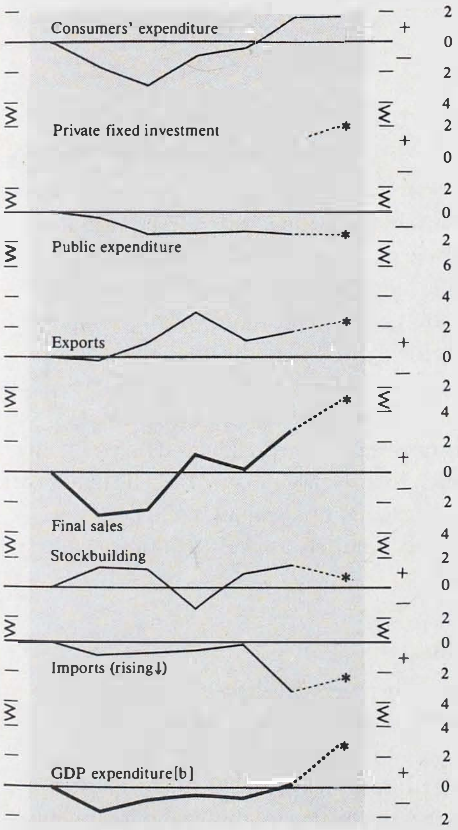
Economic commentary

Introduction

Throughout this year there has been growing evidence of an expansion of economic activity, but it remains rather subdued. After some deterioration earlier in the year, financial conditions have improved since the measures of 8th June. The rate of inflation has changed little in recent months.

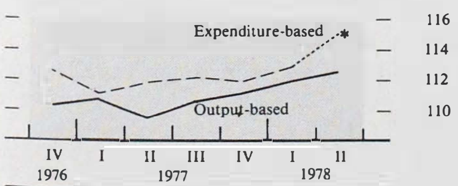
Changes in components of GDP[a]

Seasonally adjusted £ billions at 1970 prices



Indices of GDP

Seasonally adjusted 1970 = 100



* Bank estimate.
[a] Changes since the fourth quarter of 1976.
[b] At factor cost.

The main ingredients of the recovery over the last year have been evident for some time and are indicated in the chart. After two quarters of contraction, consumer spending has risen fast since the middle of last year and in the second quarter it was 5% higher in real terms than a year earlier. An unusually rapid increase in real personal disposable income—the result of earnings rising more than twice as fast as prices, augmented by tax cuts—has been responsible (see page 334). For a time this sharp expansion of demand was not reflected in much increase in output, because of much reduced stockbuilding and an interruption in the growth of exports.

But output rose by nearly 1% in the first quarter of 1978, accompanied by substantial stockbuilding and a surge in imports which put the current account back into deficit. Stockbuilding was also heavy in the second quarter, despite slightly slower growth in output, indicating the possibility of some overstocking. But the remaining components of demand are all on an upward trend, suggesting a continued rise in final sales during the rest of the year.

As the June *Bulletin* suggested (page 164), imports of industrial materials fell back in the second quarter from the unexpectedly high level of the first, but not by much. With imports of finished manufactures continuing to rise by more than 5% a quarter, the current account deficit of the first quarter was not quite offset by a £200 million surplus in the second. A modest surplus remains in prospect for the second half of the year, but with exports growing only slowly in the face of slow growth in UK export markets (see page 342), this will require that the proportion of demand met from domestic production does not fall any further. The recent appreciation in the effective exchange rate (now 3% above the level of mid-1977) has resulted in some gain in the price competitiveness of imports, but effective export competitiveness is still relatively favourable (see page 343).

These developments underline the importance of what happens to wages. During stage three, earnings appear to have risen by nearly 15%, restoring gross pay, in real terms, to the level of two years earlier. This has impeded the improvement in corporate profitability, which is still low (see page 338). This in turn limits the scope for further improvement in the rate of inflation in coming months, despite the recent favourable trend in raw materials prices. Retail prices rose in the year to June by only $7\frac{1}{2}$% —the smallest increase for more than five years. The corresponding figure for July was slightly higher and the rate seems likely to edge up a little during the rest of the year, but acceptance of the Government's pay guidelines (see page 335) would permit a reduction next year.

Recent financial developments have been broadly in line with the objectives set for this financial year. There were substantial sales of government stocks after the fiscal and monetary measures announced on 8th June, with the result that in the first three months of the current 'target' year, growth in sterling M_3 was at the lower end of the 8% – 12% target range. Domestic credit expansion and the public sector borrowing requirement in this period were also consistent with the limits agreed with the International Monetary Fund.

