

Economic commentary

Introduction

The December *Bulletin* suggested that, by contrast with the sluggish performance of the last year, the UK economy was on the threshold of a modest expansion. There is now firmer evidence of growth in consumer incomes and spending, upon which this expansion was to be based. But domestic output has so far shown little sign of picking up, while the strong growth in net exports, which was the only significant source of support to demand in 1977, seems to be slowing down. The growth in world economic activity continues to be disappointing.

The transformation in the United Kingdom's financial position over the past year provides a far more favourable environment for growth than in 1976, when the economy also appeared to be picking up: hopes of expansion then foundered amidst an external financial crisis, an acceleration of inflation, and a subsequent contraction in real incomes and consumer spending. This in turn provoked some downward revision in investment plans and some stock adjustments which do much to explain the relatively flat path of output over the past year. Disappointed expectations may also be behind the curious rise, and subsequent fall, in employment. Rather more puzzling have been the fluctuations in unemployment, in particular the recent decline; this is discussed further on page 12.

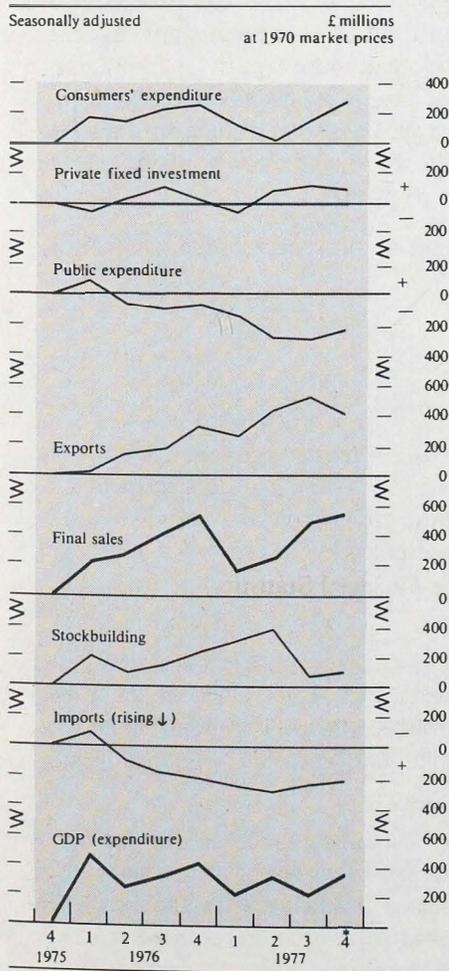
Real personal income was squeezed in early 1977 by the juxtaposition of modest growth in earnings under stage two of the Government's incomes policy and a much faster rate of inflation than expected, following the depreciation of sterling in 1976. During the second half of 1977, the position was reversed. The inflation rate has fallen below 10%, partly because of the slower increase in labour costs achieved under stage two of incomes policy and the appreciation in sterling over the last fifteen months, while the growth of earnings has accelerated to somewhat above 10%. Augmented by tax reductions, real disposable income is now growing quite rapidly. Consumption could grow equally rapidly, even if the saving ratio remains at its recent high level; possible reasons for this latter phenomenon are briefly examined later (page 7).

One possible consequence of a rapid growth of consumption could be a surge in imports. During 1977, import volume rose very little, but substitution of North Sea production for imported oil was largely responsible for this. Imports of manufactured goods, however, have been growing alarmingly fast even though domestic demand has been sluggish and there is apparently substantial productive capacity. On the other hand, this unwelcome development was more than offset by the still faster growth in export volume during 1977 at a time when world trade has scarcely grown at all. These puzzles are discussed on page 14. The rôle of competitiveness has been underlined by recent changes in the exchange rate which, following further pressure on the dollar and a UK surplus on current account, rose from an average of \$1.8175 in November to an average of \$1.9347 in January; the effective rate index rose over the same period from 63.6 to 66.0.

Although the massive capital inflows experienced until last October have largely died down, external pressures on domestic monetary conditions have not entirely vanished (see page 19); by mid-January, sterling M_3 was still above the target range. On the other hand, the public sector borrowing requirement has been smaller this year than expected. Successive forecasts of the borrowing requirement have been revised downwards, to the extent that by early this year the likely outturn for 1977/78 was nearly £3 billion below

Changes in components of GDP [a]

The effect on output of the decline and subsequent recovery of final sales in 1977 has largely been offset by stockbuilding changes.



[a] Since the fourth quarter of 1975, at factor cost.

the £8.7 billion ceiling agreed with the International Monetary Fund in December 1976 despite the additional expansionary measures announced in 1977. The reasons, discussed on page 13, are far from clear; while a lower borrowing requirement does not necessarily imply a tightening of the stance of fiscal policy, this seems to have been the result; and public expenditure on goods and services, particularly capital spending, has declined by about 3% over the past year. One area which has been particularly hard hit has been housebuilding, which has been depressed in the private sector also as costs have risen much faster than prices (see page 9).

Economic activity in the industrialised world in 1977 disappointed the modest expectations of the beginning of the year, and the outlook is sombre. The need for international agreement on policies for faster expansion, on which the Governor has recently spoken, [1] remains as pressing as ever. Only in the United States has the growth rate remained above the long-run trend, and this has been associated with a record trade deficit and increasing pressures on the dollar. Domestic economic activity in the other stronger countries—Japan and Western Germany—has been subdued, and seems likely to remain so. World trade in manufactures grew by only 2%–3% in 1977, compared with a long-run trend of about 10%. Competitive pressures appear to be increasing as a result of widespread spare capacity, particularly from countries which in the past have relied heavily upon rapid export growth. There has, however, been some reduction in the rate of price increases throughout the world, and slack demand for oil has resulted in further reductions in its price.

The assessment below discusses the prospects for the UK economy in 1978 and 1979.

Assessment: problems of 1978–1979

This assessment is concerned with the present economic outlook and the implications—in some degree, conflicting—for government policy. A general discussion of the present rôle and objectives of monetary policy was recently presented by the Governor in his Mais lecture.[2]

The December *Bulletin* reviewed prospects for 1978: there have been some changes in the scene since then, and it is useful now in a preliminary way to look rather further ahead, to the end of 1979. For the main impact of changes in taxation or expenditure that might be introduced in the coming Budget would be felt next year rather than this.

The previous *Bulletin* foresaw a significant pick-up in the economy during 1978, all the more encouraging for coming after four years of virtually no growth. This still seems the likely course, though on the basis of present policies the pick-up may be at first somewhat less rapid than thought earlier. The recovery in consumer demand, now apparently under way, seems set to continue, and as a result real consumption by the second half of this year should be 4%–5% higher than a year earlier. The other components of expenditure are also likely to contribute modestly to demand, though the growth of exports will probably be less rapid than over the last twelve months. The rise in demand will not be fully reflected in higher domestic output, because imports are likely to rise considerably faster than last year.

There are, however, some large and obvious uncertainties. Fewer wage settlements than in previous wage rounds have yet been made

[1] See page 64.

[2] See page 31.

at this half-way stage in the current round, so that it is still difficult to gauge what the results will be, and how quick and large will be the effect on spending. The first impact of higher real incomes has, as might be expected, been a rise in savings, which will probably be fairly temporary. Over the longer term, the present historically high rate of saving will probably fall if consumers are encouraged by a continuing decline in the rate of inflation. In fact, the year-on-year increase in retail prices should continue to fall for some time: by the summer the year-on-year increase, which had fallen to fractionally below 10% in January, should be significantly below that figure.

The prospects for expansion in 1979 are at the moment very difficult to estimate. A forecast of consumers' expenditure depends greatly on how costs and prices are expected to develop. With favourable assumptions about the course of inflation, consumer spending might continue to increase as rapidly as this year. Last year exports did very well, improving the UK share of export markets; [1] they should continue to rise this year and next. Two factors, however, which must be important in the determination of exports—export prices relative to those of other countries and relative unit labour costs—give somewhat differing indications for the future. Relative UK export prices expressed in foreign currency have increased sharply over the past year, more than reversing the decline that occurred during 1976. Allowing for lags, this would work against exports this year and next. Relative unit labour costs—again in terms of foreign currency—are estimated to have increased on a similar scale of late, but their fall during 1976 was much greater than in the case of relative export prices. On this showing, the competitive position therefore appears still to be quite strong by historic standards. Taking account of both these factors, it seems likely that in 1979 exports will grow less fast than world trade, which itself may be growing at a rate still somewhat slower than normal; but they should still grow faster than this year.

Thus it is at present highly unclear how rapid economic expansion in 1979 is likely to be. Bank forecasts suggest that one possibility to be reckoned with is that expansion will prove to be significantly more rapid than this year: that would argue against giving a large fiscal stimulus to the economy at this stage.

After four years of stagnation and rising unemployment, it is clearly desirable that there should now be a phase of expansion, at a pace that can be sustained. The need for caution arises less from domestic considerations than from the international context discussed below. In the present situation, renewed expansion at a moderate pace should not give rise to inflationary pressures. And while a fiscal stimulus would enlarge the public sector borrowing requirement, a moderate stimulus would appear compatible with maintaining due control over the growth of the monetary aggregates. Success here, however, will also depend on maintaining the present climate of financial confidence: for this, the composition, as well as the size, of any fiscal package would be relevant. In contrast to increases in government spending, tax reductions could be helpful, both in maintaining moderation in pay settlements and in marking a beginning to restoring incentives—both factors which would strengthen the prospects of the economy in the somewhat longer term.

The potential effects on confidence have also to be weighed in relation to the prospects for the balance of payments. This year the current balance is likely to strengthen, mainly on account of North Sea oil; and there may be a surplus, as compared with a zero balance last year. The December *Bulletin* gave reasons for doubting whether the current balance of payments

[1] Page 14.

would necessarily show further improvement in 1979, despite the fact that the contribution of North Sea oil would again rise considerably.

The 'non-oil' component of the current balance is likely to be worse this year than last in terms of real resources—though not in value terms. For imports are likely to rise more rapidly in volume than exports; and the same is likely to be true in 1979. In part the deterioration in volume terms would reflect the moderate pace of world expansion and the fact that the UK economy was showing some expansion, after none over the last four years. The worsening would also reflect the continued trend to deeper import penetration.

