official financing

In the December quarter, the deficit for official financing was the smallest for over two years (see table). The improvement between the third and fourth quarters stemmed partly from a narrower current account deficit, but mainly from an inflow of capital in December after the heavy outflows earlier in the year.

There was a distinct improvement in confidence in sterling towards the end of 1976, which continued into this year. This was reflected both in capital inflows and in an appreciation of the exchange rate. The main events influencing sterling in this period are described on page 22. Much of the impact of exchange control measures relating to the use of sterling in third-country trade (see below) will appear in the statistics of bank lending abroad in sterling; but the steps which have probably been taken to reverse leads and lags in commercial payments and to unwind other speculative positions built up against sterling earlier last year when confidence was weak will have affected a wide range of items in the balance of payments accounts, and part of the effect may not be identified.

The run-down of sterling holdings, which amounted to over £1 billion during the first three quarters, virtually ceased in the fourth: a decline in the holdings of central monetary institutions abroad — mainly in oil-exporting countries — was almost offset by a rise in the balances of international organisations and other holders.

Sterling lending abroad by UK banks was also little changed in aggregate after an increase (and, hence, a balance of payments outflow) of more than £1 billion in the previous nine months.[2] But within the total, lending associated with UK exports — mainly commercial bills with ECGD cover — went on rising in the fourth quarter, while other forms of lending declined when the use of sterling to finance trade

[1] If associated capital inflows are included, the overall effect of North Sea oil on the balance of payments last year was favourable.

[2] The total includes lending by financial institutions other than banks.

between third countries[1] was limited, and then prohibited, by exchange control measures in August and November. It was originally thought that these measures would generate a once-for-all inflow of funds of about £½ billion by the middle of this year (mostly in the current quarter); but the effect now seems likely to be larger. Not all of this finance is repayable to UK banks: some will be repaid to UK merchants, in which case the inflow will appear elsewhere in the balance of payments accounts. UK banks' net external liabilities in foreign currencies rose in the fourth quarter, after falling sharply in the third, and there was also a net inflow from private investment (direct and portfolio). In February, steps were taken to reduce the amount of sterling lending abroad associated with UK exports: in order to facilitate a switch to foreign currency financing, ECGD cover will, in certain circumstances, only be provided on contracts financed in foreign currency.

Although the deficit for official financing was only small in the fourth quarter, and public sector bodies borrowed a sizable amount under the exchange cover scheme, the reserves had to be run down heavily in order to repay the $1,545 million drawn on the $5.3 billion stand-by credit which had been arranged last June and which ended in December.

In December, negotiations were completed with the International Monetary Fund for a stand-by arrangement which would allow the United Kingdom to draw up to SDR3,360 million in stages over a two-year period. The arrangement includes various performance clauses related to the Government's programme for strengthening the economy. In January, a first drawing of SDR1,000 million (£676 million) was made; the further drawings which may be made this year amount to SDR950 million.

Because the current account deficit may still be large this year, and because the authorities are determined not to rely on short-term inflows to finance such a deficit, another agreement was reached in January, under which a group of UK and foreign banks have raised a medium-term loan of $1½ billion on behalf of the Government, of which $250 million was drawn in February. Also in February, arrangements were completed in Basle, under which the Bank for International Settlements, with the support of central banks in eleven countries,[2] have provided the United Kingdom with a $3 billion facility related to the official sterling balances. This facility has the immediate purpose of ensuring that the exchange rate and the official reserves are shielded from the impact of any further run-down of the official sterling balances; but it is also designed to meet the wider objective of enabling the Government to achieve an orderly reduction in the role of sterling as a reserve currency. To further this objective, existing official holders are being offered the option to convert any part of their sterling holdings into negotiable medium-term foreign currency bonds which are being issued by the Government on market-related terms.

Over a two-year period, the United Kingdom will be able to draw on the $3 billion facility in respect of any net decline in official sterling holdings below £2,165 million (the amount which was, in fact, outstanding on 8th December 1976) – other than reductions attributable to the sale of foreign currency bonds – but generally only when the official reserves amount to less than $6¾ billion.[3] There is provision to extend, by mutual consent, the period for drawings by one year; and repayment is to be made over four years from the end of the

[1] Other than trade within the exchange control commodity schemes (which is now also subject to stricter rules).

[2] Austria, Belgium, Canada, Denmark, Western Germany, Japan, the Netherlands, Norway, Sweden, Switzerland and the United States.

[3] But there is provision, by mutual agreement, for drawings to be made even when the reserves exceed this figure, in particular where the excess is attributable to foreign currency borrowing by the public sector.

draw-down period. After the first year, drawings on the facility in respect of any subsequent decline in official balances are limited to 75% of each reduction.

The revival of confidence gathered momentum in January, and the authorities bought a substantial amount of foreign exchange during the month. The official reserves accordingly rose by some $3 billion, of which only one third was accounted for by the IMF drawing. Given the size of the current account deficit, this implies a very large inflow on capital account. The reserves rose by a further $591 million in February; borrowing by public sector bodies under the exchange cover scheme was relatively small ($10 million), but $250 million was drawn on the $1½ billion loan.

The domestic economy

Output and demand [1]

Growth seems to have resumed (albeit rather tentatively) in the last quarter of 1976 (see table). Earlier, the strong expansion of output, which began in the second half of 1975, had been followed by a period of stagnation last summer. Provisional estimates show that the output measure of GDP rose by 1% in the fourth quarter, when it was 2¼% higher than a year earlier. The picture is broadly the same for both industrial production and manufacturing output, though interpretation of the monthly and quarterly figures during 1976 was complicated by changes in the pattern of holidays and by the drought.