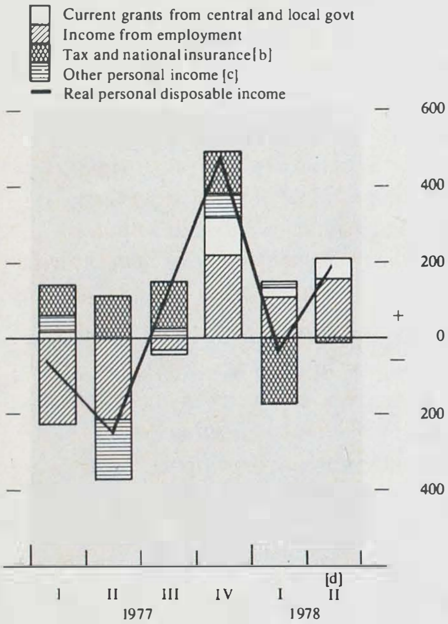
Real incomes rise

The growth in consumption, which is now well established and is the foundation of the current expansion of the economy, is the result of the

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

All the major components of income have risen since the second quarter of last year, while real tax and national insurance payments were little changed.

£ millions at 1970 consumer prices

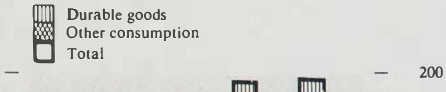


[a] Components are on occasion too small to be shown separately.
[b] Increase (–)/decrease (+). Higher tax and national insurance contributions reduce personal disposable income.
[c] Self-employment income and rent, dividends and net interest.
[d] Bank estimate.

Changes in components of consumption

Spending on durables, although accounting on average for only 10% of total consumption, contributed two fifths of the increase in the year ending June 1978.

£ millions at 1970 prices
change from previous quarter



unusually rapid rise in real personal disposable incomes over the past year. In the second quarter of this year, real disposable incomes were 7½% higher than a year earlier. Real tax payments fell, but much more important so far has been the rise in pre-tax incomes: [1] all the major components of income rose in real terms (see chart).

The prospect for the rest of this year is for continued growth in real incomes, at much the same rate. Although price inflation may pick up slightly in the second half, bringing a slower growth in real earnings, the announced 1978 Budget measures, by further reducing the tax burden and increasing child benefits, will provide a considerable boost to real disposable incomes, particularly in the third and fourth quarters when most of the changes become effective and rebates are paid.

The surge in consumption [2]

After a rise of 2% in the first quarter, the volume of consumers' expenditure rose by less than ¼% in the second, but the evidence suggests that the underlying growth is strong. [3]

Over the year to mid-1978, consumer spending rose by 5½% in real terms compared with a fall of 2% in the previous year. Spending on durable goods rose by 24%, while other consumption rose by less than 4%. Although spending on durables is much the more volatile component of consumption, it only accounts for about 10% of the total, so that changes in the volume of other consumption are just as important in determining changes in the total volume of consumption (see chart). Much of the growth in spending on durables was accounted for by greater spending on motor vehicles, which rose by more than 40%. The major part of this increase came in the first quarter of this year after real personal disposable income had risen sharply—largely as a result of the payment of tax rebates towards the end of 1977.

Fluctuation in the savings ratio

The erratic pattern of tax payments in recent quarters [4] has led to considerable fluctuations in real disposable incomes. With consumers' expenditure following a rather smoother path, the savings ratio has fluctuated from quarter to quarter. It rose sharply in the fourth quarter of 1977 to over 16%, fell to 14% in the first quarter of this year but probably rose sharply again in the second quarter. Tax rebates payable in the third and fourth quarters will tend to keep the ratio up, because of the usual lag between an increase in incomes and its effect on consumption. The continuing rise in real incomes should, however, increasingly be reflected in consumer confidence.

Earnings accelerate

Although the 10% guideline was intended as the ceiling for the increase in average earnings during stage three rather than as an entitlement for everyone, few settlements have been below this figure; and the actual increase in earnings was much greater than in the previous stage of pay policy. In the eleven months from July 1977, the older index of average earnings[5] rose by over 16½% and the new index [6] by 14½% (with about ¾% and 1¼% respectively of these figures explained by back

[1] Personal disposable income in the second quarter was £4 billion higher than a year earlier. Tax cuts during 1977 were probably worth about £¾ billion a quarter; nearly half of this could be regarded as compensation for inflation during the previous year, so that real tax cuts accounted for a relatively small proportion of the rise in real personal disposable incomes. However, the absence of indexation of specific indirect taxes contributed to some of the rise in real personal disposable incomes by restraining the rise in retail prices.