This year, the underlying trend will probably be masked not only by the effect of North Sea oil, but—even more important—by a very large improvement in the terms of trade. Import prices have been reduced, both by lower world commodity prices and by the appreciation of sterling after the exchange rate was allowed to rise at the end of October. On the other side of the account, there seems to have been little tendency, as there might have been, for export prices to be shaved down in terms of foreign currency when the exchange rate rose: in sterling terms they have risen significantly. But these kinds of gains can hardly be repeated, and there may well be a partial reversal next year.

As will be clear, there are inevitably large uncertainties—about the terms of trade, about export competitiveness, and about the pace of expansion abroad—obscuring prospects for the balance of payments in 1979. But despite the assistance of North Sea oil, the balance on current account is unlikely to be as large as this year. The scale of the deterioration however is likely to depend greatly on how rapid the expansion of the UK economy turns out to be.

It was argued in the last issue of the *Bulletin* that a continuing surplus on current account will be needed. Debt may no doubt be in part rescheduled; but, in addition to maturing debt obligations, there will be continuing structural capital outflows. Failure to provide for a surplus on current account could therefore risk unsettling external confidence. This risk would be the greater because now is the time when very substantial benefit from the North Sea is beginning to accrue, as a result of which current account surpluses had been expected.

The present outlook is that the rest of the world will be continuing to expand relatively sluggishly. In these circumstances, it will be difficult for this country to move far out of line; the balance of payments considerations just indicated make it necessary for re-expansion to proceed cautiously. Underlying this hampering constraint is the United Kingdom's poor record for efficiency and service—not only in export markets but most strikingly against imports; and while this is not immutable it will take time to change. A reduction of taxation that improved incentives would be to the longer-term benefit of the economy. But the immediate scope for tax cuts as a stimulus to domestic demand is clearly limited by the factors described above.

Recovery in incomes and spending [1]

Both real incomes and spending recovered strongly towards the end of 1977—the former more than the latter—after falling earlier in the year.

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

Changes in real personal disposable income and its components [a]

In the second half of 1977, real disposable property income fell, but this was more than offset by increases in real disposable incomes from other sources.

£ millions per half year, 1970 prices

	Real personal disposable income [b] [c]	of which, due to changes in:				Real net increase in life assurance and pension funds	Real disposable employment income [e]
		Real disposable current grants [d]	Real disposable self-employment income [c] [d]	Real disposable property income [b] [d]	Real net increase in life assurance and pension funds		
1974 2nd half	+840	+260	-70	-300	+80	+870	
1975 1st half	-200	-100	-230	-80	+80	+130	
2nd half	-530	+120	-100	-140	-40	-370	
1976 1st half	+200	+180	+70	+40	+160	-250	
2nd half	+10	+30	-110	-130	-120	+340	
1977 1st half	-390	+120	0	+180	+120	-810	
2nd half [f]	+180	+120	+180	-200	-10	+90	

[a] Figures are rounded to the nearest £10 million per half year.

[b] Gross of interest payments.

[c] Net of stock appreciation and depreciation.

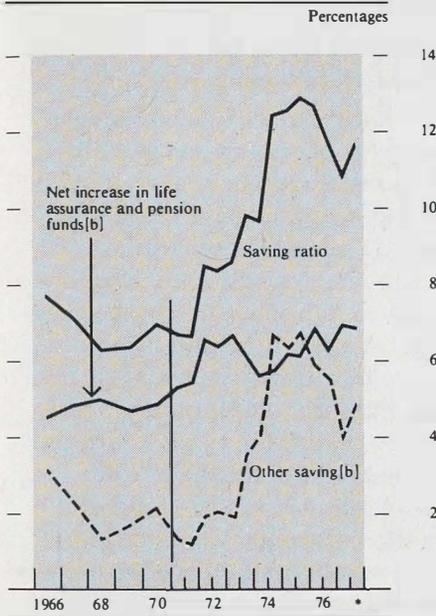
[d] Bank estimates, derived from the national accounts, but using the tax and national insurance equations in the Bank's forecasting model.

[e] Residual, includes private pension income.

[f] Bank estimates.

Personal sector saving ratios (a)

Saving other than through life assurance and pension funds has fallen sharply as a percentage of disposable income since 1975, despite some rise in the second half of 1977 associated with the payment of tax reliefs.



* Estimate.

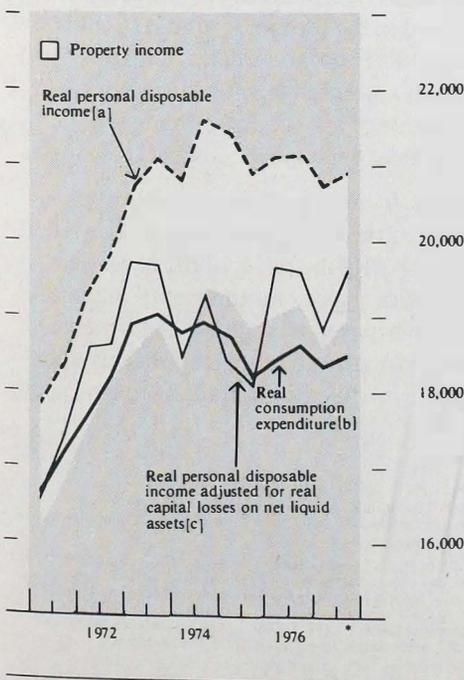
(a) Saving and disposable income are shown net of stock appreciation and depreciation; disposable income is also gross of interest payments.

(b) Shown as a percentage of disposable income.

Real income from property and consumer spending

Income adjusted for real capital losses on net liquid assets exceeded consumption in 1976 and 1977.

£ millions per half-year at 1970 prices



* Estimate.

(a) Gross of interest payments, but net of stock appreciation and depreciation.

(b) Includes interest payments.

(c) The liquid assets are net of bank borrowing.

Real personal disposable income rose again in the fourth quarter, probably by over 3%. Much of this increase was due to the October measures. Average earnings also rose faster than consumer prices from mid-1977, and by the end of the year real disposable incomes had more than regained the level of a year earlier.

Consumers' expenditure rose by about 1½% in the fourth quarter. Even so, the saving ratio rose by about 1½ percentage points in the quarter—from about 13% in the third. This probably reflected the normal lag between an increase in income late in the quarter and increased spending, rather than a change in consumers' attitudes. The pattern of retail sales confirms a sharp rise in spending in December, compared with previous months, and in the January 'sales'. In the first quarter of 1978, the higher level of consumer spending seems likely to be maintained.

Real disposable incomes from employment, which had been depressed in the first half of 1977 (see table on previous page), recovered slightly in the second half. Government current grants increased in real terms throughout the year. Real disposable self-employment income (after provision for stock appreciation and depreciation), which had fallen steeply since the middle of 1974, recovered towards the end of 1977. High nominal interest rates boosted real disposable investment income (as usually measured) in the first half of 1977, but it fell thereafter as interest rates came down.

Why has the saving ratio been so high? [1]

One of the main features—and proximate causes—of the recession in the industrial countries has been a persistently high saving ratio. In this country, the saving ratio, after adjusting for stock appreciation and for depreciation, rose from an average of just under 7% in the late 1960s to a peak of just under 13% in the second half of 1974; [2] it has since declined only slightly. One explanation of this high ratio may have been a desire to maintain the real value of asset holdings. [3] The accompanying chart of real disposable income, adjusted for real capital losses on net liquid assets, [4] shows that during 1975, when inflation was rapid, not only was adjusted investment income negative but consumption exceeded total disposable income so adjusted; in 1976 and 1977 the adjusted saving ratio again became positive.

Changes in the composition of savings may help to explain why the saving ratio has been so high, although the results are rather inconclusive. Unfortunately net identified financial transactions account for little more than 60% of the increased flow of saving between 1971 and the second half of 1974 when the saving ratio reached its peak. Broadly, however, over this period, the increase in identified real saving was largely accounted for by gross acquisition of financial assets in real terms, of which about one third was the result of increases in life assurance and pension funds [5] and may be regarded as contractual saving.

In the subsequent period to the first half of 1977, real net saving fell slightly. While real investment and contractual saving through life assurance and pension funds have increased, borrowing (other than for house purchase)—i.e. dissaving—has also increased, and the real

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

[2] Before deducting stock appreciation and depreciation, the saving ratio was 8½% in the late 1960s and reached over 15% in the second half of 1974.

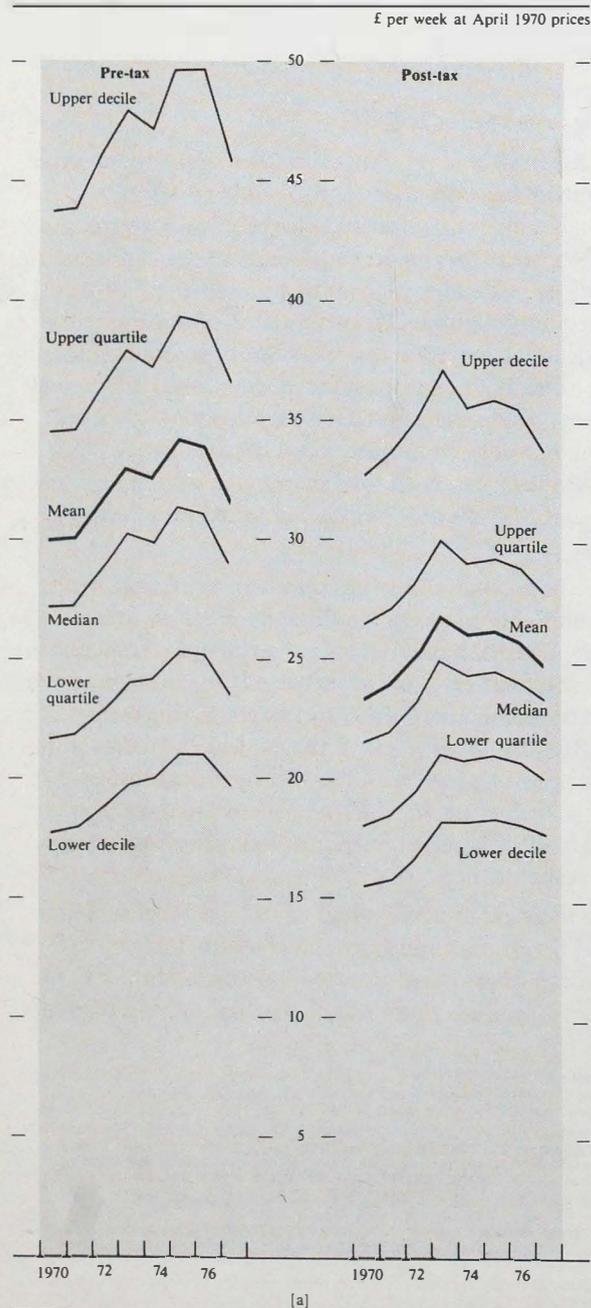
[3] The empirical relationships, for example those reported by Townend (March 1976 *Bulletin*, page 53), between changes in real asset holdings and consumer spending provide some evidence of this. In particular, equations incorporating the view that saving has risen at least partly in an attempt to offset the erosion of the real value of liquid assets by inflation have been more successful in predicting consumption than those without such a view.

