Economic commentary

Introduction

Economic growth in the industrial countries has fallen further in recent months, except in the United States.

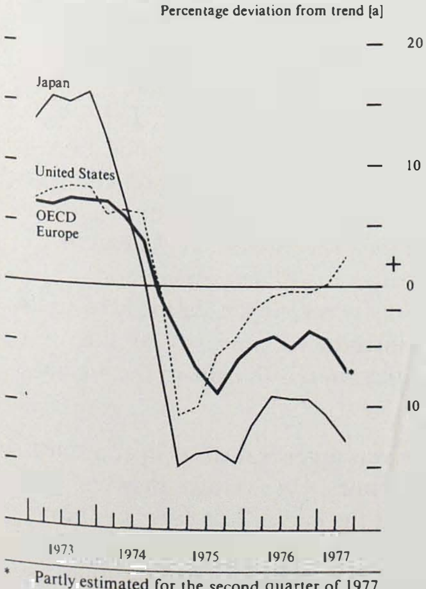
In the United Kingdom, exports have increased rapidly, but so have imports and, with depressed domestic demand, output has recently been falling. Inflation, after accelerating during the latter part of 1976 and early 1977, is easing: unit labour costs have been rising more slowly, the exchange rate has been stable for some time and world commodity prices have been falling. Average earnings rose broadly in line with the rate envisaged during stage two of the pay restraint policy, but less than prices; real personal disposable income fell by $3\frac{1}{2}\%$ in the year to the second quarter. Consumer spending, however, fell less.

Both monetary and fiscal policy have remained cautious, and the various fiscal changes brought in during the summer are expected to have much the same effect as the original Budget proposals. Although the current account is improved – because of increasing domestic production of oil and the continuing recession – the overriding determination to bring down the rate of inflation has allowed no easing of policy. The improvement in the current account, together with the firm stance of monetary policy, has led to upward pressure on the pound. The authorities' aim has been to maintain stability in the exchange rate, taking the opportunity to rebuild the much-depleted reserves. Towards the end of July, however, the continuing weakness of the dollar led the authorities to switch the focus of their attention to the effective rate, and to allow sterling to appreciate a little. Policies for the exchange rate and for the growth of the money stock can on occasion be difficult to reconcile; but, despite the improvement in the balance of payments, the rate of increase of the money stock (sterling M_3) has in fact remained without difficulty within the target range of 9%–13%.

The concluding assessment on page 296 discusses the broad prospects for the economy over the next twelve to eighteen months.

Industrial production

Only in the United States has there been a sustained recovery in activity.



* Partly estimated for the second quarter of 1977.

[a] 1966–76 trend rates of growth are 2.8% per annum for the United States, 7.9% per annum for Japan and 4.1% per annum for OECD Europe.

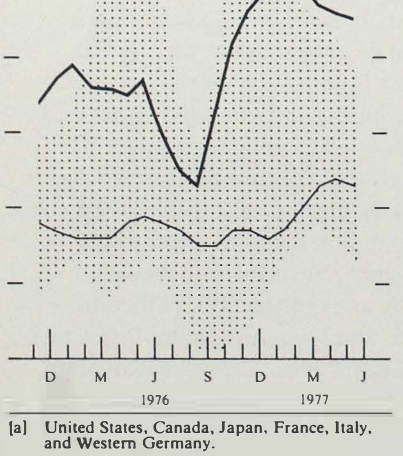
International developments[1]

Only in the United States has there been a sustained recovery in activity in the first half of this year. In the other main industrial countries, there was a brief revival in output at the turn of the year, but more recently activity has faltered: industrial production has fallen further below trend (see chart) and unemployment has risen. Inflation generally has accelerated, with an exceptionally rapid increase in food prices. Because of continuing concern about inflation and, in many cases, weak external positions, governments have remained cautious about expanding demand, even where growth has been slower than expected. Nevertheless, they have reaffirmed their commitment to the aims of the OECD medium-term strategy, agreed in June 1976, and recognise that a faster rate of expansion in the OECD area is desirable and that action may

[1] This section is in seasonally-adjusted terms, unless otherwise stated.

Consumer prices in the main industrial countries

Consumer prices in many countries rose faster in the first half of this year.



[a] United States, Canada, Japan, France, Italy, and Western Germany.

need to be taken to achieve this. Expansionary measures have been announced, or are expected, in a number of countries.

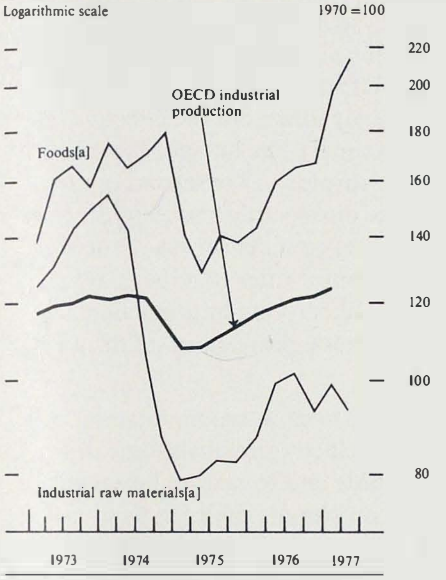
The US economy expanded very rapidly in the first half of this year. Real GNP is now estimated to have grown at an annual rate of $7\frac{1}{2}\%$ in the first quarter, and at about 6% in the second. Consumption, which rose very fast in the first quarter, continued to rise quite strongly in the second; there were also encouraging signs of some recovery in business investment. More modest growth of real GNP is expected in the second half of the year with consumption, in particular, expected to rise less. For 1977 as a whole, GNP may grow by about 5%. The saving ratio, which fell sharply in the first quarter, has begun to rise again. But, with higher employment (and a small tax reduction from the middle of the year), real incomes should continue to rise. Unemployment had fallen to 7% by the second quarter. The Administration expect the growth of GNP to be about 5% again next year, led by a continuing recovery in business investment. Public expenditure should also contribute to growth from now on: the federal government deficit for the fiscal year beginning in October is forecast to be \$60 billion, after \$48 billion this fiscal year; state and local governments, after a period of retrenchment, are now expected to increase their spending. The recovery has meant a large increase in the trade deficit.

The trend in the US economy is in marked contrast to the position in other major countries, particularly in respect of domestic demand. In Japan, although official estimates put real GNP growth in the second quarter at about $7\frac{1}{2}\%$ (at an annual rate), the underlying rate may be lower. Exports have continued to rise strongly, but domestic activity remains depressed and business confidence low. Although consumer spending was buoyant in the second quarter, the outlook is poor, with real incomes likely to continue to rise only slowly this year; the saving ratio is expected to remain high. Private fixed investment remains weak in the face of poor prospects for domestic demand, substantial spare capacity and lack of business confidence. The Government are pledged to achieving $6\frac{3}{4}\%$ growth in real GNP in the fiscal year ending in March 1978 (after $5\frac{3}{4}\%$ in the previous year). To this end, some stimulatory measures were announced in early August and a supplementary Budget was introduced in September. In Western Germany, where activity appeared to be recovering at the end of last year, output has since faltered, and industrial production fell by $1\frac{3}{4}\%$ in the second quarter. Unemployment has been rising slowly again and was over $4\frac{1}{2}\%$ in July. Neither consumption nor investment has picked up; orders for investment goods are poor, and surveys suggest that businessmen are concerned about prospects this year. The Government now expect real GNP growth this year to be more modest than their previous forecast of 5%, and some reflationary measures are expected to be announced this month. In France, activity remains depressed, and the Government at the end of August introduced further measures to aid investment and employment. The Italian economy is reacting, albeit slowly, to the series of deflationary measures introduced late last year and earlier this year; industrial production fell sharply in the second quarter.

In the first half of 1977, there was a general surge in consumer prices in the main overseas economies. On average, they had been rising at around 7% per annum at the end of last year; by the middle of this year they were rising at about $9\frac{1}{2}\%$ per annum (see chart). The increases were particularly marked in those countries with relatively low inflation rates. Food prices rose most, reflecting unusually bad weather in North America, delayed

Real cost of commodities

The real cost of industrial raw materials is still well below its peak in early 1974, whereas food prices in real terms are now considerably higher.



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

Export markets

More than 50% of the major European countries' exports go to other European countries.

Exports of goods by area in 1976, as percentage of exporting countries' GDP

Markets	Exporting countries: Major European countries[a]	Other OECD Europe	North America	Japan
North America	1.5	1.4	2.7	3.2
Japan	0.2	0.2	0.7	—
Major European countries[a]	5.7	11.7	1.1	0.9
Other OECD Europe	6.9	6.9	0.9	1.1
Other markets	6.1	5.1	2.8	7.0
Total exports of goods as a percentage of GDP	20.4	25.3	8.2	12.2
Total exports of goods and services as a percentage of GDP	25.5	..	11.1	14.5

.. not available.

Components may not add to totals because of rounding.

[a] United Kingdom, France, Italy and Western Germany.

Current account balances

Large imbalances between countries on current account persist.