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

[3] The small rise in the second quarter contrasts strangely with the 1½% increase in retail sales over the same period. The main reason for the discrepancy is that spending on food, drink and tobacco, the major component of consumer spending, is estimated to have fallen by 1¼% in the second quarter, while food retail sales rose by around 1½%. Moreover, while retail sales of durable goods rose by 3% in the second quarter, total durables consumption fell by 1% because of reduced spending on vehicles.

[4] Resulting from the timing of the implementation of various tax changes.

[5] Seasonally adjusted.

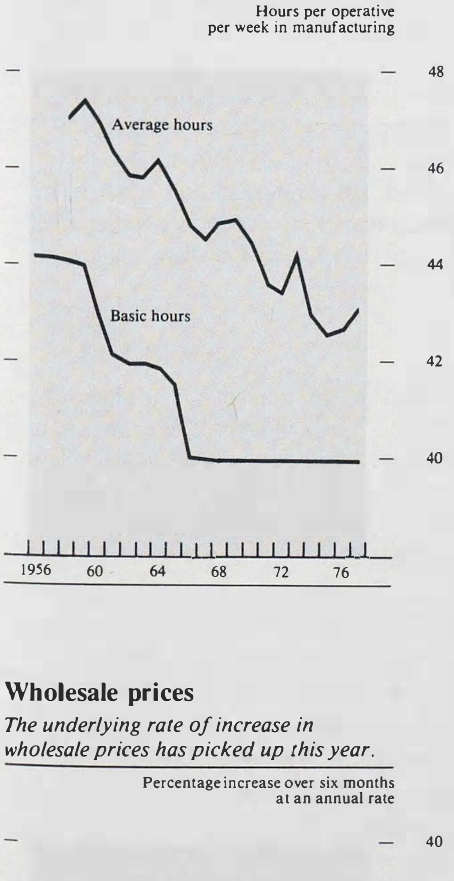
[6] Not seasonally adjusted. The difference between the old and the new index figures for average earnings may well persist even when the indices for July 1978 are available. This is because the old index concentrates heavily on production industries, where there is more scope for productivity agreements to lift earnings than elsewhere, whereas the new index gives much more weight to the non-trading public sector, where pay policy can be enforced more rigidly.

pay received in June). To some extent, the increase in excess of 10% reflects self-financing productivity schemes, allowable under the stage three guideline. But the growth of productivity since July 1977 has been less than this 'excess' rise in earnings: in both manufacturing and elsewhere in the economy, output per head has grown in this period by only about 1½%.

The rapid increase in nominal earnings, together with the moderate rise in prices, has resulted in gross real earnings over the year to June rising by 7½% (new index), enough to recoup all but 1% of the previous year's fall.

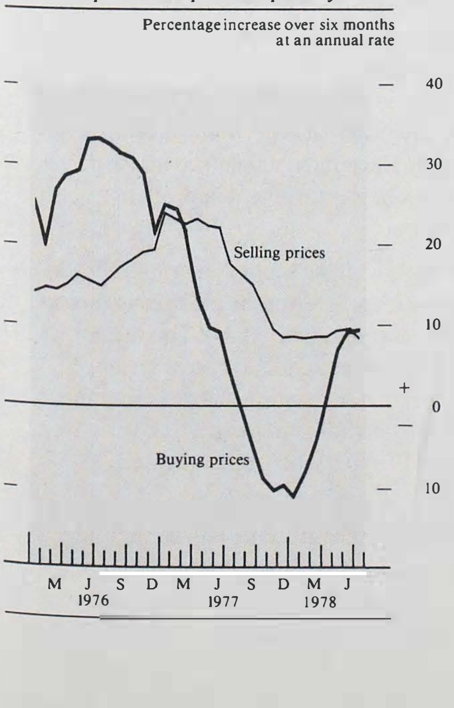
Average and basic hours, UK manufacturing

The basic working week has stayed at around forty hours for more than a decade but average hours have continued to fall.



Wholesale prices

The underlying rate of increase in wholesale prices has picked up this year.



The earnings outlook

Recent developments might reasonably be expected to favour the substantial reduction in the rate of increase in earnings required if the rate of inflation is to be brought down further (see the June *Bulletin,* page 170). Inflation is now much lower than at the outset of stage three, and real post-tax incomes have grown very strongly in the past year. Both these factors are recognised in the Government's guidelines for earnings during the current round. [1] The guidelines provide for an average increase of 5%, although larger rises would be allowable, for part of a group, for example to adjust differentials, provided that the increase for the group concerned as a whole was within the overall limit. The guidelines also provide for increases of more than 5% for the lowest-paid. [2] As in stage three, payments under productivity schemes will be permitted, provided that they meet specific conditions designed to ensure that they do not result in any increase in unit costs.