[4] This is only a partial adjustment: in particular, it ignores real capital gains and losses on other financial assets and real capital gains on personal sector liabilities other than bank borrowing.

[5] Life assurance and pension funds are treated as part of the personal sector in the national accounts. Personal sector saving therefore reflects the excess of employees' and employers' contributions (and income from property accruing to the funds) over pensions paid and maturing policies (and administrative expenses).

Real weekly earnings

The fall in real post-tax earnings over the four years to April 1977 was strongest towards the top of the earnings distribution.



[a] The figures for each year are as at April.

flow of funds into liquid and other financial assets has declined.

The increased proportion of disposable income [1] accounted for by the net increase in life assurance and pension funds—from about 4¾% in the late 1960s to about 6½% in the mid-1970s—is at least one reason why the saving ratio is unlikely to fall back to earlier levels.

Earnings during the current wage round

The rate of increase in earnings has accelerated since the end of stage two. In the five months from July, average earnings rose by 6.8% [2].

Both the Department of Employment and the Confederation of British Industry report that about 95% of employees covered by reported settlements during the current wage round have stayed within the Government's 10% guideline, although few have settled below 10%. But by the end of January settlements had been reached affecting only about a quarter of all employees expected to be covered by major wage agreements, compared with about 35% by the same date during stage two. These reports appear to be hard to reconcile with the rapid rise in earnings since July. However, earnings in this period have been boosted by late settlements under stage two rules (probably covering more than 500,000 workers), by back-payments arising from delayed settlements and by payments made under self-financing productivity schemes, which have sometimes been implemented ahead of the main settlement date. Moreover, the rate of increase in earnings in the early months of stages one and two was greater than the outcome for the whole period. Allowing for the changing composition of the labour force, productivity schemes, job mobility and other 'wage drift', earnings seem likely to rise by 13% or more during the current wage round.

What has happened to earnings differentials?

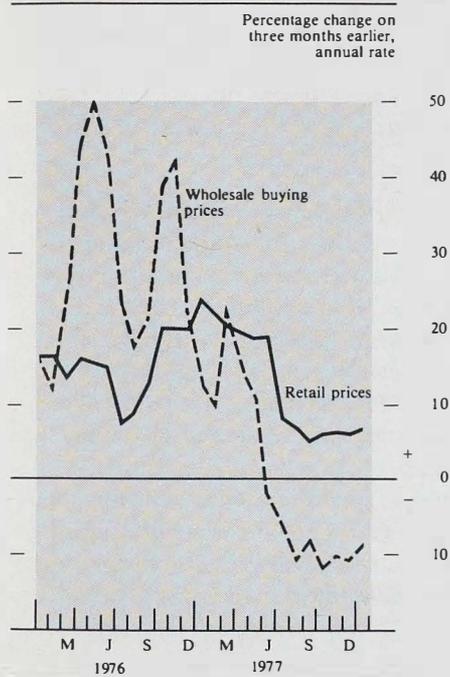
There have been large fluctuations in average real earnings since 1970; some clues as to how these appear to have affected different groups are provided by the Department of Employment's annual April earnings survey, [3] which shows weekly earnings at various points in the income distribution. [4] In the chart opposite, the figures (which refer to adult males) have been adjusted for price changes [5] and taxes [6] to give an idea of how real earnings have moved both before and after tax. The data must be treated with considerable caution for the reasons explained in the footnotes; and it should be noted that the figures refer to *earnings* not to *incomes*. Between April 1975 and April 1977, real earnings after tax fell at all income levels, but higher earnings, the slower rate of inflation and changes in tax allowances since last April will have done much to offset these losses.

Between 1975 and 1977, the distribution of post-tax earnings narrowed. The ratio of earnings at the highest decile to those at the lowest fell by 3%. This was only partly the result of the narrower pre-tax distribution associated with stages one and two of incomes policy: in pre-tax terms the ratio between the highest and lowest deciles fell by 1.7%. Moreover, virtually all of this fall was brought about by the improvement in the relative position of the lower-paid.

- [1] Gross of interest payments and net of depreciation and stock appreciation.
- [2] According to the seasonally-adjusted 'old' index of average earnings; the 'new' index (with much wider coverage but not seasonally adjusted) rose by 4.8% over the same period.
- [3] The survey is based on a 1% random sample of all employees.
- [4] The highest decile refers to the point in the earnings distribution—in terms of numbers of employees—which is 10% below the top. Thus in April 1977 earnings at the highest decile were £114 a week before tax. 10% of adult male workers earned more than this. Similarly, the upper quartile refers to earnings of workers 25% below the top (£90.8); the median refers to earnings 50% below the top (£72.3); the lower quartile to earnings 75% below the top (£58.9); and the lowest decile to earnings 90% below the top (£49.3).
- [5] The earnings figures have been converted to 1970 prices using the retail price index; patterns of consumption vary at different income levels, so the index, which is based on an average pattern of consumption, may not be entirely appropriate at each level.
- [6] The appropriate tax and national insurance deductions have been made (and child benefit added) as for a married man with two children not entitled to other deductions; social security and other benefits are not included because their net impact on income is unclear. The adjusted figures are converted to April 1970 prices using the retail price index.

Retail and wholesale buying prices

In the second half of 1977, wholesale buying prices fell and retail price increases slowed down, partly because of the strengthening of sterling.



The ratio of pre-tax earnings at the highest decile to those at the median was unchanged.

The fall in the rate of inflation

The strength of sterling during 1977 has helped to slow down the rate of inflation in recent months. Sterling commodity prices fell by almost $3\frac{1}{2}\%$ in the five months to mid-February, when they were $13\frac{1}{2}\%$ lower than a year previously. This has contributed to a fall in manufacturers' wholesale buying prices—more than $6\frac{1}{2}\%$ between April 1977 and January this year.

The increases over twelve months in manufacturers' selling prices and in retail prices have fallen sharply since the summer. The former fell from almost 21% to 13% in January. Retail prices were rising at an annual rate of only about 6% during the second half of 1977 (see chart), with the result that the increase over twelve months fell from $17\frac{1}{2}\%$ in July to just under 10% in January. This fall has been hastened by some special factors which together reduced the retail price index by about $1\frac{1}{4}\%$. [1]

As the moderate increases in labour costs brought about during stage two of incomes policy continue to be reflected in final prices, so the annual rate of price inflation can be expected to remain relatively low for some months to come. However, unless there is an accompanying increase in productivity, the annual rate of increase in earnings is unlikely to enable the rate of price inflation to fall much further.

Housebuilding depressed, but prices rising [2]

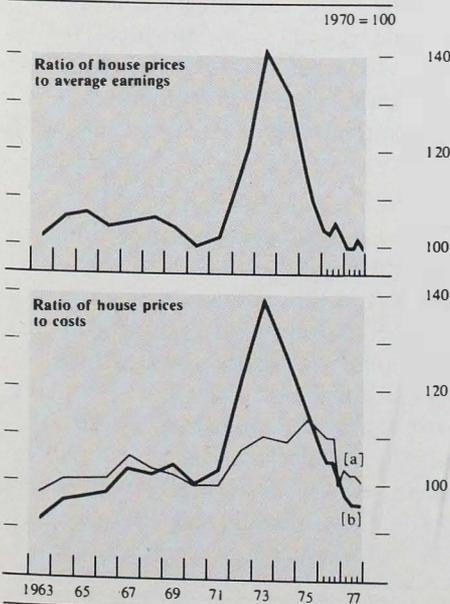
Housebuilding is slowly emerging from its deepest recession for over ten years. The volume of new housing investment reached a low point in the first half of 1977, when it was 20% lower in both the public and private sectors than a year earlier. There was some recovery in the third quarter, but only in the private sector, where investment rose by 7%. Public sector housebuilding has been stagnant and is likely to remain so for the next year at least.

Further overall recovery in housebuilding will depend upon the private sector. New housing starts have remained low; they were no higher in the fourth quarter of 1977 than in the second. But prospects are much better than a year ago. After the house price boom of 1972-73, the wide gap which had emerged between building costs and house prices has progressively narrowed (see chart). This relationship does not provide a direct indication of the profitability of housebuilding, because land prices also have to be taken into account. (The effect of doing so—using highly precarious estimates—is also illustrated in the chart.) But there seems to be little doubt that by the beginning of 1977, the profitability of housebuilding had become very low. During last year, however, the decline appears to have been halted, and both costs and prices rose by similar amounts. During 1978, prices may rise faster than costs, improving profitability and stimulating housebuilding activity. But this could be restricted if shortages of suitable building land develop, leading to bidding-up of land prices.

Demand for housing seems to have turned up towards the end of 1977, bringing faster increases in prices. During the 1960s, house prices and average earnings tended to move broadly together (see chart). They diverged sharply in 1972-73, but in the succeeding four years earnings largely caught up, as demand was at various points inhibited by three factors: the shortage of housing finance, the relatively high initial cost of servicing mortgages in a period of high interest rates, and the fall in real incomes. However,

House prices, costs and earnings

House prices have risen less quickly than earnings since 1973, and a more normal relationship between the two has been restored; this has left the profitability of housebuilding rather low.



[a] Ratio to total building cost (including land). This line is included for illustrative purposes only, as the data are very uncertain.