$ billions: *seasonally adjusted*

	1975 Year	1976 1st half	1976 2nd half	1977 1st qtr	1977 2nd qtr
United States[a]	11.7	1.1	− 2.4	− 4.3	−5.1[b]
Canada	− 4.9	− 2.5	− 2.0	− 0.8	−1.3[b]
Japan	− 0.7	2.5	0.9	2.3	2.7
France	—	− 1.8	− 4.2	− 1.3	−0.7
Italy	− 0.5	− 1.6	− 1.3	− 1.0[b]	−0.6[b]
Western Germany	3.9	1.9	0.9	0.7	1.6[b]
United Kingdom	− 3.8	− 0.9	− 1.6	− 0.8	−0.4
	5.7	− 1.3	− 9.7	− 5.2[b]	−3.8
Other OECD countries	−12.0	− 6.8	−10.3	− 5.2[b]	
Total OECD countries	− 6.3	− 8.1	−20.0	−10.4[b]	
Oil-exporting countries	33.0	21.0	19.0	8.5[b]	
Other developing countries	−31.0	−11.0	− 9.0	− 3.0[b]	

[a] The US definition excludes retained earnings of overseas subsidiaries of US companies, and earnings of foreign companies' subsidiaries in the United States. Including these items the US current account surplus would be:

$ billions

1975	1976
18.0	5.1

[b] Estimated.

effects of last summer's drought in Europe, and the effects of supply difficulties on the prices of coffee, tea and cocoa. In the first quarter, rises in food prices accounted for nearly half of the major countries' average increase in prices, compared with only about one sixth in the fourth quarter. Commodity prices have eased more recently, especially for coffee, and consumer prices should in general rise more slowly over the second half of the year. With output in OECD countries growing only slowly, the price of industrial raw materials (in terms of manufactured goods in world trade) has changed little since early 1976 and is well below the peak of early 1974. In contrast, the real cost of food has risen over the same period (see chart). Nevertheless, for 1977 as a whole, price inflation will probably be a little higher than last year, as unit labour costs accelerate. Wage increases now seem likely to be as high or higher than last year in most of the major industrial countries, and productivity gains will probably be much smaller, given the present outlook for activity.

Industrial countries' trade, like their production, has continued to expand very slowly. The major countries' export volume grew by about $1\frac{1}{4}\%$ in the first quarter and no faster in the second. Import volume, which had risen quite strongly throughout 1976, was unchanged in the first quarter (despite exceptionally large oil imports by the United States) and fell in the second. The major economies, other than Japan and Canada, have gained little direct benefit from the upturn in activity in the United States. The European economies' exports to the United States are small in comparison with their trade with each other (see table). Exports to oil-producing countries have increased and are forecast to expand steadily through the year. Non-oil developing countries' imports appear to be reviving after the restraint of last year.

Large imbalances in the current accounts of the major economic areas, and of countries within the OECD area itself, persist, although their pattern is changing somewhat (see table). The OPEC surplus is expected to decline this year, as increased imports outweigh the higher value of oil exports; even so, it will remain very large. The non-oil developing countries' aggregate deficit, which was cut by a third last year, is expected to be little changed this year, despite higher imports. The aggregate OECD deficit is likely to be somewhat larger than last year. The United States have gone into substantial deficit, which, for the year as a whole, is expected to amount to at least $12 billion. The growth in the US deficit, however, has been largely offset so far by a rise in Japan's surplus which was $5 billion in the first half of the year alone. The West German current account also remains firmly in surplus, ($2.3 billion in the first half of the year). The smaller OECD countries at present in deficit are expected to continue to run deficits which are very large in relation to their GNP. These imbalances form the background to recent developments on the foreign exchange markets. Between December and June, the yen has been allowed to appreciate by over 11% against the US dollar, and at the end of June the Prime Minister announced that the Japanese authorities would not intervene to stem further rises. The growing US trade deficit, and rumours of possible appreciation of other currencies, led to considerable selling pressure on the dollar during the summer (see page 305). At the end of August, Sweden withdrew from the 'snake' and devalued by 10% against a basket of fifteen currencies. Norway and Denmark also devalued, by 5% against their 'snake' partners.

The UK economy

The balance of payments and the exchange rate

The exchange rate for the pound against the dollar was held close to $1.72 until late July. The authorities intervened frequently in recent months – though generally on a smaller scale than earlier in the year – mainly to prevent further appreciation, but on occasions also to avoid any significant fall in the rate. Maintaining a stable rate against the US dollar implied some slight depreciation in effective terms (i.e. on a trade-weighted basis) as the dollar weakened. As a result, the authorities decided to switch the focus of their attention to the effective exchange rate and allowed the pound to appreciate so as to restore the effective rate to what it had been earlier in the year.[1] The balance for official financing showed a further sizable surplus in the second quarter, and the reserves continued to grow during July and August. Over and above the weakness of the dollar, confidence was no doubt aided by the clear resolution of the authorities to adhere to the stated monetary targets and by the underlying improvement in the trade figures; and it was robust enough to shrug off disquieting developments on incomes policy.

The authorities' general policy has been to maintain stability in the exchange rate. This policy has helped to remove some of the uncertainties from international trade and to restore business confidence, and with the pressure on sterling mainly upwards it has allowed the much-depleted reserves to be rebuilt. There is a risk that any specific exchange rate strategy may run counter to policies for monetary growth, but so far this year the money stock has remained within the declared target zone, with the expansionary contribution of external factors offset by low domestic credit expansion. There are many, and sometimes conflicting, considerations in determining exchange rate policy. Both short and long-run effects of exchange rate movements on both external competitiveness and domestic inflation have to be taken into account. This year the stability of the exchange rate has meant that the price competitiveness and the profitability of exports have declined somewhat from the exceptionally favourable positions reached last autumn.

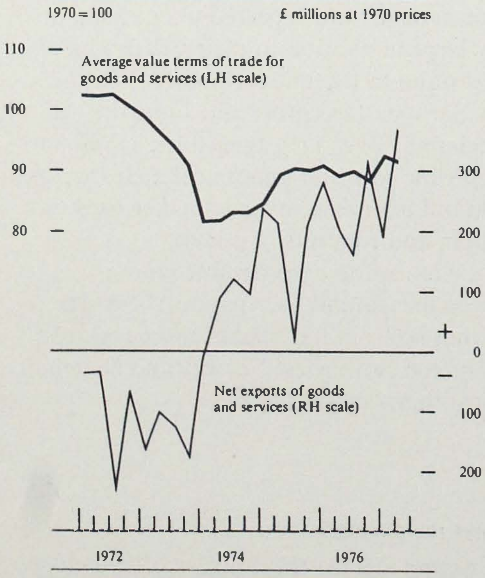
The current account[2]

The deficit on current account in the second quarter was £200 million, much smaller than the revised figure of £460 million for the first quarter. There was a marked improvement on visible trade but a slight deterioration on invisibles.

The deficit on visible trade was £700 million in the second quarter, £270 million better than in the first. These figures probably understate the underlying improvement. Although difficulties with seasonal adjustment around the turn of the year exaggerated the deficit in the first quarter, special factors in the second quarter – large imports of North Sea equipment and a deterioration in the balance of trade in precious stones – probably outweighed this. The growth of 5.8% in the volume of exports, after a fall in the first quarter, was particularly encouraging: the United Kingdom's share of world trade in manufactures must have increased. Import volume was only 1.1% higher: imports of food and industrial materials were little changed, while those of fuel fell; there was, however, a surge in imports of finished manufactures which, even after allowance for North Sea installations, have been rising fast for some time. However, as the chart shows, the volume of net UK exports of goods and services has grown, though the economic cycle may have contributed to this. Moreover, about half of the loss in the terms of trade, experienced around the time of the commodity and oil prices

UK trade in goods and services

Net exports have grown, and part of the loss in the terms of trade has been recouped.



[1] Developments in foreign exchange markets are described in more detail on page 304.
[2] This section is in seasonally-adjusted terms.

boom of 1972–73, has been recovered.[1] The prices of industrial raw materials have fallen relative to those of manufactured goods (see chart on page 285); food prices have not, but their adverse effect on the terms of trade has been mitigated by the Common Agricultural Policy. Moreover, North Sea oil has the effect of reducing the average value of imports (or, if exported, increasing that of exports), and so improves the terms of trade.[1] This year there has been a marked deceleration of both export and import prices, no doubt largely on account of the stability of sterling.

North Sea oil is now making a major contribution to improving the current account. The adverse balance of trade in oil narrowed from a record £340 million a month during the second half of 1976 to £240 million a month in the second quarter of this year, even though oil prices were by then some 8% higher in sterling terms. Last year, the value of North Sea oil production was £0.7 billion, but, after allowing for the high import content of expenditure on the North Sea programme, there was little net effect on the current account as a whole. On the other hand, because of associated capital inflows, North Sea oil benefited the overall balance of payments by almost £1 billion. Official projections have been made of the potential balance of payments effect of North Sea oil in the years ahead, on the assumptions that the exchange rate, the level of unemployment and the domestic demand for oil are all unaffected.[2] These projections indicate that, measured in terms of 1976 prices, the benefits to the current account and to the balance for official financing this year will be about £1$\frac{1}{2}$ billion and £2 billion respectively; by 1985 these benefits might each amount to about £7$\frac{1}{2}$ billion per annum.