A rapid rise in exports and a much reduced rate of destocking provided the main stimulus for the recovery early last year. Stocks were run down heavily in the second quarter, but less so in the third, and there was probably a return to positive stockbuilding in the fourth. The trade balance again contributed to growth in the fourth quarter, but took fewer real resources in the second half of the year as a whole than in the first.

Demand is expected to expand only slowly during 1977. The largest contribution is likely to come from the trade balance; but there may be some stockbuilding as well, at least early in the year. It is also possible that fixed investment by private industry will increase more quickly than expected if recent financial developments help to restore confidence – though the effect would probably only come through towards the end of the year. The other components of demand – expenditure by consumers and by public authorities, and private housing – seem likely to remain depressed for some time.

Domestic activity

Output increased in the fourth quarter, after changing little in the previous six months.

Percentage changes on previous quarter, 1970 prices: *seasonally adjusted*

	1975	1976			
	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr
GDP (output measure)	+ ½	+1½	– ¼	+ ¼	+1
Industrial production[a]	+1½	+2¼	– ¾	– ¾	+2½
of which,					
Manufacturing production[a]	*+1½*	*+2½*	*–*	*–*	*+2¼*
GDP (expenditure measure)	+1¾	+2¾	–3	+1½	. .
Consumers' expenditure	– ¼	+1¼	– ¾	+1¼	+ ¾
of which,					
Retail sales	*+ ¼*	*+1½*	*+ ¼*	*+1¼*	*– ½*
Exports (goods and services)	+4¼	+2¼	+3	– ½	+5 [b]
Imports (goods and services)	– ½	–1½	+8	+ ½	+ ½[b]

. . not available.

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

[b] Goods only.

Unemployment

Unemployment has risen more slowly in recent months but there is little immediate prospect of a significant decline in view of the sluggish growth of output during the past year.

After seasonal adjustment, the number of unemployed in the United Kingdom (excluding school-leavers and adult students) fell by 6,800 in February to 1,331,400, making an average monthly increase of only 2,600 since September, compared with about 15,000 in the previous six months. Unfilled vacancies in February were 24,000 higher than in October (figures were not compiled for November and December because of an industrial dispute): this would appear to indicate a rise in the demand for labour in recent months, but the course of output suggests that any such increase will probably be short-lived.

The number of school-leavers on the register fell again in February, to 41,800. Although well below the average for last summer, this is more than a year ago, and those leaving school from May onwards are likely to have as much difficulty in finding work as their predecessors last year.

[1] Figures in this section are seasonally adjusted and at constant (1970) prices.

Figures for employment suggest that manufacturing industry began to recruit on a modest scale in the second half of 1976, but such recruiting may have tailed off again recently. The pattern varies widely among individual industries, with activity in heavy engineering and construction being particularly depressed, and the present lack of orders makes further redundancies likely in these industries.

The potential labour force in the United Kingdom is now increasing at around ½% per annum; and with productivity rising by perhaps 2½%–3% in the long term, a sustained reduction in unemployment is not likely until output is growing steadily at an annual rate of at least 3%–3½%.

Costs and prices

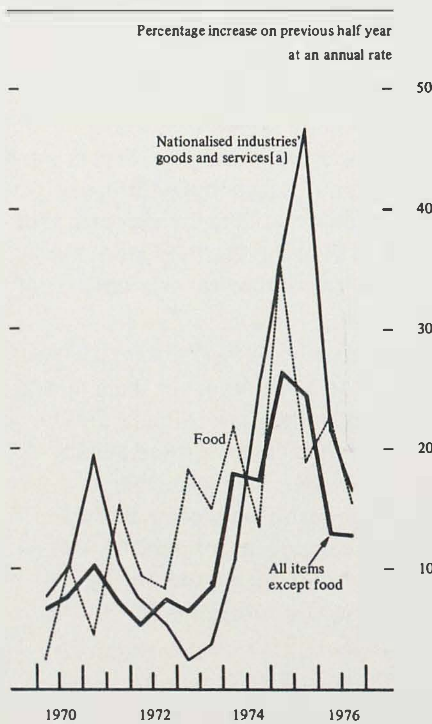
The rate of increase in retail prices, which fell below 13% during the summer of 1976, has recently quickened again to a year-on-year rate of about 16½%. This acceleration largely reflected the depreciation of sterling last year, but it also owed something to a sharp rise in seasonal food prices, reductions in certain subsidies, and firmer world prices for some commodities. In January, food prices were 23% higher than a year earlier, and would have risen even faster but for the relative stability of the 'green pound'.[1]

The rise in wholesale selling prices slowed down in 1975 and early in 1976, but began to quicken again in the second half of last year, reaching 4¾% in the fourth quarter – the largest quarterly rise for eighteen months. In January the rise was as much as 3¼%, but more than half of this can be attributed to the bunching of price increases at the beginning of the year, the effects of higher excise duties and a sharp rise in food prices. Prices rose by 1¼% in February, the same as in December.

The rate of increase in wholesale buying prices accelerated early in 1976 and was kept high during the remainder of the year by the depreciation of the exchange rate. Around the turn of the year, dearer oil had a stronger impact on prices than sterling's improvement, and wholesale buying prices were almost 29% higher in February than a year earlier.

