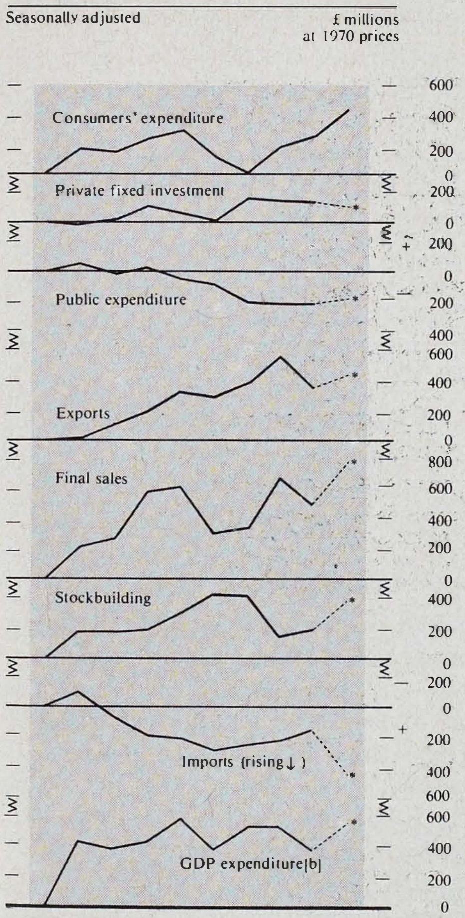
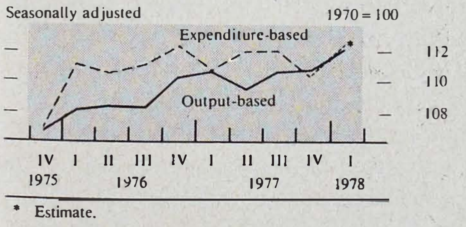
Economic commentary

Changes in components of GDP [a]

Despite a large increase in imports, GDP rose by about 1% in the first quarter.



Indices of GDP



* Estimate.

[a] Changes are since the fourth quarter of 1975, at factor cost.

[b] After factor cost adjustment.

Introduction

Since the beginning of this year there has been a pronounced change in the pattern of developments in the economy. Last year saw a rapidly improving financial position — a huge swing of the current account into surplus and upward pressure on the exchange rate — but stagnant output and rising unemployment. This year there has been growing evidence of a pick-up in demand and output, but financial conditions have become less settled — there was a current account deficit in the first quarter, and the exchange rate has fallen back.

The adverse swing in market sentiment this year is in contrast to the marked optimism which prevailed for much of 1977. Monetary and exchange rate developments undoubtedly played a part in this swing, but the most obvious and immediate cause was the large and unexpected current account deficit in the first quarter, which cast doubt on previous expectations of a substantial current account surplus this year and next.

The first quarter current account deficit of about £$\frac{1}{4}$ billion (compared with surpluses of about £$\frac{1}{2}$ billion in each of the previous two quarters) is analysed in more detail on page 162. It seems likely that it was something of an aberration. Exports held up well, despite the continuing sluggishness of world trade. But imports rose by 11%, principally food and industrial materials.

The first quarter deficit may owe something to the rise in the exchange rate last year, and perhaps to expectations that it would fall again; at the same time, it must have been a factor behind the fall in the rate which actually took place. Between the end of January, when the rate peaked, and the end of May the effective rate fell by 7$\frac{1}{2}$% to 61.4 — roughly the same as it had been a year earlier.

At the beginning of this year, it was expected that the growth of sterling M_3 would be contained within or close to the 9%–13% target for the financial year, despite the acceleration towards the end of 1977. In the event, these hopes were dashed by quite a large margin; revisions to the earlier months' seasonally-adjusted figures, and higher government borrowing combined with an unsettled market for gilt-edged, resulted in sterling M_3 growth of 16$\frac{1}{4}$% in the twelve months to mid-April. In response to this growing evidence of excessive monetary growth, minimum lending rate was raised by 1% to 7$\frac{1}{2}$% in the Budget, and to 9% in two stages in the first half of May.

The PSBR in 1977/78 is now estimated to have been £5.6 billion, nearly £3 billion below the original estimate, despite additional expansionary measures during the year. The 1977/78 outturn represented a substantial fiscal tightening (see page 161). The April Budget did something to offset this, mainly through personal tax reductions, and was estimated to increase the 1978/79 PSBR by some £2 billion (£2.5 billion in a full financial year) to an estimated £8.5 billion. Government expenditure on goods and services, which declined in real terms throughout 1977, has now levelled off and, on present plans, will begin to grow again this year.

However, consumer spending rather than government expenditure is the main influence behind the expansion in demand which is taking place this year. Consumption has been growing strongly since the middle of last year, under the influence of tax cuts and of earnings increases well above the growth in prices. The signs are that consumption will continue to rise fairly strongly. In the first quarter, the other significant positive influence on demand was stockbuilding (see page 157). Investment intentions remain surprisingly buoyant, in view of the level of output.

Output apparently grew quite strongly in the first quarter, with a rise of about 1%. Industrial production rose as well although it is still below previous historical peaks, and capacity utilisation is still undoubtedly very low (see page 158). But, despite continuing high unemployment, there are some shortages of skilled labour. Retail prices rose by little more than ½% a month in the nine months to March, with the result that there has been a steady reduction in the twelve-month increase in the index, to less than 8% in April; the prospect is that it will fluctuate around this level until the end of this year, given the recent fall in the exchange rate and the acceleration in earnings (see page 156).

Whether the present recovery of demand can be sustained depends in large part on whether there is a response of domestic output to the undoubtedly rapid growth in consumer spending that is occurring this year. In the past, such an expansion has tended to be frustrated by the tendency for most of the increase in demand to be met from imports, and for domestic production to respond only slowly.

The uncertainties surrounding any forecast at this stage in the cycle are inevitably very great. But on the basis of recent Bank projections, GDP growth of 3% per annum appears likely during the next one–two years. The current account surplus forecast at the time of the Budget would be broadly consistent with this.

The factors behind the erosion of earlier confidence, and their bearing on future developments in the real economy, are discussed in the assessment on page 168.

Consumption: the first phase of recovery [1]

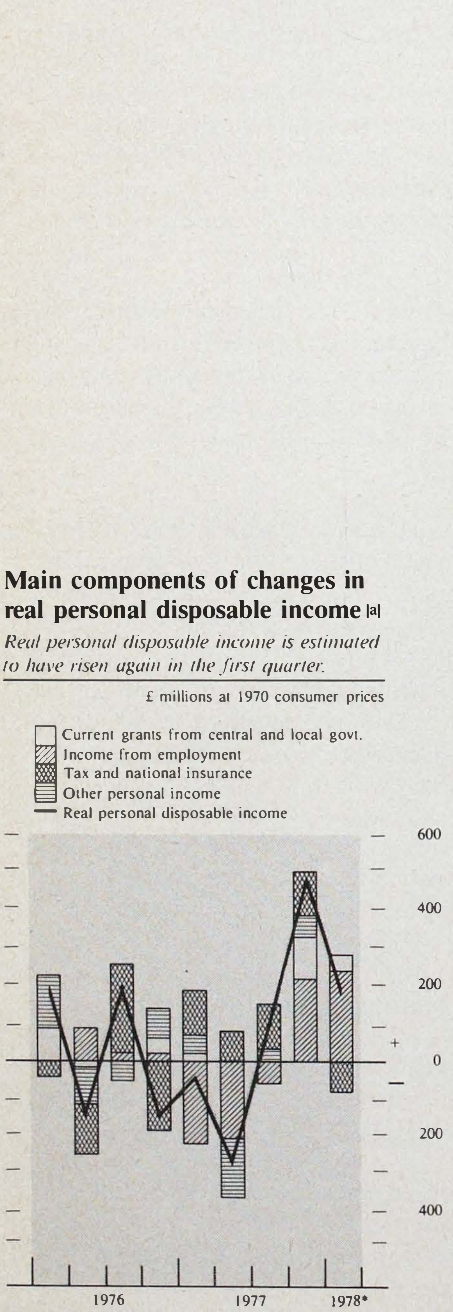
Consumer spending has been rising strongly since the middle of last year. There was a 2% rise in the first quarter, and the indications are that consumption will continue to grow throughout the year. Almost half of the increase in the first quarter was accounted for by greater spending on durable goods, which rose by 10%, largely reflecting a rise in car sales. Spending on alcoholic drink and on fuel and light also rose. The volume of retail trade in April, although slightly lower than in March, was nevertheless higher than the average for the first quarter.

The increase in consumer spending in the first quarter was not unexpected, since the sharp increase in real incomes, stemming partly from last October's measures, came too late to be fully reflected in spending in the fourth quarter, and some carry-over was therefore inevitable. Real incomes have continued to rise (see chart). Real income from employment rose by almost 2½% in the fourth quarter after three consecutive quarterly falls, and, with earnings continuing to rise faster than prices in recent months, will have risen again in the first quarter. The real tax burden fell throughout 1977 as a result of the series of budgetary measures. There was a particularly sharp fall in the fourth quarter when the tax rebates announced in October were paid. While the tax burden is likely to have increased again in the first quarter, real personal disposable income is nevertheless expected to have risen, although by much less than the exceptional 5% in the previous quarter. The saving ratio which was a record 16.2% in the fourth quarter, is likely to have fallen in the first quarter, but only slightly.