The surplus on invisibles in the second quarter, at £490 million, was £10 million smaller than in the first. The surplus on services, which has increased sharply over the past few years, rose again in the second quarter. There was a further large rise in net earnings from travel and tourism; banking and commodity earnings were also higher. Net receipts of interest, profits and dividends, however, shrank very considerably; in particular, there was a large fall in the net interest received by UK banks from euro-currency business and an increase in the earnings of foreign companies operating in the North Sea.

The current account deficit for July is provisionally estimated to have been about £40 million. The volume of imports was lower than in June, but not by as much as might have been expected in view of that month's exceptionally large imports of North Sea oil equipment. Exports, on the other hand, which were very high in June, were nearly as high in July.

The recent performance of exports of goods, at a time when world trade is slack, has been encouraging; they should continue to grow. However, the persistent increase in imports of finished goods, at a time when the economy is stagnant, is a cause for concern; on the other hand, the balance of trade in oil will continue to improve. On the invisibles side, profits earned by foreign companies operating in the North Sea will grow – a debit item. The surplus on services, however, which more than doubled between 1974 and 1976, should increase further. Altogether, with domestic activity low, the current account is expected to move into substantial surplus.

[1] Calculated from average values. The terms of trade calculated from unit values, which attach fixed weights to groups of commodities in the calculation of the index, and so take less account of changes in the composition of trade, are much less favourable. Because oil was relatively cheap in 1970 – the base date for national income statistics at constant prices – North Sea oil production contributes little to the balance of trade measured at 1970 prices; most of the benefit comes through the terms of trade.

[2] See HM Treasury's *Economic Progress Report*, August 1977.

Summary of the UK balance of payments

In the second quarter, despite a continuing current account deficit, the balance for official financing was in large surplus.

£ millions	1976			1977	
	1st half	3rd qtr	4th qtr	1st qtr	2nd qtr
Seasonally adjusted					
Current balance	− 480	− 511	− 414	− 461	− 204
Not seasonally adjusted					
Current balance	− 596	− 386	− 423	− 593	− 276
HMG foreign currency bonds[a]	—	—	—	—	+ 395
Non-official gilt-edged holdings[a]	+ 13	+ 53	+ 50	+ 367	+ 42
Foreign currency borrowing by British National Oil Corporation[a]	—	—	—	—	+ 436
Sterling holdings of:					
Central monetary institutions	− 1,001	− 349	− 57	+ 190	− 392
Other holders	− 6	+ 212	+ 49	+ 199	+ 350
UK banks' external sterling claims:[b]					
UK export credit	− 461	− 152	− 247	− 198	− 131
Other	− 442	− 119	+ 254	+ 188	− 105
UK banks' net external liabilities in foreign currencies	+ 8	− 272	+ 158	+ 411	− 704
Other identified capital flows and balancing item	− 148	+ 151	+ 83	+ 1,349	+ 1,295
Balance for official financing	− 2,633	− 862	− 133	+ 1,913	+ 910

[a] Part of overseas investment in the UK public sector.

[b] Increase (−). Also includes lending by a few financial institutions other than banks and export credit refinanced by the Export Credits Guarantee Department.

Capital flows and official financing

The identified net inflow on capital account was some £270 million in the second quarter, much less than the exceptional £2 billion in the first. However, the positive balancing item (£910 million) was even larger than in the first quarter.

Overseas sterling holdings fell by about £40 million in the second quarter. Within this total, the holdings of central monetary institutions fell sharply, reflecting their take-up in April of foreign currency bonds offered by HM Government,[1] and other reductions made in response to the Government's request that holdings should be reduced to the level of working balances. In contrast, other holdings rose, largely as a result of purchases of sterling in conjunction with applications for British Petroleum stock.

Inflows into the public sector in the second quarter included the foreign currency bonds mentioned above, further, but much smaller, net purchases of gilt-edged by overseas investors other than central monetary institutions, and the $750 million drawn in June by the British National Oil Corporation on a $825 million eight-year loan, arranged through a group of British and American banks. The loan is to fund part of British National Oil Corporation's North Sea exploration and development programme, enabling BNOC to repay existing borrowing from the Government.

Sterling lending to overseas by UK banks and certain other institutions, which changed little, in total, in either of the preceding two quarters, grew in the second quarter. Within the total, lending not directly associated with UK exports expanded afresh – although relatively modestly – towards the end of the period, having earlier contracted by £370 million in the six months following the exchange control measures of last year. This seems to confirm the belief that most of the once-for-all impact of those measures had worked through by the end of the first quarter.[1]

Foreign currency lending abroad by UK banks and certain other institutions appears to have increased by considerably more during the second quarter than foreign currency deposits taken from overseas residents. The result shows up as a net outflow of some £700 million in the capital account. However, this may reflect the attribution to overseas account – the usual practice – of some unusually large unallocated items emerging from the aggregated bank returns (in respect of unidentified holdings of dollar certificates of deposit and of a difference between the figures reported by the banks for liabilities to and claims on each other).[2] The fact that a very large positive balancing item is necessary to balance the accounts for the quarter (indicating overstated outflows or understated inflows in the 'identified' items) points to the highly provisional nature of many of the estimates at this stage. Among other identified capital flows, both overseas investment in the UK private sector – which includes investment by foreign companies operating in the North Sea – and UK private investment abroad were very high.

Besides the surplus of £910 million on the balance for official financing in the second quarter, there was a further drawing under the IMF stand-by facility, and small amounts were borrowed by public sector bodies under the exchange cover scheme. As a result, the reserves increased by the equivalent of some £1,160 million. They rose by a further £1,070 million in July, after some £30 million of public sector borrowing under the

[1] See June *Bulletin*, page 141.

[2] See additional notes to Tables 20 and 21 in the statistical annex.

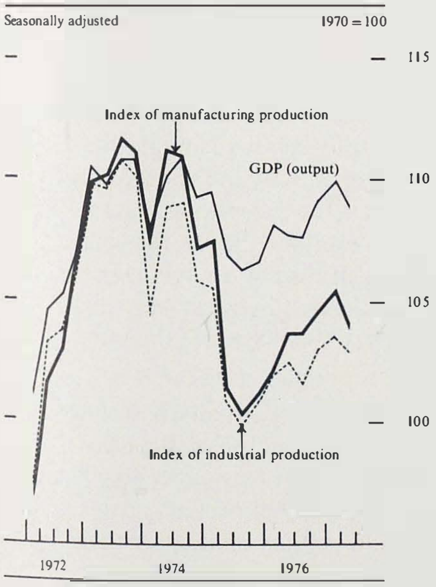
exchange cover scheme. In August, the reserves again rose sharply, by some £810 million, after drawings on the IMF stand-by and the Government's $1.5 billion loan equivalent to £214 million and £57 million respectively.

Reference has been made above to the impact of external flows on the money supply. Broadly speaking, apart from changes in the non-deposit liabilities of the banks, changes in the money stock differ from domestic credit expansion by the sum of the current account and capital flows involving the non-bank private sector, but the relevant items are not readily identifiable from the balance of payments accounts. Capital inflows to the non-bank private sector, however, will only have an expansionary effect on the money stock to the extent that domestic credit expansion is unaffected by them. In fact, numerous compensatory changes are likely to take place so that an explanation in such statistical terms has a somewhat limited significance.[1]

During the second quarter, the current account remained in deficit; the relevant capital flows to and from the private sector amounted to a substantial net inflow; on balance, the expansionary contribution of the external counterpart to the increase in sterling M_3 was not as large as might have been expected (in the three months to mid-July, however, the statistical contribution of external factors to sterling M_3 was much larger). In fact, much of the substantial increase in the reserves could be accounted for by flows into the public sector.

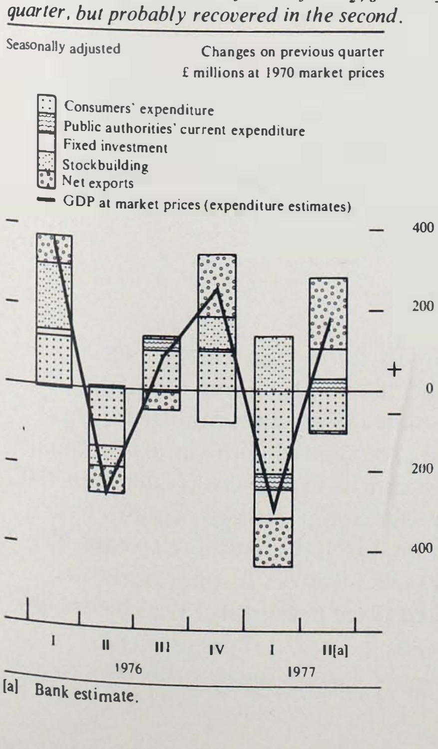
Fluctuations in output

Industrial production is still well below what it was in 1974.