Retail prices

To compensate for earlier restraints, nationalised industries' prices have recently risen faster than prices as a whole.



[a] During the period shown, the weight of nationalised industries' prices in the index for all items except food varied between 10% and 12½% of the total.

As the chart shows, prices of goods and services supplied by the nationalised industries have risen faster than other prices since the middle of 1974, as steps were taken to compensate for the containment of price increases during the previous two years or so – in each case, a reflection of official policy. The industries' gross trading surpluses (net of subsidies) have accordingly recovered strongly in recent months.

The Department of Employment estimates that, by the end of January, agreements notified to them under the second stage of the present incomes policy covered over 4½ million workers (about a third of the total who are expected to inform the Department of settlements under the second stage). In December, average earnings (seasonally adjusted) were almost 12% higher than a year earlier. The increase during the first five months of the second stage (13½% at an annual rate) was rather higher than earlier forecasts for the period of the policy as a whole might have implied. But there have been no reported breaches of the policy; and during the first few months of the first stage, average earnings also rose faster than appeared to be consistent with the policy, before slowing down markedly in the first half of 1976. The latest rise in average earnings might have owed something to higher overtime ahead of the unusually long holidays at Christmas and the New Year, and to the effect of late settlements and back payments under the first stage of the policy.

[1] Early in March, the 'green pound' was over 35% above the market rate for sterling. The Ministry of Agriculture, Fisheries and Food estimates that about 70% of UK imports of food, drink and tobacco are covered by the Common Agricultural Policy and perhaps a little more in the case of home-produced food. The net cost of the 'green pound' to the rest of the EEC is currently about £1.1 million per day.

Personal incomes and spending[1]

After remaining fairly stable for about a year, real wages and salaries fell by about 1½% in the fourth quarter of 1976. In the same period, total personal income fell little, if at all, in real terms, because of an increase in current grants from public authorities, together with larger net dividend and interest receipts associated with higher interest rates. But real personal disposable income, which had been boosted in the third quarter by the back-payment of tax relief, fell by almost 1½% in the fourth to its lowest for nearly four years. Between the first quarter of 1973 and the fourth quarter of 1976, real wages and salaries rose by about 8% (although real national income was virtually unchanged on balance); but the impact of income tax and national insurance contributions was such that real personal disposable income increased by only 1%.

In spite of the fall in real personal disposable income in the fourth quarter, consumers' expenditure rose slightly in real terms: more was spent on fuel and light, and sales of drink, tobacco and consumer durables were also higher, no doubt in anticipation of the December measures. The saving ratio thus appears to have fallen during the quarter – perhaps by about 2 percentage points – after declining slightly in the third, when spending appears to have adjusted unusually quickly to the back-payment of tax relief. However, the volume of retail sales in December and January suggests that consumer spending has since fallen a little.

Over the two years since the end of 1974, the squeeze on real incomes and the moderate success in reducing inflation were accompanied by a considerable decline in the saving ratio, from about 15½% to perhaps as low as 10½%. This has not been reflected in a rise in consumer credit: on the contrary, hire-purchase debt outstanding fell by roughly 20% in real terms during 1975 and it remained fairly stable last year, while bank advances to persons declined (in real terms) throughout the period.

Housebuilding[1]

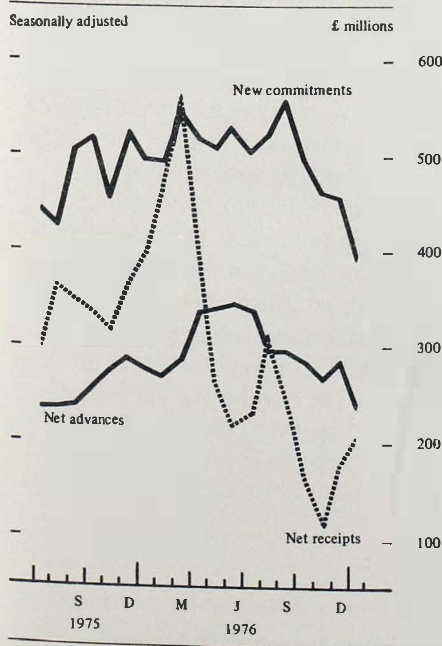
Housebuilding activity is likely to decline for much of this year. The number of new houses started in the fourth quarter of 1976 was not much larger than at the low point of the severe recession two years earlier; and although starts in 1976 as a whole were slightly higher than in 1975, they fell rapidly during the second half of the year. However, building society rates have become more attractive in recent months, and the outlook for housebuilding later this year has accordingly improved.

Public sector starts were very high early in 1976, but then fell steadily after controls over housebuilding by local authorities were introduced last July as part of the measures to contain public expenditure. The total in the fourth quarter was some 30% lower than in the third, and in December was about 45% below July. The building programmes of new towns and housing associations were reduced further as part of the cuts in public expenditure announced in December. Although there was a marked increase in January, starts in 1977 as a whole are likely to be well down on the total for last year, with a further shift in the balance of spending towards inner cities and towards improvement and conversions rather than new building.

The private sector housing market is very unsettled. Lending by building societies has remained quite high in spite of a sharp decline in net receipts (see chart), and liquidity has accordingly fallen from a peak of 22.2% in March 1976 to 18% in January. Societies have responded by cutting back on commitments; and the number of houses started in the fourth quarter fell by 25%, reflecting pessimism among builders about the availability (and cost) of mortgage finance and, hence, about the prospective course (and profitability) of house sales.