Looking ahead, real incomes and spending should continue to increase in the coming months: for earnings continue to grow faster than prices; and the Budget tax cuts and increased child benefits—although initially offset by a reduction in child allowances—are of themselves expected to add some 2% to personal disposable income in the current financial year. Any reduction in the saving ratio from its present very high level would also add to the growth of consumption; however, it seems quite likely that individuals will take the opportunity to rebuild their stocks of liquid assets which, in real terms, have been depleted during the past five years. Taking

Main components of changes in real personal disposable income [a]

Real personal disposable income is estimated to have risen again in the first quarter.



* Estimated.

[a] Components are sometimes too small to be shown separately.

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

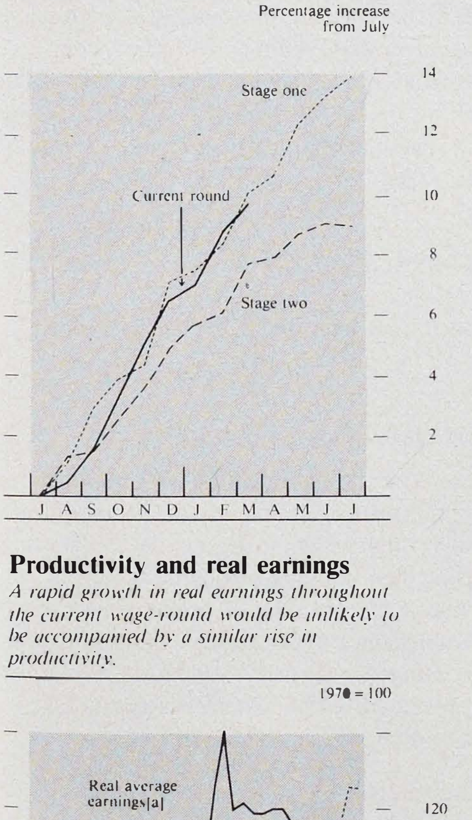
all these factors into account, there is the prospect of a rise in consumer spending of perhaps 5%–6% during 1978.

Settlements lag but appear within guidelines

The Department of Employment reports that, by mid-May, about two thirds of the employees expected to be covered by major settlements monitored by the Department during the current wage round had settled. Some 98% are reported to have accepted increases consistent with the guidelines. By the same date last year about 80% of such employees had settled. This implies a substantial number of pay rises (some back-dated) to come through in the next few months. However, monitored settlements cover only about half of total employees and contain a high proportion of public sector settlements. The extent of the backlog may therefore be overstated if those not covered by monitoring (but perhaps included in the average earnings figures) are settling at the same time as last year.

Average earnings and pay policies

So far in the current wage-round, earnings have risen about as rapidly as in stage one.

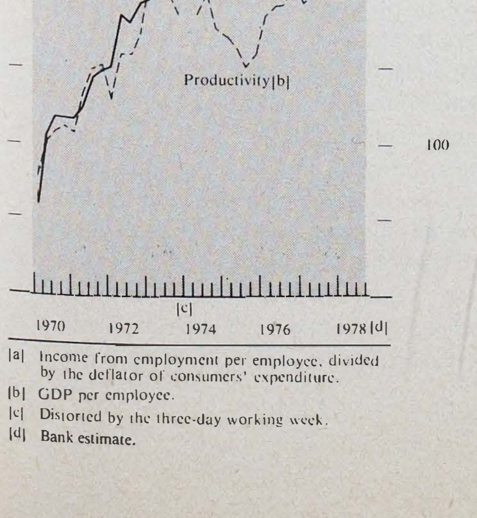


Earnings accelerate

In the eight months from July to March, the index of average earnings (old series, seasonally adjusted) rose by 9.7%. This rapid rise—about the same as in the corresponding period of stage one (see chart)—coupled with the much lower rate of price increase after earlier wage restraint and the appreciation of the exchange rate, represent an increase of 5¼% in real average earnings. It seems likely that real earnings will increase further during the rest of this pay round. The second chart shows that real average employment incomes moved more or less in line with productivity in the early 1970s. The relationship broke down during the period of rapid inflation between 1973 and mid-1976 but was almost restored after stage two. During the current wage round, the growth of real wages appears to be moving ahead of that of productivity once again. The present pay guidelines provide for an average increase in earnings of 10% plus any addition attributable to self-financing productivity schemes. Productivity schemes, reported to benefit about one worker in eight (but on some anecdotal evidence covering a higher proportion), and main settlements might, together, be expected to raise the increase in earnings to about 11%–12%. However, on the basis of eight months' figures, the overall increase in the current pay round seems likely to be a little higher than this. The excess may turn out to be less than in the previous stages of pay policy (about 3% in stage one and 4½% in stage two) because of somewhat greater flexibility in the basic provisions of the current round. The very rapid recent growth of real earnings could also reduce drift.

Productivity and real earnings

A rapid growth in real earnings throughout the current wage-round would be unlikely to be accompanied by a similar rise in productivity.



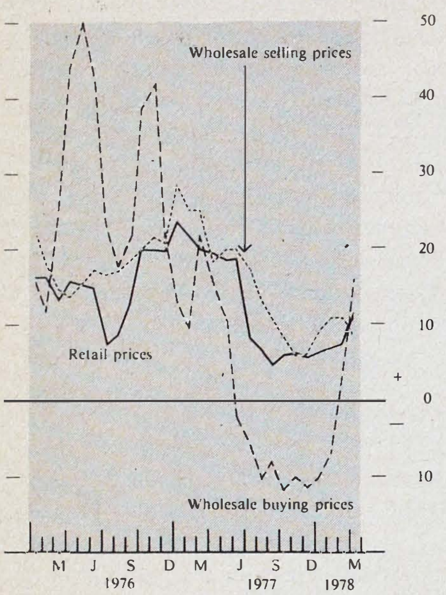
[a] Income from employment per employee, divided by the deflator of consumers' expenditure.
[b] GDP per employee.
[c] Distorted by the three-day working week.
[d] Bank estimate.

A factor which may be restraining earnings growth in this pay round, but at the expense of faster earnings growth subsequently, has been the introduction within the public sector of phased pay awards (and commitments to reduce hours of work) as a way of meeting claims outside the guidelines. To date such awards have been agreed with several groups of public sector employees guaranteeing increases of up to a further 20% (over two–three years) over and above 'normal' settlements in those years, in addition to a 10% pay rise in this round.

Because the older index of average earnings concentrates heavily on production industries, where the opportunities to introduce self-financing productivity schemes may be greatest, it may overstate the increase in earnings in the economy as a whole. The new index of average earnings, which cannot yet be seasonally adjusted, is much more representative. The increase over the previous twelve months in this index was 10.1% in March, compared with 11.0% for the 'old' index. This difference may reflect some of the influences noted above, together with the greater weight in the new index of groups with settlements due later in the round.

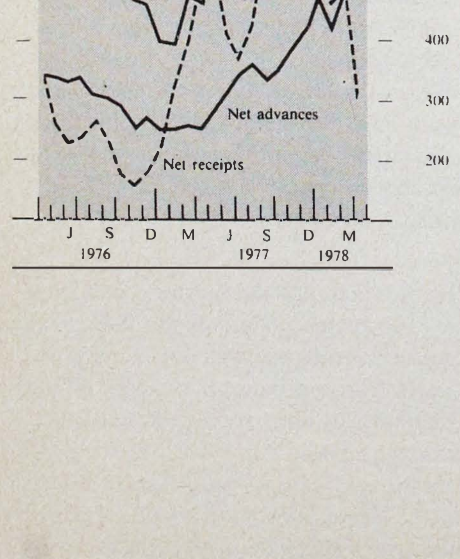
Wholesale and retail prices

The rate of increase of retail prices has turned up slightly in recent months.



Building society funds

New commitments have fallen less sharply than net receipts.



The falling pace of inflation

The inflation rate has fallen sharply over the past year. After increasing rapidly until mid-1977, the retail price index rose by less than ½% a month during the second half of the year, mainly reflecting the favourable trend of materials prices and the reduction in wage inflation. This brought the twelve-month increase down from 17.7% in June to 12.1% in December. Although the monthly increases this year have been slightly higher, they have remained well below those of the corresponding period last year, so that the twelve-month increase has continued to fall, reaching 7.9% in April. Increases in earnings and import prices in the early part of 1978 suggest that the recent rate of monthly price increases may be maintained until later in the year, implying that the twelve-month increase may, after falling a little further, edge up in subsequent months.

Manufacturers' wholesale buying prices, which had fallen by 7½% during the preceding ten months, began to rise again in March. The rise largely reflected the weakening of the exchange rate this year. The appreciation of sterling during 1977 had a favourable effect on raw material costs, which could only be sustained if the higher exchange rate were maintained. Movements in the exchange rate quickly affect buying prices, and feed through to manufacturers' selling prices after about four–five months on average. In addition, manufacturers may respond to both higher sterling export selling prices (which are in part determined by world prices for similar goods) and higher prices of competing products by widening margins on home sales.

The recent fall in the exchange rate (about 7½%) on its own may, after about a year, directly add about 2% to wholesale prices but rather less to consumer prices—partly because of lags but partly also because consumers' expenditure is less import-intensive than manufacturing output.

Building societies and housebuilding [1]

Inflows into the building societies were very high in the last three quarters of 1977 and the first quarter of this year. Consequently, the societies were able to expand their lending to an unprecedented degree (see chart) while still, for the most part, increasing their liquidity substantially. When, towards the end of 1977, the rate of growth of house prices began to accelerate, there was considerable concern that a price explosion might develop. As the acceleration continued in the early months of this year, the Government concluded that preventive action was necessary and asked the societies to cut back their lending.

Since then, lending for house purchase has fallen, but still remains very high. Early fears of a price explosion have not been realised, but the rise in prices has brought forward demand and helped contribute to a very active housing market.