Reduction in the working week

A similar proviso applies to cuts in normal hours of work, implying that the cost of such reductions should be fully offset either by increases in earnings of less than 5% or by increased output per man-hour. The length of the basic working week for workers in manufacturing (fixed by collective agreement etc.) has remained almost unchanged at forty hours during the last decade (see chart). Nevertheless, *average* total hours of work per worker have, except for cyclical fluctuations, fallen steadily.

Wholesale prices rising faster

Manufacturers' buying prices rose by 4¾% between January and July, partly as a result of sterling's depreciation in the early part of the year. But, despite this, buying prices were 1¼% lower in July than they had been a year earlier. Buying prices have been restrained by the weakness of the US dollar, in particular through the effect on oil prices (which are fixed in dollars). Nevertheless, the increase over six months earlier, expressed at an annual rate, which is a better guide to changes in trend than the rise over twelve months, has picked up considerably in recent months (see chart).

The rate of increase of wholesale selling prices has also turned up this year, but not so markedly. The underlying rate of increase of selling prices may edge up further in the next few months, as the effects of earlier increases in the prices of materials and the faster rise of earnings feed through. But the recent strength of sterling should ensure that the upward pressure from materials costs, at least, will be short-lived.

Retail prices edge up

The rate of increase of retail prices has risen slightly under pressure from the much more rapid growth of unit labour costs since the end of stage two and the pick-up in unit import costs this year. The month-to-month rise in prices, which averaged under ½% in the latter half of 1977, has been running at nearly ¾% this year. Despite this slight acceleration, the increase over twelve months has fallen considerably, dropping to 7.4% in June, less than half what it had been a year earlier. In July, however, the

[1] See the White Paper, *Winning the battle against inflation,* Cmnd. 7293.

[2] Those earning no more than £44.50 for a normal full-time week after the increase.

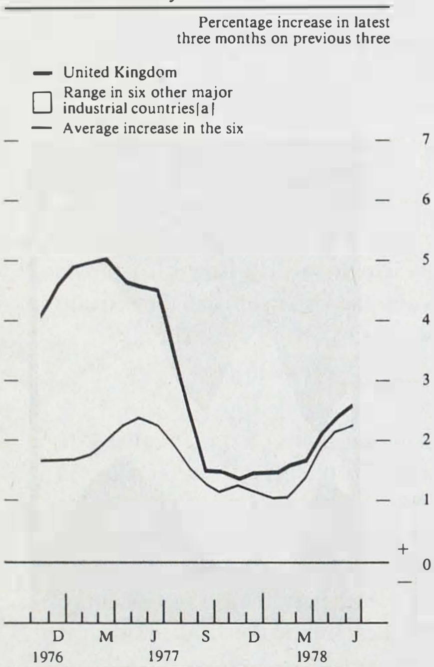
twelve-month increase in the retail price index rose to 7.8%, the first such rise since June last year. Cost pressures, in particular from labour costs, will probably lead to some continuing upward movement in the twelve-month rate of increase for much of the remainder of this year. Whether the rise in prices then decelerates will depend largely on the course of earnings during the new wage round.

Similar price experience overseas

Since the turn of the year, the average rate of consumer price inflation in the six largest overseas economies has quickened from an annual rate of around 5% to around 9½% (see chart). Only part of this acceleration appears to be seasonal. It was particularly marked in the United States, where consumer prices rose at an annual rate of over 10% in the second quarter. Rises in wages and in unit labour costs have not generally been slowing down recently, and commodity prices, which had fallen sharply in terms of most currencies in the second half of last year, were rising gently in the early months of 1978. These movements in commodity prices appear to have been translated fairly rapidly into wholesale buying prices and thence into consumer prices. There is some evidence of a faster rise also in the major industrial countries' export prices: these had been virtually unchanged (on average, in national currencies) in the second half of 1977, but in the first quarter of 1978 they rose by some 2%. Part of this turn-round will have been due to the prices of raw materials exported by these countries; but the prices of their manufactured exports which rose by ½%–1% per quarter in the latter part of 1977 have probably risen faster since then.

Consumer prices in the main OECD countries

The average rate of price inflation has accelerated recently.