Building society funds

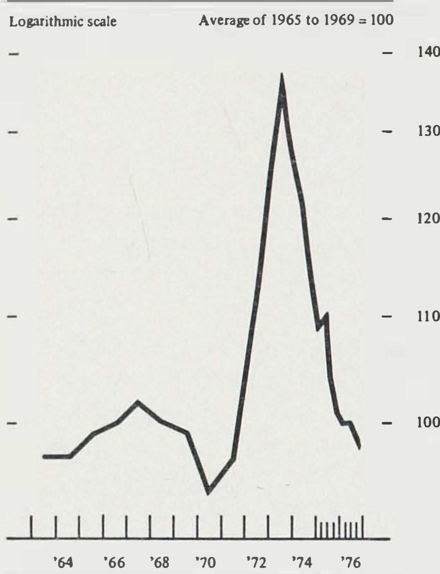
Net receipts have recovered somewhat from the low point in November; new commitments have fallen for four successive months.



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

Ratio of new house prices to average earnings

After falling steeply for two years, the ratio has changed little since the end of 1975.



Net receipts[1] by the building societies fell by over 40% in the fourth quarter, because of a large rise in withdrawals. Some of the funds were no doubt withdrawn for spending ahead of the December Budget; but most of the outflow was probably in the form of large deposits which are more likely to be sensitive to changes in interest rates. The rise of 2% (to 12%) in the building societies' gross share rate in November was rather less than earlier increases in competing rates and led to no immediate improvement in net receipts; but the unfavourable differential narrowed further in December and January after successive reductions in minimum lending rate, and net receipts recovered from an average of about £150 million in the fourth quarter to just over £200 million in January. This improvement would still not allow the societies to maintain their lending at its recent average of around £500 million a month without drawing further on their liquidity – and new commitments fell to £400 million in January. However, with net receipts likely to improve further in February after another decline in competing interest rates, the societies may decide to increase their commitments again before long.

In spite of record lending by the building societies in 1976, house prices[2] rose by only about 7% over the previous year – much less than the general rise in prices. After reaching a peak in the first quarter of 1974, the ratio of new house prices to average earnings fell steeply for two years, but has since changed little (see chart).

Company spending and finance[3]

Profits rose quite strongly in the first nine months of 1976, but even so the recovery was much less pronounced than had earlier been expected. Gross trading profits of industrial and commercial companies were about 19% higher than in the corresponding period of 1975, but after allowing for stock appreciation and the cost at replacement prices of capital consumption, the increase was only 13%; indeed, in the third quarter net profits as a proportion of net domestic income were lower than in any quarter of 1975 (see table). Profits were no doubt depressed partly by stagnant domestic production and, in the third quarter, by the set-back to exports. And while there may have been an improvement in the fourth quarter, some of this will reflect the profits of companies engaged in North Sea oil activities.

Industrial and commercial companies' profits

Gross trading profits recovered substantially in 1976; even so, in the third quarter the share of net profits in net domestic income was lower than in any quarter of 1975.

£ millions, current prices: *seasonally adjusted*

	Gross trading profits	Stock appreciation	(1)–(2)	Capital consumption[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]	5,050	250	4,800	1,150	3,650	*12·9*
1969[c]	5,800	590	5,210	1,510	3,700	*10·4*
1972[c]	8,430	1,070	7,360	2,210	5,150	*10·4*
1974	12,330	4,900	7,430	3,140	4,290	*6·6*
1975 1st qtr	3,120	1,270	1,850	950	900	*4·7*
2nd qtr	2,920	980	1,940	1,020	920	*4·6*
3rd qtr	2,910	910	2,000	1,080	920	*4·4*
4th qtr	3,220	940	2,280	1,140	1,140	*5·2*
1976 1st qtr	3,370	1,150	2,220	1,180	1,040	*4·7*
2nd qtr	3,610	1,310	2,300	1,220	1,080	*4·7*
3rd qtr	3,680	1,430	2,250	1,270	980	*4·2*

[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 cyclical peaks.

The cash flow[4] of industrial and commercial companies worsened from £1,860 million in the second quarter to £1,620 million in the third. With fixed investment slightly higher than in the second quarter and only a small amount of destocking, the net financial liabilities of these companies rose by £320 million, though their liquidity did not appear to deteriorate.

The volume of private industrial fixed investment[5] last year was some 4% lower than in 1975, but it recovered slowly during the year from the low point in the first quarter. However, the improvement does not appear to have been sustained in the fourth quarter when, on provisional figures, investment was much the same as in the third. Nevertheless, a substantial rise is expected this year. The latest investment intentions survey by the Department of Industry, published in January, was a little less optimistic about prospects for 1977 than the previous survey in October, but it still projected a rise in investment by manufacturing industry of 10% – 15% (compared with the previous forecast of 15% – 20%). Investment by the distributive and service industries was again forecast to rise by about 5%. The survey was carried out in the period between the steep rise in minimum lending

[1] Including interest credited.
[2] Department of the Environment/Building Societies Association index of new house prices at approval stage.
[3] This section is in seasonally-adjusted terms.
[4] Defined as undistributed income before providing for depreciation, plus net capital transfers, less stock appreciation.
[5] Manufacturing and the distributive and service industries (excluding shipping).

rate and the completion of negotiations with the International Monetary Fund; so it does not reflect the influence of the fall in interest rates during January and February and the effect on confidence of a steadier exchange rate, both of which could be helpful. But reactions to these developments were probably captured by the Confederation of British Industry's survey in January, which confirmed the buoyant outlook for investment.