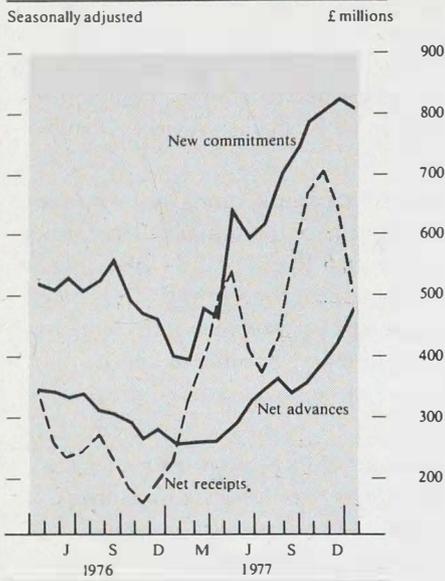
[b] Ratio to cost of materials and labour.

[1] A fall of one sixth in owner-occupiers' mortgage interest payments, and 20% fall in seasonal food prices as the effects of the 1976 drought diminished.

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

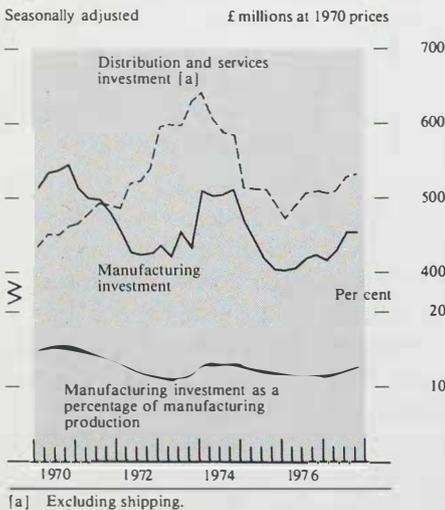
Building society funds

After very high inflows in earlier months, new commitments reached a record height at the end of 1977.



Industrial investment

Despite recovering a little in 1977, investment remained well below its previous peaks.



real personal disposable income rose in the latter part of last year and is expected to rise steadily this year; the mortgage rate has fallen from a peak of 12¼% to 8½%; and the building societies, whose lending is the major influence on the *effective* demand for housing, have for some months now been receiving substantial inflows which have enabled them to make record new commitments (see chart), and to build up their liquidity. Even with the share rate generally reduced to 5½% (net) from the beginning of February, the societies remain in a strong competitive position. Thus their financial position is unlikely to prevent a rise of house prices in line with earnings this year, unless restraints are put on lending.

An investment recovery despite low rates of return [1]

Industrial investment (excluding off-shore investment in North Sea activities) picked up fairly strongly in 1977: manufacturing investment [2] increased by over 6%, and investment in distribution and service industries (excluding shipping) by 5%. But there was little change in the fourth quarter. Nevertheless, for both groups, investment in 1977 was still some 15% below the previous peaks, in 1970 and 1973-74 respectively. This reflects the severity of the recent recession, doubts about the strength of the upturn, widespread and substantial spare capacity, and the need, at least until recently, for companies to give attention to restoring their financial position after the difficulties of 1974-75. Notwithstanding the difficulties of measurement, it appears that capital consumption has been rising in relation to total investment in recent years.

Against this background, the upturn in 1977 seems remarkably brisk. To a considerable extent, no doubt, it rested on the expectations of stronger growth. Moreover, the progressive strengthening of companies' financial position permitted the authorisation of new investment projects and of some which had been postponed during the financial squeeze of 1974-75. Investment in the North Sea accounted for 7% of total investment.

During 1977, industrial and commercial companies experienced a pronounced financial recovery. Their trading profits (net of stock appreciation) in the first three quarters of last year were about 45% higher in cash terms than in the corresponding period of 1976—about 30% higher on non-North Sea activities—largely because of the slower growth of industrial costs. Profits rose by 20% in the third quarter alone. Mainly because of this—and with interest charges falling—cash flow [3] improved sharply, and income gearing [4] fell from just over 40% during 1974-75 to under 25% in the third quarter of last year. Moreover, company liquidity has been rebuilt in the last couple of years. But although real rates of return recovered somewhat last year, they remained very low, at about 3¼% on non-North Sea activities, compared with about 9%-13% during the 1960s.

The most recent investment intentions surveys point to continued strong growth of capital spending during 1978: manufacturing investment is projected to rise by 10%-13% and investment in distribution and services by 6%-8%. Expressed intentions for 1979 are as yet tentative but suggest a similar, or slightly slower, growth. These results do not seem altogether consistent with reports, from the Confederation of British Industry survey and the Bank's industrial contacts, of little upturn in business confidence, and the likelihood that real rates of return will remain very low. If business investment is as strong in 1978 as the surveys suggest, it would still remain below

[1] All investment and stockbuilding figures are seasonally adjusted and at constant (1970) prices; company finance figures are in seasonally-adjusted current price terms.

[2] The Central Statistical Office definition of manufacturing investment includes capital expenditure by the iron and steel industry, which is predominantly undertaken by the public sector and fell sharply last year. Private manufacturing investment in 1977 rose by about 12%.

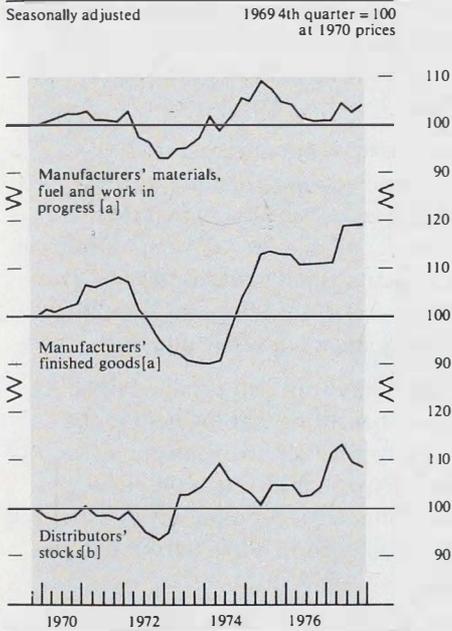
[3] Undistributed income, plus net capital transfers, less stock appreciation.

[4] Interest charges as a percentage of companies' income, net of stock appreciation and tax payments.

the previous peaks; and longer-term prospects for a sustained upturn in capital spending will obviously depend upon the expectation of resumed growth in the domestic and international economies.

Stock ratios

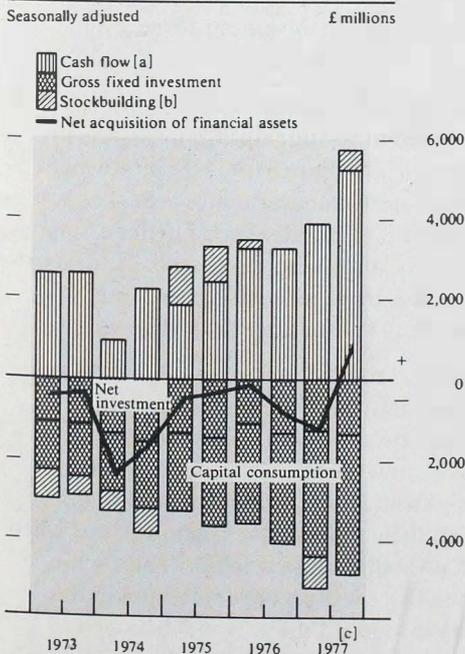
Manufacturers' stocks of finished goods remain very high in relation to production.



[a] As ratio of manufacturing production.
[b] As ratio of retail sales.

Appropriation account of industrial and commercial companies

Higher cash flow and some destocking brought companies into financial surplus during the third quarter and probably again in the fourth.



[a] Undistributed income, plus net capital transfers, less stock appreciation.
[b] Destocking is treated as a source of funds.
[c] Incorporates Bank estimate for the fourth quarter.

An inventory adjustment in 1977

Stocks rose by nearly £500 million, in the first half of 1977: manufacturers' stocks rose by £300 million (more than half of it in finished goods); wholesalers' and retailers' stocks each rose by nearly £100 million. A large part of the build-up, particularly of finished goods, was probably a consequence of the downturn in consumers' expenditure and the incomplete adjustment of output to this lower level of demand; declining interest rates and strengthening cash flow may also have been responsible. There must, however, be some doubts about the extent of deliberate stockbuilding in view of the already rather high stock ratios, particularly for manufacturers' finished goods (see chart).

During the second half-year, the pick-up in demand provided companies with the opportunity to reduce excessive stocks. Destocking of £70 million in the third quarter was followed by destocking of £50 million in the fourth; finished goods accounted for most of the reduction in both quarters. Even so, stocks at the end of the year were still high in relation to the level of activity.

Destocking—together with the recovery of companies' cash flow—led to a sharp improvement in industrial and commercial companies' financial balance in the third quarter, when they were in surplus by nearly £400 million (at current prices), after a deficit of nearly £1.4 billion in the first half-year. Cash flow may since have recovered a little further, and the sector is likely to have remained in surplus during the fourth quarter. The outlook in 1978 is less clear and will depend on the strength of any pick-up in output and on developments in industrial costs, but increasing capital spending may push the sector back into deficit.

Output stagnant and capacity utilisation low

The contraction in demand and the accumulation of stocks during the first half of 1977 checked the moderate growth of industrial output which started in mid-1976. Output fell in the second quarter of 1977, and by the fourth quarter was no higher than a year earlier. Such growth as has occurred has been concentrated in industries geared closely to export markets, but even here relatively buoyant export performance has frequently not been sufficient to avoid a net fall in output over the year. The exceptions are predominantly in high technology industries, such as electrical engineering, where output in the fourth quarter is provisionally estimated to have been 2% higher than a year earlier, and extractive industries, where North Sea output is becoming increasingly important. By contrast, metal manufacturing, and in particular steel, has lost much of its traditional export market because of world over-capacity; its output fell by a further 13% during 1977 and is now around 25% below what it was in 1973.

Capacity utilisation remains low. A recent CBI survey suggested that around two thirds of manufacturing companies are working below capacity, especially the larger firms. As always, measures such as these should be treated with caution, but there seems little reason to doubt their conclusion that major shortages of industrial capacity remain remote; the concern is that this may be due to the United Kingdom's high marginal propensity to import. Short-run supply constraints have, however, recently created difficulties for some industries, partly because of shortages of skilled labour but more frequently because of labour disputes. The motor industry has remained particularly vulnerable in this respect, accounting for

one in four of all working days lost through strikes and resulting lay-offs in 1977.