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

Housebuilding

Housing starts have picked up, but the upward trend of housing investment has been uncertain. After rising steadily throughout last year, the volume of fixed investment in dwellings fell by 8½% in the first quarter, back to what it had been a year earlier; this may turn out to have been a temporary lapse. The fall was more pronounced in the private sector where investment fell by 11%. Public sector investment fell by 4% but on average has changed little for four quarters. With approvals to build picking up towards the end of last year, however, and with greater official encouragement to local authorities to spend up to the limit of their allocations, some increase throughout the rest of 1978 is likely.

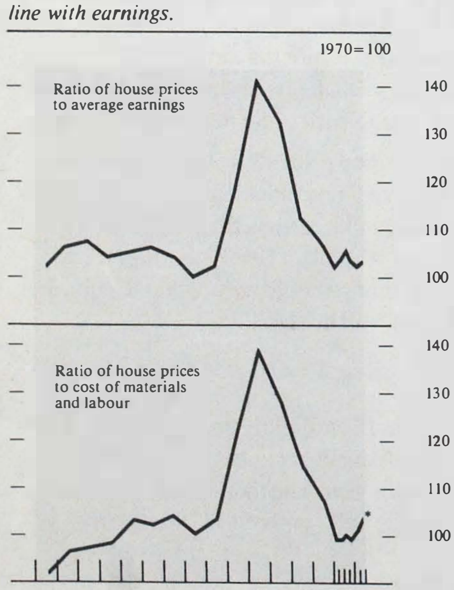
Private housing starts, which had been little changed over the previous year, rose by 13% in the second quarter; and in March the Private Enterprise Housing Enquiry forecast 165,000 starts for the year as a whole, which would imply considerable acceleration in activity in the second half. This now looks over-optimistic, but does reflect the greater degree of confidence amongst builders at that time, doubtless the result of improving demand and profitability. Recent movements in house prices and building costs suggest a significant improvement in profit margins in the early part of this year (see chart).

House prices continued to accelerate in the second quarter, rising by over 6% on average,[1] to bring the increase over the past year to around 16%—much in line with the rise in earnings (see chart). The recent rise in the mortgage rate will have added a little more to the cost of house purchase. Moreover, there are signs that building costs are beginning to pick up more quickly; and with land becoming increasingly expensive, it seems doubtful whether builders will experience much further improvement in profitability.

Another factor tending to limit the future growth of housebuilding activity is a reversal of the strong upward trend in building society commitments to lend, which reached a peak around the turn of the year. The building societies have reacted to the sharp drop in receipts in the second quarter by cutting back on new commitments, which fell by

House prices, costs and earnings

Building costs have been rising more slowly than house prices, which have moved broadly in line with earnings.

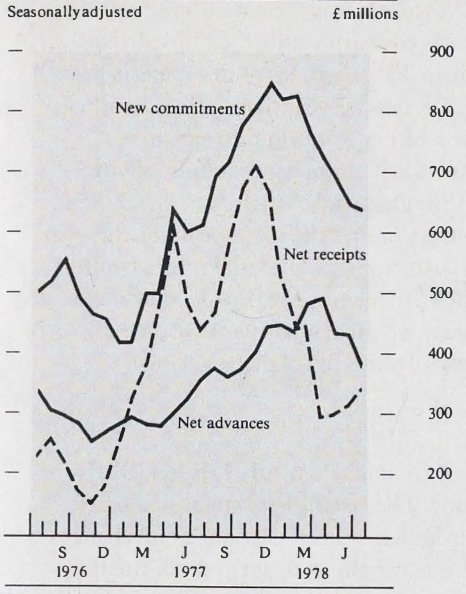


* Provisional.

[1] At the mortgage approval stage.

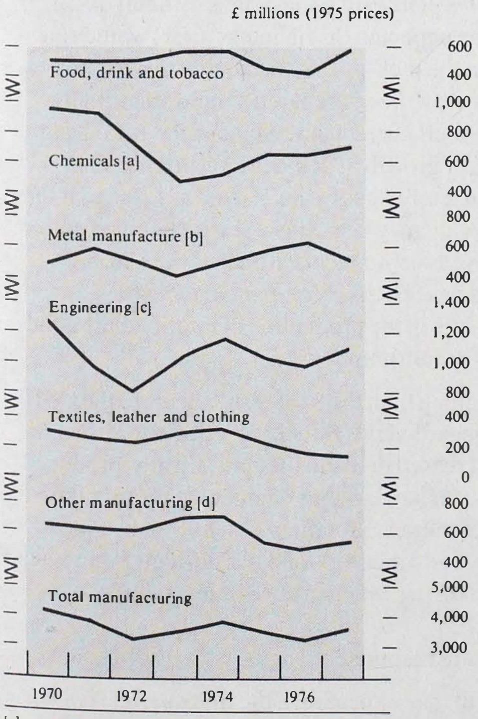
Building society funds

Net receipts have been very low for some months and this has led to a cut in new commitments.