Private industry built up its stocks by £95 million (at 1970 prices) in the fourth quarter (though there was virtually no change over 1976 as a whole). The financial year of many companies ends on 31st December, and some of the stockbuilding in the quarter may have been prompted by a desire to take advantage of the provisions for relief from corporation tax: high interest rates and continuing weak demand certainly provided little incentive for such a build-up.

The public sector

The public sector borrowing requirement for 1976/77 now seems likely to fall not only below the original Budget estimate of nearly £12,000 million, but also below the revised forecast of £11,200 million published in December. In the first three quarters of the year, the borrowing requirement amounted to about £7,000 million (seasonally adjusted). Full details of public sector accounts are available only for the first six months of the fiscal year, but incomplete information suggests that expenditure could have been a little less, and revenue substantially more, than predicted in the Budget.

Public spending has been contained, even though the recession has been deeper, and inflation faster, than originally expected. It follows that, in real terms, expenditure has been well below the forecast in last year's White Paper. Much of this shortfall is likely to be in spending on goods and services and can probably be attributed to the new methods of control. Debt interest payments have also been smaller than forecast in the Budget, partly because of a recent switch in the composition of government debt from Treasury bills to gilt-edged, which has delayed some interest payments until the next financial year.

On the revenue side, most categories of receipts have risen faster than originally expected. In spite of the squeeze on real personal incomes, revenue from expenditure taxes has been particularly buoyant: consumer spending increased in money terms because of the unexpectedly high rate of inflation. Also, the trading performance of most of the nationalised industries has improved during the year.

Because of the cuts announced in July and December last year, spending on programmes (i.e. excluding debt interest) is now expected to fall sharply in real terms in 1977/78. The latest White Paper on public expenditure foresees a fall in real terms of 3½% in public spending as newly defined.[1] But present plans are for an increase of some 1½% in 1978/79, in which case spending on programmes would remain higher in real terms than in any year before 1974/75.

The squeeze on spending during the next two years will be reflected mainly in smaller subsidies and in lower lending to the private and overseas sectors, both of which will probably have a relatively small effect on demand. In particular, the planned cut in spending during 1977/78 includes the sale of part of the public sector's holdings of British Petroleum shares. But it is also planned to reduce public investment by almost 18% in 1977/78 and by a further 7% in the following year, and to spend rather less on current goods and services.

Over the two-year period as a whole, local authority expenditure, which at present comprises around 30% of total public spending, is expected to account for 60% of the reductions for the public sector as a

[1] On the old definition, public spending on programmes would have fallen by 3¾%. The difference between the two definitions was explained in the December 1976 *Bulletin* (page 417).

Public expenditure and the overall tax burden[a]

Public spending may decline steadily as a proportion of GNP; but the overall tax burden is unlikely to be reduced by a similar amount.

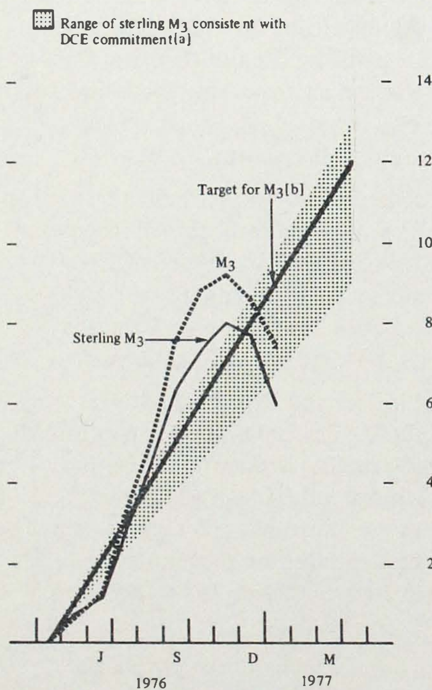
Percentages of GNP at factor cost[b]

	1976/77	1977/78	1978/79
Public expenditure programmes (including contingency reserve)[c]	49½	47	46
Debt interest	1½	2	2
	51	49	48
Financed by:			
Borrowing[d]	8	7	6
'Other' receipts[e]	2	2	2
	10	9	8
Taxation	41	40	40

[a] As measured in the latest White Paper.
[b] Derived from the December forecast.
[c] An allowance is made for the difference between the rise in public sector costs and in prices as a whole.
[d] The targets announced by the Chancellor last December.
[e] Excluding receipts which are offset against expenditure under the new presentation.

Monetary objectives

By mid-January monetary expansion was a little below target.



[a] As announced in December 1976.
[b] As first announced in July 1976.

whole, and spending by the central government (including lending to nationalised industries) for a further 30%; the balance will fall on investment by public corporations other than the nationalised industries.

Revenue has been unexpectedly high during the current financial year, and fiscal policy may thus have been tighter than intended. The estimates in the table, which are no more than broad indicators of prospective developments, suggest that public spending should fall steadily as a proportion of GNP. But the need to reduce the public sector borrowing requirement makes it most unlikely that the ratio of taxes to GNP can be reduced at the same rate – though it would not prevent a shift in the distribution of the burden from income to expenditure taxes, thus reversing the trend of the last few years. However, the rate support grant settlement suggests that one type of expenditure tax – local rates – will remain unchanged as a proportion of GNP.