Factors contributing to changes in GDP

The expenditure measure of GDP fell $1\frac{1}{2}\%$ in the first quarter, but probably recovered in the second.



[a] Bank estimate.

Output and demand[2]

After eighteen months of hesitant recovery, the growth of output halted in the first half of this year; the output measure of GDP fell by 1% in the second quarter and is $2\frac{1}{4}\%$ below the peak in 1974 (see chart). Even so, GDP has been less depressed than industrial production, because of some growth in the output of services. Industrial production, which includes North Sea oil, remained virtually flat throughout the first half of 1977; in the second quarter it was only $\frac{1}{2}\%$ higher than a year previously, and 7% below the 1973 peak. Manufacturing output in particular is very depressed.

On the expenditure measure, GDP fell by $1\frac{1}{2}\%$ in the first quarter, but may have recovered a little in the second (see chart). Between the second quarters of 1976 and 1977, real personal disposable income declined by $3\frac{1}{2}\%$. Until the end of last year, consumer spending held up quite well, though in the fourth quarter only because of a sharp fall in the saving ratio. Subsequently, however, consumer spending fell sharply (by $2\frac{1}{4}\%$ in the first quarter and by a further $1\frac{1}{4}\%$ in the second). With the help of the tax rebates paid in August and September, and some recovery in real incomes as price inflation decelerates, consumers' expenditure may increase a little in the third quarter.

After falling in the first quarter, private industrial investment, though still depressed, grew a little in the second (investment in manufacturing industry increased by 3%, and in distribution and service industries by 1%). Surveys of investment intentions suggest that investment may pick up strongly in the near future but poor demand prospects cast some doubt on whether this will happen. There are signs of a modest recovery in private sector housebuilding.

It had been expected that at least part of the heavy stockbuilding in the first quarter, much of which was probably an unplanned consequence of the fall in consumers' expenditure, would be reversed in the second. This does not seem to have happened, and stockbuilding, though less than in the first quarter,

[1] For a full description of the statistics, see the March *Bulletin*, page 39.

[2] All figures are seasonally adjusted and at constant (1970) prices.

was still very large. Possibly manufacturers and distributors were frustrated in attempts to reduce stocks of finished goods by the further fall in consumer demand.

Public sector current spending fell by $1\frac{1}{2}\%$ in the first quarter and is unlikely to rise very much in the near future. Spending cuts have, however, been concentrated on capital spending, which has fallen sharply in the past two years and may fall further.

The balance of trade contributed more to demand in the first half of 1977, when export volume is estimated to have been $3\frac{1}{2}\%$ greater and import volume $2\frac{1}{2}\%$ greater than in the second half of last year. Exports of goods and services should continue to grow fairly strongly in the near future, but little faster than imports, in spite of the United Kingdom's growing production of oil and the continuing slow growth of domestic demand.

Overall, therefore, demand is likely to rise, but relatively slowly in the near future. Consumers' expenditure, investment and net exports of goods and services are likely to show some growth. On the other hand, public spending may fall further, and stocks may be reduced.

Unemployment

Unemployment has risen rapidly in the last three months. This reversal of the improvements recorded earlier in the year has largely dispelled suspicions that output indicators might be seriously understating the strength of activity in the economy. Part of the increase, however, reflects the exceptionally large number of school-leavers, but even excluding these, the total number registered as unemployed still rose by an average of more than 30,000 a month (seasonally adjusted) between May and August to reach 1,414,000 (6%), over 100,000 more than in August last year.

Unemployment amongst the young is a particularly serious problem. In July, the number of unemployed school-leavers exceeded a quarter of a million for the first time, over 40,000 more than a year earlier, and although the number on the register is now starting to decline as many find employment, nevertheless many school-leavers are likely to be without work for some months. The Government's special employment and training schemes are undoubtedly providing relief, but it is only short-term relief and those benefiting may well become unemployed again subsequently.

The growth in manufacturing employment over the past year, which was partly responsible for earlier optimism about unemployment, has apparently slackened in recent months, and despite the prospect of some recovery in output (see above) there is little reason to expect unemployment to turn down in the near future.

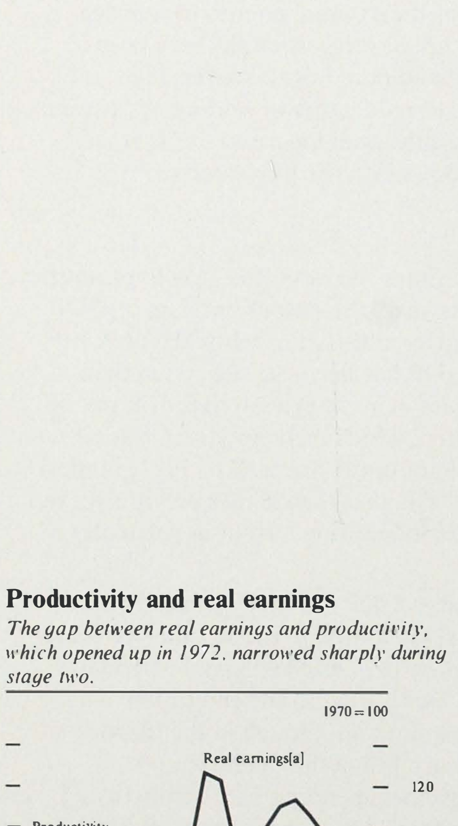
Costs and prices

Average earnings rose less rapidly during the second stage of incomes policy than during the first; in the eleven months to June 1977, the index of average earnings (seasonally adjusted) rose at an annual rate of less than 10%, compared with almost 14% in the year to July 1976.[1] Although this was somewhat faster than had been hoped, the year-on-year increase in average earnings has declined from almost 30% to single figures within two years. The associated fall in real earnings has reversed to some extent the large increases which had taken place previously. The chart shows

[1] This comparison is on the 'old' index; the 'new' index with wider coverage showed an increase of about $8\frac{1}{2}\%$ in the year to June 1977.

Productivity and real earnings

The gap between real earnings and productivity, which opened up in 1972, narrowed sharply during stage two.



[a] Index of average earnings divided by the consumer price index.

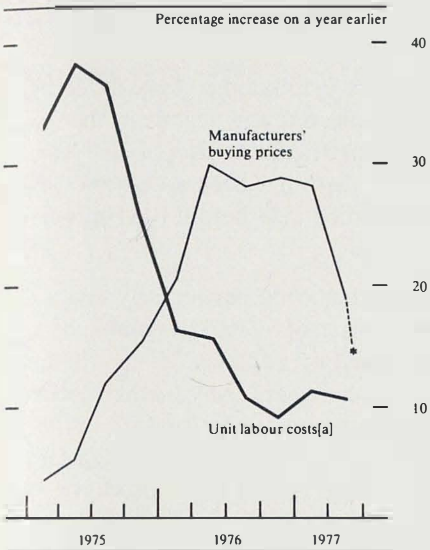
[b] Productivity is measured by GDP per employee. The latest observations are Bank estimates.

[c] Differences between the terms of trade on goods and services in each quarter and in 1970 were multiplied by the share of exports in GDP; this product was subtracted from the productivity index.

[d] Distorted by three-day working.

Unit labour costs and wholesale buying prices

Manufacturers' buying prices have slackened appreciably so far this year.



* Manufacturers' buying prices in July.

[a] Bank estimate.

Number settling during stage two of the incomes policy [a]

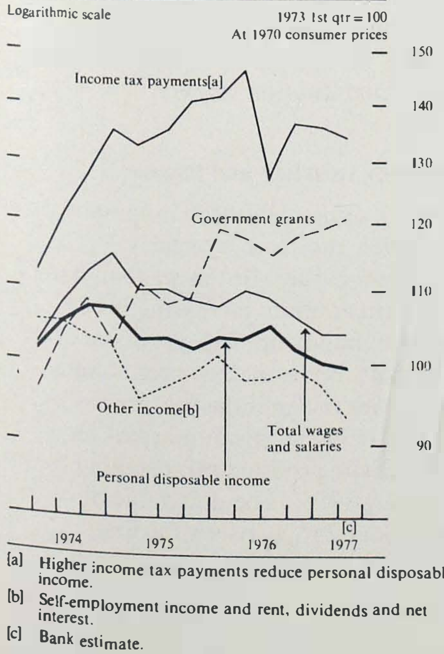
About 60% of settlements took place between December and June.

	Millions	Cumulative percentage
1976 Aug.	0·6	5.1
Sept.	1.1	14.5
Oct.	0.8	21.4
Nov.	1.3	32.5
Dec.	0.6	37.6
1977 Jan.	0.2	39.3
Feb.	0.3	41.9
Mar.	3.7	73.5
Apr.	1.5	86.3
May	0.3	88.9
June	0.9	96.6
July	0.4	100
	11.7	

[a] Number of settlements *notified* to the Department of Employment.

Main components of real personal disposable income

Real personal disposable income has fallen over the last year, despite an increase in government grants and a reduction in the real value of income tax.



[a] Higher income tax payments reduce personal disposable income.