The movement in prices has been most apparent amongst new houses, and it also appears to be a regional phenomenon, with the most marked increases in London and the South-East. Overall, new house prices [2] are estimated to have risen by just under 5% in the first quarter, compared with just over 3% in the previous three months; with the increase in builders' costs moderating throughout last year, this will have gone some way towards restoring the profitability of housebuilding. However, the recovery in private sector housebuilding, which began in the second quarter of last year, far from taking off, appears rather to be slowing down. Starts, although up by 9% in the second half of last year, were little higher in the fourth quarter than in the second, and rose no further in the first three months of this year. Completions, too, were only 6% higher than at the start of the recovery. The reasons for the evident lack of builders'

[1] This section is in seasonally-adjusted terms.
[2] At mortgage approval stage.

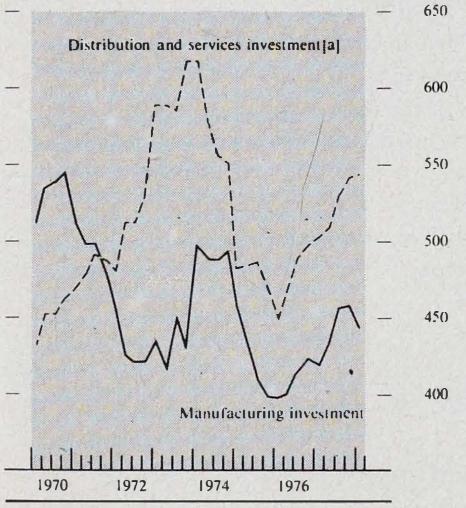
confidence are not clear; it may be that a longer period of improved profitability will be needed to overcome the caution resulting from the prolonged recession. There has too been widespread concern over the cost and availability of building land; and the recent upturn in interest rates, which will already have added to builders' costs, has led to a sharp reduction in building society receipts. With the public sector still subject to strict controls on expenditure, it seems likely that any further recovery in housebuilding this year will remain modest.

Industrial investment still rising [1]

The pick-up in investment last year was stronger than the preliminary estimates indicated. Revised figures [2] show an increase of nearly 8% for manufacturing industry and 9½% for the distribution and services sector, excluding shipping (see chart). After allowing for the sharp fall in investment by the steel industry—most of which is within the public sector—the rise in private manufacturing investment was nearly 15%. Furthermore, manufacturing industry made substantially greater use of leased assets last year. These are recorded as investment by the original purchaser (generally within the distribution and services sector). Thus, investment for manufacturing may have risen more—and in distribution and services less—than the reported figures suggest.

Industrial investment
Industrial investment has recovered over the last two years.

Seasonally adjusted £ millions at 1970 prices



[a] Excluding shipping.

The comparative buoyancy of investment is somewhat surprising in view of the weakness of demand and an apparently substantial margin of spare capacity (see below). Several factors may have helped to sustain investment. First, the recovery in financial confidence in early 1977 seems to have been accompanied by some improvement in business confidence. Secondly, last year's improvement in companies' financial position may have encouraged some firms to go ahead with projects deferred in the previous three years. In the second half of 1977, profits (net of stock appreciation) of industrial and commercial companies outside the North Sea sector were nearly 30% higher than a year before. Cash flow rose by some 20% over the same period, and liquidity improved markedly.

There was a pause in the recovery of investment at the turn of the year, but the June Department of Industry investment intentions survey (pointing to increases of 10%–13% in manufacturing investment and 6%–8% for distribution and services investment in 1978) suggests a resumption of growth on a significant scale during the remainder of this year. It is hard to reconcile such intentions with the generally pessimistic view of economic prospects reported in the latest Confederation of British Industry survey, and the outcome may, especially for manufacturing, be less buoyant. But the improvement in home engineering orders since the middle of last year is consistent with growth in investment this year. The company sector's financial position is likely to weaken during the year, as accelerating costs erode profit margins. This may have little effect on investment in 1978, but could well depress it in 1979.

A resumption of stockbuilding [1]

After some destocking in the latter part of 1977, stockbuilding was quite strong in the first quarter (£175 million by manufacturers and distributors). Expectations of rising demand and of some weakening of the exchange rate, together with improving company liquidity, may have contributed to a wish to increase stocks. But since stocks were already high in relation to the level of economic activity, there may have been some unplanned stockbuilding as well. Some at least of the increase in stocks was reflected in the sharp rise in imports in the first quarter.

[1] Investment and stockbuilding figures are seasonally adjusted and at constant (1970) prices.
[2] The revisions arise mainly from the introduction of new price deflators for investment in buildings.

A revival of industrial output

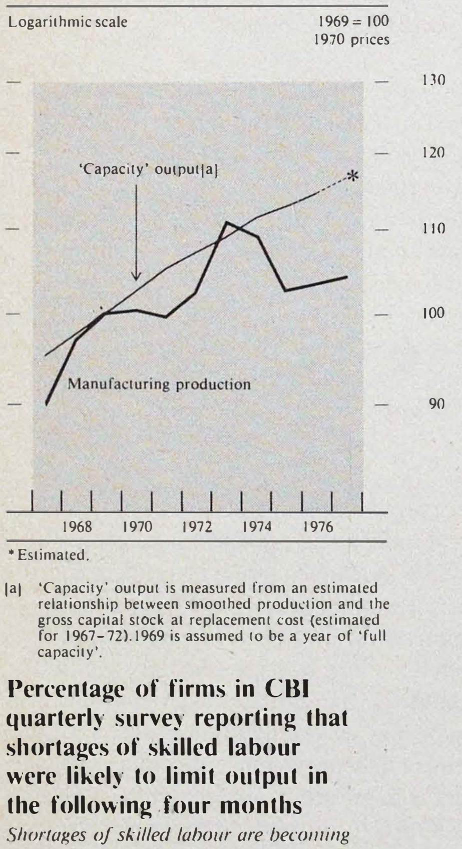
Output rose quite sharply in the first quarter of 1978. The preliminary output estimate of GDP (the most reliable indicator of short-term developments in the level of activity) rose by 1.2% in the first quarter, and is 1½% higher than the average for 1977. This increase in one quarter compares with growth of 1.6% in the whole of 1977, although the forthcoming rebasing of the national accounts using 1975 prices is likely to add something to this figure.[1] The rate of growth of output is forecast to be slightly slower in the remaining quarters of the year, before picking up again in 1979.

Industrial output rose by 1.7% in the first quarter from the depressed level of the fourth quarter of last year. A large part of the improvement was due to increased energy production—partly no doubt because of the cold weather in the first two months of the year, and partly because of an increase in the production of North Sea oil. Manufacturing production rose by just over 1% in the first quarter, a much larger rise than recent industrial surveys had suggested. This is one of the first indications of a response in activity to the growth of demand.

The increase in consumers' demand for manufactured goods in the first quarter was accompanied by rises in imports and in stocks. Domestic production remained flat. However, with continuing growth of consumer spending, and the improvement in price-competitiveness associated with the recent decline in the exchange rate, production of consumer goods is expected to rise. Production of investment and intermediate goods is expected to continue rising, and there should be an overall increase in manufacturing production in the remainder of 1978.

Manufacturing output and capacity

There has been substantial spare capacity in manufacturing industry since 1975.



* Estimated.

[a] 'Capacity' output is measured from an estimated relationship between smoothed production and the gross capital stock at replacement cost (estimated for 1967–72). 1969 is assumed to be a year of 'full capacity'.

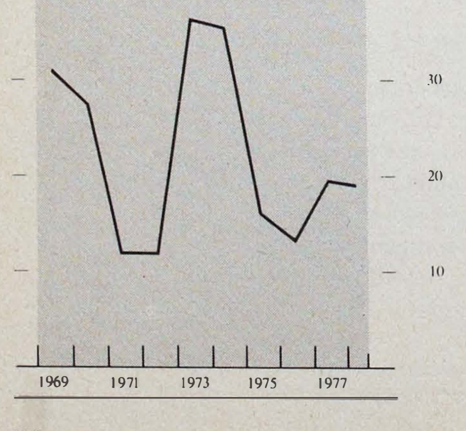
How much spare capacity?

Despite the recent improvement, manufacturing production is still only 3.9% higher than the average for 1970. Since capital investment has continued, it is clear that many firms have ample spare, if sometimes outdated, capacity—a view supported by recent industrial surveys.

A common way of gauging the degree of capacity utilisation has been simply to compare actual output with an assumed trend rate of increase in capacity, based on actual output growth over several years; this in turn might be expected to bear a simple relationship to the growth of the capital stock. In the period 1967–72, manufacturers' capital stock is estimated to have increased at about 3½% a year. If this growth had continued at the same rate, the capital stock would have risen by 19% in the next five years, which, assuming the same relationship between output and capital as in 1967–72, would suggest a 13% increase in capacity. However, investment was depressed for much of this period, and the growth in the capital stock [2] is estimated to have been only 12% (see chart), implying a growth of capacity of less than 9%. In the event, manufacturing production grew by only 2% in this period, suggesting that capacity utilisation, in aggregate, fell substantially (although obviously the extent of capacity utilisation will vary from industry to industry). Thus it seems that capacity constraints on manufacturing activity are unlikely to emerge, at least in the short term. Shortages of some types of skilled labour may, however, be a problem (see below).

Percentage of firms in CBI quarterly survey reporting that shortages of skilled labour were likely to limit output in the following four months

Shortages of skilled labour are becoming more widespread.



The shortage of skilled labour

Recent reports by the Confederation of British Industry and the Bank's own industrial contacts have mentioned the difficulties confronting some manufacturing firms in recruiting suitable skilled labour. The paradox of labour shortage in a period of high unemployment, if true, raises some important questions for manpower and incomes policies and indicates the need for vigilance if damaging supply bottlenecks are to be avoided.