Puzzling developments in the labour market

In the year to mid-1977, employment in the United Kingdom rose by 120,000—entirely among women. Much of the increase occurred in service industries at the expense of some male employment, but women also accounted for half of the 1½% rise in manufacturing employment, where they make up less than a third of the workforce. Some 40,000 fewer men were employed in construction.

Between June and September, there was no increase in the total number employed, and some reduction in manufacturing, a trend which has continued. But it seems surprising that the previous rise should have occurred at all in a period when output was initially growing only slowly and actually fell towards the end. Part of the explanation lies in the expansion of the temporary employment subsidy, which has prevented redundancies in some industries.

One result of these developments has been that productivity has remained stagnant or even fallen—benefiting employment in the short run, but raising questions as to whether an expansion in activity will now lead to the gains in productivity observed in previous upturns. On the other hand, the outlook for productivity in a cyclical recovery could turn out to be unusually good if low output per head reflects labour hoarding.

Even more difficult to explain than the recent course of employment has been that of unemployment.

Despite continuing slow growth of output and some apparent reduction in employment, adult unemployment has fallen slightly in recent months. This reduction has to be considered against normal growth in the labour force of around 45,000 a quarter. By contrast, between June and September last year the rise in adult unemployment was 92,000—far more than the growth in the labour force, even allowing for the small reduction in employment.

Several possible explanations can be advanced for this uneven path of unemployment. The proportion of the unemployed who register may have fluctuated substantially. The figures for self-employment which are included in the total employment estimates are taken to have been constant over the period, in the absence of better estimates; but in fact self-employment may also have fluctuated. And, as the December 1977 *Bulletin* suggested, there may have been some alteration in the pattern of seasonal fluctuations in the figures.

The last point is worth further elaboration. Unemployment among school-leavers has been exceptionally high between June and September in the past two years, because of increasing numbers leaving school in search of work at a time of acute slackness in the labour market. Those aged eighteen and over join the adult register directly, raising the number on the unadjusted register at a time when other seasonal factors would normally cause it to fall. This factor, coming as it did at a time when there was severe depression in the construction industry, may have reduced the seasonal boost to employment, and thus caused a temporary change in the seasonal behaviour of the series. Moreover, unusually large numbers of other school-leavers have increased the competition for vacancies during the summer months, thereby increasing the difficulties for job-seekers on the adult register—the so-called 'shadow effect'.

Viewed in this way, the rapid growth of unemployment in the third quarter of last year may have been a temporary aberration, suggesting that the subsequent reduction in unemployment should not necessarily be regarded as a trend.

The shrinking public sector deficit

During the current financial year, there have been successive reductions in the forecast public sector borrowing requirement (PSBR) for the year as a whole. In the absence of any evidence to suggest that these reductions reflect faster growth than expected, there is an implication that the stance of fiscal policy has been tighter than expected, i.e. that the public sector has been contributing less to overall real demand.

The PSBR for the third quarter of this financial year was £1.9 billion unadjusted, or £1.1 billion seasonally adjusted; the seasonally-adjusted total for the first nine months of the financial year was £3.6 billion. After allowing for special factors (e.g. the timing of the sale of British Petroleum shares and the tax rebates from the October package) the borrowing requirement for the financial year as a whole seems likely to turn out below £6 billion.[1] This shortfall is supported by the rather less complete information so far available on public revenue and expenditure.

There can be little doubt that in 1977/78, as in the previous year, revenue has been much more buoyant than expected. Receipts of tax and national insurance contributions have been larger than expected, as have the trading surpluses of the nationalised industries, notwithstanding the difficulties of British Steel. The unexpectedly heavy yield of direct tax and national insurance contributions has not yet been satisfactorily explained, although slightly higher growth in average earnings than was assumed at the time of the Budget may have been a factor. A possible reason for the high public corporation surpluses is that demand for their products appears to have been much less sensitive to the price increases of 1976/77 and 1977/78 than was expected when the Budget estimates were made.

In the case of public expenditure, the January White Paper stated that in 1977/78 there would be a shortfall of 4½% on the plans (in volume terms) published in the previous White Paper, implying an overall reduction, year-on-year, of 2.8%; for fixed investment the implied year-on-year reduction is much greater (18.7%).

The areas of probable shortfall are shown in the White Paper,[2] and summarised in the table. The causes of shortfall are extremely varied. The White Paper mentions changes in the financing arrangements for nationalised industries and for export and shipbuilding credits; lower interest rates; some delay in defence and procurement programmes; and the fact that in some cases firmer estimates of expenditure in 1976/77 have necessitated revisions for this year.

The unexpected strength of revenue, and some shortfall in real expenditure, suggest that the Government's fiscal stance, as in 1976/77, has been tighter than intended. Some experimental estimates have been made by a number of economists to measure fiscal stance.[3] They attempt to show what budget deficits would have been, given the expenditure policies and tax rates of recent years but excluding variations arising from changes in the level of activity, on the grounds that these are less directly under the Government's control. All such estimates show the budget deficit contracting sharply as a percentage of GDP in 1976 and 1977.

The Government's expenditure plans for 1978/79 are set out in the recent White Paper. Public spending in real terms is projected to rise by a little over 2% next year on the planned level for this year. If these plans are achieved, the year-on-year rise in 1978/79 would be

Shortfall in public expenditure

£ millions at 1977 survey prices

	Difference from plans in 1977/78
Current expenditure:	
Goods and services	- 260
Grants	- 50
Capital expenditure:	
Goods and services	- 190
Grants	+ 110
Central government net lending to nationalised industries and some other public corporations	- 510
Other public sector lending and capital transactions	- 750
Contingency reserve	- 750
Total	-2,400

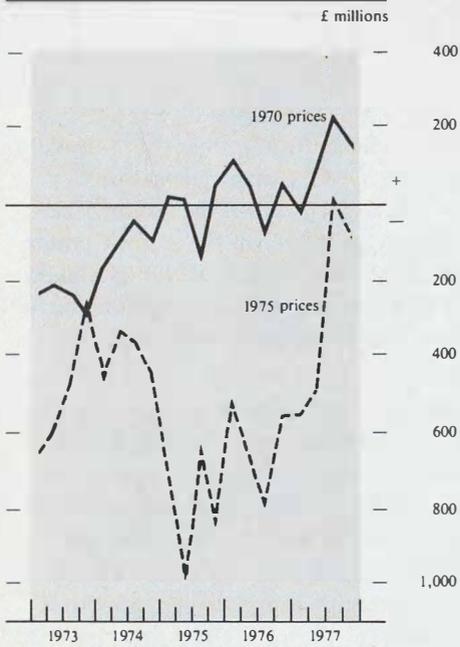
[1] This compares with the Budget forecast of £8.5 billion (or £8.7 billion if the July amendments to the Finance Act are taken into account). The shortfall would have been even larger but for the October package, which provided additional tax reliefs of £1 billion.

[2] *The Government's expenditure plans 1978/79 to 1981/82*, Cmnd. 7049-1, Volume 1, Table 13.

[3] See, for example, the February 1977 issue of the *National Institute Economic Review*, pages 43-4.

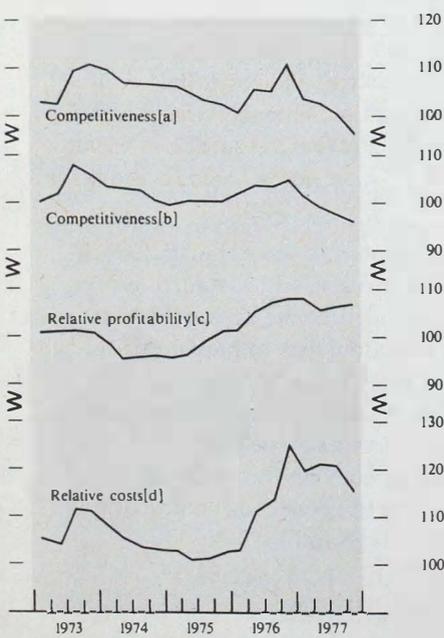
Real goods balance

There was an improvement in the United Kingdom's net exports of goods in 1977. This is more marked in terms of 1975 prices than in terms of 1970 prices.



UK export competitiveness and profitability

There is some evidence of erosion of the United Kingdom's export competitiveness in 1977 (but see text).



- [a] Ratio of competitors' export prices of manufactures to those of the United Kingdom (in dollar terms); partly estimated. 1970 = 100.
 [b] Finished manufactures: ratio of UK import unit value to export unit value. 1975 = 100.
 [c] Ratio of unit value of UK exports of finished manufactures to UK wholesale prices (excluding food, drink and tobacco). 1970 = 100.
 [d] Ratio of competitors' unit labour costs to those of the United Kingdom, adjusted for cyclical effects: IMF series. 1970 = 100.

close to 7%—more perhaps than could be achieved without displacing some private sector activity. The shortfall in expenditure in the current year, however, is of some relevance here: in practice, it may not be unreasonable to envisage another shortfall next year, so that the year-on-year rise in public spending might perhaps be closer to 4%.

External trade

External trade was the main source of growth in the UK economy in 1977. Changes in the oil and non-oil balance contributed about equally to this growth; the balance of resources in services was little changed.

In terms of indices based on the pattern of trade in 1970, the volume of exports of goods and services rose by about 6¼%, while that of imports increased by only about 4½%. [1] Since the beginning of 1974, the shift of resources into the balance of payments—the change in exports of goods and services at constant prices net of imports—has amounted to more than 4% of GDP, although the change between 1976 and 1977 was smaller than in any of the three preceding years. This picture is altered somewhat if the volume indices are derived from weights based on the pattern of trade in 1975. [2] This gives, in particular, a much higher weight to trade in oil. On this basis, there was an increase in the balance of resources in goods at 1975 prices of almost £1½ billion in 1977, after an increase of £700 million in 1976. The gain in 1977 was concentrated in the second half of the year when exports were 3½% higher, and imports 4½% lower, than they had been in the first half.