Manufacturing investment by industrial group

Not all sectors shared in the upturn in manufacturing investment in 1977.



[a] Includes coal and petroleum products.
[b] Iron and steel, and non-ferrous metals.
[c] Includes shipbuilding, vehicles and other metal goods.
[d] Includes paper, printing and publishing.

£350 million between the first and second quarters (see chart). Although they raised their share rate to 6.7% (net) from 1st July, the societies seem unlikely to attract sufficient funds in the next few months to finance even the current reduced rate of commitments without further drawing on their liquidity. Their liquid assets expressed as a percentage of total assets have fallen steadily to 18½% at the end of July, compared with over 21½% in February. The societies will be reluctant to see liquidity fall much further and, unless their inflow improves, they may find it necessary to cut back further on lending in the second half of the year or to consider a further increase in their interest rates. In these circumstances, the £640 million per month guideline (excluding 'peripheral' lending, i.e. lending for improvements, extensions, etc.) agreed with the Government for the third quarter—a £30 million increase on the first half of the year—seems unlikely to be reached.

Resumed growth in industrial investment

Industrial fixed investment [1] rose by 3% in the second quarter, after a pause at the turn of the year. In the first half of this year, it was 11% higher than a year earlier—10% higher for manufacturing and 13% higher for distribution and services. Not all industries, however, have shared in the upturn in manufacturing investment (see chart). In 1977, although investment in metal manufacture, and textiles, leather and clothing fell, investment in food, drink and tobacco rose by well over 30%. A strong upturn in investment had been predicted by investment intentions surveys, and may have reflected some improvement in business confidence—admittedly, then very low—early last year. The strengthening of companies' financial position may also have eased a constraint on investment; and companies with rapidly growing profits may have found that capital allowances became a more effective inducement to invest. At the same time, some companies which, because of depressed profits or because of a backlog of unused allowances, could not themselves take advantage of the tax incentives to invest, have nevertheless been able to increase their capital stock on attractive terms by leasing; the relaxation of the Control of Hiring Order last year has been a factor behind this year's sharp growth in vehicle leasing. There is anecdotal evidence that particular emphasis has been placed on labour-substituting rather than capacity-expanding investment.

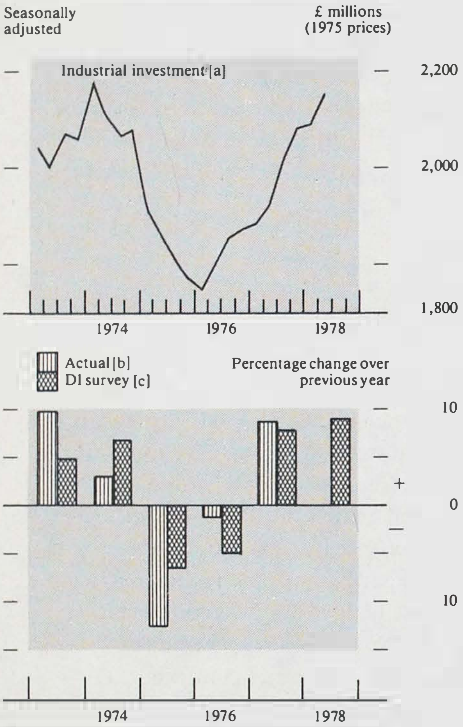
Investment prospects

The June Department of Industry investment intentions survey suggested that industrial investment would rise by about 9% [2] in 1978; this would require growth of just over 1% per quarter during the remainder of the year and may well be exceeded. In recent years, the survey has had quite a good record in predicting the course of industrial investment (see chart overleaf), and the Bank and the Treasury short-term economic forecasts rely heavily on it. For each of the last five years, the survey has predicted the direction of the change in industrial investment correctly and, in general, the error of prediction has been quite small. Where this has not been the case, it is usually possible to identify one of a small number of factors as being responsible: changed business conditions; a different, usually higher, rate of inflation from that expected; unexpected changes in companies' financial position; or unforeseen constraints on the delivery of capital goods. For example, the substantial underprediction of the fall in investment in 1975 can be attributed to underestimation (by companies) of the extent to which inflation would accelerate, and failure to anticipate the severity of the downturn in the economy, at a time when companies' finances were already strained.