[1] This rebasing gives more weight to the growth of North Sea oil production and may add about 1% to the growth of GDP between 1975 and 1977 (see *Economic Trends*, March 1978, page 110).

[2] Assuming no change in the rate of scrapping.

In their April survey, the CBI reported that 20% of respondents in manufacturing industry gave shortages of skilled labour as a factor likely to limit their output in the coming four months. This level is small in relation to reports received in 1973 and 1974, but is already significantly higher than during 1975 and 1976.

Taken in isolation this comparison does not provide conclusive evidence of serious shortages. Skills are, by definition, relatively scarce. Nevertheless, with manufacturing production in recent months still around 7% below its 1973 peak and unemployment around 450,000 higher than its 1972 peak, it is disturbing that shortages should be reported with such regularity.

A more meaningful measure of the acuteness, as opposed to the spread, of labour shortage is given by the ratio of vacancies to registered unemployment. The table shows this ratio for a selection of skilled engineering occupations over recent cycles. In virtually all occupations, the ratio was higher in December 1977 than two years earlier, despite a fall in engineering output. Of greater significance, however, is that for half of the occupations the ratio is already higher than in December 1972 when unemployment was little more than half what it is at present and when output was growing rapidly.

The ratio of vacancies to registered unemployment for a selection of engineering occupations [a]

Classification	1969 Dec.	1971 Dec.	1973 Dec.	1975 Dec.	1977 Dec.
Moulders and moulder/coremakers	5.80	0.28	3.74	0.17	0.43
Electroplaters	0.92	0.15	1.59	0.12	0.22
Press and machine tool setters and setter operators	3.94	0.20	5.40	0.32	1.07
Machine tool operators	0.95	0.08	2.14	0.07	0.23
Tool makers, tool fitters and markers out	4.08	0.14	3.88	0.27	1.20
Metal working production fitter-machinists	..	..	1.10	0.17	0.39
Maintenance fitters of plant and industrial machinery	0.80	0.14	1.34	0.15	0.39
Electricians (installation and maintenance of plant and machinery)	..	..	1.76	0.19	0.36
Sheet metal workers	1.94	0.30	3.84	0.30	0.67
Welders (skilled)	0.46	0.05	1.02	0.13	0.11
Coach and vehicle body builders/makers	1.10	0.26	3.51	0.55	0.73
Maintenance and installation fitters (mechanical and electrical)	..	..	2.16	0.40	0.49
Output of engineering and related industries, fourth quarter of (1970 = 100)	100.7	97.8	108.3	99.6	98.8

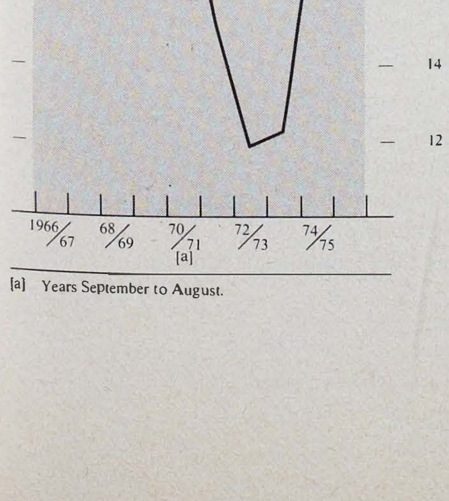
Source: British Labour Statistics (Department of Employment)

.. not available.

[a] The ratio of unfilled vacancies notified to employment offices to registered male unemployment.

Completion of first-year apprenticeships in engineering

Apprentice recruitment was very small between 1971 and 1973.



[a] Years September to August.

Some reports have attributed the emerging shortages to growing disillusionment amongst craftsmen, prompted by the erosion of pay differentials since 1972, which may have led some workers at least temporarily into new areas of employment unrelated to their skill. The available evidence, however, suggests that while the erosion of differentials may be important, it is only one of a number of factors contributing to recent developments.

In particular, surveys conducted by the National Economic Development Office amongst skilled engineers have suggested that lack of job prospects and fear of recurring redundancy were major reasons prompting workers to leave the industry. Employment in the mechanical, electrical and instrument engineering industries, where craftsmen are relatively highly concentrated, is amongst the most volatile of all employment categories: it fell by 8½% between its peak in mid-1974 and the end of 1976, and the size and speed of this fall may have led many skilled workers into new occupations.

Another important constraint on the supply of craftsmen, at present, results from the exceptionally low level of apprentice recruitment between 1971 and 1973 (due partly to the recession but also associated with the raising of the school-leaving age to sixteen in 1972). Although recruitment has subsequently recovered, its effect upon the stock of qualified craftsmen is now at its height and will only partly be alleviated by the improved flow of newly-qualified craftsmen expected this year.

Whether or not shortages of craftsmen will lead to supply bottlenecks is still, of course, open to doubt. Output, in general, remains well below plant capacity, and current indications are that the coming twelve months will be a period of only moderate growth. Nevertheless, the evidence for serious shortages of some key craftsmen is growing, and these could inhibit growth in some parts of the engineering industry over the next year.

The decline in unemployment

Recorded unemployment continues to fall much faster than the state of the economy might suggest. Historically, it has taken output growth of about 3% per annum to absorb increases in productivity and in the size of the labour force without an increase in unemployment. Moveover, after periods of stagnation, there has usually been a substantial delay before unemployment responds to a pick-up in activity. Yet since September, the number of unemployed on the register has fallen by an average of more than 8,500 a month seasonally adjusted, despite stagnant output throughout 1977. In the year ending last December, employment grew by only 28,000, well under a quarter of the estimated increase in the labour force, and between September and December, employment actually fell by 10,000. Around the turn of the year, employment began to increase once again in the manufacturing sector at least. It is doubtful, however, whether the increase since then has been sufficient both to absorb the growth in the labour force and to bring about the recent falls in unemployment. The underlying trend in unemployment may well be flatter than the recorded figures suggest.

The last issue of this *Bulletin* suggested that problems of seasonal adjustment, resulting from an uneven growth in the labour force, were partly responsible for these developments. If this proves to be the case, it will not be confirmed until June and July, when this growth is most highly concentrated.

It is interesting, however, that there has been remarkable stability in the unemployment rates of many overseas countries as well as of the United Kingdom, despite comparatively low rates of growth of output (see table). While comparison of unemployment rates between countries is very difficult, it does seem that the UK experience has been paralleled in a number of the other major economies. As in the United Kingdom, part of the explanation may lie with the expansion and implementation of temporary measures to support employment; but even in the United States, where output has continued to grow quite fast, the rate of unemployment has fallen further than might have been expected.

Unemployment rates [a]

Percentage of civilian labour force, *seasonally adjusted*

	1976	1977				1978
	Year	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
United States	7.7	7.4	7.1	6.9	6.6	6.2
Canada	7.1	7.9	8.0	8.2	8.4	8.4
Japan	2.0	1.9	2.0	2.1	2.1	2.1
France	4.3	4.3	4.8	5.1	4.7	4.7
Italy [c]	..	6.8	6.6	7.7	7.4	7.1[b]
Western Germany	4.6	4.4	4.6	4.6	4.5	4.5
Netherlands	5.4	4.9	5.2	5.6	5.4	5.0
Belgium [c]	5.8	6.5	6.3	6.4	7.1	7.2
United Kingdom	5.3	5.6	5.6	5.9	6.0	5.9

.. not available.

[a] Unemployment rates are not comparable between countries.

[b] New series from 1977.

[c] Not seasonally adjusted.

Public spending at a turning point [1]

Public spending fell in 1977, but will rise in 1978. General government [2] final consumption changed very little last year, but is thought to have increased in the first quarter of this year as some departments sought to catch up on underspending earlier in the financial year. Final consumption is projected to grow by about 1½% between the first quarter of 1978 and the first quarter of 1979.

Public sector fixed investment fell sharply in the second quarter of 1977 and slightly in the third; thereafter it was little changed; over 1977/78 as a whole it is estimated to have fallen by about 14%. It is expected to rise by about 4% during 1978/79.

Shortfall in public expenditure [3]

The *Financial Statement and Budget Report* (FSBR) suggests a shortfall in public expenditure in 1977/78 of some £1.3 billion over and above that shown in January's White Paper (*The Government's expenditure plans, 1978/79 to 1981/82*, Cmnd. 7049). An approximate breakdown of the shortfall in 1977/78 is shown in the table.

Spending on programmes (i.e. excluding debt interest) in 1977/78 is now thought to have been about 6½% below the 1977 White Paper (Cmnd. 6721) provision for programmes and contingency reserve, or about 3% below if net lending and other financial transactions are excluded.

A shortfall of £2 billion is assumed in the FSBR forecast for 1978/79, comprising £1.5 billion on current and capital spending on goods, services, grants and subsidies (similar to the shortfall in 1977/78) and £0.5 billion on net lending and other financial transactions. This implies a real increase over 1977/78 in spending on public expenditure programmes of some 7%, or 3% if net lending and other financial transactions are excluded.

Shortfall in public expenditure

£ millions at 1977 survey prices

	Differences from plans in 1977/78
Estimated in Cmnd. 7049 [a]	
Current expenditure:	
Goods and services	− 300
Subsidies and grants	− 450
Capital expenditure:	
Goods, services and grants	− 300
Net lending to nationalised industries and some other public corporations	− 500
Other net lending and capital transactions	− 800
Added in FSBR	
Current and capital expenditure on goods, services grants and subsidies	− 550
Net lending and financial transactions	− 800
Total	**−3,700**

[a] Allocations of the contingency reserve have been added to the appropriate categories.

