Economic commentary

Introduction

There has been a sharp contrast in the United Kingdom this year between the persistent sluggishness of the real economy and the transformation of the overall financial position. Output has been stagnant since the beginning of the year and unemployment was higher in the third quarter than at any time since the war. There are, however, now signs that demand may be picking up. The pace of inflation has been falling, though further progress will depend increasingly on the outcome of the present wage round.

The main manifestation of the improving financial position has been the scale of capital inflows, which took the reserves to over \$20 billion by the end of October. But this led to increasing difficulties in reconciling the objectives of monetary and exchange rate policy. It was possible earlier in the year to insulate the money supply from the direct expansionary effect of official intervention to prevent appreciation of the exchange rate. But by October, when minimum lending rate had fallen to 5% and the reserves had risen by \$3 billion in a month, it became clear that the exchange rate could no longer be kept down without putting seriously at risk the prospect of staying within the upper limit of 13% for the growth of sterling M_3 in the current financial year. This consideration led to the decision, on 31st October, to modify intervention policy.

In the event, the subsequent appreciation of sterling was fairly small – after a larger initial rise, the sterling/dollar rate averaged \$1.81¾ in November, only 2½% above the average in October, and at the end of November, the effective exchange rate index was only 1½% higher than before the change of policy.

Although the proximate reasons for the upward pressure on the rate have been the strength of capital inflows and the weakness of the dollar, an important factor has also been the sharp improvement in the current account, which in the third quarter was in surplus for the first time since 1972. Increasing deliveries of North Sea oil were an element in this improvement but, as a result of strong growth of exports, the non-oil balance has also improved. The UK share of world trade has risen, although world trade itself has hardly grown at all. This performance no doubt partly reflects the improvements in UK price competitiveness in 1976, although these have been somewhat eroded this year.

Output has been stagnant since the beginning of the year. In the first half-year, real incomes were severely squeezed by the continued high rate of inflation and the relatively modest increases in earnings accommodated within the incomes policy; the volume of consumers' expenditure and retail sales fell. Estimates for the third quarter show some revival in demand, but this appears to have been largely absorbed by reductions in stocks, with little immediate effect on output.

The stabilisation measures announced a year ago also exerted a contractionary influence on the economy in the first half of this year, and to a greater extent than had been originally foreseen: the reduction in government expenditure, mainly capital, appears to have bitten sooner and harder than expected and revenue has been greater than forecast. The measures announced by the Chancellor in July and on 26th October go some way towards offsetting these effects, though the public sector borrowing requirement in the current financial year is likely to be more than

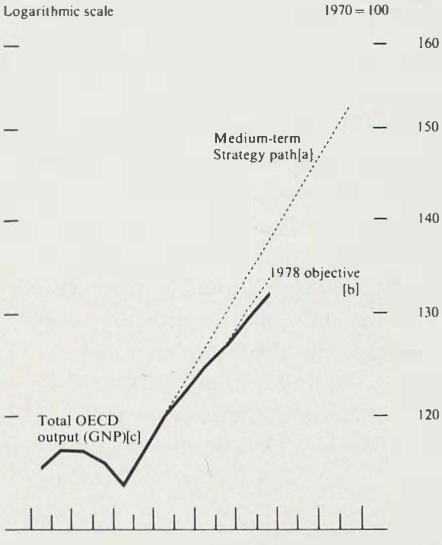
£1 billion below the £8.7 billion ceiling agreed with the International Monetary Fund a year ago.

The main price indices have all risen much less during the last six months than during the previous half-year. Some of this improvement results from external factors, such as the fall in world commodity prices. But much of it comes from the slower rate of increase in UK labour costs, which has been achieved under stage two of the incomes policy. How far this can be sustained depends largely on the outcome of the current wage round.

The immediate prospects and the longer-term outlook are discussed in the assessment on page 428.

Total OECD output (GNP)

Output has been growing slowly; little improvement is expected next year.



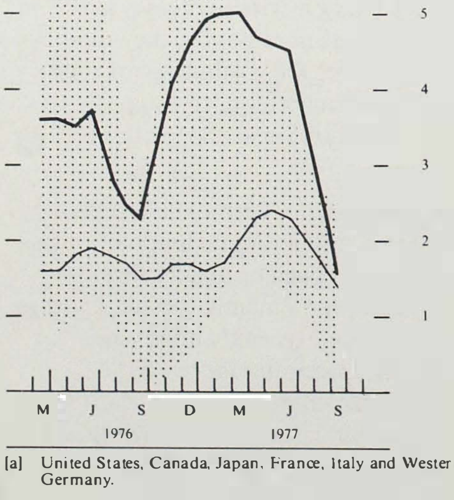
[a] 5.5% annual average growth rate 1976–80, agreed as the objective for the OECD Medium-term Strategy in June 1976.

[b] 5% growth rate agreed as the objective for 1978 by the OECD in June 1977.

[c] For certain countries, only GDP figures are available. The plots from the second half of 1977 onwards are estimates.

Consumer prices in the main industrial countries

Consumer prices have generally risen much more slowly since the spring.



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

International developments

Activity in most of the main industrial countries has remained depressed since early in the year.

Except in the United States, unemployment has risen and industrial production remains well below trend; in several countries official forecasts of output in 1977 have been revised downwards. Total output in the OECD area this year is likely to have risen by less than 4%, after $5\frac{1}{4}$% in 1976. A number of countries announced stimulatory measures during the autumn, but these, in the main, will not affect activity until next year. Even so, total OECD output will probably not expand much faster next year than this – rather more slowly than was expected earlier in the year (see chart).

The US economy, at least, has been growing broadly in line with earlier expectations. After very rapid progress in the first half of the year, real GNP growth slowed down, to about $4\frac{3}{4}$% at an annual rate, in the third quarter. This was expected, and growth is likely to have picked up a little in the fourth quarter and may be about 5% for the year. Employment has continued to rise, although the rate of unemployment remains around 7%. Business spending, particularly on new plant, has, however, continued to be weak. Although activity is still likely to expand into 1978, growth next year may be a little slower than this year. The trade deficit has continued to widen, as imports of oil have risen and the economy has expanded.

Growth in most of the other major economies has been slower than was expected earlier in the year.

In Japan, domestic activity remains depressed. Although GNP growth in the first half of the year was significant by international standards, it largely reflected the continuing substantial trade surplus and, in the second quarter, the effect of government spending. To help meet the real GNP growth target for the fiscal year to March 1978, a supplementary Budget and other measures were announced in September, amounting to about 1% of GNP. But only about a half of the package will take effect in this fiscal year. The recent sharp appreciation of the yen, however, is reported to have damaged business confidence. Altogether, it seems unlikely that the target rate of growth will be achieved.

The West German economy has been very depressed throughout the year; unemployment rose steadily to 4.6% in the third quarter. The Government have conceded that growth this year will be much more modest than the 5% forecast at the beginning of the year (it may even be less than 3%) and have announced measures to stimulate consumption and investment. Taking these into account, the Government hope for $4\frac{1}{2}$% real growth in 1978.

Hourly earnings in manufacturing

In general, earnings have been increasing relatively slowly this year.

Percentage increase on a year earlier

	1976			1977		
	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr	Latest month
United States	8.2	8.2	8.3	7.9	8.8	7.9 (September)
Canada	14.4	14.1	12.9	12.0	10.6	9.8 (August)
Japan[a]	13.7	10.6	12.8	11.1	11.6	8.8 (July)
France[b]	14.2	14.9	15.1	13.2	12.4	..
Italy[b]	16.3	25.4	28.3	33.5	31.1	26.3 (July)
Western Germany	6.1	6.5	6.6	7.9	7.5	7.0 (September)
United Kingdom [c]	19.8	14.7	12.8	11.8	10.0	8.0 (August)

.. not available.

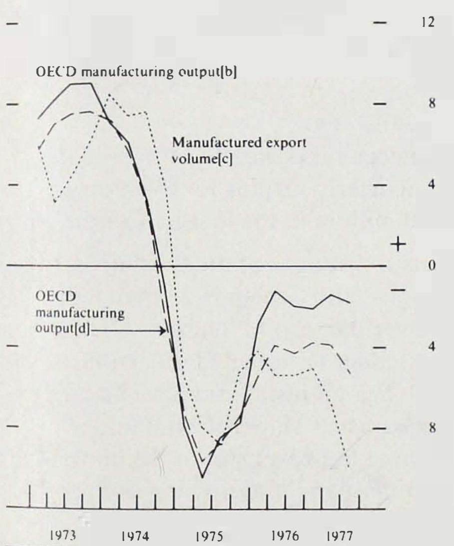
[a] Monthly earnings.

[b] Hourly wage rates.

[c] Weekly earnings in industry and services.

OECD manufacturing production and exports

Manufactured exports have performed much more sluggishly than manufacturing output.



[a] Trend rates of growth:
Manufacturing output (output weights) 1966–76 3.7% per annum
Manufacturing output (trade weights) 1966–76 4.0% per annum
Manufactured export volume 1966–76 9.1% per annum

[b] Output-weighted.