Rapid growth of exports despite stagnant world trade

The volume of exports of goods rose by 9¼% in 1977. [3] The strongest growth occurred in the third quarter. In the fourth quarter, export volume fell by more than 4½%, and there was a further fall in January. The decline was widespread, a major exception being agricultural exports, and almost certainly reflects the depressed state of demand overseas. The impact of the US dock strike is thought to have been small.

The volume of exports of manufactures rose by 8¼%, considerably above the growth of world trade in manufactures (about 3%). [4] This impressive performance contrasts sharply with the experience of the past two decades, when on average the growth in UK manufactured exports has been less than two thirds of that of world trade. In the past, a relatively good UK export performance has tended to coincide with periods when world trade has been depressed.

Exports and competitiveness

Gains in competitiveness during 1976 were partly responsible for the rise in exports in 1977. The best measure—or combination of measures—of competitiveness has become a subject of much debate and is of considerable importance because there are often differences in the movements of the various indicators (see chart). Moreover, the effects of these changes are spread over several years. Thus, in a particular year, exports will be influenced to varying degrees not only by competitiveness in that year but also by the delayed effects of changes in previous years. The net effect of all such changes—*effective competitiveness*—was probably positive for the United Kingdom in 1977 as a whole, largely because of the very sharp improvement in all measures of competitiveness in 1976—an

- [1] Changes in the volume of services in the fourth quarter are estimated.
 [2] The unit value/volume breakdown of the external trade statistics in 1978 is based on 1975 trade flows, as is the subsequent discussion of performance in 1977.
 [3] On an overseas trade statistics basis.
 [4] Weighted by the UK share of such trade.

improvement the effects of which will be felt for some time yet. On some measures, however—relative export prices in particular—effective competitiveness has probably been declining in recent months as a result of the decline in competitiveness since the beginning of 1977. On the other hand, effective competitiveness based on relative unit labour costs is still improving. This divergence seems likely to continue.

A surge in imports of manufactures

The volume of UK imports [1] rose by only 2½% in 1977, mainly because of a fall in the second half of the year. This fall, however, was reversed in December and January; this reversal cannot be explained entirely by the ending of the US dock strike.

The disturbing feature of the behaviour of imports in 1977 is the rise of nearly 13% in the volume of imports of finished manufactures, which account for about 30% of all imports by value. Imports of road vehicles rose by 26%. The supply difficulties of the UK motor industry are well known, but the size of the increase in other kinds of manufactures is puzzling, occurring as it did in a period of rather depressed demand, and can only partly be attributed to prices. It may be that imports respond faster than exports to price changes, which suggests, in view of the recent appreciation of sterling, that prices could have a large effect on import volume in 1978. Various hypotheses have been put forward to explain the apparently secular rise in imports of finished goods, but most would apply equally to other European countries. One reason, for which there is some empirical evidence and which applies particularly to the United Kingdom, is that a country where the growth of production and investment is slow cannot adjust to changes in demand as well as countries with faster growth, so that any increased demand or change in tastes is more likely to be satisfied by imports than by goods produced at home.

The volume of agricultural imports has fluctuated widely in the past but without any clear trend. The January figures show a massive rise of nearly 22% over the average for the fourth quarter. This rise is difficult to explain; it may partly be due to recovery from the US dock strike and anticipation of the devaluation of the 'green pound'.

Imports of industrial materials were little changed in volume terms throughout 1977, though there is evidence of a rise towards the end of the year, continuing in January (which was 10% above the 1977 monthly average). The rise is curious in view of the current depression in manufacturing production and the relatively high levels of stocks and work in progress, but it may be that recent falls in import prices have encouraged companies to switch to overseas suppliers.

Import prices in 1977 were 15½% higher on average than in 1976. The rise was much the same for all commodity classes, with only road vehicles (21%) showing a significant disparity. There was, however, a slight fall in the fourth quarter, continued in January, due to the appreciation of sterling, though the prices of food, machinery and road vehicle imports continued to rise.

The terms of trade

The terms of trade improved throughout 1977; the export unit value index as a percentage of the import unit value index increased by 5½% over the year to the fourth quarter of 1977. This was not due to changes in the prices of commodities (of which the United Kingdom is a net importer) relative to those of finished manufactures (of which the United Kingdom is a net exporter). Instead, the combination of a relatively high UK rate of price increase and the

[1] On an overseas trade statistics basis.

rise in sterling's effective exchange rate appears to have been mainly responsible. This is reflected in the terms of trade in finished manufactures, which rose by 9% between the fourth quarter of 1976 and the fourth quarter of 1977—associated with the loss of price competitiveness. It is clear that exporters have not been guided solely by prices in overseas markets in setting their own prices. While this may have worsened price competitiveness, it has raised export profitability, both in relation to supplying the domestic market and against costs, above what it would otherwise have been; this would tend to offset the detrimental effects of declining price competitiveness.

The improving oil balance

The balance of trade in oil improved in 1977 by nearly 30% compared with 1976, making the deficit for the year just under £3 billion. There had been a steady improvement in this balance since the middle of 1976, though it was not sustained in the fourth quarter of 1977 when exceptionally bad weather reduced production and exports.

The volume of imports of crude oil was 21% smaller in 1977 than in 1976, although it rose in December and January.

Invisibles

Net invisible earnings continued to fall in the fourth quarter. For 1977 as a whole they were considerably lower than in 1976, mainly because of a sharp fall in net receipts from interest, profits and dividends, which was only partly offset by an improvement in services. Although some of the fall may be temporary, the invisibles surplus is likely to come under further pressure, particularly as a result of profits earned by foreign oil companies in the North Sea.

During 1977, the most striking feature was the fall in the private sector's surplus on direct investment earnings. Outward direct investment earnings are sensitive to exchange rate changes, and the appreciation of sterling will have contributed to their sharp fall. Trading profits of companies operating in the United Kingdom improved, and this led to an increase of nearly 27% in direct investment debits. Elsewhere, the repatriation of oil profits and the sharp fall in banks' euro-currency earnings, associated with the narrowing of margins between borrowing and lending rates, added to the deterioration of the interest, profits and dividends surplus.

The relaxation of exchange control restrictions on emigration allowances and on gifts in October led to a large jump in private transfers towards the end of the year. This, coupled with higher government subscriptions to the EEC and other international organisations, caused the transfers deficit to widen by 41% in 1977.

Among services, more foreign visitors came to the United Kingdom, and travel credits rose by 31%, while depressed personal incomes in this country held down the rise in travel debits. Overall, the services balance improved to £2½ billion, 28% higher than in 1976.

Overall the current account was roughly in balance in 1977 as a whole (see table).

Capital flows

The continuing heavy demand for sterling in the fourth quarter was reflected in another large surplus on the balance for official financing and, after the end of October when sterling was allowed to float more freely, a significant appreciation of the exchange rate—over 4½% in effective terms and nearly 10% against the US dollar.

Before seasonal adjustment, the surplus on current account was £380 million. With a balance for official financing of £1,930 million, net capital inflows, including the balancing item, were £1,550 million.

UK current balance

£ millions: seasonally adjusted

	1976		1977			
	Year	Year	1st qtr	2nd qtr	3rd qtr	4th qtr
Exports of goods	25,422	32,176	7,502	7,930	8,540	8,204
Imports of goods	28,932	33,788	8,449	8,694	8,486	8,159
Visible balance	- 3,510	- 1,612	- 947	- 764	+ 54	+ 45
of which, oil	- 3,973	- 2,804	- 800	- 745	- 602	- 657
Invisibles	+ 2,403	+ 1,577	+ 442	+ 400	+ 429	+ 306
Current balance	- 1,107	- 35	- 505	- 364	+ 483	+ 351
Percentage changes from previous year/quarter (goods)[a]						
Volume of exports	+ 9.9	+ 8.2	+ 1.9	+ 2.0	+ 5.2	- 4.0
Volume of imports	+ 5.5	+ 1.4	+ 1.7	+ 0.6	- 3.1	- 3.6
Unit value of exports	+ 20.6	+ 18.1	+ 4.5	+ 4.1	+ 2.7	+ 1.4
Unit value of imports	+ 21.9	+ 16.0	+ 2.8	+ 2.8	+ 1.9	+ 0.1
Terms of trade	- 1.1	+ 1.8	+ 1.7	+ 1.3	+ 0.7	+ 1.4

[a] Balance of payments basis.

Capital flows in 1977

£ millions: not seasonally adjusted

	1977			
	1st qtr	2nd qtr	3rd qtr	4th qtr
Current balance	- 530	- 336	+ 455	+ 376
Capital flows				
Official long-term capital	- 24	- 16	- 17	- 245
Overseas investment in UK public sector:				
Gilt-edged stocks	+ 350	+ 37	+ 246	+ 346
Other	+ 148	+ 884	+ 45	+ 123
Exchange reserves in sterling:				
Countries	+ 197	- 430	+ 80	- 89
International organisations	- 7	+ 32	- 6	+ 204
Private sterling balances	+ 199	+ 350	+ 323	+ 599
Sterling claims of UK banks:				
UK export credit	- 198	- 131	- 116	- 165
Other	+ 185	- 104	- 16	+ 49
UK banks' net external liabilities in foreign currencies	+ 421	- 706	+ 184	+ 366
Other capital flows (including balancing item)	+ 1,172	+ 1,328	+ 1,432	+ 368
Balance for official financing	+ 1,913	+ 908	+ 2,610	+ 1,932

The table shows that, of the identified inflows over the quarter, the largest movements were a rise of nearly £600 million in private sterling balances (taking the increase in 1977 to £1½ billion and the stock outstanding to nearly £5 billion), non-official overseas net purchases of gilt-edged of £350 million, and an increase of some £370 million in UK banks' net external liabilities in foreign currencies. There was a further slowdown in the growth of UK banks' overseas sterling claims. Although the increase in lending for UK exports was higher than in the second and third quarters, lending outstanding for other purposes fell. The modest rise of £115 million in official sterling balances was more than accounted for by an increase of over £200 million in the holdings of international organisations (largely reflecting the counterpart of the payment of UK subscriptions). Other net flows were small.