[1] This section is in National Accounts terms, constant (1970) prices, seasonally adjusted.

[2] Central government *plus* local authorities.

[3] This section is expressed in 1977 survey prices.

The PSBR in 1977/78 [1]

The public sector borrowing requirement (PSBR) in 1977/78 was estimated at £5.7 billion in the FSBR published at the time of the 1978 Budget [2]—£1.8 billion below the forecast published six months previously. Receipts of taxes on income (including corporation tax) and national insurance contributions exceeded the March 1977 forecast by some £0.4 billion (even after tax reliefs of £1 billion in the October package) and the trading surpluses of public corporations were also £0.4 billion higher than forecast.

On the expenditure side, current spending on goods, services, grants and subsidies fell short of the March 1977 forecast by some £0.2 billion; capital spending by general government and by public corporations fell short by some £0.2 billion and £0.5 billion respectively. To some extent, these figures reflect unexpected movements in prices; the shortfall in public expenditure in real terms is discussed above. Net lending abroad fell by some £0.8 billion, principally because there was less government refinancing of export credit, largely as a result of the changed arrangements with the banks. [3]

The Budget

The principal Budget proposals were tax cuts estimated to cost almost £2 billion in 1978/79 and £2.5 billion in a full year. Personal allowances were increased at a cost of £450 million in 1978/79, and a new lower rate tax band was introduced on the first £750 of taxable income, with higher rate band thresholds increased, at an estimated cost of £1,450 million in 1978/79. The other taxation proposals are not expected to have a significant impact on government revenue. Amendments providing further tax reductions have since been introduced by the Opposition during the debates on the Finance Bill; if enacted, these would reduce tax revenue by £445 million in 1978/79, but the Government are committed to not allowing the PSBR to exceed the £8.5 billion which was forecast in the Budget.

On the expenditure side, increases in pensions from November 1978, and in child benefit from April 1979, were announced; these had already been allowed for in January's public expenditure White Paper. A first instalment of the increase in child benefits will be paid from November 1978 from the contingency reserve. Other allocations of the contingency reserve for 1978/79 were also announced, and in all about three quarters of it has now been allocated. About £200 million (at 1977 survey prices) remains in the reserve, and the Chancellor has stated his intention that any additional expenditure in the remainder of the year will be met from this or from offsetting savings elsewhere.

Has fiscal policy been getting tighter?

Large Budget deficits in recent years, and the associated borrowing requirements, have given rise to the argument that fiscal policy has become too lax, and that a reduction in the size of the deficit should be a central aim of policy. Part, at least, of the deficit, has been a product of the recession. When the level of activity in the economy slackens, tax revenue is depressed because of slower-growing—or lower—incomes and profits, while expenditure rises with increasing payments of unemployment and other social security benefits. Once rates of taxes and benefits have been established, such variations in revenue and expenditure are automatic, requiring no further action by the Government, and tend to counteract variations in economic activity; hence they have been labelled 'automatic stabilisers'.

Attempts have been made to calculate what the Budget balance would have been if the effects of changes in the level of activity were removed, the result providing a measure of discretionary change in fiscal policy.

[1] This and subsequent sections are expressed in current prices unless indicated to the contrary.
[2] Since revised to £5.6 billion.
[3] See the March *Bulletin*, page 61.

There are definitional problems in identifying what changes are automatic, but a common approach has been to calculate the Budget balance at a constant rate of unemployment; the level of unemployment chosen is an arbitrary base and not a target. In practice, such a measure can best be calculated with the aid of an econometric model. Four recent attempts to measure a 'standardised budget balance' on different models (including a recent Bank estimate) are shown in the table. The changes from year to year reflect the extent of discretionary fiscal action as measured by this technique.

Estimates of standardised budget balances as a percentage of gross domestic product [a]

Calendar years: *changes in italics*

	1974		1975		1976		1977	Cumulative change
HM Treasury [b] [c]	−5.8	*−1.3*	−7.1	*+2.7*	−4.4	*+3.3*	−1.1	*+4.7*
National Institute for Economic and Social Research [b] [d]	−6.2	*+1.0*	−5.2	*+2.4*	−2.8	*+4.5*	+1.7	*+7.9*
Department of Applied Economics, Cambridge [b] [e]	−3.9	*−0.9*	−4.8	*+2.8*	−2.0	*+2.7*	+0.7	*+4.6*
Bank of England [e]	−6.1	*+1.7*	−4.4	*+2.5*	−1.9	*+3.8*	+1.9	*+8.0*
Outturn financial deficit as a percentage of GDP	−6.5	*−2.0*	−8.5	*+0.8*	−7.7	*+3.1*	−4.6	*+1.9*

[a] None of the estimates takes account of the measures announced in the Chancellor's statement of 26 October 1977.

[b] Source: N. Hartley and C. Bean, *The Standardised Budget Balance*, HM Treasury working paper No. 1, February 1978.

[c] Based on 3% unemployment.

[d] Based on 2.6% unemployment.

[e] Based on 2.5% unemployment.

The differences between these estimates illustrate the definitional and estimation problems involved, but the broad pattern has been similar. The Bank estimate implies that the fall in the level of activity over the period under consideration has, by the operation of 'automatic stabilisers', offset the contractionary nature of 'discretionary' fiscal policy by increasing the public sector financial deficit by 6.1% of GDP. It also shows the considerable extent by which 'discretionary' fiscal policy has tightened over the period.

Erratic trade figures

Recent monthly trade figures have been unusually erratic. There was a large deficit on visible trade in the first quarter, after modest surpluses in the previous two quarters (see table), and then an exceptionally large surplus in April. While fluctuations in the traditionally erratic items have been greater than usual and figures around the turn of the year may have been influenced by seasonal adjustment problems, the volatility of recent trade figures nevertheless poses considerable problems for interpretation and forecasting.

Current balance

£ millions: *seasonally adjusted*

	1977					1978
	Year	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Exports of goods	32,176	7,502	7,930	8,540	8,204	8,441
Imports of goods	33,788	8,449	8,694	8,486	8,159	9,015
Visible balance	− 1,612	− 947	764	+ 54	+ 45	− 574
of which, oil	*− 2,804*	*− 800*	*− 745*	*− 602*	*− 657*	*− 646*
Invisibles	+ 1,777	+ 451	+ 399	+ 483	+ 441	+ 269
Current balance	+ 165	− 493	− 365	+ 537	+ 486	− 305

In the first four months of 1978, the visible trade balance showed a deficit of over £¼ billion compared with a modest surplus in the previous four months. With the terms of trade improving on balance over this period, the balance of resources in goods declined.

Impact of the rise and fall in the exchange rate

The rise in the exchange rate in late 1977 and its subsequent fall will have exerted a range of diverse influences. Evidence suggests that manufactured export volumes are not influenced strongly by very recent changes in competitiveness; a short-lived variation in the exchange rate is unlikely to have any particularly sharp effect on export performance. The volume of manufactured imports is believed to react more quickly, however, and it is possible that some of the growth in these imports in the first quarter reflected a loss of UK competitiveness over the preceding months. In addition, import purchases may have been advanced in order to take advantage of what may have been judged to be a temporarily favourable exchange rate and also possibly in anticipation of dearer commodity prices: the sharp jump in imports of industrial materials in the first quarter and the subsequent fall in April are consistent with this hypothesis. Tending to offset these volume effects was the short-term impact on the terms of trade by which the higher exchange rate reduces import prices more than export prices.

The depressed world economy

The rate of growth of the OECD area slowed last year to only $3\frac{1}{2}$%, from $5\frac{1}{4}$% in 1976; indeed in the second half of the year, activity was growing at an annual rate of only 3%. Although there are slight signs of strengthening in underlying demand, it does not at present seem likely that growth this year will be any faster than last.

In the United States, real GNP fell marginally in the first quarter, partly as a result of exceptional weather and the miners' strike; activity has revived very sharply since the end of February, but the Administration have revised downwards their forecast for growth in 1978 to 4%–$4\frac{1}{2}$%. In Western Germany, although there was some acceleration in output growth in the last quarter of 1977 (attributable almost entirely to the external account), the underlying trend remains very weak; the latest forecast from the five economic institutes suggests that growth this year will be no faster than last ($2\frac{1}{2}$%). In France and Italy, however, output now appears to be recovering. In Japan, GNP growth in the fiscal year to March 1978 met the revised official target of 5.3%, and the outlook is now more promising than it seemed earlier in the year.

World trade and UK export markets even more depressed

The state of activity in most of the industrial economies has meant that world trade was particularly depressed last year, growing by only about $5\frac{1}{2}$%, against 12% in 1976. This was a much more abrupt slowdown than that of total output and cannot be fully explained; it certainly owed something to the fact that the growth of activity last year was heavily concentrated in the United States, and perhaps also to the quite widespread attempts in Europe to restrain the growth of imports. The latter was a significant factor in slowing down the growth of total UK export markets last year from $11\frac{3}{4}$% to about $5\frac{1}{4}$%; UK export markets for manufactured goods were even more depressed, growing by less than 4%. Even these low growth rates were bolstered by import demand from outside the OECD area (see table). The outlook for the growth of world trade this year is not very bright, though trade in manufactures may grow rather faster than last year. The volume of imports into Japan and the major European countries is likely to pick up slightly, but elsewhere, and particularly in the United States, imports will almost certainly grow more slowly. The smaller European countries have been particularly hard pressed recently. Many have been obliged to restrain domestic demand (and in some instances to devalue) to try to improve their external positions; they will almost certainly be cutting back further this year. The growth of OPEC imports is also likely to slow down quite markedly, as export receipts remain sluggish in the face of the continuing weak state of the oil market.