[c] Main manufacturing countries only (i.e. Group of Ten and Switzerland).

[d] Trade-weighted.

Current account balances

The large imbalances between countries on current account have changed only a little.

$ billions: *seasonally adjusted, annual rates*

	1974	1975	1976	1977	
	Year	Year	Year	1st half	3rd qtr*
United States[a]	− 5.0	11.6	− 1.4	− 17.6	− 18.5
Canada	− 1.5	− 4.7	− 4.2	− 4.6	− 4.4
Japan	− 5.0	− 0.7	3.4	10.0	10.8
France	− 5.9	—	− 6.0	− 4.2	− 2.4
Italy	− 8.0	− 0.5	− 2.9	− 3.2	3.2
Western Germany	9.7	3.9	2.8	4.6	2.4
United Kingdom	− 7.9	− 3.8	− 2.5	− 2.4	3.6
	− 23.6	5.8	− 10.8	− 17.4	− 5.3
Other OECD 'surplus' countries[b]	6.3	4.1	5.5	3.2*	
Other OECD 'deficit' countries	− 15.7	− 16.4	− 22.1	− 27.2*	
Total OECD countries	− 33.0	− 6.5	− 27.4	− 41.4*	
Oil-exporting countries	60.9	33.0	40.0	34.0*	
Other developing countries	− 24.2	− 31.0	− 20.0	− 20.0*	

* Estimated.

[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 balance would be:
$ billions

1974	1975	1976
1.2	17.7	3.5

[b] Belgium, Netherlands, Switzerland.

In France, the Government have reduced their forecast of growth this year to 3%. After a modest package of measures in August, the Budget for 1978 was announced: the authorities hope for rather faster growth in 1978 ($4\frac{1}{4}$%) although the budget proposals and August measures have not substantially changed the Government's cautious economic policy. In Italy, the economy continues to slow down. Forecasts of growth in Canada this year have also been revised sharply downwards.

As expected, rates of inflation in the major overseas economies slowed down in the second half of the year (see chart on opposite page). The deceleration has come partly from food prices; depressed industrial raw material costs have also helped, as has exchange rate stability in Italy and in the United Kingdom. The prospects, however, for a further general reduction in consumer price inflation appear more limited. Little further benefit can be expected from food and raw material price movements and it may be difficult to ensure that the growth of unit labour costs slows down further. Although earnings have not been growing very fast (see table), wage settlements have been as high as last year and, on present prospects, productivity gains may continue to be relatively small.

Industrial countries' total trade has been even more depressed than might have been expected from the path of output.

In the second quarter, total OECD export volume remained well below trend; in the third quarter, the seven major countries' export volume probably rose by less than 1%. Similarly, import volume has remained very depressed. There has been a striking divergence between the path of manufacturing output and the volume of manufactured exports since early 1976 (see chart). This partly reflects the isolated revival of activity in the United States. The OECD countries as a whole can look to little recovery in exports until activity picks up outside the United States, particularly in Europe.

The pattern of imbalances between the current accounts of the major economic areas (and within them) is changing slowly (see table). The oil-importing countries have had a somewhat smaller trade deficit with OPEC so far this year, partly because OPEC imports have risen and partly because demand for oil in industrial countries has been slack. In the first half of the year, the OPEC surplus at an annual rate was somewhat lower than in 1976. The non-oil developing countries appear, in aggregate, to be maintaining their improved current account position, and market fears about their collective creditworthiness have generally eased although individual problems remain.

The most notable change in the current accounts of the major OECD countries has been the increase in the US deficit. This is likely to be between $17 and $20 billion for 1977 as a whole. Elsewhere, the major change has been an improvement in the external positions of some of the weaker countries. On the other hand, the surpluses of Western Germany and, particularly, Japan remain large. The smaller OECD countries, in total, have gone further into deficit. Although many of them have adopted restrictive policies or devalued their currencies, their collective deficit for the year as a whole is likely to be very large.

Recent monetary and exchange rate developments, and changes in international reserves broadly mirror these external positions.

Despite higher interest rates in the United States and lower interest rates in a number of other countries, the US deficit has led to pressure on the dollar and has tended to make for larger increases in international official liquidity this year than last. Total OECD reserves rose more in the first nine months of this year than in the whole of 1976. The bulk of the increase has accrued to the United Kingdom and Italy, however, and the ratio of all OECD countries' reserves to the value of their imports has risen little. The continued reduction in the non-oil developing countries' current deficit has resulted in their reserve position, which improved markedly in 1976, improving still further this year (see table).

Ratios of reserves to imports[a]

The United Kingdom's gross reserves are now much more in line with those of other OECD countries.

Per cent

	1973	1974	1975	1976	1977 (to Sept.) [b]
Six major OECD countries[c]	31.3	22.7	22.6	21.3	20.5
United Kingdom	16.7	12.8	10.2	7.6	28.7
Smaller 'surplus' OECD countries[d]	34.7	27.3	29.3	28.1	24.2
Other OECD countries	42.5	25.8	24.0	22.0	21.8
Total OECD countries	32.3	22.9	22.6	21.2	21.9
OPEC	68.7	131.2	100.6	93.3	84.8
Other developing countries	38.1	25.2	22.3	29.9	32.7

[a] Gross reserves (as defined in *International Financial Statistics*) at end of period as percentage of previous twelve months' imports.

[b] Gross reserves at end-September as a percentage of imports in the twelve months to June.

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

[d] Belgium, Netherlands and Switzerland.

The UK balance of payments

The current account swung sharply into surplus in the third quarter. Accompanying the improvement in the current account were heavy capital inflows, and there was a surplus of £2.6 billion in the balance for official financing. The capital inflows continued during October, putting increasing upward pressure on the exchange rate and on the growth in sterling M_3. On 31st October sterling was allowed to float more freely, but by 30th November the effective rate had risen by only $1\frac{1}{2}\%$ on top of the $2\frac{1}{4}\%$ rise during the first ten months of the year.

Current account[1]

There was a surplus on current account of nearly £400 million in the third quarter – the first quarterly surplus for five years – compared with a deficit of £800 million in the first half of the year.

The trade balance strengthened throughout the third quarter, and, with surpluses in both August and September, there was an improvement of £650 million over the second quarter. Although about two thirds of this improvement represented special factors – a sharp fall in imports of North Sea oil installations and a larger surplus on trade in erratic items such as ships, aircraft and diamonds – there was a continuing improvement in the underlying non-oil balance of about £60 million and a narrowing of the oil deficit of £140 million (see table).

UK current balance

There was an improvement in both oil and non-oil trade, although much of the latter reflected a sharp fall in imports of North Sea installations.

£ millions: *seasonally adjusted*

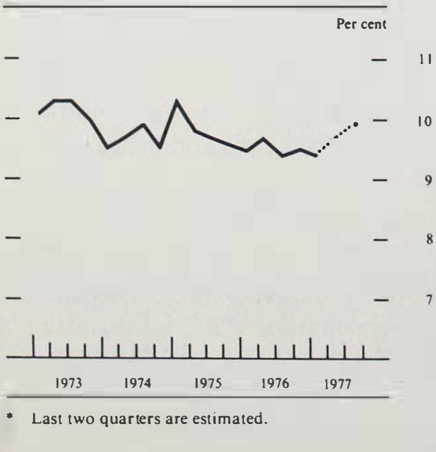
	1976	1977		
	Year	1st qtr	2nd qtr	3rd qtr
Exports of goods	25,416	7,472	8,071	8,439
Imports of goods	28,987	8,402	8,769	8,489
Visible balance	− 3,571	− 930	− 698	− 50
of which, oil	*− 3,960*	*− 816*	*− 725*	*− 587*
Invisibles	+ 2,344	+ 414	+ 418	+ 449
Current balance	− 1,227	− 516	− 280	+ 399
Percentage changes from preceding year/quarter (goods)				
Volume of exports	+ 8.3	+ 0.3	+ 5.6	+ 2.5
Volume of imports	+ 6.2	+ 3.0	+ 1.5	− 1.8
Unit value of exports	+ 21.2	+ 4.9	+ 2.3	+ 2.7
Unit value of imports	+ 22.0	+ 3.1	+ 2.7	+ 0.8
Terms of trade	− 0.7	+ 1.6	− 0.4	+ 1.7

In October, there was a slight fall in the trade surplus to £31 million. By comparison with September, exports fell back somewhat; imports fell too but by rather less. Both reductions are probably at least partly to be explained by the US dock strike.

Comparing the third quarter with the second half of 1976, the terms of trade rose by more than $2\frac{1}{4}\%$, although there was little change in the effective exchange rate. Much of the increase occurred in manufactures, particularly finished manufactures, where export unit values had risen nearly 9% faster than import unit values over the same period; the corollary of this unprecedented divergence could, however, be a decline in UK competitiveness (see below). By contrast, the terms of trade in foodstuffs and raw materials have deteriorated slightly.

UK share of world trade in manufactured goods

In volume terms, the United Kingdom has recouped the loss of share of world trade in manufactures which it suffered in 1975 and 1976.



* Last two quarters are estimated.