The overall composition of external flows during the quarter (a surplus on current account, large net public and banking sector inflows but only a small surplus on private sector capital) may not provide a reliable guide to the sources of pressure on sterling over the period. Private sector capital transactions may also have contributed to pressure on the rate during October but may subsequently have been choked off or reversed.

While the scale of inflows in 1977 was large, it was by no means unprecedented. Flows in 1971-72, also a time of changing fortunes for sterling and the dollar, were comparable with those in 1977 if an adjustment is made for the growth in the value of transactions (as approximated by the change in trade values) between the two periods (see table). A rigorous classification of capital flows into 'structural' and 'short-term' components is not possible from available statistics, and the classification given should only be regarded as a broad indication.

Comparing 1977 with 1971 on this basis shows that the balance for official financing was larger in 1971, chiefly because of a stronger current balance. Capital flows were of roughly the same magnitude, but the proportion of short-term flows in 1971 was greater, including a much faster build-up of official sterling balances. The small growth in official holdings in 1977 reflected the success of the steps taken to reduce the rôle of sterling as a reserve currency. Another important influence on flows which did not exist in 1971 was the effect of the exchange control restrictions on the sterling finance of third country trade introduced in late 1976. These were estimated to have brought about a once-for-all inflow of about £1 billion by the middle of 1977 as UK merchants switched to foreign currency financing.

A relaxation of exchange control took effect from 1st January. The 25% surrender requirement applied to the sale of overseas securities was abolished; and controls on certain current and capital account transactions with the European Economic Community were eased. The latter marked a further stage in liberalisation of controls under the terms of the Treaty of Accession. The overall effect of these changes is not expected to be very large.

In the first two months of the year, the reserves rose by \$140 million, after net repayments of borrowing under the exchange cover scheme of \$330 million. The repayments mainly comprised further prepayments of high-interest debt that would otherwise have matured in the early 1980s (the peak years for repayments); these began on a limited scale in the fourth quarter, and announced prepayments up to and including April now total around \$730 million. The Government have also declared their intention to repurchase, during this year, \$1 billion of drawings from the International Monetary Fund.

A comparison of the scale of capital inflows

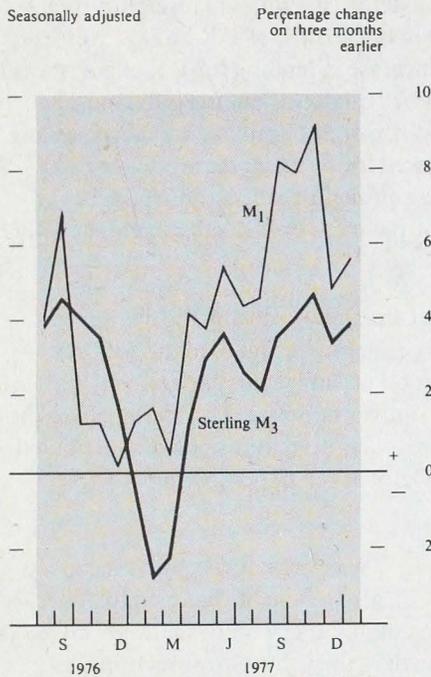
£ millions: in 1977 trade values[a]

	1971	1972	1976	1977
Current balance	+ 3,667	+ 394	-1,323	- 35
'Short-term' flows: [b]				
Non-official gilt-edged holdings	+ 280	+ 338	+ 139	+ 979
Sterling holdings of:				
Central monetary institutions[c]	+ 2,339	+ 751	-1,758	+ 153 [d]
Other holders	+ 2,421	- 285	+ 305	+ 1,471
UK banks' net external liabilities in foreign currencies[e]	+ 652	- 795	- 324	- 355
Other short-term transactions[f]	+ 300	- 986	- 679	+ 121
Balancing item	+ 873	-2,200	+ 341	+2,596
Total 'short-term' flows	+ 6,865	-3,177	-1,976	+4,965
Other 'structural' flows	+ 208	-1,176	-1,036	+2,433
Balance for official financing	+10,740	-3,959	-4,335	+7,363

- [a] Trade (goods and services) is measured as the sum of exports and imports. In each year before 1977, the recorded flows have been multiplied by the ratio of trade in 1977 to trade in the earlier period.
- [b] Some flows, classified as 'short-term', include transactions that might remain unaffected by changes of confidence in sterling and insensitive to changes in interest rates. Conversely other 'structural' flows include trade credit and inter-company transactions which may be subject to large swings in the short term.
- [c] Excludes international organisations.
- [d] Includes +395 for HMG foreign currency bonds.
- [e] Excluding borrowing to finance UK investment overseas.
- [f] UK banks' external sterling claims and other commercial short-term flows.

Money stock

The rate of growth of M_1 appears to have been less fast recently. Sterling M_3 has been growing on average over 1% a month since last summer.



DCE and the money stock [M_3] [a]

With individuals receiving large income tax rebates at the end of last year, sterling M_3 continued to grow quite fast—despite last October's change in intervention policy.

£ millions: seasonally adjusted; mid-month

	Oct. 76- Jan. 77	Jan.- Apr. 77	Apr.- July 77	July- Oct. 77	Oct. 77- Jan. 78
Central government borrowing requirement	+1,170	+1,350	+1,070	+ 540	+1,500
Net purchases (-) of central government debt by non-bank private sector	-2,870	-1,105	-1,675	-2,380	-1,650
Other public sector [b]	+ 630	- 165	+ 155	+ 750	- 105
Bank lending in sterling to:					
UK private sector [c]	+ 995	- 120	+1,045	+1,240	+ 790
Overseas	- 185	- 35	+ 160	+ 210	+ 225
Domestic credit expansion	- 260	- 75	+ 755	+ 360	+ 760
External and foreign currency finance (increase -)	+ 255	+ 675	+ 935	+1,390	+ 700
Other	- 235	- 75	- 625	- 95	+ 205
Sterling M_3	- 240	+ 525	+1,065	+1,655	+1,665
Percentage change in sterling M_3	- 0.6	+ 1.3	+ 2.6	+ 4.0	+ 3.9
M_1	+ 235	+ 765	+ 845	+1,580	+1,205
Percentage change in M_1	+ 1.3	+ 4.2	+ 4.4	+ 7.9	+ 5.6

[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]

In the nine months from mid-April to mid-January, sterling M_3 rose by 11%, faster than was consistent with the 9%–13% target for 1977/78 as a whole. M_1 —still influenced by the falls in interest rates earlier in the year—has also continued to rise quite rapidly. In the nine months to mid-January, it rose by some 19%; nevertheless, the rate of increase of M_1 should fall substantially in the next few months as the recent greater stability of interest rates begins to be felt.

During last year, especially between July and October, external inflows brought about a rapid decline in interest rates. Despite large sales of gilt-edged stocks, which more than financed the central government borrowing requirement (CGBR) and which considerably raised the proportions which such stocks formed of the portfolios of financial institutions (mainly those of insurance companies and pension funds), there was still substantial upward pressure on the rate of growth of the money supply. The decision at the end of October to allow the exchange rate to float more freely moderated the external pressures, but the increased personal tax allowances for 1977/78, announced at about the same time, had a fairly sizable impact on the CGBR around the turn of the year.

Despite last year's fall in interest rates, there has been little change in the rate of growth of bank lending in sterling to the private sector. The underlying rate of growth has remained at some 1% a month during the current financial year. But this disguises the fact that in real terms bank lending has recently started to rise rather than fall. The rate of inflation has declined over the last year from around 1½% per month to something around ½%, bringing down with it the growth of firms' working capital needs.

Over the three months to mid-January, the moderate rate of growth of bank lending, coupled with a fairly rapid rise in current accounts, meant that the banks had little need to bid for funds, and the rise in wholesale deposits was probably modest.

Nevertheless, the growth of sterling M_3 as a whole in the three months to mid-January has continued to be slightly faster than is consistent with the present monetary targets. This was largely matched in these months by a faster rate of domestic credit expansion (DCE). Even so, DCE amounted to less than £1,900 million in the first nine months of the financial year—only about a third of the amount which would have been consistent with the limit agreed with the International Monetary Fund in December 1976 (£7,700 million for the year as a whole). This limit has now been extended to cover the increase in the fifteen months to mid-July 1978.

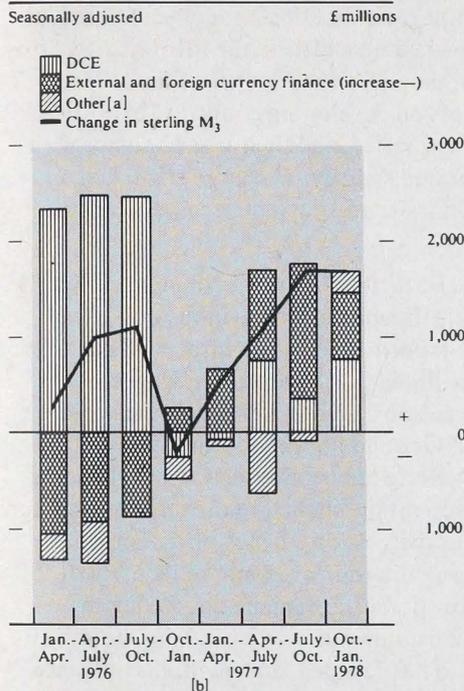
The faster rate of DCE in the three months to mid-January was largely associated with a rise in the CGBR. A major factor behind this was a largely once-for-all effect from the fiscal measures announced in October. There was also, however, increased on-lending to the rest of the public sector, as local authorities took up their quotas for borrowing from the Public Works Loan Board for the second half of the financial year; this will, however, have been reflected in lower market borrowing by the rest of the public sector.

As in the two previous quarters, the CGBR was more than covered by sales of central government debt outside the banking sector—even though these were below the exceptional sales of the previous three months. Christmas once again proved to be a period of strong demand for gilt-edged, with expectations of falling interest rates.[2] Sales of certificates of tax deposit, which had been exceptionally high in the three months to mid-October, fell back in the following two

[1] Figures in this section are seasonally adjusted.

[2] Minimum lending rate fell to 6½% in the New Year.

DCE and sterling M₃



[a] Too small to be shown separately in July-October 1976.

[b] Mid-months.

months as their rates became less competitive. In January, certificates began to be surrendered to meet tax payments. The private sector also continued to run down its holdings of Treasury bills; though net purchases of national savings rose.