[b] Self-employment income and rent, dividends and net interest.

[c] Bank estimate.

that the rise in real earnings from the end of 1972 to early 1975 was much faster than the growth of productivity, even before allowance for the adverse movement in the terms of trade which has only partially been recouped.[1]

The easing of wage inflation during the past two years has helped to slow down the annual rate of growth of unit labour costs from over 35% in the middle of 1975, just before stage one began, to less than 16% in the year ending in the second quarter of 1976, and to about 10% during the following year. Moreover falling world commodity prices, and the stability of sterling during the first half of this year, have resulted in a much slower growth of manufacturers' buying prices (see chart).

But this deceleration in costs has yet to be reflected in the year-on-year increase in retail prices which in June were 17.7% higher than a year earlier (the highest year-on-year increase since April 1976). During this year, however, the rate of price inflation has in fact slowed down considerably. Lower prices for seasonal foods and the reduction in mortgage rates meant that between June and July prices scarcely rose at all, and in July were only about $6\frac{1}{2}\%$ higher than in January. Excluding seasonal foods, the retail price index rose at an annual rate of just over 15% between January and July, compared with nearly 19% during the preceding six months. The rate of price inflation is likely to ease further and may well have a significant bearing on the course of wage settlements during the coming year, particularly if last year's pattern of settlements is adhered to (see table). In that case, about 60% of settlements will take place during the first half of 1978, by which time prices should be rising more slowly than they were in the first half of this year.

Personal incomes and spending[2]

In the two years between the second quarters of 1975 and 1977 – broadly the period covered by stages one and two of the incomes policy – average wages and salaries are estimated to have risen by less than 30% while consumer prices rose by 33%. All of this decline in real earnings occurred during stage two: average wages and salaries increased slightly faster than expected, but nevertheless more slowly than consumer prices.

The fall in real average wages and salaries before tax has been the major element in the estimated $3\frac{1}{2}\%$ fall in real personal disposable income during the last year. Other personal incomes also fell, in spite of higher interest rates during the latter part of 1976. On the other hand, current grants from the central government and local authorities have increased slightly in real terms, and real income tax payments have fallen (see chart).

By comparison with this marked decline in real disposable incomes, consumer spending has been relatively well maintained; despite falls in the first two quarters of this year, spending was only about $1\frac{1}{4}\%$ lower in the second quarter than a year before. The saving ratio, which was about $14\frac{1}{2}\%$–15% early in 1976, fell to about 12% in the fourth quarter and rose only slightly in the first half of 1977.

The outlook for consumer spending is dominated by that for real earnings. With the rate of price inflation likely to slow down in the latter part of this year, real wages and salaries may rise. People will also benefit from the back-payment of tax reliefs in August and September (and continuing lower tax payments thereafter). Thus, there is likely to be some rise in real incomes in

[1] See page 304, and also the article by J. Hibbert, 'Measuring changes in the nation's real income', *Economic Trends*, No. 255, January 1975.

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

the second half of this year. All this may tend to support consumer spending, though uncertainty about future wage and price inflation may continue to make consumers cautious.

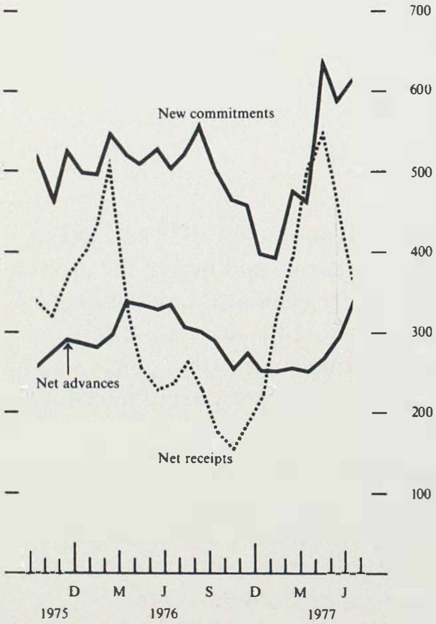
Housebuilding[1]

The volume of housing investment is estimated to have fallen by $12\frac{1}{2}\%$ in the first quarter of 1977, reflecting the decline in the number of new houses started during the latter part of last year. In the first six months of this year, there has been a hesitant recovery in the number of starts, which may herald the beginning of an upturn in housing investment.

The recession in private housing has been particularly severe. After a fall of 7% in the fourth quarter of 1976, the volume of private sector housing investment fell by a further 16% in the first quarter, to its lowest level for fourteen years. Any further decline is now unlikely; indeed, private sector starts rose by 16% in the second quarter. While this sharp increase is from a first quarter total affected by unusually wet weather, starts must also have received some boost from an easing of conditions in the housing finance market. Net receipts by building societies averaged an exceptional £500 million a month in the second quarter (see chart), an increase of some £190 million on the first quarter, although this was not sustained in July (see page 295). New commitments have risen in response – they rose by 34% in the second quarter – and, at £612 million in July, have remained high. The societies' liquidity ratio improved from 18% at the beginning of the year to $19\frac{1}{2}\%$ at the end of July, and the present volume of inflows, though lower than in earlier months, should enable the societies to continue lending at around £550–600 million a month for some months, without causing undue pressure on liquidity.

Building society funds

New commitments remain high in spite of a fall in net receipts. Net advances continue to rise.



The average price of new houses[2] increased by $3\frac{1}{2}\%$ in the second quarter, considerably faster than in the previous two quarters. Over the past twelve months, house prices have risen by around $8\frac{1}{2}\%$; this is much less than prices in general, but the disparity seems unlikely to continue: the combination of increased demand and little new building may well cause house prices to rise faster, at a time when the rate of general price inflation is expected to slacken.

Public sector housebuilding fell by a further 9% in the first quarter. Starts were 9% higher in the second quarter, but this comparison may be misleading as the first quarter included the exceptionally poor month of February. While the rate of new building continues to be low, this may in part reflect an increasing emphasis on improvement and rehabilitation work.

Industrial and commercial company spending and finance[1]

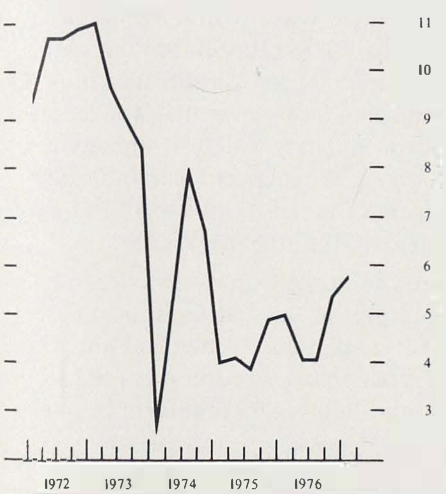
Gross trading profits (net of stock appreciation) in nominal terms continue to rise. In the first quarter, they rose by nearly 7%, to £2.9 billion, 25% higher than a year earlier. But more than half of the increase over the year represents rapidly increasing profits from North Sea oil, as production builds up. The profits of other companies were much less buoyant. Nevertheless, profits were probably also boosted by the slower rise in industrial costs – particularly labour costs – and by higher profit margins on exports (relative to those on domestic production), resulting from the fall in the exchange rate during 1976. (The unit value of manufactured exports rose by about 25% between the first

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

[2] At the mortgage-approval stage.

Share of net profits in net domestic income[a]

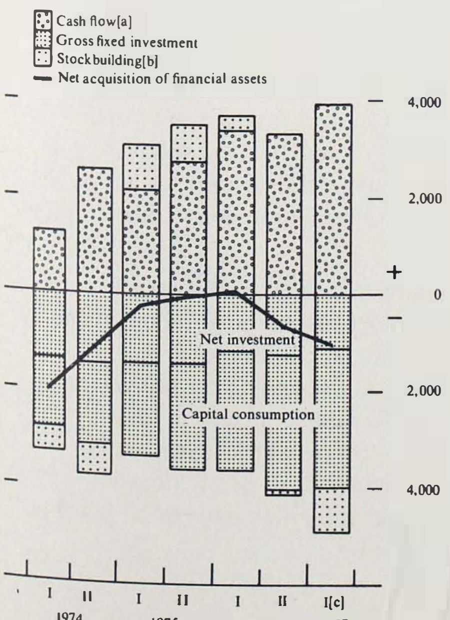
The share of net profits in net domestic income has risen but remains very low.



[a] Net profits and net domestic income are derived by subtracting the appropriate measure of stock appreciation and capital consumption (at replacement cost) from gross trading profits and total domestic income.

Appropriation account of industrial and commercial companies

Industrial and commercial companies are again in substantial deficit.



[a] Undistributed income, *plus* net capital transfers, *less* stock appreciation.
[b] Destocking is treated as a source of funds.
[c] First quarter at half-yearly rate.

quarters of 1976 and 1977, compared with an increase of 20% for domestic selling prices.) Profits are likely to continue to rise throughout 1977 as the growth of labour costs and manufacturers' buying prices has continued to moderate. Even so, with provisions for capital consumption (at replacement cost) rising rapidly, cash profits, net of stock appreciation and capital consumption, are only about the same as in 1973, despite the doubling of the general price level over this period. Real rates of return, and the share of net profits in net domestic income (see chart), have recovered only slightly and are likely to remain extremely depressed.