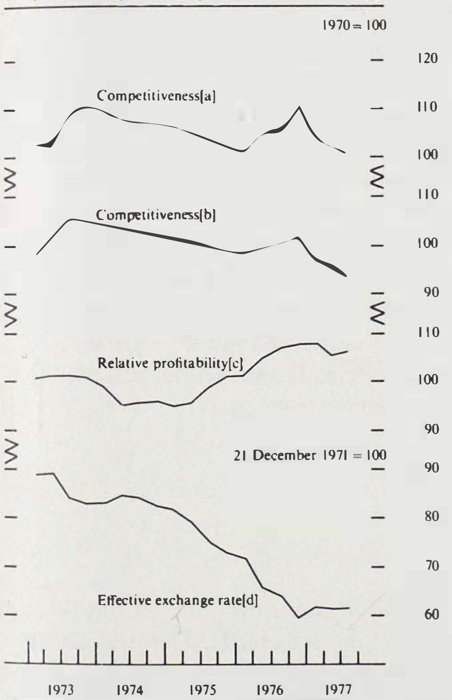
The volume of world trade (as measured by exports of manufactures by the major industrial countries) was probably little changed in either the second or third quarters. But over this period, UK exports of manufactures rose more than 7% so that the loss in the UK share of world trade during 1975 and 1976 appears to have been recouped (see chart).

These factors go some way to explain the current strength of exports, but they scarcely explain the rise in imports. Domestic demand picked up in the third quarter, but was little stronger than a year earlier. Despite this, there has been a significant increase in the volume of non-oil imports, particularly of finished manufactures

[1] All figures except unit values are seasonally adjusted.

UK export competitiveness and profitability

There is some evidence of erosion of the United Kingdom's export competitiveness this year.



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

[b] Finished manufactures: ratio of UK import unit value to export unit value.

[c] Finished manufactures (excluding food, drink and tobacco): ratio of unit value of UK exports to UK wholesale prices.

[d] Other things being equal, a rise in the effective exchange rate reduces competitiveness.

Summary of the UK balance of payments

The current account swung into substantial surplus in the third quarter and there were again very large capital inflows.

£ millions

	1976 1st half	1976 2nd half	1977 1st qtr	1977 2nd qtr	1977 3rd qtr
Seasonally adjusted					
Current balance	– 415	– 812	– 516	– 280	+ 399
Not seasonally adjusted					
Current balance	– 500	– 727	– 592	– 345	+ 528
Non-official gilt-edged holdings	+ 13	+ 103	+ 367	+ 42	+ 186
Sterling holdings of:					
Central monetary institutions	– 1,001	– 406	+ 190	– 392	+ 74
Other holders	– 6	+ 261	+ 199	+ 350	+ 323
UK banks' external sterling claims:[a]					
UK export credit	– 461	– 399	– 198	– 131	– 116
Other	– 442	+ 135	+ 188	– 105	– 22
UK banks' net external liabilities in foreign currencies	+ 8	– 114	+ 421	– 706	+ 220
Other identified capital flows and balancing item	– 244	+ 152	+ 1,338	+ 2,195	+ 1,417
Balance for official financing	– 2,633	– 995	+ 1,913	+ 908	+ 2,610

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

which, in the third quarter, were $9\frac{1}{2}\%$ higher than in the second half of last year. The increase appears to have been concentrated in a few industries, notably vehicles and machinery, where there have been shifts in the pattern of trade as a result of recent decisions by some companies to switch certain of their operations between the United Kingdom and Europe. If this process merely reflects a trend towards increased international specialisation, it need not be to the United Kingdom's disadvantage – because exports could gain as much as imports; but if it reflects, for example, higher costs, lower productivity or supply constraints, the implications for employment and the UK balance of payments would be more serious.

The United Kingdom's present overall competitive position is particularly hard to assess. No single index provides an entirely adequate measure of competitiveness. Four relevant indicators are shown in the chart: two of them suggest that competitiveness may have fallen below the average for 1975; the others suggest some decline this year but an overall improvement since 1975. While it is thus difficult to reach any firm conclusion about the extent of recent changes in overall competitiveness, the available indicators suggest some loss since the end of 1976.

The contribution of North Sea oil to the balance of payments continues to grow. Production this year – likely to be about 37 million tonnes – has more than trebled since last year, while the saving to the current balance in terms of lower net imports of oil and related costs has increased even more, to as much as £$2\frac{1}{4}$ billion, compared with £$\frac{1}{2}$ billion in 1976. On the other hand, profits and interest due abroad will this year, for the first time, have been substantial (possibly of the order of £$\frac{1}{2}$ billion). Some part of these earnings, however, is likely to have been retained in the United Kingdom, so that the net balance of payments outflow will be much less. Similarly, imports of goods and services related to development in the North Sea, though smaller than last year, are likely to have been around £1 billion, but because they will have been largely financed by capital inflows, their net impact on the balance of payments is likely to be small.

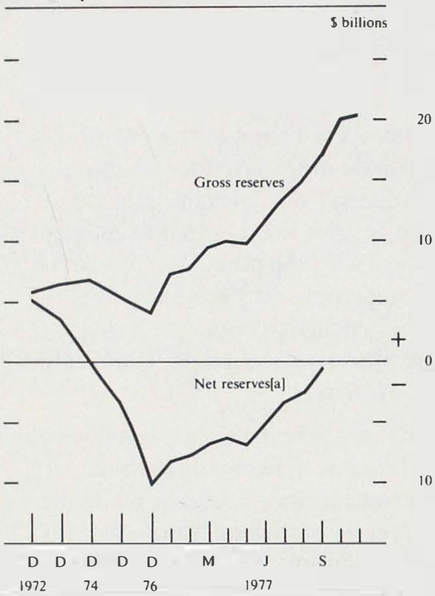
The surplus on invisibles in the third quarter, at £450 million, was slightly larger than the revised second quarter figure of £420 million. In the services account, net earnings from travel rose; overseas tourists in the United Kingdom spent more, and UK residents made fewer trips abroad and spent less; also, commodity earnings which had fallen sharply in the first two quarters recovered in the third. Net receipts from interest, profits and dividends remained very depressed in the third quarter: there was a marked recovery in the net earnings of UK banks in the euro-currency markets and much greater receipts of interest on the official reserves; but net earnings on direct investment were lower.

Capital account and official financing

In the third quarter, the surplus on investment and other capital flows (including the balancing item) was over £2 billion (see table). Much of this appears to have taken the form of inflows into liquid assets, resulting in part from the weakness of the US dollar. Identified inflows amounted to £1.4 billion. There was a recorded increase of some £190 million in private overseas holdings of gilt-edged stocks. This may, however, be somewhat of an underestimate, partly because the process of registration takes some time to complete. Private non-resident sterling bank deposits and other money-market liabilities rose by £320 million, only slightly less than in the second quarter when the increase had reflected a build-up of funds before the sale of British Petroleum

Gross and net reserves

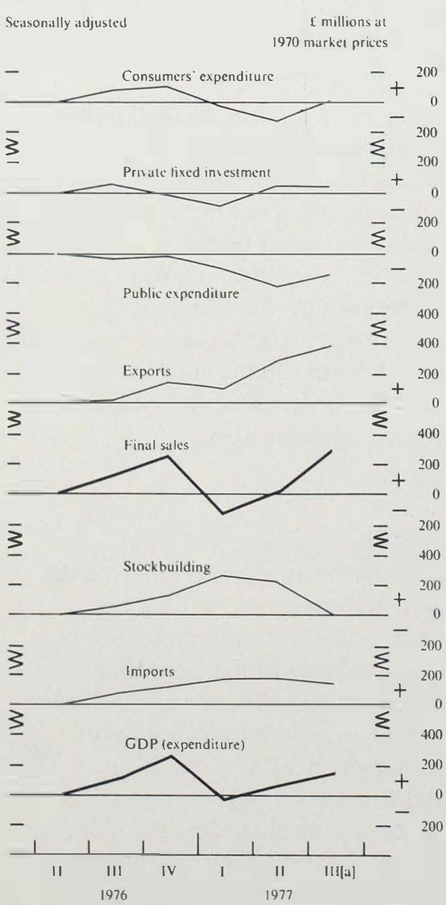
Gross reserves have risen sharply this year but the net reserves position remains weak.



[a] As defined in footnote [1] below.

Changes in components of GDP (from second quarter of 1976)

The expenditure measure of GDP probably rose again in the third quarter: net exports remained buoyant, consumer spending picked up, but stocks fell.



[a] Bank estimate.

shares; despite the small amounts allotted per application, a high proportion of these balances remained in sterling. In the first three quarters of the year, the outstanding stock of private sterling balances rose by more than a quarter; there was a further increase of nearly £300 million in the first three weeks of October. In the third quarter, there was a large increase, of £220 million, in the bank's net external liabilities in foreign currencies, after a sharp fall in the second quarter. Also, there was only very slow growth in bank lending for UK exports: one reason for this may have been expectations of an appreciation of sterling. Outstanding credits rose by only £115 million in the third quarter, and the rise in such lending in the first nine months of the year was much smaller than in 1975 and 1976, despite the rise in the value of UK exports.