Growth of UK export markets

Percentage changes

	Volume growth of total imports into UK export markets	
	1976	1977
UK export markets		
United States	+18.5	+13.3
Canada	+ 7.2	+ 1.2
Japan	+11.5	+ 2.5
Western Germany	+16.6	+ 5.1
France	+19.9	+ 1.1
Italy	+15.2	− 0.4
Netherlands	+14.2	+ 3.6
Belgium	+10.7	+ 6.1
Other OECD Europe	+11.0	+ 2.3
Australia, New Zealand, South Africa	+ 1.6	− 5.1
OPEC	+11.5	+12.2
Less developed countries	+ 4.6	+ 6.8
Growth of UK export markets	+11.7	+ 5.2
Growth of UK export volume	+ 9.9	+ 8.2

Exports hold up

The volume [1] of UK exports of manufactures [2] rose by $1\frac{3}{4}$% in the first quarter. The volume of exports of machinery fell somewhat, but this was more than offset by gains in other areas, particularly metals and textiles. Manufactured exports remained buoyant in April, especially exports of road vehicles. Agricultural exports jumped in the first quarter and remained high in April, in part reflecting sales from stocks of cereals built up after last year's good harvest. Although production of North Sea oil was again held back by bad weather and technical delays, the volume of exports of oil was considerably higher than in the fourth quarter. With world oil prices weak and the pound relatively strong, however, there was only a small increase in value terms. In total the volume of exports of goods rose by 2% in the first quarter.

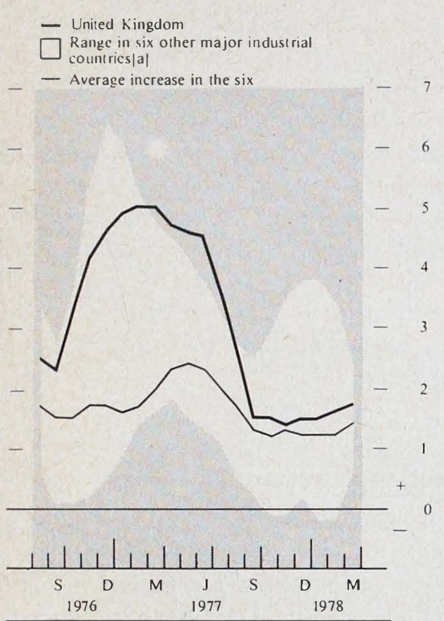
[1] The unit value/volume breakdown of the external trade statistics is based on 1975 trade flows.

[2] Excluding erratic items such as ships, aircraft, precious stones and North Sea production installations.

Consumer prices in the main OECD countries

The average rate of price inflation has remained fairly steady since late 1977.

Percentage increase in latest three months on previous three

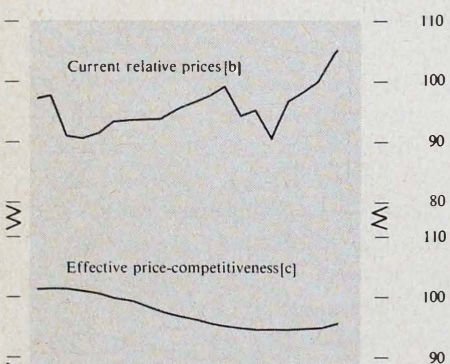


[a] United States, Canada, Japan, France, Italy and Western Germany.

Export competitiveness[a]

The deterioration in relative prices and costs since the end of 1976 has had only a limited impact so far on effective competitiveness.

1970 = 100



[a] A downward movement in a series indicates an improvement in competitiveness.

[b] Ratio of UK export prices of manufactures to those of competitor countries.

[c] Effective price-competitiveness is a weighted average of current and past relative export prices, the weights being derived from the relative price coefficients in an equation explaining the volume of manufactured exports.

[d] Ratio of UK unit labour costs to those of competitor countries: OECD series.

[e] As in [c] but with relative unit labour costs replacing relative export prices.

Competitiveness

Last year unit labour costs in nearly all of the major overseas economies rose noticeably faster than in 1976, largely as activity slowed down and employment either rose, especially in the United States, or did not fall much. This year industrial production in most countries is expected to grow at about the same rate as in 1977. However, earnings may rise no faster, or even more slowly (especially in Europe), and with little or no growth in employment expected, unit labour costs will probably rise less fast on average this year than last.

The improvement in the United Kingdom's relative inflation rate has been maintained (see chart). Rates of inflation in most of the major overseas countries have not increased much. In Western Germany and Japan, the year-on-year rate of consumer price increase is now at or below that of the average for the period 1960–70. The average rate of increase for the major six industrial countries has remained quite steady since last autumn; although it picked up in March, this may have been largely seasonal. However, in the United States there are indications that the underlying rate of price increase may have moved up towards 7%.

The charts show movements in UK export and import competitiveness as given, on the one hand, by measures of costs and prices in the current period, and on the other by the weighted impact of current and past changes in competitiveness—effective competitiveness. The squeeze on real incomes in the United Kingdom, relative to those abroad, in 1975 and 1976 had the effect of improving current cost competitiveness more than the corresponding price measure, and this differential has been maintained.

On the export side, the lags used in determining effective competitiveness are long and hence there is an important divergence between recent movements in effective cost and price competitiveness, with the former still improving but the latter now deteriorating.

On the import side, the lags are much shorter and there is less difference between recent movements in the effective measures. An article, on page 181, concludes that, in the past, relative costs have been superior to relative prices in explaining manufactured export volumes, but that there is less difference for imports.

Large imports of industrial materials

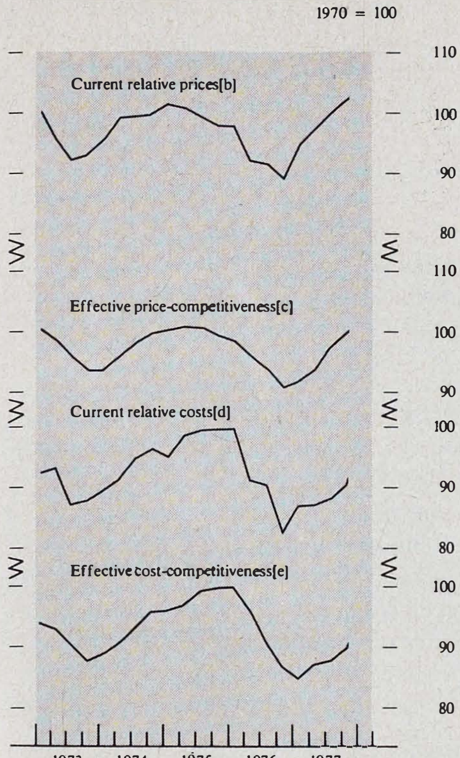
After the modest rise in the volume of UK imports in 1977 as a whole, there was a strong and, to some extent, unexpected surge of 11% in the first quarter of 1978. But in April import volume fell sharply. While it is perhaps too early to be confident of the reasons for the first quarter surge (especially in food and industrial materials), a number of hypotheses can be advanced. Towards the end of last year, food imports were unusually low, and the return to the more normal volumes of recent months is not, therefore, particularly disturbing. The increase in the volume of imports of industrial materials in the first quarter ($12\frac{1}{2}$% excluding erratic items) was particularly notable in chemicals and other semi-manufactures. It is possible that some of these imports were associated with the stockbuilding noted above. To the extent that some import orders were advanced in the expectation of an imminent fall in the exchange rate, this increase in imports is unlikely to be repeated and indeed should be reversed: this is consistent with the sharp fall in the volume of these imports in April.

Imports of finished manufactures

Imports of finished manufactures continued to grow strongly in the first quarter, with an increase in volume of 7% (excluding erratic items). As suggested in the March *Bulletin*, the slow rate of growth of the UK economy in the past appears to have made UK producers reluctant to expand output and accelerate investment until they have become confident about the durability of the recovery.

Import competitiveness[a]

Imports react faster than exports to price and cost movements, and the loss of competitiveness since the end of 1976 is being felt quite sharply.



[a] A downward movement in a series indicates an improvement in competitiveness.

[b] Ratio of UK prices of manufacturing output to import prices of finished manufactures.

[c] Effective price-competitiveness is a weighted average of current and past relative prices, the weights being derived from the relative price coefficients in an equation explaining the volume of imports of finished manufactures.

[d] Ratio of UK unit labour costs to those of competitor countries: OECD series.

[e] As in [c] but with relative unit labour costs replacing relative prices.

Moreover, the growth in demand for finished manufactured goods in prospect is very strong, and the growth in the volume of these imports may well exceed that experienced in 1977. But the recent fall in the exchange rate should reverse some of the loss of competitiveness experienced last year.

Turnround in the terms of trade

The merchandise terms of trade [1] rose throughout 1977, reflecting the higher rate of price inflation in this country than elsewhere and the appreciation of sterling. The UK inflation rate has now, however, become much closer to that of other countries, while sterling has recently depreciated. Thus the terms of trade, which increased from just under 100 at the beginning of 1977 to 105½ in January 1978, fell back to 104 in April. On a quarterly comparison, they increased at the beginning of 1978 but may well decline in the second quarter. While this would initially worsen the trade balance, the associated gains in competitiveness should improve the resource balance in due course.

Invisibles

The estimated net invisibles surplus in the first quarter, £270 million, was much smaller than that of fourth quarter, £440 million (revised).