Monetary developments[1]

The domestic financial situation has changed markedly in recent months. In sharp contrast to the rapid growth late last summer, when bank lending increased rapidly while official sales of gilt-edged temporarily ceased, the money stock actually declined over the three months to mid-January. The sterling component of M_3 (see page 39) fell by a little over 1%, after rising by more than 7% in the previous six months (see chart). Meanwhile, M_1 was held in check by high interest rates and rose by only ½%, compared with an increase of 4½% in the six months to mid-October. The course of domestic credit was broadly similar: on the new definition (see page 39), it had expanded by nearly £4,900 million in the six months to mid-October, but contracted by over £800 million in the following three months.

This contraction was largely the result of action taken by the authorities in the early autumn, which enabled heavy official sales of government debt to be made to domestic investors other than banks. However, while the increase in interest rates and calls for special deposits in September and October (see the December 1976 *Bulletin*, page 418) progressively tightened the banking system's reserve base, they did not immediately reduce the excessive growth in bank lending. But these measures were subsequently reinforced in November by the reintroduction of the supplementary special deposits scheme and by exchange control measures relating to the finance of third-country trade. Thereafter, the growth of bank lending slowed down, while the successful negotiations with the International Monetary Fund and the belief that interest rates would begin to decline led to further very heavy official sales of government stock, which continued until the end of January.

These sales sharply reduced the banks' liquidity, in spite of large inflows from abroad, and payment of an outstanding call for special deposits was twice postponed. But with the central government moving into surplus (before seasonal adjustment) for a few weeks around the turn of the year, it became clear by early January that special deposits would have to be released if undue stringency in the money markets was to be avoided. Accordingly, the Bank announced on 13th January that special deposits equivalent to 2% of eligible liabilities would be repaid, and the outstanding call of 1% cancelled. This reduced the rate of call to 3%; and two weeks later a further reduction to 2% was announced. These repayments were designed solely to deal with the exceptional money-market conditions and not to ease the stance of monetary policy. Thus, the Bank let it be known that, unless banks and finance houses were notified to the contrary, the rate of call would be restored to 3% on 10th March.

[1] This section is in seasonally-adjusted terms except where otherwise stated.

The revised expectations in financial markets induced falls in both short and long-term interest rates. By the end of January, yields on long-dated gilt-edged were over 2 percentage points below their peak at the end of October; and yields on short-dated gilt-edged fell rather more sharply. Money-market rates also eased in spite of the shortage of liquidity. Minimum lending rate came down in several stages from 15% to 12¼%, in line with a progressive decline in the average rate of discount on Treasury bills. But on 3rd February, the Bank announced an administered change in minimum lending rate to 12% – thereby preventing a further decline in the rate for the time being (see page 21).

DCE and the money stock (M_3)[a]

Domestic credit contracted sharply in the three months to mid-January, but the fall in M_3 was moderated by an inflow of funds from abroad.

£ millions: *seasonally adjusted*

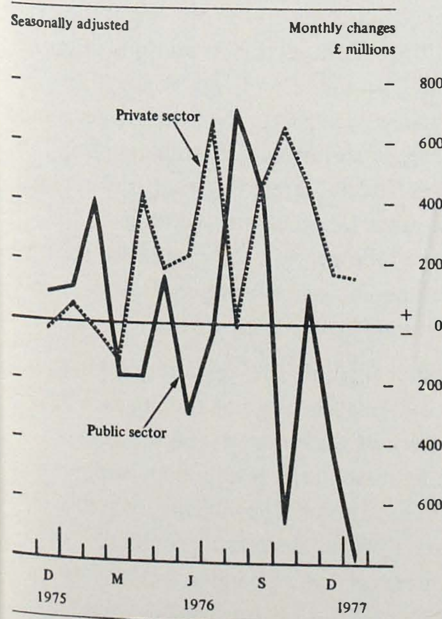
	Oct. 75– Jan. 76	Jan.– Apr. 76	Apr.– July 76	July– Oct. 76	Oct. 76– Jan. 77
Central government borrowing requirement	+1,790	+2,150	+1,580	+1,860	+ 800
Net purchases (–) of central government debt by non-bank private sector	–2,340	– 600	–1,090	–1,150	–2,850
Other public sector[b]	+ 750	+ 120	+ 490	+ 720	+ 390
Bank lending in sterling to UK private sector and to overseas[c]	– 170	+ 740	+1,210	+1,250	+ 830
Domestic credit expansion	**+ 30**	**+2,410**	**+2,190**	**+2,680**	**– 830**
External and foreign currency finance	– 80	–1,110	– 780	–1,000	+ 490
Other	+ 70	– 310	– 350	–	– 150
Sterling M_3	**+ 20**	**+ 990**	**+1,060**	**+1,680**	**– 490**
Percentage change in sterling M_3	*+ 0·1*	*+ 2·7*	*+ 2·8*	*+ 4·4*	*– 1·2*
UK residents' foreign currency deposits	+ 120	+ 320	+ 260	+ 610	– 130
Total M_3	**+ 140**	**+1,310**	**+1,320**	**+2,290**	**– 620**
Percentage change in total M_3	*+ 0·4*	*+ 3·3*	*+ 3·3*	*+ 5·5*	*– 1·4*

[a] Further details are shown in Table 11 / 3 in the statistical annex.
[b] Other public sector borrowing requirement, less purchases of other public sector debt by the private sector (other than banks).
[c] Including commercial bills bought by the Issue Department of the Bank of England.