In August, a drawing of £214 million was made under the IMF stand-by arrangement, and the final tranches of the Government's $1.5 billion euro-currency loan, totalling £287 million, were drawn in August and September. In the third quarter, net public sector borrowing under the exchange cover scheme was £116 million. The reserves rose by nearly £$3\frac{1}{4}$ billion and there was a further large rise – over £$1\frac{1}{2}$ billion – in October before the decision to allow sterling to float more freely was implemented on 31st October. At end-November, the reserves stood at £$11\frac{1}{4}$ billion, after a rise of about £$8\frac{3}{4}$ billion in the year so far. Relative to imports of goods and services, the United Kingdom's gross reserves represented 3.2 months' cover. However, net reserves[1] remained negative until end-September (see chart).

The domestic economy

Demand and output[2]

Final sales seem to have recovered in the third quarter, but the pick-up in output may have been less (see chart). The preliminary output measure of GDP rose a little in the third quarter, after falling in the second.

During the first half of the year, real personal disposable income was squeezed, consumption fell sharply, and there was quite heavy, though perhaps largely involuntary, stockbuilding. The other major domestic components of demand fell early in the year but then began to pick up. In the third quarter, consumption too began to revive. This recovery, however, appeared to have little immediate effect on the growth of output, because stocks, which had risen sharply earlier in the year, were run down.

Private industrial investment (excluding North Sea installations) rose during the third quarter (see page 424). The surveys of investment intentions continue to suggest strong investment growth in 1978, although they have been revised downwards; even so, they still suggest a rise in manufacturing investment of well over 10% next year. However, after the prolonged stagnation of the domestic economy, many companies may be reluctant to undertake substantial new investment without first seeing clear signs of a sustained upturn in activity. Private sector housebuilding remains depressed and, despite an increase in advances and commitments by the building societies, is showing signs of only a very modest recovery.

[1] Comprising gross reserves less outstanding official short and medium-term borrowing, as defined in Table 24 / 1 of the statistical annex. No deduction has been made for certain long-term government borrowings (mainly the post-war North American loans), nor for medium-term foreign currency borrowing by the public sector outside the exchange cover scheme, nor for foreign currency bonds issued by the Government under the Third Group Arrangement. If these were taken into account, net reserves at end-September would have amounted to – £7.3 billion.

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

Public sector current spending has not changed much from the average for 1976. It is likely to remain flat during the rest of this financial year. The sharp cutback in public sector fixed investment (nearly 20% below the 1975 average in the first half of this year), which has been an important contractionary influence on the domestic economy, may have come to an end. As in the second quarter, the increase in net exports contributed significantly to the expansion of demand in the third.

After falling in the first half of 1977, output seems to have started to recover in the third quarter. The output measure of GDP rose by $\frac{3}{4}$% in the third quarter (industrial production rose by $\frac{1}{4}$% and manufacturing production was unchanged). The impact on output of the small revival in domestic demand was muted by the reduction in manufacturers' and retailers' stocks. However, with domestic demand continuing to recover in the fourth quarter and probably into early 1978, there is now an opportunity for a faster growth of output too.

Unemployment and capacity

Unemployment fell slightly in October and November (to 1,433,000), but the underlying trend still seems to be upward. Output is growing very slowly and unemployment has risen sharply since May after a somewhat surprising fall earlier in the year. The number of unemployed school-leavers has fallen throughout the autumn, but at 73,000 in November is still high by post-war standards.

The movements in unemployment this year have been somewhat puzzling. One possible explanation is that the very high level of unemployment in recent years has weakened the effectiveness of the seasonal adjustments.

Because import penetration is still rising in many industries, while output per head in the manufacturing sector has been no higher this year than in 1973, fears have been expressed that capacity constraints may emerge earlier in the recovery of demand than they have in the past. The growth of exports, however, has equalled or outpaced import penetration in the manufacturing sector in the last three years so that the balance of trade in manufactures has improved. Thus, while there are particular production problems in certain areas such as the motor industry, it seems clear that, in general, slow growth of domestic demand still remains the main deterrent to increased output. This reason was cited by nearly three quarters of firms questioned in a recent CBI survey. Other factors, notably shortages of skilled labour, were also mentioned, but in the main the latter may reflect a short-term mis-matching of resources which would only become a serious constraint if output were to grow very fast.

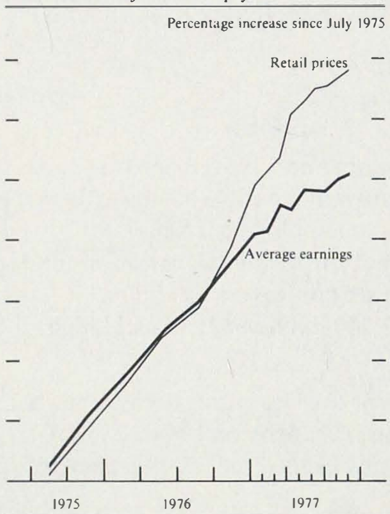
Costs and prices

Retail and wholesale price increases continue to moderate as a result of the combination of the decline in wage inflation during stage two, falling world commodity prices and the strength of sterling this year. Even after allowing for some acceleration in wage costs in the current wage round, the rate of price increases is likely to remain moderate for some months yet.

Manufacturers' wholesale buying prices fell in each of the six months to October by almost $4\frac{1}{2}$% in all, taking the year-on-year increase down to 2% and the index to below what it had been in January. This fall in buying prices, which has stemmed largely from falling world commodity prices and from the strength of sterling, should continue to be reflected in the months ahead both

Increase in average earnings and prices since the beginning of stage one of the incomes policy

Real average earnings rose slightly during stage one but have since fallen sharply.



Factors accounting for the general rise in UK prices[a]

Percentage increase on previous period

	Prices[b]	*of which accounted for by*			
		Labour costs[c]	Net taxes on expenditure	Other factor incomes[d]	Import costs
	(1)	(2)	(3)	(4)	(5)
1973 1st half	4.6	0.4	−0.3	2.3	2.1
2nd half	6.4	3.2	0.2	−1.1	4.1
1974 1st half	10.7	4.0	−0.1	0.6	6.2
2nd half	10.6	7.7	−0.4	1.8	1.5
1975 1st half	12.0	9.0	1.1	1.7	0.2
2nd half	11.3	5.4	1.8	2.0	2.1
1976 1st half	6.7	1.8	0.6	2.2	2.0
2nd half	7.6	2.4	0.7	1.1	3.4
1977 1st half	7.7	2.1	1.0	2.6	2.0
2nd half*	5.0	1.6	0.8	3.0	−0.4
Shares of total final expenditure at current prices in 1976 (per cent)	*100.0*	*49.5*	*8.3*	*19.2*	*23.0*

* Bank estimate.

[a] The values of the various cost components were each divided by total final expenditure (TFE) at 1970 prices to give costs per unit of expenditure. Unit cost increases for the various components were then expressed as percentages of the implicit deflator of TFE in the preceding period to give increases in total costs attributable to particular components. No lags were incorporated. Figures in columns 2 – 5 may not sum to those in column 1 because of rounding.

[b] The implicit price deflator of TFE.

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

[d] Self-employment incomes, company profits, and trading surpluses of public corporations (all net of stock appreciation), rent, charge for consumption of non-trading capital, and the residual error – all per unit of TFE at 1970 prices.

in wholesale selling prices (the year-on-year increase in which fell to $17\frac{3}{4}\%$ in October) and in retail prices.

The retail price index rose by just over $1\frac{1}{2}\%$ between June and September, compared with over $5\frac{1}{2}\%$ in the previous three months. This much slower rise partly stemmed from special factors (lower prices for seasonal foods, lower summer fuel prices, the telephone rental rebates, and reductions in mortgage payments) which will not all be present in later months. Nevertheless, with falling world commodity prices, the continued strength of sterling, and the benefits of wage restraint still coming through, monthly increases in retail prices should continue to be low, and the year-on-year increase should fall further early in 1978. The prospect for inflation thereafter will depend upon the size of wage increases in the current pay round.

By end-October, settlements covering only some 500,000 workers had been notified to the Department of Employment since the end of stage two of the incomes policy. This is only about $3\frac{1}{2}\%$ of the total and only about a fifth of the number settling in the same period last year. According to the Department and the CBI, 85% of those workers who have so far settled are covered by settlements within the Government's guideline of an average increase in *earnings* of 10%. But wage claims have generally been much higher, and there is evident danger that 10% will become the norm for increases in *wages*. This would imply rather greater increases in earnings when account is taken of reductions of anomalies, consolidation of stage one and stage two supplements, other wage drift, and productivity schemes. Such schemes have been a feature of about a fifth of settlements to date. Provided they are in fact 'self-financing', they would push up earnings but not labour costs.

Real average earnings fell sharply during stage two, by 8% (see chart). They seem not to have increased much after the end of stage two, despite the modest increase in prices, mainly because only a few wage settlements were made in this period.