Prior calls on profits have increased relatively slowly: interest charges fell in the first quarter as interest rates declined, and tax payments, which are made, on average, about eighteen months after they accrue, were also lower. Against this, dividend payments increased, reflecting both exemptions from the statutory limit (particularly for companies with a high proportion of overseas earnings) and payments on new equity issues; profits due abroad also rose and will probably continue to do so, as part of the profits earned on North Sea activities is attributable to foreign companies. But on balance, cash flow[1] has been recovering appreciably (see chart).

Nevertheless, industrial and commercial companies, as a whole, have gone back into appreciable financial deficit since mid-1976, and, in the first quarter of 1977 alone, the deficit was over £$\frac{1}{2}$ billion. This was partly because of heavy stockbuilding (nearly £$\frac{1}{2}$ billion at current prices), perhaps largely involuntary. Stockbuilding was again large in the second quarter. Fixed investment in nominal terms by industrial and commercial companies amounted to about £2 billion in the first quarter, but it was still very low in real terms. Provisional figures for the second quarter point to a slight pick-up, with investment in manufacturing rising by 3% (in real terms) and in distribution and services by 1%. Replacement investment (as measured by capital consumption at current prices) has been representing an increasing proportion of total fixed investment; in money terms, net investment[2] is no higher than in 1973. The July Confederation of British Industry's industrial trends survey, which took a more optimistic view than the June Department of Industry's investment intentions survey, indicated growth in the volume of manufacturing investment of 10%–15% in 1977 and 15%–20% in 1978. This may well prove too optimistic, given what has already happened in the first half of this year and that slow growth of demand, considerable spare capacity, low real rates of return and uncertainty about the future path of wage and price inflation are likely to persist.

Bank borrowing by industrial and commercial companies continued to rise in the first quarter of 1977, but in real terms the amount of borrowing outstanding has changed little. In late 1976 and early this year, equity issues tailed off; but they recovered strongly in the second quarter. Borrowing from abroad has been heavy, partly because of high capital expenditure by foreign-owned companies engaged in North Sea oil operations. The Department of Industry's survey of company liquidity shows, after little change for just over a year, an improvement in company liquidity in the first half of this year.

If investment does in fact increase strongly, industrial and commercial companies as a whole will probably remain in deficit over the next year or so, despite the improving position of those companies engaged in North Sea operations.

[1] Defined as undistributed income, *plus* net capital transfers, *less* stock appreciation.
[2] Gross investment *less* capital consumption at current prices.

The public sector

In the first three months of the financial year, the public sector borrowing requirement was £1.7 billion, seasonally adjusted. This is less than a quarter of the £8.5 billion forecast at the time of the Budget for 1977/78 as a whole – and well in line with the £8.7 billion limit agreed with the International Monetary Fund last December.

The central government borrowing requirement in the June quarter was £1.7 billion. Rather less than usual was borrowed on the central government's own account, but an unusually large amount was raised for onlending to local authorities who repaid short-term market debt. In the preceding six months, local authorities had been reluctant to incur loans with long maturities at a time of high interest rates. The fall in rates during the spring made such borrowing more attractive. Moreover, the advent of the voluntary Code of Practice, requiring local government to lengthen the average maturity of its borrowing, may well have encouraged authorities to do so. Accordingly, in the quarter local authorities drew substantial sums in the form of longer-term loans from the Public Works Loan Board and also from the market.

The central government's need to borrow on its own account was reduced somewhat by the receipt of the first instalment of the proceeds from the sale of the BP stock, and revenue had not yet been affected by the conditional tax changes proposed in the Budget, and now put forward in a slightly different form in July.

The Chancellor's statement on 15th July contained two elements: income tax reliefs and some additional public expenditure. The former, consisting of a reduction in the basic rate of income tax from 35p to 34p and an increase in personal allowances, will cost very much the same as the original proposal (which was to be conditional on reaching a satisfactory stage three agreement) of reducing the basic rate to 33p. The extra public spending consisted mainly of an increase in the subsidy on milk and special assistance to the construction industry. The final impact of the package implemented in July is much the same as that of the original Budget proposals announced in April; the withdrawal of the petrol tax increase and the rebate to telephone subscribers might have been expected to push the borrowing requirement above the Budget forecast, but other developments in the economy – particularly lower interest rates – are likely to work in the opposite direction, so that public sector borrowing is still expected to remain under £8.5 billion for the financial year as a whole.

Most public expenditure is subject to some form of cash control, either direct, as is the case with most central government spending, or indirect, through the cash limits on central government grants to local authorities and through controls on borrowing by public corporations. The Chancellor made it clear in his July statement that he does not intend to revise this year's limits upwards. If, therefore, inflation turns out to be greater than expected, the volume of public spending may have to be lower (as seems to have been a factor last year).

Monetary developments[1]

After the small fall in the money stock last winter, there has been moderate growth in recent months. Nevertheless, domestic credit expansion (DCE) has remained well within the limits set by the Chancellor in agreement with the International Monetary Fund. Minimum lending rate remained at 8% from mid-May to early August, but yields on gilt-edged stock rose until the latter part

[1] Figures in this section are seasonally adjusted unless otherwise stated.

DCE and the money stock[a]

Despite large external inflows, sterling M_3 grew only moderately during the first half of 1977; M_1 has been rising rather faster as interest rates have fallen.

£ millions: *seasonally adjusted*

Mid-month	Apr.– July 76	July– Oct. 76	Oct. 76– Jan. 77	Jan.– Apr. 77	Apr.– July 77
Central government borrowing requirement	+1,950	+1,910	+1,030	+1,410	+1,190
Net purchases (–) of central government debt by non-bank private sector	– 990	–1,120	–2,870	–1,100	–1,620
Other public sector[b]	+ 440	+ 410	+ 620	– 160	+ 180
Bank lending in sterling to:					
UK private sector[c]	+ 990	+1,210	+1,010	– 140	+1,030
Overseas	+ 150	+ 100	– 190	– 30	+ 150
Domestic credit expansion	**+2,540**	**+2,510**	**– 400**	**– 20**	**+ 930**
External and foreign currency finance (increase –)	– 930	– 880	+ 260	+ 670	+ 870
Other	– 450	–	– 200	– 60	– 640
Sterling M_3	**+1,160**	**+1,630**	**– 340**	**+ 590**	**+1,160**
Percentage change in sterling M_3	*+ 3.1*	*+ 4.2*	*– 0.9*	*+ 1.5*	*+ 2.9*
M_1	**+ 510**	**+ 300**	**+ 140**	**+ 820**	**+ 870**
Percentage change in M_1	*+ 2.9*	*+ 1.7*	*+ 0.8*	*+ 4.4*	*+ 4.5*

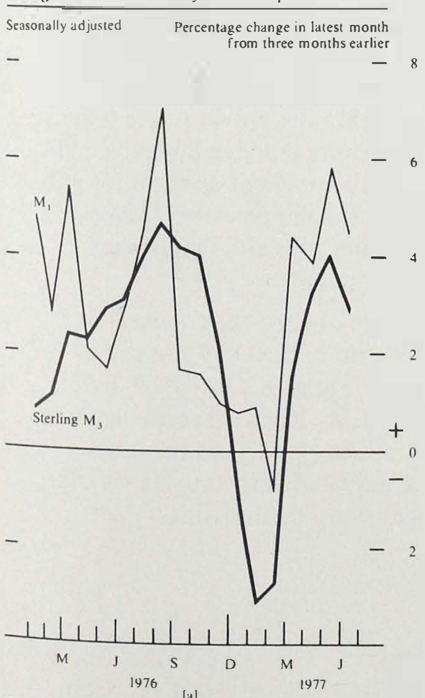
[a] Further details are shown in Table 11 / 3 in the statistical annex.

[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.

Money stock

After falling last winter, sterling M_3 has again been rising, but more slowly than M_1.



[a] Mid-months.

of July by about $1\frac{1}{4}\%$, to produce a very large yield differential between short-dated gilt-edged and money-market rates. After sterling was allowed to appreciate a little at the end of July, interest rates began to ease; minimum lending rate fell to 7%, in two steps, by 12th August and yields on both short-dated and long-dated gilt-edged stocks fell, by about $1\frac{1}{4}\%$ and $\frac{3}{4}\%$ respectively up to mid-August. The large yield differential over money-market rates remained.

The fall in interest rates since last October appears to have encouraged the growth of sight deposits. In the three months to mid-July, M_1 grew by $4\frac{1}{2}\%$, the same as in the previous three months (see table and chart). This was somewhat faster than the sterling component of M_3 which, having fallen short of the guidelines set for the year ending mid-April 1977, rose by some 3% in the three months to mid-July.