The counterparts to the growth in money and domestic credit are shown in detail in the table. The central government borrowing requirement in the three months to mid-January, at only £800 million, was very much lower than had been expected earlier in the year, and was far outweighed by heavy official sales of central government debt to domestic investors outside the banking system, amounting to over £2,850 million (net). Sales of gilt-edged to such investors were even larger (£3,050 million), but part of these sales may be considered as the funding of Treasury bills held outside the banking system, which fell by £400 million. Overseas purchases of gilt-edged appear to have accounted for only a small proportion of total sales, but they had a significant influence on market sentiment.

Bank lending in sterling

Heavy repayments of bank credit by the public sector gave banks some scope for lending to the private sector within the limits of the supplementary special deposits scheme.



Bank lending in sterling to the private and overseas sectors together, which had risen by over £1,200 million in each of the two previous quarters, increased by less than £850 million in the latest period – perhaps partly because of higher interest rates and also because of the reintroduction of the supplementary special deposits scheme. Under this scheme, each bank has to ensure that, by the spring (February/March/April), its interest-bearing eligible liabilities are not more than 3% larger than six months earlier; otherwise, non-interest-bearing deposits become payable. On 17th November, the day before the scheme was reintroduced, the banks' total interest-bearing eligible liabilities had been more than 6% (not seasonally adjusted) above the average for the base period. By mid-January they were only 2% over the base, and they contracted by a further 4½% in the following month: it seems that few banks will be liable to pay penalty deposits in the spring.

In aggregate, the banks have been able to reduce their interest-bearing eligible liabilities without unduly restraining lending to the private sector. If £220 million of commercial bills bought by the Issue Department of the Bank are included, total sterling lending to the private sector rose by £1,020 million in the three months to mid-January (see chart) – only £100 million less than the average increase in the two previous quarters. As was recognised when the supplementary special deposits scheme was reintroduced, the banks could adequately meet the private sector's demand for credit by reducing their lending to the public sector (helped, if necessary, by a release of special deposits) and to the overseas sector. The public sector was able to repay bank credit following the heavy sales of debt; and overseas borrowers were repaying sterling credit for third-country trade (see December 1976 *Bulletin*, page 412). Between mid-October and mid-January, sterling lending abroad fell by nearly £200 million, in contrast to a rise of £100 million in the previous three months.

Inflows from abroad into the private sector (other than banks) – some of which may represent the unwinding of leads and lags in commercial payments – tend either to reduce bank lending to the private sector (thus lowering DCE, though leaving M_3 unchanged), or to increase their bank deposits (thus raising M_3 but leaving DCE unchanged). The recent contraction of domestic credit after its rapid expansion last summer was mirrored by the improvement in external

confidence; and the associated inflows had an expansionary effect on M_3. Thus, M_3 contracted less than domestic credit.

In the Letter of Intent to the IMF in December, the Chancellor indicated his aim of containing DCE to £9,000 million in the twelve months to mid-April 1977. With DCE amounting to less than £4,000 million in the first nine months of this period, this aim seems certain to be achieved. In the following year, it is intended to restrict DCE to £7,700 million.

The Chancellor also stated in December that he expected an increase of 9% – 13% during 1976/77 in the sterling component of M_3 to be consistent with the DCE limit of £9,000 million. DCE should, in fact, be noticeably less than this figure, but mainly because of the expansionary effects of inflows from abroad, the growth of sterling M_3 is likely to be not so much below its expected range.

Assessment

The conclusion of the stand-by agreement with the International Monetary Fund in December, followed by the announcement of the facility relating to official sterling balances and of the $1½ billion loan, led to a marked improvement in financial confidence. It will be important that this should be preserved, since it is a prerequisite to progress in dealing with the problems of the real economy.

As in the crisis of confidence last year, so in its subsequent reversal, the separate elements tended to reinforce each other. Large sales of gilt-edged, along with other factors, checked the pace of monetary expansion; the check to monetary expansion, among other things, helped to strengthen sterling; and the strengthening of the exchange rate, and of the reserves, helped to improve the gilt-edged market. The turn-round in sentiment in financial markets was at first so rapid as to raise questions for the authorities in the management of the markets; and it may be useful to comment on these before discussing problems of economic policy in general.

Market management

In both the exchange market and domestic financial markets, the authorities have sought to exert a moderating influence on the surge of market sentiment, which appeared at times to be in danger of neglecting the uncertainties ahead. In managing the exchange rate, the authorities have to strike a balance between, on the one hand, the need to preserve the competitive position of UK exporters and producers of goods which can be imported; and, on the other hand, the need to secure stability after the excessive movements in the rate last year, so as to reinforce the greater confidence in sterling which is emerging and to ease pressures on domestic prices. The dollar/sterling exchange rate has remained within a fairly narrow range (for much of the time $1.70–1.72) since the beginning of the year. In the context of strong upward pressure stemming from the improvement in confidence, the authorities welcomed the opportunity to reconstitute the reserves.

A recent speech by the Governor (page 48) set out the thinking which lay behind the adoption by the authorities of the practice of fixing targets for the rate of growth of the monetary aggregates – couched at first in terms of the increase in the total money supply, and more recently of domestic credit expansion. The advantages seen were that a quantitative monetary target provided a relatively clear indication of the intentions of monetary policy, and a standard by which it might be judged.