The accompanying table provides an indication of the proximate sources of price increases over the last five years. Because, however, it is simply a product of a statistical identity, it does not necessarily give an indication of the causes of inflation. Since the second half of 1975 (when stage one began), the proportion of the rise in prices (expressed in terms of the price deflator of total final expenditure) which has been represented by labour costs has been smaller than their share of total costs. At the same time, other factor incomes – principally trading profits of companies and public sector enterprises – which were squeezed between 1973 and 1975 have accounted for a bigger proportion in the past two years. Import costs accounted for a disproportionately large share of the increase in prices in the second half of 1976, but Bank estimates suggest that in the second half of this year import costs might be a negative influence. Over the five years from the second half of 1972, import costs accounted for a bigger proportion of the overall increase in prices than their share in total costs.

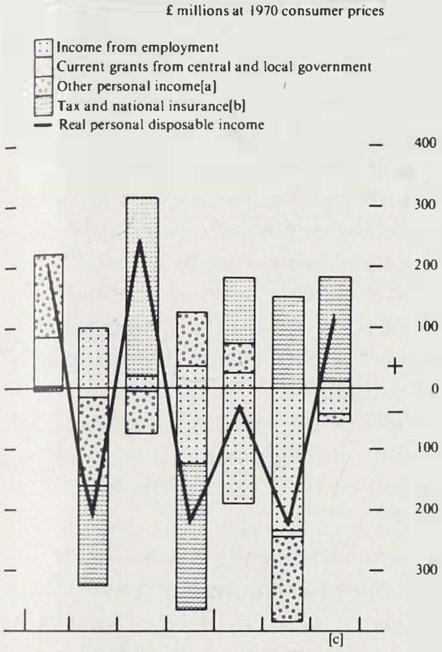
Personal incomes and spending[1]

Real personal disposable income, which had been declining since the end of 1974, may well have bottomed out in the second quarter (see chart on opposite page); in the third quarter, it is estimated to have risen by $1\frac{1}{4}\%$ and it is likely to have risen by about twice as much in the fourth. This recovery has occurred despite a small fall in real gross earnings: the back-payment of tax reliefs in August and September, and a small increase in government grants, were sufficient to cause disposable income to

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

Main components of changes in real personal disposable income

In real terms, disposable income rose in the third quarter because of lower tax payments; real income from employment probably fell for the fourth successive quarter.



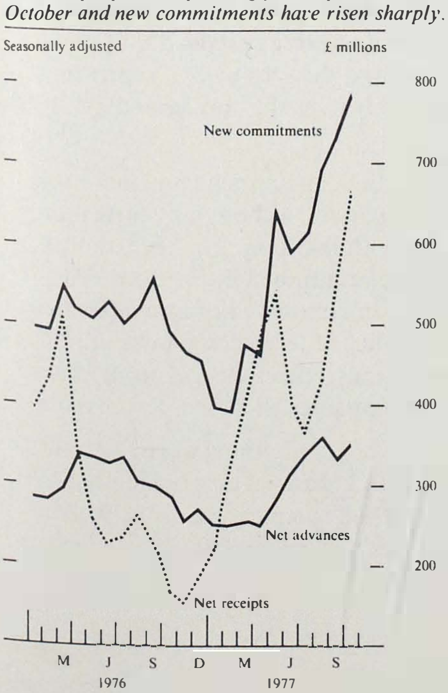
[a] Self-employment income and rent, dividends and net interest.

[b] Increase(–)/decrease(+). (Higher tax and national insurance contributions reduce personal disposable income.)

[c] Bank estimate.

Building society funds

Net receipts picked up strongly in September and October and new commitments have risen sharply.



rise faster than retail prices. The slowing down of price inflation between the second and third quarters was very pronounced and contributed significantly to the recovery in real incomes. Even so, real personal disposable income in the third quarter was still probably more than 3% lower than a year earlier.

Consumer spending – particularly retail sales and new car buying – picked up quite strongly in the third quarter, when it was only 1% below a year earlier. There must, therefore, have been a marked fall (over two percentage points) in the saving ratio since the third quarter of last year, when it was about $15\frac{1}{2}\%$. It is not yet clear how far this fall indicates a recovery in consumer confidence or merely the effects of the particularly sharp squeeze on incomes since mid-1976. The improvement, which coincided with a period of remarkable buoyancy in financial markets, doubtless owed something to the expectation of an end to the fall in real incomes.

Consumer spending in the fourth quarter and subsequently should be further stimulated by the October measures, which will augment persons' disposable income by about £1 billion between November and March. Most of this should filter through to consumers' expenditure within a few months. Thereafter, the pace of consumer spending will be determined by the extent of any further recovery in real incomes, and by the effect on real asset values, and on consumer sentiment more generally, of the slowdown in inflation. On balance, it is not implausible that consumer spending in 1978 could easily rise by more than the $2\frac{1}{4}\%$ necessary to exceed its 1973 peak, even without any further budgetary stimulation.

Housebuilding[1]

The volume of housing investment fell a further 2% in the second quarter and, although the decline now appears to be ending, investment is at present the lowest for seven years. Housebuilding currently accounts for only 3% of GDP, compared with an average of $3\frac{3}{4}\%$ between 1970 and 1976. There are some signs of recovery but these are as yet only tentative.

Public sector housing investment fell by a further 15% in the second quarter. The outturn for the first nine months of this year suggests that public sector starts in 1977 will fall considerably below the number for which the Government have made financial provision. It is quite possible that, in the second half of the financial year, local authorities will have made good some of the shortfall on approvals but this will take some time to work through into starts.

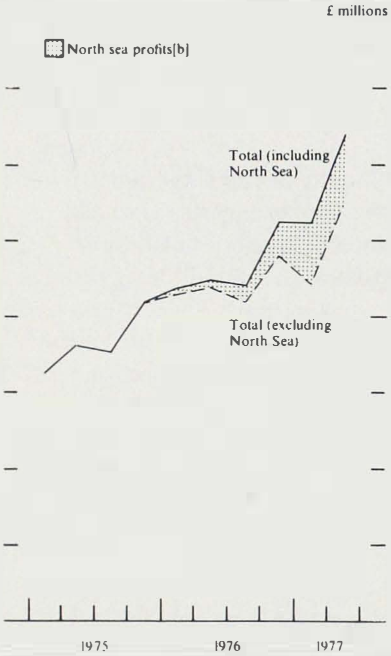
Private sector housebuilding, which had fallen very sharply in the first quarter, rose by 14% in the second. This recovery is expected to continue, but it may be rather hesitant. Indeed private sector starts rose by only 3%, and completions actually fell, in the third quarter, despite the much greater availability of housing finance. In response to the extremely strong inflow in September and October, building societies' new commitments are exceptionally high, and this has started to show up in advances which, at £640 million in October, were 6% higher than the average of the third quarter and some 26% above the average for 1976 (see chart). This buoyant picture is not yet reflected in housebuilding activity. Instead, it has merely stimulated the market in existing houses. Over the last four years, building costs have risen much faster than house prices. Since early this year, however, the gap has narrowed slightly, but it seems likely that there is some way to go yet before

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

building new houses again becomes sufficiently profitable to stimulate any marked revival of activity in this area.

Industrial and commercial companies' gross trading profits[a]

A large part of the recovery in companies' cash profits in the last year has been due to North Sea oil and gas production.

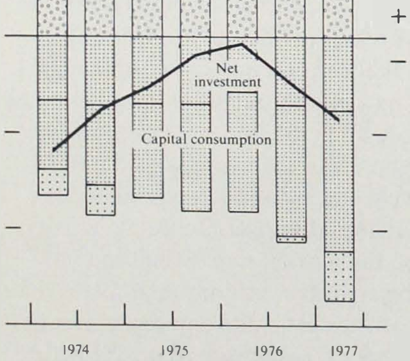


[a] Gross trading profits net of stock appreciation.

[b] Small losses were incurred before 1976 because exploration expenditure (treated as a current operating cost) exceeded sales revenue. See *National Income and Expenditure 1966–76* (the 'Blue Book'), page 119.

Appropriation account of industrial and commercial companies

Despite a recovery in cash flow, heavy stockbuilding in the first half of 1977 helped to push companies into deeper financial deficit.



[a] Undistributed income, plus net capital transfers, less stock appreciation.

[b] Destocking is treated as a source of funds.

Industrial and commercial companies' spending and finance[1]

Trading profits (net of stock appreciation) have recovered significantly in cash terms; during the first half of 1977, they were about 20% higher than in the second half of 1976 and 30% higher than a year earlier. A substantial part of this increase reflects rising output of North Sea oil. By the first half of this year, profits from North Sea oil had grown to about 15% of the total (see chart). But other profits have also picked up, particularly in the second quarter, when selling prices, reflecting past increases in costs, continued to rise at a time when labour costs were growing slowly and the rise in buying prices was moderating. Thus profits, excluding those from North Sea operations, rose by about 10% during the first half-year after little increase, even in nominal terms, during 1976. The easing of cost pressures, together with some recovery in domestic demand, should ensure that profits continue to increase in the second half-year. Nevertheless, company profitability remains historically low, and the share of net profits in net domestic income, although rising from about $4\frac{1}{2}$% in 1976 to $5\frac{1}{2}$% in the first half of 1977, is still little more than half what it was in the early 1970s.