The decision, at the end of October, to let sterling float more freely reduced the contribution of external finance to sterling M₃ between November and January by about half, compared with the previous three months. Moreover, the latest three-monthly figure includes the effects of the heavy foreign exchange intervention in the second half of October. Nevertheless, some external inflows have continued. The influence of such flows on sterling M₃ was explained in some detail in the December 1977 *Bulletin*, page 427. If there were no official intervention at all in foreign exchange markets, a current account surplus would have to be offset by a capital account deficit of the same size, but this would not necessarily mean that transactions which tended to increase the private sector's money balances and those which reduced them would completely balance out. Broadly speaking, the current account surplus together with any capital flows into the private sector (other than banks) will initially tend to increase sterling M₃. In the third and fourth quarters of 1977, the current account surplus was some £150 million a month, and, since November, there appear to have been some continuing capital inflows into the private sector, with outflows from the banking and public sectors. Thus external inflows have still—though to a much smaller extent than earlier—been adding to the expansionary pressures on sterling M₃. In so far, however, as desired holdings of sterling M₃ are determined by nominal income and by the level and structure of interest rates, the ultimate effects of external inflows on the monetary aggregates will depend on how far the current account surplus and private sector capital inflows affect interest rates and incomes.

Although the exchange rate has no longer been held down at a fixed level, a degree of intervention has continued in order to maintain the orderliness of the foreign exchange markets. This has involved both purchases and sales of dollars, but the scale of speculative offerings of dollars was such that over the January banking month the purchases quite substantially exceeded sales. Moreover, the external finance of the public sector was affected by foreign currency swaps. Short-term swaps were at times carried out to even out surpluses and deficits in the sterling money market; such swaps can be expected to have their counterpart almost entirely in overseas sterling deposits and the banks' net foreign currency position. In addition, there were maturing longer-term swaps from previous operations, which had been arranged to meet heavy end-year government foreign payments. Such swaps, especially short-dated ones, are unlikely to have a large effect on sterling M₃.

Output: real GNP/GDP

Output in many countries grew more slowly last year than governments had expected.

Percentage change: seasonally adjusted, annual rates

	1976		1977					
	Fore-cast[a]	Out-turn	Fore-cast[a]	Outturn	1st qtr	2nd qtr	3rd qtr	4th qtr
	Year	Year	Year	Year				
United States	6.2	6.0	5.2	4.9	7.5	6.2	5.1	4.0
Canada	5.3	4.9	3.7	2.6[b]	6.7	-1.0	5.2	3.2
Japan [c]	5.7	5.7	6.7	5.0[d]	10.9	7.0	2.0	..
France	4.7	5.2	4.8	3.1[d]	8.3	-5.1	0.8	..
Italy	2.0	5.6	2.0	1.9[d]	7.4	-9.8	-2.4	..
Western Germany	5.0	5.7	5.0	2.5[b]	3.8	-0.8	-0.4	5.2[b]
United Kingdom	2.4	2.1	2.5	-0.1[b]	-3.5	1.1	-0.7	0.7[b]

.. not available.

[a] Official forecasts at the beginning of each year.

[b] Provisional.

[c] Annual figures for fiscal years to March.

[d] Bank estimates.

The international background

Economic growth in the industrialised world remained sluggish throughout 1977, with output in many countries rising much more slowly than had been expected (see table).

In the United States, almost alone, growth was substantial. Although the rise in real GNP slackened further in the fourth quarter, to an annual rate of 4.0%, final demand was strong. It owed most to personal consumption (even though the saving ratio rose further): employment was expanding at a fair pace, and real personal incomes rose sharply. Business investment remained weak. In Japan, GNP growth fell to an annual rate of 2% in the third quarter and was probably not much faster in the fourth. The main impetus came once more from government spending, but this did not spark off a revival in private demand. Consumption grew only very slowly, and private investment fell. The foreign balance continued to contribute to growth, with imports falling and exports rising. In

Current account balances

Major imbalances within the OECD area persisted to the end of 1977.

\$ billions: seasonally adjusted, annual rates

	1976		1977		
	1st half	2nd half	1st half	3rd qtr	4th qtr[a]
United States	2.0	-4.9	-17.5	-17.2	-19.2
Canada	-4.8	-3.7	-4.6	-4.4	-2.8
Japan	5.3	2.0	10.1	10.8	12.4
France	-3.5	-8.5	-3.9	-1.7	-1.0
Italy	-3.5	-2.2	-0.2	3.2	0.8
Western Germany	4.6	2.1	4.3	-2.0	7.2
United Kingdom	-1.5	-2.4	-3.0	3.4	2.5
Other OECD	-13.1	-20.9	-19.7	-20.0[a]	
OECD	-14.5	-38.5	-34.5	-27.9[a]	
Oil-exporting countries [b]	29.2	45.4	33.6	34.8[a]	
Other developing countries	-11.1	-8.8	-9.3	-17.6[a]	

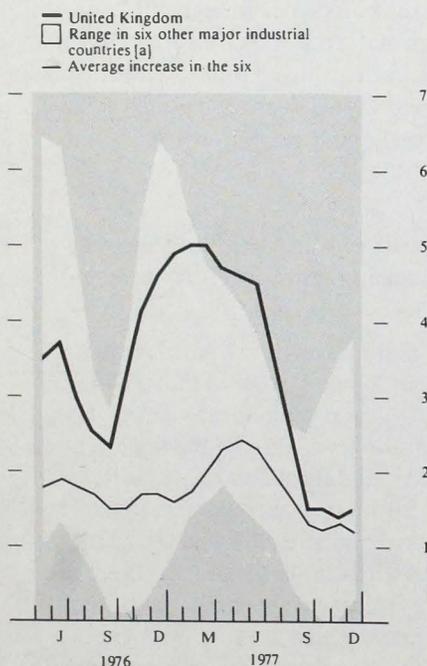
[a] Estimated.

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

Consumer prices in the main OECD countries

The decline in the average rate of price inflation halted towards the end of 1977.

Percentage increase in latest three months on previous three



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

Europe, there were some signs of revived demand towards the end of the year in Western Germany.

The volume of total OECD trade seems to have risen little in 1977. Trade among OECD countries may actually have fallen, but exports to the non-oil developing countries and to OPEC countries appear to have increased. Imports from OPEC countries fell sharply in the first half of 1977 but picked up a little in the third quarter: there was probably some stockbuilding of oil in advance of the OPEC conference in December. Non-oil developing countries' exports have fallen markedly since the first quarter, and their trade balance with the OECD has since deteriorated sharply. The large US deficit and the large Japanese surplus on trade and current account persisted through the year (see table).

The US trade deficit widened further in the fourth quarter, with a deterioration in volume terms. Despite a decline in the dollar and falling prices of agricultural exports, the terms of trade changed little. Japanese export volume rose in the third quarter but levelled off in the fourth. Despite weak domestic demand, import volume rose. In Europe, the increase in West German import volume apparently benefited French exporters among others. Special factors [1] pushed the West German current account into deficit in the third quarter for the first time in five years, but there was a surplus once more in the fourth. The Italian current account improved markedly in the first nine months of 1977, with low domestic demand coupled with destocking. The gain in Italian competitiveness brought about by the fall in the lira in 1976 will also have helped, although this has since been considerably eroded.

The size of the Japanese trade and current account surpluses in 1977 put increasing upward pressure on the yen, which appreciated in effective terms over the year by 20%. With the US trade and current accounts expected to remain in large deficit, pressure on the dollar became particularly severe in December, causing the Administration and the Federal Reserve to shift their policy in January and to intervene more actively in the foreign exchange markets and raise short-term interest rates to protect the currency. In Western Germany in December interest rates were lowered and selective controls on capital inflows imposed in an attempt to hold down the exchange rate.

OPEC oil production rose only slightly in 1977. The low level of activity in the OECD as a whole depressed demand for oil, and increased alternative supplies began to be available from the North Sea and Alaska. The OPEC surplus remained around \$8 billion in the third quarter and is likely to have totalled some \$34 billion in 1977 as a whole. It is becoming increasingly concentrated in a small number of countries with a low capacity to absorb imports. Some high-absorbing countries are already in deficit, and more may become so this year.

The non-oil developing countries' export receipts were boosted early in 1977 by the surge in the prices of tea, coffee and cocoa, but subsequently these fell away and, with a fall in the volume of their exports, export receipts declined. The volume of their imports, however, rose quite sharply, and the aggregate trade and current account deficits of the developing countries widened during 1977 and, for the year as a whole, are likely to have been greater than in 1976.

The rate of increase of consumer prices in the major countries generally slackened until late 1977 (see chart). The relative performance of the major countries has changed during 1977, reflecting in part their exchange rate experience. Those countries where inflation improved relative to the average—the United Kingdom, Japan and

[1] In particular, a change in the regulations relating to the finance of overseas subsidiaries.

Italy—had stronger currencies than before. The continued strength of the deutschemark also helped to keep the rate of inflation in Western Germany lower than in other major countries (although the margin did not increase much).

The prospects that the world economy will grow faster this year than last are not good. In the United States, the Administration have proposed a package of tax cuts worth \$24.5 billion and hope to obtain growth of 4½%–5% in each of the next two years. Fiscal policy as a whole may, however, not be very stimulatory, as a large part of the tax cuts will simply go to offset higher social security contributions and fiscal drag. Consumption may rise more slowly than in 1977. Rising interest rates may also eventually deter investment, particularly housing. The most likely prospect is for rather slower growth this year than last. The Japanese Government have set a 7% growth target for the fiscal year ending in March 1979, and have introduced a moderately stimulatory Budget in support. The outlook for private and particularly business spending is however doubtful. In Western Germany, the authorities have expressed unwillingness to take any further stimulatory action until later in 1978. Their forecast is for higher GDP growth in 1978 than 1977 (3½% against 2½%) but for no significant reduction in unemployment. Even this forecast is said to be at risk if the deutschemark appreciates further. Although some other countries in Europe may expand faster in 1978, many continue to have balance of payments constraints, and there is a limit to what they can achieve on their own. Altogether, it seems unlikely that growth in the OECD area as a whole will be much faster than in 1977 (3½%); with slightly faster growth in the open economies of Europe, world trade may grow faster this year than last.