As other countries have found, conducting monetary policy with the aim of keeping the monetary aggregates close to their intended path may conflict with the desire to avoid large temporary fluctuations in interest rates. The return of financial confidence since the turn of the year brought strong downward pressures on interest rates, and it appeared to the authorities that, if not moderated, the decline might go further than could be maintained for long; and, indeed, less favourable news subsequently imposed a check on the earlier downward movement. While they lasted, however, conditions were very propitious to the sale of gilt-edged, and massive sales were in fact made. In conjunction with other factors operating at the same time, this led to an absolute decline in the money stock for a few months – following a period in the autumn when monetary growth had been well above the target rate. Since the summer there have thus been very considerable fluctuations, for several months at a time, in the rate of monetary expansion. Such fluctuations may in practice be difficult to avoid over periods when there are changes in sentiment as abrupt as those in recent months, and if they are only temporary, may have little deep-seated significance. In any case, the rise in the money stock (M_3) over the current financial year as a whole seems likely to be fairly close to, and domestic credit expansion well within, the targets set for the year.

Present prospects

The prospects for the economy depend to some extent on steps that might be taken at the next Budget, restricted though the room for manoeuvre may then be. Forecasts prepared in the Bank suggest that on present policies growth, though slow this year, might be faster next. Domestic demand seems likely to expand little in total over the next eighteen months or so, despite the prospect of a fairly brisk upturn of investment by manufacturing industry this year and, perhaps, of resumed growth of consumers' expenditure in 1978 after the fall this year. The main expansionary element remains likely to be exports. Abroad, a progressive though still moderate expansion of demand seems probable (for details, see page 3); and the present exchange rate puts UK exporters in a good position to compete.

Partly for this reason, but largely because of increased oil production from the North Sea, the balance of payments seems bound to show progressive improvement, though how rapid is uncertain. The terms of trade are difficult to predict, as is the trend of imports. The recent rise in imports may have contained temporary elements and the increase may now slow down. If so, the current account of the balance of payments might begin to show consistent surpluses before the end of the year. Progress could be slower than this; but a surplus in 1978 seems fairly well assured.

Profits may show little growth, except for firms involved with the extraction of North Sea oil, which are now beginning to see a return on their investment; and for firms heavily engaged in exporting, where greater profits will provide a desirable encouragement to further investment. At home, the rise in prices could begin to slow down in the second half of this year; prices could rise by under 10% next year – depending very largely, however, on whether agreement can be reached for a moderate pay settlement under a third stage of incomes policy.

The Budget and pay restraint

The public sector borrowing requirement, as has been evident, is difficult to predict – being, like the current account of the balance of payments, the difference between two much larger numbers: public

sector receipts and outgoings. The outturn for the present financial year now seems likely to prove to be well below earlier predictions, which makes it possible that on present policies the public sector borrowing requirement next year would be below the limit of £8.7 billion agreed with the International Monetary Fund.

If a relaxation of fiscal policy were judged feasible against this background, it would result in a rather faster expansion of the economy – and in due course improve the prospect for unemployment. Reductions of taxation would increase real take-home pay – especially helpful in a period of continued pay restraint – and might alleviate the position of some of those hardest hit by past pay restraint.

Though the scope for stimulating the economy is severely restricted in present circumstances, a strictly limited acceleration of expansion ought not to create economic difficulties – either as regards capacity limitations, or as regards the balance of payments, where an early move into surplus on current account remains an essential aim.

Fiscal relaxations would, however, clearly be imprudent unless at the same time there was a good prospect that the rate of inflation could be materially slowed down: a halving of the rate would still leave it too high for comfort. Hopes here must depend very largely on there being agreement on moderate pay settlements for the year beginning in August.

It would also be essential to keep the growth of the monetary aggregates under control. Though emphasis has recently been put on domestic credit expansion, it will none the less continue to be important to keep the growth of the money stock to a moderate rate. The public sector borrowing requirement and domestic credit expansion next year will also need to be kept within the limits agreed with the IMF.

In general, the room for manoeuvre is inevitably restricted by the necessity to consolidate the improved state of financial confidence. Last year's experience shows how quickly confidence can be undermined, and how seriously the Government's economic policy can be hampered by the resulting instability of exchange rates and unduly high rates of interest on government borrowing.

Prospects for the longer term

Looking further ahead, the limitations which have so severely constrained economic policy in recent years should begin to ease – thanks very largely to oil from the North Sea; and it is important to take stock of the opportunities and the problems. These were touched on in another recent speech by the Governor (see page 50).

The external financial position of the country will be progressively strengthened. But it has to be remembered, first, that there will be need of a large current account surplus for many years in order to repay the debt which has been incurred over years of deficits. Second, the outturn on current account will continue to be affected by the strength of demand in this country, and by demand among its trading partners. If economic expansion were fast in this country, but slow elsewhere in the world, the UK balance of payments might remain weak, despite the help of North Sea oil.

It will therefore remain very important to increase exports of goods other than oil, and be able to confront competition from the import of such goods. The present favourable conditions for exporting will need to be preserved so that industry may have the confidence to expand investment for the sake of long-run exports. It will also remain a major

interest of this country, as of others, that there should be a sustained economic expansion throughout the world. How fast this country can climb back to fuller employment is likely to depend very largely on how far other countries succeed in achieving this.

A domestic supply of oil will not transform the economic situation of the United Kingdom. But it is a large bonus of a sort rarely available. It is difficult to see reasonable advantage being taken of the opportunity which this provides unless, meanwhile, the rate of rise of prices – and thus also of incomes – can be brought down again to low annual percentage figures.