Prior calls on companies' income increased somewhat in the first half of this year. Significant increases in dividend payments, and in profits due abroad, were partly offset by reduced interest payments as interest rates fell. Consequently, cash flow[2] rose by about 15% to £3.8 billion in the first half-year; the particularly sharp increase in the second quarter (about 40%) principally reflected the rise in profits.

Despite this improved cash flow, industrial and commercial companies returned to very substantial financial deficit in the first half-year (£$1\frac{3}{4}$ billion), mainly as a result of heavy, and probably largely unplanned, stockbuilding – about £1 billion at current prices (see chart). There was some destocking in the third quarter, chiefly of manufacturers' work in progress and retailers' stocks. Fixed investment rose by about 8% in current prices in the first half-year to £4.4 billion; a particularly sharp increase in the second quarter partly reflected large deliveries of platforms for the off-shore oil and gas industry. In real terms, private industrial investment has clearly begun to recover from the low point reached in early 1976. Investment in manufacturing rose by 5% in the third quarter and in distribution and services by 3%, representing increases of 8% and 4% respectively over the corresponding period last year.

Bank borrowing by industrial and commercial companies rose further in the second and third quarters, although by little more than was required to keep pace with inflation. The revival of equity issues in the second quarter continued in the third. The Department of Industry's survey of company liquidity indicates a further improvement in the liquidity of large companies during 1977. Some of this improvement may reflect inflows from abroad, especially from foreign parent companies to their UK subsidiaries.

In summary, company profits should continue to recover until at least the early part of 1978, with industrial costs rising relatively slowly and demand reviving. But the company sector is likely to remain in financial deficit next year, despite relatively subdued growth in capital spending.

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

[2] Defined as undistributed income, plus net capital transfers, less stock appreciation.

Public sector

At the time of the March Budget, the Government expected to finance around £8½ billion of public sector spending in 1977/78 through borrowing – slightly below the limit agreed a year ago with the International Monetary Fund. In the event, the borrowing requirement was less than £3 billion in the first half of the financial year and, in the absence of an October Budget, might have reached no more than around £6½ billion for the financial year as a whole. Higher revenue would have accounted for £1¾ billion of the difference; the other £¼ billion is explained by lower expenditure. The Chancellor was therefore able to announce further rises in personal allowances against income tax this financial year of around 12%, thus broadly anticipating his commitment to increase allowances in line with inflation in next year's Budget. Together with certain other tax concessions and additional payments to pensioners, these measures should cost slightly over £1 billion in 1977/78, putting the public sector borrowing requirement at £7½ billion.

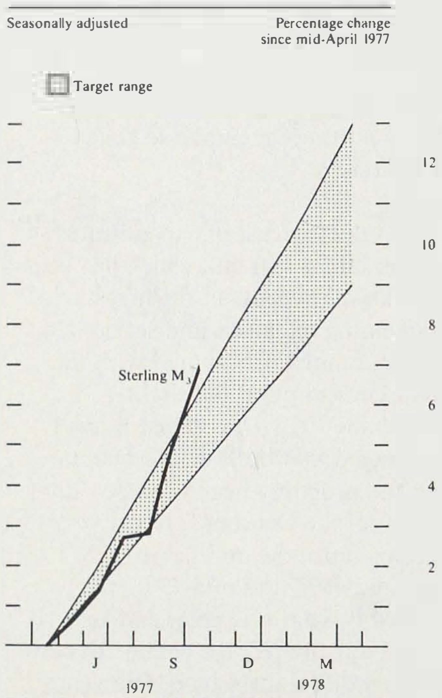
The relatively small reduction in the forecast of expenditure in money terms may mask a rather larger real fall, which has been offset by higher costs and prices. Developments in the first half of the calendar year suggest that spending on goods and services has fallen below the volume originally planned. Compared with the second half of 1976, public sector consumption fell slightly and public sector investment by about 10%. The official Budget forecast published in March envisaged that both would remain flat. Although current spending has probably begun to rise slowly since then and will continue to do so, the October forecast suggests that investment will decline until the middle of 1978. The implication is that, between mid-1977 and mid-1978, the two taken together will run 2% below what was projected last March. Some part of this shortfall must reflect the change to new systems of control over public expenditure introduced last year.

Higher incomes and prices must have helped to push public sector revenue above the Budget forecast, but other factors have been more significant. First, corporation tax receipts have been unexpectedly large. Secondly, excise tax receipts have reflected a shift in the pattern of consumer spending in favour of the goods on which they are levied. Lastly, the public corporations' trading surpluses appear to be running well above what was forecast, as happened last year. Certainly they have borrowed much less than was expected in March.

Because the decline in expenditure and rise in revenue have been associated neither with unexpected developments in output or prices, nor, primarily, with purely financial transactions, fiscal policy appears to be slightly more restrictive (in the sense of implying a lower deficit with a given level of activity) than was envisaged earlier in the year, even after allowing for the October measures. Moreover, many of the contractionary influences on the public sector borrowing requirement this year are likely to persist into 1978/79. The latest published Treasury forecast suggested that public sector borrowing next year might scarcely have exceeded £6 billion even after taking into account the October tax measures. The Chancellor, therefore, anticipated this year's White Paper on public expenditure by announcing increases in spending programmes of around £1 billion for next year, thus raising the borrowing requirement in 1978/79 to £7 billion. Even so, borrowing is still expected to go on declining as a proportion of GNP, not least because of the rapid increase in revenue from North Sea oil operations.

Monetary objectives

The growth of sterling M_3 in the first half of the financial year was slightly above target.



DCE and the money stock (M_3)[a]

Most of the increase in sterling M_3 in the three months to mid-October was the counterpart of external inflows.

£ millions: *seasonally adjusted*

Mid-month	July– Oct. 76	Oct. 76– Jan. 77	Jan.– Apr. 77	Apr.– July 77	July– Oct. 77
Central government borrowing requirement	+1,830	+1,170	+1,350	+1,070	+ 560
Net purchases (–) of central government debt by non-bank private sector	–1,130	–2,870	–1,100	–1,620	–2,430
Other public sector[b]	+ 420	+ 630	– 160	+ 160	+ 750
Bank lending in sterling to:					
UK private sector[c]	+1,260	+1,000	– 120	+1,050	+1,260
Overseas	+ 100	– 190	– 40	+ 150	+ 220
Domestic credit expansion	**+2,480**	**– 260**	**– 70**	**+ 810**	**+ 360**
External and foreign currency finance (increase –)	– 770	+ 260	+ 680	+ 870	+1,400
Other	– 120	– 240	– 80	– 620	– 60
Sterling M_3	**+1,590**	**– 240**	**+ 530**	**+1,060**	**+1,700**
Percentage change in sterling M_3	*+ 4.1*	*– 0.6*	*+ 1.3*	*+ 2.7*	*+ 4.1*
M_1	**+ 240**	**+ 240**	**+ 770**	**+ 840**	**+1,580**
Percentage change in M_1	*+ 1.3*	*+ 1.3*	*+ 4.2*	*+ 4.4*	*+ 7.9*

[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 held by the Issue Department of the Bank of England.

Monetary developments[1]

The money stock has been growing faster as the year has progressed. Last winter and in the spring the demand for money balances was depressed, both by the lack of economic growth and by the high interest rates available on other financial assets at that time. Since then, the steep decline in interest rates and heavy inflows from abroad have – despite the lower rates of inflation experienced in recent months – resulted in a faster growth of sterling M_3. For most of the period this was still consistent with the 9%–13% target range adopted for the year to next April (see chart). But by mid-October, sterling M_3 had grown at a rate a little above the target range. Lower interest rates had had a more marked effect on the growth of M_1, which rose by over $12\frac{1}{2}$% in the six months to mid-October. But since then the pressure on monetary growth arising from external inflows has been removed by the decision to allow the exchange rate to float more freely; and the subsequent rise in minimum lending rate to 7% should help to restrain the rate of monetary expansion in the months ahead.

The acceleration of sterling M_3 was not associated with a faster rate of domestic credit expansion; in the three months to mid-October, DCE amounted to only £360 million, much less than the £810 million recorded in the previous three months (see table). Thus, DCE in the first half of this financial year [2] totalled only £1,170 million – less than a third of what would have been consistent with the £7,700 limit (agreed with the International Monetary Fund a year ago) for DCE in 1977/78 as a whole.

One factor behind the small domestic credit expansion in the three months to mid-October was a modest central government borrowing requirement of £560 million – less than a third of that in the same period in 1976. The central government had no need of bank finance for this borrowing requirement, which was more than covered by net sales of central government debt to other UK residents of as much as £2,430 million. Roughly 85% of these purchases were of gilt-edged, for which demand was stimulated by expectations of further falls in yields; but there were also significant inflows into certificates of tax deposit. There had been only small purchases of these certificates until this summer but, as other interest rates fell, their yield became competitive and many companies took the opportunity to purchase them. Some £500 million were bought in the three months to mid-October, even though the interest rates offered on new certificates were reduced early in September and again in October.