A large part of this fall was due to a change in the arrangements for paying the UK contribution to the EEC, and a refund of part of the first quarter's payment is to be made in the second quarter; nevertheless in 1978 as a whole the UK contribution will be greater than in 1977 because the European Communities' budget is larger and the UK share higher. Furthermore, the private transfers deficit widened by some £40 million after last winter's relaxations of exchange control in respect of emigration. Another factor which has begun to impinge unfavourably on invisibles during the past year is the earning of profits by foreign companies operating in the North Sea. Despite this, and other adverse movements on both sides of the direct investment earnings account, the net surplus on interest, profits and dividends as a whole rose slightly, because the Government's position improved—largely through the increased return on the higher level of official reserves and lower payments of interest on official debt.

On the other hand, net earnings from services continued to underpin the invisibles account, with particular increases in the first quarter in the contributions made by commodity dealings, insurance and civil aviation.

Exchange rate and capital flows

In the first quarter, the current account (before seasonal adjustment) was in deficit by over £400 million. This deficit will have tended to exert downward pressure on the exchange rate, and the pressure may have been exacerbated by capital outflows in response to higher interest rates abroad. By definition, however, under conditions of floating a current account deficit must be matched by net capital inflows. In fact over the quarter, there was on balance a net inflow of some £600 million (including a balancing item—representing unidentified inflows—of over £550 million). The exchange rate remained fairly stable for much of the quarter, but fell in the latter part of March. For the most part, the authorities were content to allow it to find its own level, with only small amounts of intervention intended to prevent disruptive fluctuations. Such intervention was however needed to a much greater extent in April, when the recovery of the dollar put considerable pressure on sterling.

[1] Export unit value index as a percentage of the import unit value index.

Capital flows

£ millions: *not seasonally adjusted*

	1977				1978
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr
Current balance	**− 523**	**− 351**	**+ 351**	**+ 508**	**− 416**
Capital flows					
Official long-term capital	− 22	− 16	− 17	− 228	− 47
Overseas investment in UK public sector:					
Gilt-edged stocks	+ 350	+ 37	+ 246	+ 346	+ 51
Other	+ 148	+ 885	+ 43	+ 128	− 54
Exchange reserves in sterling:					
Countries	+ 197	− 430	+ 80	− 89	+ 147
International organisations	− 7	+ 32	− 6	+ 204	+ 13
Private sterling balances	+ 199	+ 350	+ 323	+ 599	− 59
Sterling claims of UK banks:					
UK export credit	− 58	− 184	+ 34	− 190	− 202
Other	+ 185	− 104	− 16	+ 49	− 249
UK banks' net external liabilities in foreign currencies	+ 421	− 706	+ 189	+ 416	+ 87
Other capital flows (including balancing item)	+1,023	+1,395	+1,201	+ 189	+ 902
Balance for official financing	**+1,913**	**+ 908**	**+2,608**	**+1,932**	**+ 173**

As the table shows, capital flows were varied but small, as indeed was the balance for official financing (£170 million). The official reserves fell by $237 million during the quarter in contrast to the massive increases in 1977. In addition to the balance for official financing, there were also, for the first time, net repayments of public sector borrowing under the exchange cover scheme ($450 million); these repayments represent an early reduction in some of the high-interest debt outstanding which would otherwise have matured in the 1980s. In April, the reserves fell by $3,282 million. There was an early repayment to the International Monetary Fund of $943 million, and further net repayments of public sector foreign currency loans amounting to $224 million; moreover, the authorities intervened more strongly in support of sterling, which fell by about 1% in effective terms during the month. Some support was also given in May, and the reserves fell by some $370 million despite receipt of the proceeds of the Government's $350 million bond issue in New York.

Monetary developments

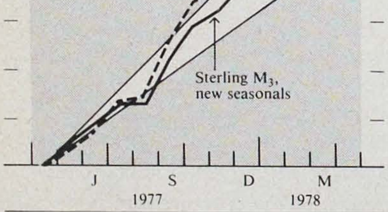
The months from January to May were a difficult period. Financial confidence, which had been particularly, and perhaps excessively, strong during 1977, became unsettled. Three factors contributed to weakening confidence: an apparent weakening of the current account position, worries over the future course of inflation and increasing unease over the trend of the monetary aggregates. The poor March trade figures announced in mid-April reinforced the worry over the balance of payments, and after the Budget market expectations of a further rise in interest rates began to build up. Moreover, it became apparent shortly afterwards that the growth of sterling M_3 in the last part of the financial year had been appreciably faster than had been expected beforehand. In the event, sterling M_3 in the year to mid-April rose by over 16%, compared with the target range of 9%–13% (see chart). This was as much of a disappointment to the authorities as to the markets. Although it was widely recognised that the rise in sterling M_3 in the month to mid-April was erratically and quite unexpectedly large, [1] markets reacted adversely, and both long and short-term yields rose sharply as the market became aware of the change in trend.

Monetary objectives

Revisions to the seasonal pattern now suggest a faster rate of growth in sterling M_3 towards the end of the target period.

Seasonally adjusted

Percentage change since mid-April 1977



Earlier in the spring there had been market worries about the future course of interest rates, but until mid-April there were also pointers against a marked upward adjustment. The dollar still seemed weak, so that a sharp rise in UK interest rates did not seem necessary for external reasons. Moreover, while there had undoubtedly been an acceleration in the rate of growth of sterling M_3 around the turn of the year, in subsequent months the rate of growth seemed to be still roughly in line with the top end of the target range. With the recovery in the real economy still very fragile, the authorities were naturally unwilling to see interest rates go higher than was essential.

By mid-April, however, it was evident that circumstances had changed: action was clearly necessary to get the growth of the money supply back onto trend. Moreover, the recovery of the dollar and the rise in US interest rates combined to give rise to quite large external outflows. An upward adjustment in interest rates become both necessary and desirable. Accordingly, minimum lending rate, which had been raised from $6\frac{1}{2}$% to $7\frac{1}{2}$% in the Budget, rose again, in two stages, to 9%. On 25th May, the Bank announced that minimum lending rate would, in future, be set by administrative action rather than by the formula normally used since October 1972. Although the formula had in general worked well, it had been found that a close automatic link with the Treasury bill rate could on occasion lead to undesirable erratic movements in interest rates; MLR will continue to be adjusted flexibily, taking account of market developments.

[1] An added factor was the annual revision of the seasonal adjustments which this year had the effect of sharply increasing the seasonally-adjusted rate of growth of sterling M_3 in the months after mid-December. An article on page 196 describes the process of seasonal adjustment in detail.

Sales of public sector debt in the period under review were not on the same scale as earlier in the financial year. The gilt-edged market was generally subdued, with the financial institutions on the whole preferring to stay liquid. [1] Moreover, towards the latter part of the period expectations that interest rates would have to rise became widespread. Even so, there were times when sentiment improved and the authorities were able to sell stock. Over the period, yields on long-dated stocks rose by about 1½%; yields on shorter-dated stocks rose by rather less. National savings securities remained competitive in yield and continued, as in the previous three months, to be purchased on a large scale. Certificates of tax deposit, however, which had contributed significantly to financing the Government's borrowing requirement during the autumn (when rates were especially favourable) were now partly run off as companies surrendered them to meet tax liabilities.

The effect on the money supply of weakening conditions in the gilt-edged market was aggravated by an increase, fully apparent only after the revision to seasonal patterns, in the central government borrowing requirement (CGBR). The CGBR was especially high in the month to mid-April, reflecting in part accelerated spending towards the end of the financial year in programmes covered by cash limits where unspent funds were available. Market borrowing by the rest of the public sector was also high in that month. In the first quarter, for the first time for four quarters, the CGBR exceeded net sales of central government debt.

DCE and the money stock M_3[a]

£ millions: *seasonally adjusted*: mid month

	Apr. 77– Apr. 78	Apr. 77– July 77	July 77– Oct. 77	Oct. 77– Jan. 78	Jan. 78– Apr. 78
Central government borrowing requirement	+4,603	+1,069	+ 88	+1,577	+1,869
Net purchases (−) of central government debt by non-bank private sector	−6,765	−1,694	−2,304	−1,719	−1,048
Other public sector [b]	+1,297	+ 247	+ 676	− 35	+ 409
Bank lending to:					
UK private sector [c]	+4,087	+ 969	+1,259	+ 726	+1,133
Overseas	+1,226	+ 158	+ 208	+ 225	+ 635
Domestic credit expansion	**+4,448**	**+ 749**	**− 73**	**+ 774**	**+2,998**
External foreign currency finance (increase −)	+2,740	+ 820	+1,523	+ 693	− 296
Other	− 592	− 549	− 126	+ 278	− 195
Sterling M_3	**+6,596**	**+1,020**	**+1,324**	**+1,745**	**+2,507**
Percentage change in sterling M_3	*+ 16.4*	*+ 2.5*	*+ 3.2*	*+ 4.1*	*+ 5.7*
M_1	**+4,533**	**+ 882**	**+1,470**	**+1,175**	**+1,006**
Percentage change in M_1	*+ 23.6*	*+ 4.6*	*+ 7.3*	*+ 5.5*	*+ 4.4*

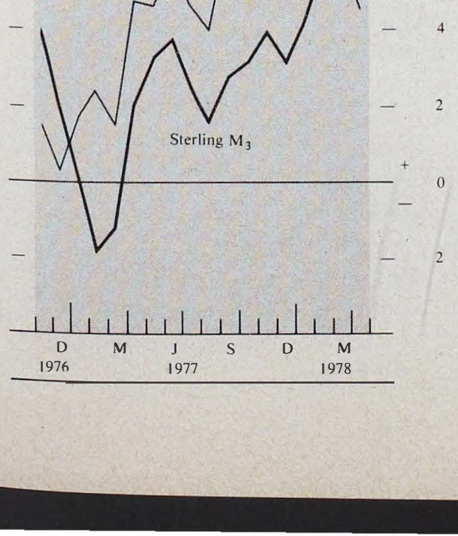
[a] Further details are shown in Table 11/3 in the statistical annex.