Among the components of wider measures of liquidity, building society net receipts rose sharply in April and May to around £500 million a month, when interest-rate differentials were very much in their favour: the societies' share rate was 12% (gross of standard rate tax) up to 1st May, 10.8% in May and June, and 10.2% thereafter, whilst local authority deposits yielded only about 7% and clearing bank seven-day deposit rates, for example, were as low as 4% from May onwards. However, it seems that April and May were exceptional, as the societies' net receipts fell back in June and further in July, to around £400 million a month. National savings receipts have also been high – particularly in the months before April, when the high-yielding sixteenth issue national savings certificate was available. This suggests that a wider definition of liquidity would not have fallen as much as sterling M_3 in the early months of this year, but that more recently the growth rates of the various measures of liquidity have come more into line.

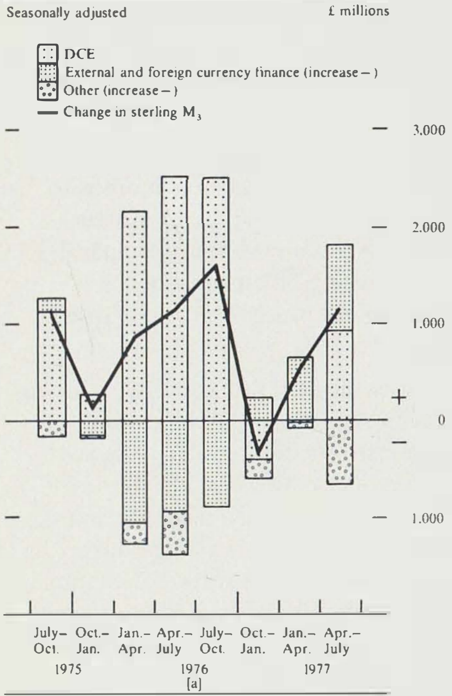
With the balance of payments deficits of recent years, external factors have tended to exert a contractionary influence on the money supply and DCE has been greater than the growth of sterling M_3. As explained earlier, this situation is now changing with the return of external confidence and the improvement in the current account. In the three months to mid-July, external and foreign currency finance[1] contributed, in a statistical sense, £870 million to the growth of sterling M_3 (see chart on following page); on the other hand, there was an increase in the banks' net non-deposit liabilities, and the rise in sterling M_3, £1,160 million, was little greater than domestic credit expansion (£930 million).

The reversal in recent months of the earlier falls in sterling M_3 appears to have been associated with renewed growth of bank lending. Over the three months to mid-July, bank lending in sterling to the private sector has risen by over £1,000 million. Lower interest rates may have helped to stimulate borrowing, and the special factors, such as the unwinding of leads and lags in commercial payments, which had earlier served to depress bank lending, were now no longer having much effect. In the three months to mid-May, the rise in bank lending seems to have gone primarily to retail distribution, probably reflecting stockbuilding which was at least partly involuntary, and to individuals, rather than to manufacturing. Lending in sterling to the overseas sector also rose (by £150 million) in the three months to mid-July after falls earlier in the year. This suggests that the effects of the restrictions on sterling lending to finance third-country trade announced last November have now worked through.

[1] See Table 11 / 3 in the statistical annex, columns 8–10.

DCE and sterling M_3

Because of external factors, sterling M_3 has grown more rapidly than DCE.



[a] Mid-months.

The revival of bank lending did not lead to pressure on the banks under the supplementary special deposits scheme, which had been extended in May for a further six months. After the sharp fall (not seasonally adjusted) in interest-bearing liabilities between mid-November and mid-March, which brought the banks as a whole well below the level in the base period, there was a rise subsequently. Nevertheless, at mid-July, the banks collectively were only $\frac{1}{2}\%$ (unadjusted) above the base, and the three-month moving average (at 1% below the base) was $5\frac{1}{4}\%$ below the free limit. As the demand for bank credit remained moderate, and both DCE and sterling M_3 were within the targets set, the scheme seemed to be serving no immediate purpose and, accordingly, the Bank announced on 11th August that it would be suspended. The scheme could, however, be reactivated without prior notice if circumstances warranted, and the qualitative guidance on bank lending remains in force (see page 309).

Amongst the other influences on sterling M_3, the central government borrowing requirement was somewhat lower in the three months to mid-July than it had been in the previous three months, despite local authorities borrowing considerably more from the Public Works Loan Board: both receipts from the sale of British Petroleum stock and British National Oil Corporation's repayment to the central government out of the proceeds of its foreign currency borrowing served to reduce the borrowing requirement. On the other hand, the rest of the public sector needed to borrow more than in the previous three months. In spite of lower interest rates, sales of central government debt were maintained, with cash receipts boosted by calls on the two partly-paid stocks issued in the spring. The first issue of a new debt instrument, £400 million of variable rate stock, was exhausted towards the end of June and a further issue was announced in July, on similar terms to the previous one (see page 302). Further, fixed-coupon, issues were made in late July and early August to take advantage of the renewed demand for gilt-edged after sterling had been allowed to appreciate. The private sector continued to invest in Treasury bills and in national savings.

In announcing the fiscal measures in July, the Chancellor reiterated his determination to maintain the DCE limit of £7.7 billion agreed with the IMF, and the related control of sterling M_3. To date, the growth of sterling M_3 has been consistent with the 9%–13% range for the year to next April; and the large official sales of gilt-edged in late July and early August should alone ensure that monetary expansion remains within the target range for some time to come.

Assessment

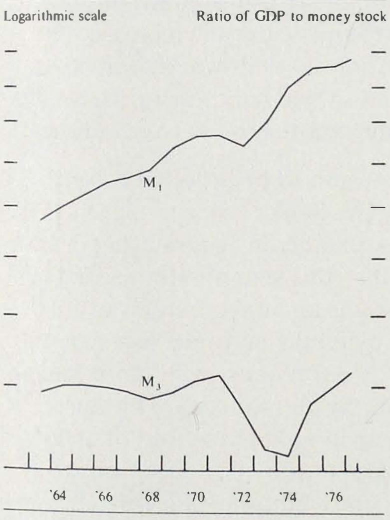
This assessment discusses the broad prospects for the economy over the next twelve to eighteen months – it being always assumed, more particularly in view of the uncertainties regarding inflation, that monetary expansion will be kept under firm control. It also discusses briefly some issues concerning exchange rate and monetary policy. Since inflation continues to be the main economic problem, this must be the starting point for any discussion of economic policy at this juncture.

Monetary policy and the prospects for inflation

The present lines of monetary policy were established at the end of last year. For the current financial year it was agreed that domestic credit expansion should not exceed £7.7 billion; and that, in parallel with this limit, the growth of money supply broadly defined (sterling M_3) should be kept within the range 9%–13%. The objective of the authorities is to provide for a planned expansion of the money supply at a rate that, while sufficient to accommodate a reasonable expansion of the economy, will at the same time help to restrain an excessive growth of money incomes or prices. In publicly specifying these monetary objectives, the intention is to give those responsible for economic decisions throughout the economy – including decisions affecting future costs and prices – a clear indication of the course which the authorities intend to pursue in the year ahead. This should provide an element of general stability in the economy, which, more especially at this juncture, needs to be resolutely continued.

Velocity of circulation

The velocity of circulation of M_3 was extremely stable until 1971. It then declined steeply but has subsequently recovered.



To gauge the way the policy is likely to operate, it is important to note how the velocity of money in circulation may vary. Since the beginning of 1974, the velocity of circulation of M_3 has risen considerably, reversing the fall that occurred in the previous two years (see chart); but for the seven or eight years before 1971 the velocity of M_3 was relatively unchanged. The velocity of M_1 has risen much more nearly continuously. Holding monetary expansion within the present target range may prove to be associated with a further rise in the velocity of circulation. But it can be expected that prices will rise less than under a more accommodatory monetary policy: the degree of constraint exercised over inflation should increase the longer monetary targets are persevered with, and in the longer term should be increasingly effective.

There are a number of reasons why wage settlements in the next round could be moderate. First, the success of stage two, the stability of the exchange rate this year and, in more recent months, falling commodity prices should, together, lead to a further significant deceleration of inflation. Although consumer prices at mid-July were $17\frac{1}{2}\%$ above a year ago, the rate of price increase has recently slowed down markedly – in the six months to July the annual rate of increase has fallen back to $13\frac{1}{2}\%$; and inflation should decelerate further still by the end of the year. In the second place, demand pressures, and the degree of capacity utilisation, are lower than at any time during the last thirty years. In much of the private sector such market forces play a significant role in wage negotiations, even though in particular areas the power of organised labour may override market forces. There clearly are such areas also in the public sector: here the crucial stage will be at the time of wage negotiations, not later when the resultant higher level of expenditure might be in collision with cash ceilings.

Despite the restraining influence of the slackness of demand and of the monetary environment, particular groups of workers may nevertheless be able to obtain large immediate increases in wage rates. If that occurred, the subsequent consequences would be to worsen economic prospects in many ways – perhaps not immediately apparent or, to individual unions, sufficiently deterrent – producing slower expansion and higher unemployment. In essence, the immediate outcome is likely to depend on the degree of restraint displayed by unions in the exercise of their influence over the wage and price level, and on the effectiveness of resistance by employers to excessive wage increases.