The low central government borrowing requirement was in part a reflection of the small amount of central government lending to local authorities and public corporations during this period. The local authorities had already by June taken up nearly all their quotas for borrowing from the Public Works Loan Board in the first half of the financial year, and were thus unable to borrow further until 1st October. Partly as a result of this, but also perhaps because some banks felt freer to expand their lending after the supplementary special deposits scheme was suspended in August, [3] bank lending to local authorities rose quite quickly. Overall, borrowing by local authorities and public corporations contributed far more to DCE in the three months to mid-October than in the previous three months. Meanwhile, the growth in bank lending in sterling to the private and overseas sectors remained rather subdued, although it was a little greater than in the previous three months (see below). Within the total, lending to manufacturing

[1] Figures in this section are seasonally adjusted.

[2] Measured from mid-April.

[3] See the September *Bulletin*, page 296.

rose quite strongly in the three months to mid-August after falling slightly in the previous three; this was presumably associated with stockbuilding of finished goods in the second quarter. Lending to persons continued to rise and there was a further increase in lending to agriculture.

But if DCE was small, the influence of exchange inflows certainly was not. In terms of the accompanying table, 'external and foreign currency finance', at £1,400 million, was the counterpart of over four fifths of the rise in sterling M_3. Yet this figure was itself only about half of the total increase in the gold and foreign exchange reserves (net of official borrowing) over the same period. It may be useful to try to explain this difference.

In broad terms, it is external flows to the UK private sector (other than banks) which, other things being equal, lead to residents increasing their money balances. Among such flows are net receipts from current account transactions (including not only the current surplus as recorded but also trade credit, sometimes recorded but often in the balancing item) and net direct and portfolio investment in the private sector. It is, however, difficult to identify precisely from the balance of payments accounts the flows which do add directly to sterling M_3. Also, most of these statistics are not available on the mid-monthly basis on which the monetary statistics are compiled.[1] Data for 'external and foreign currency finance' are instead compiled by deducting from the change in the reserves in the period those flows which do *not* directly increase sterling M_3 (i.e. overseas purchases of public sector securities, increases in non-residents' sterling deposits with UK banks, and UK banks' switching into sterling). In the three months to mid-October, half of the inflows were in such forms. Of the remaining inflows of £1,400 million, the current account surplus will have accounted for between a third and a half; much of the balance is unidentified and a large part probably represents leading and lagging of payments in favour of sterling. It is these inflows which have, in terms of the statistical identity with DCE, contributed to the expansion of sterling M_3 in the three months.

However, the effect of the inflows is more pervasive than this statistical accounting would suggest. The inflows will have served to improve the liquidity of UK residents, particularly that of industrial and commercial companies whose net receipts from overseas trade have improved (as a result of both the increase in net exports and a shift in the timing of payments). This improved cash flow will have reduced companies' need for bank credit and possibly facilitated the purchase of public sector debt. Thus, the existence of the inflows may help to explain the rather modest rate of growth of bank lending to the private sector in recent months: if the inflows had not been so strong, sterling lending to the private sector might well have been rather higher. A corollary to this argument is that, if the inflows had not taken place, DCE might have been somewhat higher than it was, so that the impact of the inflows on the growth of sterling M_3 might not have been quite as great as the statistical presentation appears to show.

The decision, on 31st October, to allow the exchange rate to float more freely should have largely removed the risk of further exchange inflows exerting a marked expansionary effect on the growth of sterling M_3 – although the substantial inflows in the second half of October could still have had an impact on the

[1] Furthermore, to arrive at the figures for 'external and foreign currency finance', which complement DCE as a counterpart to sterling M_3, it would be necessary to allow for some external items already included in DCE. Thus, public sector lending abroad (which contributes to the public sector borrowing requirement) and banks' sterling lending to overseas would have to be deducted from the inflow into the private sector. Also, to obtain a precise figure for the inflow into the private sector it would be necessary to make an adjustment for the UK banks' net foreign currency position vis-à-vis other UK residents.

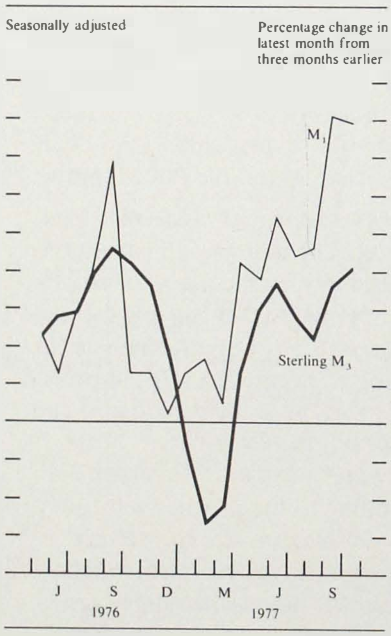
money supply figures for the month to mid-November. But the inflows also left their mark in lower interest rates. This could increase the demand for bank credit in the period ahead.

The recent course of bank lending to the private sector has given some hint of a revival, although this may prove to have been no more than an erratic fluctuation. It is notable, however, that the categories of borrower mentioned by the London clearing banks as accounting for most of the increase in their advances in the month to mid-October – agriculture, retailers, personal and professional – are among those which would have been least likely to have improved their liquidity position through inflows from abroad. It is possible that some increase in the demand for credit from other categories has been masked by the inflows into the private sector, and that, as they dry up, bank lending may pick up in response to any upturn in economic activity. The likelihood of any excessive growth in bank lending in the months ahead will have been reduced by the increase in short-term interest rates associated with minimum lending rate rising to 7% on 25th November.

The extent of the fall in interest rates earlier in the year was remarkable. At the beginning of 1977, minimum lending rate was $14\frac{1}{4}\%$; it then fell quite steadily to reach 5% on 14th October; this was the lowest since it replaced Bank rate in 1972 and indeed Bank rate itself had not been below 5% since 1964. Yields on gilt-edged did not fall as steeply (particularly at the longer end), but they also reached levels not seen for three or four years. As already mentioned, the fall in interest rates has led to a rapid rise in the narrower version of the money stock, M_1 (see chart). The fall in interest rates has also been associated with quite substantial rises in the value of various assets. For example, the market value of gilt-edged stocks outstanding rose from £29 billion at the beginning of the year to £37 billion at the end of September.[1] The value of equities of UK-registered companies quoted on the stock exchange rose from £41 billion to £62 billion over the same period. Values of prime commercial and industrial investment properties have also risen, but much less fast. House prices too have risen only moderately, presumably because of the reduced rate of building society lending earlier in the year, although there could be some acceleration during the winter as new commitments are now being extended by the societies at a rate well above the average of last year. In the United States, such changes in asset values are generally believed to play a major rôle in transmitting the effects of monetary policy to economic activity and inflation: consumers' expenditure is believed to be particularly responsive to changes in personal wealth. There may well be similar effects in this country, but efforts to measure them are hampered by lack of data and have so far been largely unsuccessful. In any event, the recent modest rise in interest rates, and falls in security prices, should have averted the dangers of too rapid a rise in asset values.

Money stock

M_1 has accelerated sharply in recent months.



Assessment

The economy may now be entering a more hopeful phase of economic development: with a stronger balance of payments, it would be reasonable to hope for a more sustained expansion than has been possible recently. There will, however, clearly continue to be limits to what can be achieved.

[1] Excluding stock issued or redeemed between the two dates.

This assessment, after first reviewing immediate economic prospects, goes on to consider the prospects a year or two further ahead – with a view to indicating the kind of limits to which the economy is likely to remain subject; what it would be reasonable to hope for; and the dangers that will have to be guarded against.

Short-term prospects

The view taken in this *Bulletin* three months ago was that – after what has in effect been four years without any growth – there were forces at work in the economy which, quite apart from any additional stimulus which might be given, should produce a more normal rate of expansion. Subsequent developments appear to call for only slight modification of this view.

In the last twelve months, the one important expansionary force has been the growth of exports, even though world trade grew only slowly. UK exports grew faster than those of other industrial countries, no doubt in part because of the improvement in the competitive position – now somewhat eroded. Next year, given present prospects for developments abroad (page 416), this country's exports still seem likely to grow faster than GDP, even if somewhat less rapidly than over the last year.

In contrast to the past twelve months, however, domestic demand can now be expected to grow at a more normal rate. In the last twelve months consumers' demand showed little increase, in the year ahead, real purchasing power is likely to start growing again. Consumers' expenditure should therefore show an appreciable growth. Fixed investment, which fell last year, has begun to pick up and should go on rising.

In the year up to the second half of 1978, final sales in total might therefore increase by almost 5%, in contrast to the negligible expansion of the last twelve months. In this event, however, the volume of imports is likely to rise considerably faster than the 2%–3% rise over the past year – notwithstanding the continuing shift to domestic sources of oil. This would still leave the current account of the balance of payments in substantial surplus next year.

The growth of GDP over the next twelve months might then be of the order of 3% – a forecast not substantially different from that suggested in this *Bulletin* three months ago. The course of unemployment has recently been difficult to interpret. But a growth rate of this sort would probably be within the range needed to prevent unemployment, which has now been rising fairly continuously for four years, from rising further.