[1] Investment in manufacturing, and in distribution and services.
[2] About 10%–13% for manufacturing industry and 6%–8% for distributive and service industries. The increase for manufacturing industry is much the same as that indicated by the July CBI survey.

Investment intentions and outcome

There was a resumption of growth in investment in the second quarter; further growth this year is expected.



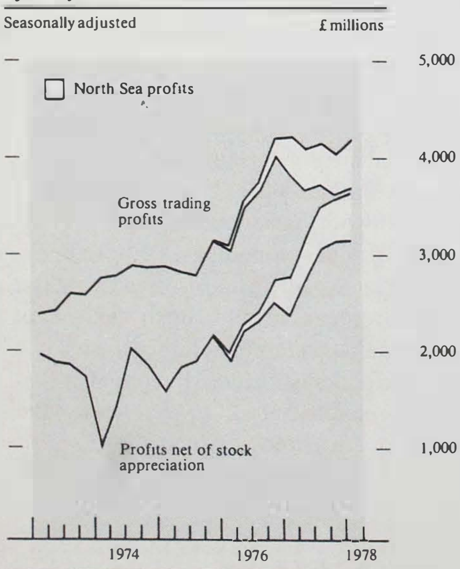
[a] Manufacturing, and distribution and services, investment.

[b] Because the chart is a comparison of the results of the survey with latest estimates of investment, actuals are expressed in 1975 prices but survey results in 1970 prices.

[c] Aggregation of results for manufacturing, and distribution and services, investment. The chart shows the results of the second main survey which is published in January of the year to which it relates.

Industrial and commercial companies' profits

The rapid improvement in profits, net of stock appreciation, outside the North Sea sector came to a halt in the third quarter of last year.



Company profits no stronger

Companies' gross trading profits have been almost unchanged since the end of 1976 (see chart); output has been depressed, and falling raw material prices last year were, at least partly, offset by growth in unit labour costs under stage three. Net of stock appreciation and excluding North Sea activities, profits recovered sharply until the third quarter of 1977 but they have risen little since. Falling prices of raw materials had a beneficial effect on profits last year, but this year these prices have risen and their effect on profits will be adverse. Some improvement in profitability can be expected from the pick-up in economic activity (though this has so far been quite modest) but even so, non-North Sea profits, net of stock appreciation, are unlikely to increase much this year. There may not be much help to costs from raw material prices while labour costs will, for much of the year, have been influenced by the rapid increase in earnings during stage three. Real rates of return on non-North Sea activities may still be under 4% by the end of the year.

Heavy stockbuilding

Stockbuilding in the first quarter amounted to nearly 1½% of GDP; it continued strongly in the second. The last *Bulletin* suggested that a build-up of stocks of materials in anticipation of exchange rate changes may have been one reason for this unusually buoyant growth. But it now looks as though the impetus has come from the quite rapid growth in output early in the year.

Despite already ample stocks of manufacturers' finished goods at the end of 1977, there was a rise of over 1% in the first quarter, with a further 2½% increase in the second. This pattern of behaviour is difficult to rationalise—it might have been expected that manufacturers would run down their 'high' stocks, given the pick-up in demand, but this has not been the case so far. Firms may have been prepared to hold abnormally high stocks, partly because of their current liquid financial position and partly in expectation of a further growth in demand. An alternative explanation may be that manufactured goods are classed as finished if they are ready for despatch from the factory, regardless of whether they are intended for final sale or for use as components. Much of the rise in stocks of finished goods could have been in 'component industries', reflecting the recent rapid growth in the production of intermediate goods, rather than in finished goods for consumption.

With domestic stocks remaining high (86% of respondents to the CBI June monthly trends inquiry regarded their stocks as 'adequate' or 'more than adequate'), part of the increased demand for domestically-produced goods is expected to be met out of stock—thus dampening the growth in output during the remainder of the year. Retailers' stocks rose by more than 3% in both the first and second quarters, and it is difficult to envisage such a rapid rate of accumulation persisting in the coming months.

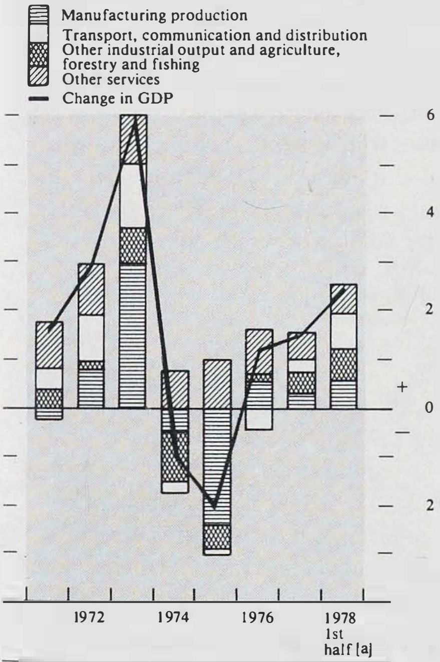
Domestic output—a moderate response

After somewhat brisker growth than expected in the first quarter (0.8%), the output-based measure of GDP, usually regarded as the best indicator of short-term movements, rose by only 0.4% in the second. Nevertheless, it has now risen for four quarters in succession, and the indications are that this modest expansion is set to continue, though possibly with a pause in the second half of this year as the recent high rate of stockbuilding moderates.