A satisfactory development of the economy will require moderation in the growth both of the money stock and in costs and prices. Undue monetary expansion would risk recreating the adverse financial conditions experienced last year, from which the economy is now beginning to recover. It is therefore important that there should be a general awareness by all concerned with wage negotiations of what the maintenance of monetary guidelines is likely to imply. The planned rise in the money stock has therefore been put at 9%–13%, which provides some indication of how fast the wage bill may appropriately increase. If the increase in wage earnings were materially higher than this, there would be little room for faster real expansion and for reducing unemployment. Looking beyond the realm of monetary policy, it also seems likely that there will be little scope for fiscal relaxations unless inflation is brought down.

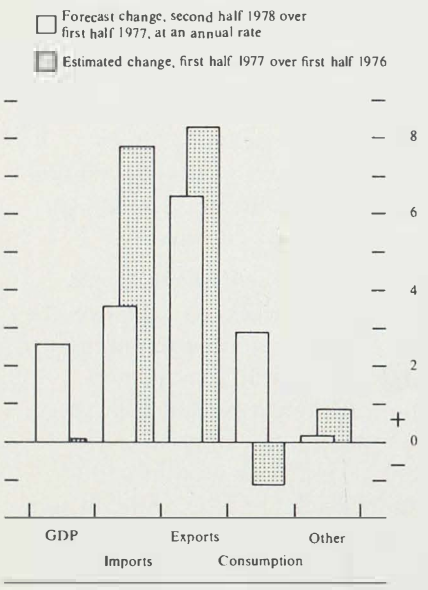
Prospects for expansion

Output has been falling in recent quarters but may now be turning towards a modest recovery, which should continue through next year. Exports have provided the only significant source of growth so far this year. Even though world trade has increased only slowly, the rise in UK exports has been relatively fast – increasing their share in overseas markets; and seems likely to continue so. Domestic demand, notably private consumption, which has been falling, now seems likely to rise. Consumers' purchasing power, squeezed during the last twelve months, is likely soon to begin to show something nearer the increase achieved in a normal year as inflation slows down. Private fixed investment, too, has picked up and should continue to rise, though perhaps not so fast as some recent surveys have indicated.

As usual, the exact pace of expansion to be expected depends on the precise period considered. The Bank forecasts suggest that a reasonably typical impression is obtained by considering the rate of expansion between the first half of this year and the second half of next. In the chart, this (expressed as an annual rate) is compared with developments over the twelve months up to the first half of this year. Over that period ahead, the forecasts suggest – assuming that fiscal policy is unchanged and tax allowances are increased in line with the rise in prices – a rise in national output of about $2\frac{1}{2}\%$ a year. Exports should continue to provide a significant stimulus; from now on, however, consumption – a larger component of national expenditure – seems likely to become a bigger source of growth.

Forecast of GDP

GDP may rise by about $2\frac{1}{2}\%$ per annum over the next eighteen months, with the main stimulus coming from exports and consumption.



Exchange rate policy and inflation

The improvement in the balance of payments on current account should bring it into surplus in the latter part of this year, and more substantially in 1978 – the scale depending to some degree on the rate of expansion of the domestic economy. Clearly, however, it has not been this strengthening trend of the current account, but the inflow of capital, that has accounted for the massive growth of the reserves. Much of the inflow earlier in the year was of a once-for-all nature.[1] The reserves have also benefited from foreign currency borrowing by the government and other public bodies.

There has been a wide discussion of the role of the exchange rate in relation to inflation and monetary policy, and much weight has sometimes been put on the argument for an appreciation – a policy which the greater strength of sterling, should it continue, might permit. It is clear enough that an appreciation would help to reduce the pace of inflation in the United Kingdom. What is not so clear is what are the costs to be paid – in terms of adverse effects on imports, exports and output – and how large these costs might be. For reasons that may be worth spelling out, the answers to the questions depend on how quickly, and completely, domestic prices would respond to changes in the sterling cost of imports brought about by appreciation.

[1] See the June *Bulletin*, pages 141–2.

The first impact of an appreciation would come through the effect on import prices: as imports amount to one fifth of total spending, a 10% appreciation should, for example, reduce the rate of price increase by two percentage points in the first instance. This initial price effect should have further repercussions: wage settlements could be smaller, thus further reducing the rise in prices, thus again reducing wage settlements; and so on perhaps for a number of wage rounds, spreading over several years. There might be other effects on profits which would speed up the effects on prices.

In principle, the process could continue until at the end of the day domestic costs had been reduced, as compared with what they would otherwise have been, by the full 10% of the initial appreciation. Exporting and import-competing industries would, to begin with, have been made less competitive, or less profitable, by the appreciation. But if costs were in the end reduced by the full 10%, the competitivity or profitability of exports and import substitutes would at the end of the process have been restored.

A good deal, then, turns on how quick the adjustments to exchange rate changes are. For, in the transitional period, the harmful effects on exporting and import-competing industries would persist and be important. The evidence seems to suggest that market conditions are in fact somewhat inflexible, in the sense that it takes a number of years before most of the reaction to a change in the exchange rate works through the system. Apart from effects on relative prices and the pattern and level of output, this means that it would require a very large appreciation to obtain any large effect on domestic prices within any short time, such as a year.

There must also be some doubt about how large the reaction of domestic costs to an appreciation at the end of the adjustment process, would be. Much of the evidence is, inevitably, indirect, and moreover derives from observations of the consequences not of appreciation but of depreciation. Experience with subsidies may raise doubts as to how far an inflationary process once started can be braked by inducing smaller price increases. This suggests that an exchange appreciation might be reflected only incompletely in domestic price changes, and that the competiveness and profitability of exporting and import-competing industries might be eroded, not only in the transitional period, but also after the adjustments had run their course. This would discourage exports and encourage imports; and though the adverse effect on the balance of payments would, for a period, be masked by the effects of growing production of North Sea oil, the discouragement of traditional industries would still have dangers.

The foregoing considerations, though necessarily stated very briefly, suggest that an appreciating exchange rate might exert a smaller braking effect on inflation, and have greater impact on the balance of the economy, than some recent discussion has allowed.

External inflows and monetary control

There has been discussion also of whether the recent strength of sterling would allow adherence both to an unchanged exchange rate policy and at the same time to unchanged domestic monetary targets. This would be one form of conflict between the internal and external objectives of monetary policy, and such a conflict is always a possibility; it is, however, not inevitable. So far this year, monetary expansion has remained within the target range, despite very sizable capital inflows; and it may be useful to suggest reasons.

Over the first seven months of the year, the reserves increased by about £5 billion. An increase in the reserves frequently entails greater public sector borrowing from domestic sources, which may in turn be associated with an increase in the money supply. Some £3 billion of the inflow was, however, of a form which could not be so categorised: much of it was the counterpart either of external borrowing by the public sector itself, or of other capital flows which came in but were invested in public sector debt.

More complicated questions arise in describing the effects of other types of private capital inflows. The conventional statistical account of the factors forming the counterpart of changes in the money stock (as for instance, shown earlier in the table on page 295) divides the factors into a number of distinct categories, in particular distinguishing external from domestic. Discussion in these terms can be misleading if it fails to take account, when noting a change in one category, of associated compensating changes elsewhere. Such compensatory changes have this year clearly been important, inasmuch as the expansion of domestic credit has been lower, partly because of inflows. For example, some large part of the inflow was to industrial and commercial companies; and the consequent strengthening of their financial position undoubtedly reduced their borrowing from the banks – hence reducing upward pressure on the money stock from this source. There is reason to think that compensatory movements such as this will in fact always be significant. For the usual statistical narrative relates only to factors affecting the supply of monetary as opposed to other financial assets, while the stock of money reflects not only the supply, but also the demand for money. Should the desire to hold monetary assets increase for other reasons, the increased supply due to inflows might go to meet that demand. But it is not in general evident that the demand to hold money would increase simply as a result of external inflows: if it does not increase, there would be likely to be the sort of compensating supply adjustments mentioned above. But if the inflows were to provoke falls in interest rates, and easier monetary conditions, beyond what would otherwise have occurred or be appropriate, then the demand for money might well be increased thereby, even though this could for a time be masked by a markedly favourable climate for official sales of gilt-edged.

If sterling remains strong in the period ahead, this may be less because of capital inflows as hitherto, and more because of the improving trend of the balance of payments on current account. It is not clear that this will lead to any significant increase in the money balances required by UK residents. Much of the current account surplus will be reflected in increased profits of the oil companies operating in the North Sea; and a large part of these funds is likely to be remitted abroad to service and repay debt, or to be reflected in petroleum revenue tax payments to the Exchequer.

The changing external situation of the economy will, however, undoubtedly affect the timing and pattern of the different financial flows which affect the growth of the monetary aggregates. These have always been difficult to predict and control exactly. None the less, and for the reasons stated earlier, the growth of the money supply is by no means immune from external influences; and the close monitoring by the authorities of monetary developments will certainly continue to be required in order to secure adherence to the monetary targets.