Prospects for lower inflation

Good progress has recently been made in reducing the rate of inflation. The fact that the pressure of demand on the economy is low and that the rate of growth of the money stock is under control both favour a further abatement of inflation. One of the main reasons why prices have recently been rising more slowly was the moderate scale of wage increases in the last pay round. Wage increases take six to nine months to appear fully in prices. The more moderate rate of price increase is thus likely to continue for some months. After that, the course of prices will depend very much on the outturn of coming wage negotiations.

At this early stage of the wage round, it is difficult to assess the probabilities. But if wage settlements prove to be of the order of 10%, there will be good prospects that the rate of increase in consumer prices, which in recent months has fallen below a 10% annual rate, can be kept within the single digit range. If on the other hand inflation should unfortunately look like being much faster than this, there would be evident risks in stimulating the economy.

In any event, it will take more than the twelve months ahead to get inflation adequately under control. Until that can be accomplished, inflation will remain the country's major problem which, while it remains unresolved, risks perpetuating a potent source of economic and social instability. This makes it the more important that money does not itself become a source of instability, and that firm control continues to be exercised over the rate of growth of the money stock. Perseverance with appropriate monetary restraint should over time sustain an increasing moderation in the pace of inflation.

World recession

The UK balance of payments is now being greatly strengthened by North Sea oil. Against this, however, the world economy has failed to show a sustained recovery from the present recession, which has already been unusually deep and prolonged. There is a limit to how far a single country such as the United Kingdom, even with a new-found source of oil, can go against the general trend.

In the decade up to 1973, the output of industrial countries expanded on average by 5% a year, but in the last four years by less than half as fast. World trade, as measured by OECD export volume, grew by 9% a year in that decade, but again in the last four years the rate of growth has been halved. Output has thus risen, but not enough to reduce the margin of unemployment and unutilised capacity, so that the recession has in this sense persisted. The hopeful feature is that this year and last the United States maintained a pace higher than its normal potential and has succeeded in reducing unemployment. But of no other major country, and few smaller ones, is this the case.

The reasons for the present prolonged trough of demand – often discussed – include caution on the part of governments faced with inflationary dangers, a still persistent concern. In many cases balance of payments anxieties remain and are all the greater because deficits, and growing indebtedness, have continued for some years. Economies traditionally reliant on exports face difficulties in offsetting lower foreign sales with higher domestic demand, which would often involve unusually large budget deficits. With prolonged underutilisation of capacity and seriously eroded profit levels, the private sectors of many countries' economies must also be becoming less buoyant than in the past.

Previous hopes of sustained recovery having now been repeatedly falsified, it has perhaps to be accepted that the reasons for the present recession could continue for a considerable time. The international rules instituted at Bretton Woods, under the shadow of the depression of the 1930s, were intended to safeguard the ability of countries to pursue full-employment policies despite any falling away by their neighbours. But as pre-war experience showed, policies of competitive exchange rate depreciation and of protection are likely to be self-defeating; and in a widespread recession, such as has now emerged for the first time since the war, are likely to have serious costs of their own. Exchange rate depreciation could cost a country a heavier depression of living standards, and heavier upward pressure on prices, than could easily be supported. Import restrictions may also seem a wall behind which an independent policy can be pursued. But in a world in general recession, where other countries face an exactly similar dilemma – for many indeed, without their own oil, more acute than that of this country – the example of one major country imposing extensive restrictions would be likely to promote an avalanche of imitations, which would undo the benefits the initiating country sought to obtain.

The need for a current account surplus

The UK balance of payments is now moving back into current account surplus. After large current deficits for four years, it seems clearly desirable for the current account now to stay in surplus. One reason is the size of the debts that have been incurred during the years of deficit: maturing official external debt in the years 1978 to 1982 totals $16 billion, averaging some £2 billion a year. Although the repayment burden might be eased by some new borrowing, it will clearly be necessary to provide for a net reduction of debt on a scale that is appreciable in relation to maturing repayment obligations.

More generally, it is widely accepted that the benefits of North Sea oil should be used as far as possible for investment purposes so as to strengthen the economy. There is room both for more domestic investment and for acquiring assets abroad or repaying overseas debt.

Over the next few years, various factors seem likely to lead to larger net outflows of long-term capital. It is reasonably predictable that North Sea investment inflows will tail off, and some types of long-term capital outflow seem likely to increase. It can be argued that repayment of medium-term debt and continuing outflows on long-term capital account could be met by short-term capital inflows. It is widely argued, indeed, from a monetarist point of view, that the composition of the balance of payments – e.g. whether or not there is a current surplus – is not a matter with which policy should be concerned, on the grounds that with a free-floating exchange rate the account must balance, and that how it does so is only of secondary importance.

Such an approach takes little account of considerations of creditworthiness. If it could be assumed that in all circumstances confidence in sterling would continue, short-term inflows would be readily available and the exchange rate should remain stable. In fact confidence would risk being undermined by dependence on short-term flows. Though the volume of international funds seeking an investment home is now very large, recent experience shows there can be rapid changes in the preferences of investors as between different currencies.

It has been the relative weakness of the United Kingdom's current account position in the post-war period that has underlain the chronic exposure of the United Kingdom's external financial position and the past instability of sterling. A current account surplus having now been achieved, it would surely be imprudent to re-create those conditions by not maintaining a position of surplus.

Current balance of payments

£ billions

	1976	1977	1978
Oil[a]	−4	−3½	−2¼
Non-oil	2½	4	4½
	−1½	½	2¼

[a] Balance of trade in petroleum and petroleum products less estimated net interest, profits and dividends due abroad in connection with North Sea oil operations.

Balance of payments prospects

The improvement in the balance of payments this year, though partly due to North Sea oil, owes even more to other developments – in part lower import prices, in part the better competitive position. Next year, with a faster growth of the economy, any improvement in the non-oil balance will probably be much less marked, and may arise only from the terms of trade. With a rate of growth of the economy only somewhat higher than at present expected, the non-oil balance might easily be weakened.

Looking further ahead, the net assistance to the current balance from North Sea oil, in the sense defined above, will probably not continue to rise so rapidly. The trend towards lower imports of oil and higher exports will continue, so that the balance of trade in oil should continue to strengthen – though over time by smaller amounts. But the oil companies' profits due abroad will begin to rise to substantial levels. In total, the current oil balance, as defined in the table, is likely to strengthen next year and again, perhaps by as much, in 1979. But after that the contribution of North Sea oil to the current balance of payments, substantial as it will be, may rise only slowly. Though prospects for the 'non-oil' current account cannot be accurately assessed two or three years ahead, it seems clear that the balance will be much affected by how fast the UK economy expands and how fast the rest of the world does.

Fiscal and monetary policy

The preceding discussion suggests several implications for the direction of fiscal and monetary policies. Though a number of cautions have been stated, the most important conclusion is a positive one – that if the opportunities provided by North Sea oil are properly used, significant growth could well continue for years. That would represent a radical change from the lack of growth experienced over the last four years; and over time, if developments proceeded favourably, unemployment and underutilisation of capacity could be progressively reduced.

Progress in these directions will, however, not be sustainable unless the pace is cautious. The most immediate and pressing considerations in this respect are domestic. The major problem remains that of inflation. After a period of stagnation, it would be imprudent to permit an over-rapid acceleration in the rate of growth, since this would be likely to give rise to short-run supply bottlenecks. The pace of advance is, indeed, likely to depend on continuing success in reducing the rate of inflation. Looking a few months ahead, if wages were seen to be advancing more rapidly than now expected, this might clearly rule out the possibility of expansionary measures that might otherwise have appeared prudent.

Balance of payments considerations, though less immediately pressing, also point in the same direction. In the years ahead the current balance of payments is clearly going to be in a radically stronger position by virtue of North Sea oil. If the domestic reasons for a cautious approach to the re-expansion of the economy are given due weight, balance of payments considerations should not by themselves prove to be a constraint. The need to make best use of the resources of North Sea oil dictates, nevertheless, that the benefits should not be expended on financing an undue growth of imports for consumption, such as would be entailed by over-rapid expansion of the economy.

These considerations need to be taken into account in deciding the shape of both fiscal policy and monetary policy next year. Both fiscal and monetary policy affect demand; there are thus important interconnections between the two branches of policy. A more expansionary fiscal policy would increase the Government's borrowing requirement. One consideration is that beyond a point this would be difficult to finance without either leading to an expansion of the money stock that would seem excessive, or alternatively raising interest rates. The latter would in turn have negative effects on the private sector partially offsetting those of the Budget itself. For these reasons fiscal and monetary policy need to be decided as part of a single policy.

Further progress will be needed to bring inflation fully under control: if, however, this could be accomplished, all the other economic problems would be greatly eased. Since it is important that the expansion of money incomes should not call into question the scope for real output growth, appropriate monetary restraint will continue to be necessary; and in formulating new monetary targets for next year, the posture of monetary policy, while accommodating a moderate rate of economic expansion, must clearly be such as to take full account of the need for inflation to be reduced.