[b] Other public sector borrowing requirement, *less* purchases of other public sector debt by the private sector (other than banks).

[c] Including commercial bills held by the Issue Department of the Bank of England.

Money stock

In contrast to sterling M_3, M_1 has grown much less fast since the autumn.



In real terms bank lending grew by a moderate amount over the period, although some rise in lending might have been expected in any case as funds moved out of sterling, and companies and individuals came to take further account of lower interest rates. On the other hand, the improvement in corporate liquidity may have reduced companies' need to borrow. There seems to have been some increase in lending to manufacturing. Lending to agriculture, the professional and scientific category (which includes leasing companies and the motor trade) and to persons (other than for house purchase) has continued to be buoyant and, at the time of the Budget, the Bank repeated their qualitative guidance to banks on the direction of their lending. Bank lending in sterling to overseas also rose more rapidly in the three months to mid-April, partly because of the increased threshold for refinance of export credit, a factor that—in its influence on the monetary aggregates—will have been offset by lower public sector lending.

There was a much greater expansion of domestic credit alongside the acceleration in the rate of growth of sterling M_3 in the three months to mid-April. Indeed, in this period DCE amounted to £3.0 billion against a total for the year as a whole of some £4.4 billion (see table). [2]

External factors were a contractionary influence on sterling M_3 in this period. This was in sharp contrast to earlier in the year and reflected a move into deficit on current account, and substantial capital outflows in the month to mid-April.

In contrast to sterling M_3, the rate of growth both of narrower and probably of broader measures of liquidity fell back towards the end of the financial year. M_1, which had grown very fast in the latter part of 1977 after the steep fall in short-term interest rates, rose by 4½% in the three months to mid-April, rather less rapidly than sterling M_3. The recent increases in interest rates should serve to reduce the rate of growth of M_1 still further in the coming months. Similarly, it is likely that the rate of growth of broader measures of liquidity will also have slowed down in recent months. Statistical difficulties inhibit any very precise analysis of wider measures of liquidity but net inflows into building societies have fallen back sharply from the record figures in the fourth quarter of 1977.

[1] As can be seen, for instance, from the sectoral breakdown of sterling M_3 in Table 6.2 in the statistical annex.

[2] This still constituted not much more than half the limit agreed with the IMF in December 1976.

Assessment

The review of developments in the economy given in the commentary suggests that there are now signs of a beginning to faster growth. Though these have been slow to appear, there is little reason to doubt that some moderate expansion this year is in prospect. For such expansion to proceed successfully financial confidence needs to be maintained. In the period before the announcement of new monetary and fiscal measures on 8th June, the mood was notably less buoyant than at the turn of the year. It is important that recent swings in financial confidence should be seen in perspective, and the correct lessons drawn from them.

The change in mood in financial markets over recent months reflected a number of interacting developments: the poor trade figures for the first quarter; the periods of pressure on the exchange rate associated with the strengthening of the dollar; some aspects of the Budget proposals; the growth of sterling M_3 during the closing months of the last financial year; and underlying doubts about the future course of inflation. These are discussed in turn below.

After two quarters of surplus, the deficit on the current balance in the first quarter of 1978 came as a surprise and a disappointment. The reasons have already been discussed earlier in the commentary. Exports performed relatively well and were not below forecast. Nor was the trouble due, as might have been feared, to unexpectedly large imports of finished manufactures. The main cause was very large imports of food, not accompanied by any large increase in consumption; and of industrial materials — much more than could be simply associated with the increase in output. The likelihood is that stocks of industrial materials have been built up (see page 157); this should mean that in later months imports will be lower than they otherwise would have been.

This interpretation is, in degree, supported by the good trade figures for April. Though the poor performance in the first quarter must be considered as erratically bad, it is a reminder that concern for the balance of payments is not something — even with the benefit of North Sea oil — that can be put out of mind.

An article later in this *Bulletin* (page 181) suggests that UK competitiveness in export markets — and to a lesser extent also against imports in the domestic market — is best measured by comparing unit labour costs in this country with those in other countries. This seems to provide a better explanation of the course of exports than the more usual comparison of export prices. On such a comparison of relative labour costs, the United Kingdom still retains much of the improved competitiveness gained in 1976. It is clearly important that competitiveness should be maintained — and that it should be maintained not by further depreciation of the exchange rate, but by keeping cost increases very moderate.

It is rarely easy either to predict exchange rate movements over any short period, or fully to explain them after the event. To some considerable extent, however, the movement of sterling over the last eight months must have reflected, inversely, the earlier weakness and subsequent strengthening of the dollar. More generally, given the more optimistic climate prevailing in October, it is not surprising that the rate should have risen when the decision was made to allow the exchange rate to float more freely. Nor is it surprising that, in the general revision of expectations that occurred afterwards, there should subsequently have been a downward adjustment in the rate, which had by the end of March reversed the earlier rise. The downward impetus was then arrested, subsequent pressure on the rate having been cushioned by appreciable intervention at the end of March and in April.

Among other influences that must have affected the exchange rate, two call for further comment. First, short-term interest rates were low compared with international rates, and this gained importance when the dollar began to strengthen in March and when US interest rates began to rise. Between the beginning of April and the beginning of June, short-term interest rates in the United Kingdom had risen by some $2\frac{1}{2}$ percentage points.

A second factor that has been discussed in this context has been monetary expansion. In general, the pace of monetary expansion must affect the exchange rate. But, despite research efforts in the Bank and elsewhere, it is hard to establish a close-knit relationship between the exchange rate and the relative rate of monetary expansion here and abroad, of a sort which could explain recent changes in the exchange rate in these terms. The pace of monetary expansion this year, moreover, did not become fully apparent until May and only then gave rise to widespread concern. It thus seems unlikely to have played a major rôle in the weakening of confidence in sterling in March. Nevertheless, over the longer term, the evidence suggests that it can only be helpful for exchange rate stability that monetary expansion should be kept within the target range.

The original figures for banking February and March had given the authorities reason to believe that the growth of the money stock had come down after the high level in January; but the revised figures [1] for these months and the outturn for banking April now show this to have been far from the case. Recent developments carry an important lesson. Given the vagaries of the factors determining monetary growth — and in particular the erratic month-to-month behaviour of the public sector borrowing requirement — the acceleration of the growth of sterling M_3 in any particular month is unpredictable. But the rise in banking April would have been less damaging to confidence if the previous course of sterling M_3 had been at the middle rather than above the upper point of the target range. With the object of ensuring that the growth of sterling M_3 should be well within the target range set at the time of the Budget, minimum lending rate was increased to 10% on 8th June and the supplementary special deposits scheme was reactivated.

The importance of keeping due control of the monetary aggregates appeared all the greater in that the Budget in April had in the event some features which proved to be an additional cause for financial uncertainty. The case for giving a moderate fiscal stimulus to the economy, set out in the last issue of this *Bulletin*, had been generally accepted. But the forecast for the PSBR for this financial year was higher than had been expected, and there has since been uncertainty as to how far any shortfall in revenue resulting from Opposition amendments to the Budget proposals would have to be made good. In his Letter of Intent to the International Monetary Fund, the Chancellor reaffirmed his undertaking to keep the public sector borrowing requirement this year to the published forecast of £$8\frac{1}{2}$ billion. The increase in the National Insurance surcharge, announced on 8th June along with the accompanying monetary measures, was made to give effect to this commitment.

Fears of a new acceleration in wage inflation have been an underlying source of market uncertainties. Such a development is not impossible and the fear of its occurring cannot be demonstrated to be unreasonable. But in the summer before each of the previous three pay rounds, the continuance of wage moderation appeared uncertain. In fact, there is no reason to regard a renewed acceleration as inevitable. But there is need now for a very general and widespread understanding of the importance of reducing the rate of inflation further, and of what is required to do this, rather than allowing it to creep up again.

[1] The methods employed by the Bank in making the seasonal adjustments are described at length on page 196 of this *Bulle*

Very considerable progress has been made. The rate of inflation in this country is now almost in line with the average among the United Kingdom's competitors. However, this is clearly only a relative success, and other countries are now likely to give renewed priority to containing inflation. This year's increase in earnings, though in some respects moderate, is still quite large — and is resulting in a clearly abnormal increase in real incomes. As the Government have already made clear, a continuation of anything like this year's rate of increase in earnings would be quite incompatible with holding the rate of inflation next year or reducing it below this year's figures. This may not be fully appreciated: there seems need of much greater awareness that nothing like this year's increase can safely be repeated, and that a very marked and distinct fall in the rate of increase in wages is needed if the success of efforts so far is to be pressed home.

For the rest of this year, on the usual twelve-month comparison, retail prices may stand about 8% higher than last year, with small fluctuations around this level. The rise in prices next year could be well below 8%, if the rise in earnings also were below this 8% figure. To achieve this, the rise in wage rates would have to be somewhat lower still. There will have been a large increase in personal real income in the present pay round, with earnings going up far faster than prices; if the next rise in wage rates were kept to moderate dimensions, this would not be incompatible with a continued rise in real incomes next year.

If inflation could be reduced next year, there would be a good chance of continued moderate economic expansion over the next few years — as would be very desirable in the present state of the economy. How fast a rate can be sustained will depend in part on how fast expansion proceeds in the rest of the world. The importance of the proposals for collective action to be discussed at the meeting of Heads of State in July stems from this consideration.