Industrial output rose by about 1% in the second quarter and is now 1½% above the average for last year. The increase in activity has so far been rather moderate, but appears to be sustained. With manufacturing production in the first half of 1978 only 0.6% higher than in the second half of 1977, there has probably been some further fall in capacity utilisation. (This is suggested by two of the indices shown in the chart on page 347, though the results of the CBI survey—also shown on that

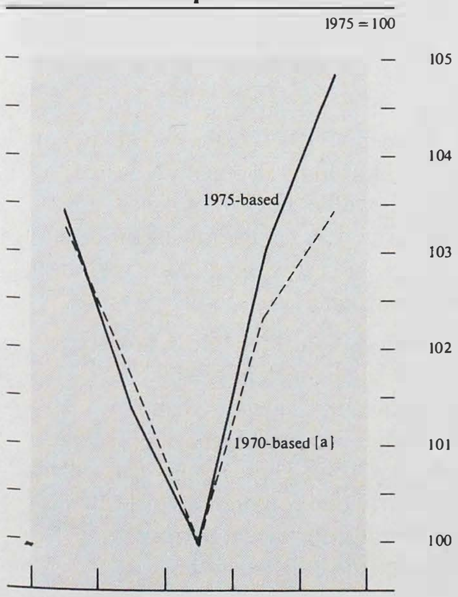
Contributions to the change in GDP

Output of the services sector has improved in every year since 1970, despite cyclical fluctuations in the rest of the economy.



[a] Bank estimate, at an annual rate.

Gross domestic product



[a] Rescaled to 1975 = 100.

chart—seem to suggest that capacity utilisation has shown some increase in recent months.)

A surprising feature of the recent rise in manufacturing activity is that the bulk of the growth has been in intermediate goods industries, rather than in industries producing consumption goods where most of the strength of demand has been concentrated. In 1971-72, when consumers' expenditure began to expand rapidly, production in non-consumer goods industries fell for more than a year, while industries producing consumer goods expanded at an increasing rate.

With little evidence of a substantial rise in manufacturing employment so far this year, the rise in manufacturing production has probably been associated with an improvement in productivity. Given the provisional nature of the employment statistics from 1976, it is difficult to be sure about recent movements in productivity. The available figures, however, suggest that productivity in the United Kingdom fell in 1977 and is currently only slightly above what it was in 1973, despite the improvement this year. A comparison of the UK performance with that of other major industrial countries shows that the recovery in output and productivity has been swifter abroad, but also brings out the slower UK growth over a longer period (see chart overleaf).

The depression of the past few years has been mainly concentrated in manufacturing, with activity in other sectors on the whole stronger, particularly in services (see chart). Output of the 'other services' sector has grown by just under 2½% per annum on average since 1970 with strong growth in financial, and professional and scientific services. Industrial production fell behind during the downturn but since 1975 has more or less kept pace with aggregate output. The recalculation of the National Accounts using 1975 as the base year (shortly to be published in full) might alter this feature, however, with a much greater weight being assigned to North Sea oil output which will in turn boost the growth of GDP since 1975. Some indication of the effect of this recalculation is shown in the chart; between 1975 and 1977, GDP increased by 4.8% using 1975 as the base year as against 3.4% using 1970; the greater weight assigned to North Sea oil accounts for just over half of the difference.

The labour market

The trend of unemployment has been downwards in recent months; yet it is difficult to reconcile this with recent data for employment—which suggest little change over the last year—and the probable growth in the labour force in the same period. The pattern for men is particularly difficult to explain.

Seasonally-adjusted unemployment fell for nine months from last September's peak of 6%, and, although this reduction was checked in June and partly reversed in July and August, the figures for these three months were nevertheless lower than in the corresponding months of 1977. Moreover, the recent rise may simply reflect seasonal adjustment problems [1] and could be reversed in the autumn. Slightly lower male unemployment has been partly offset by higher female unemployment.

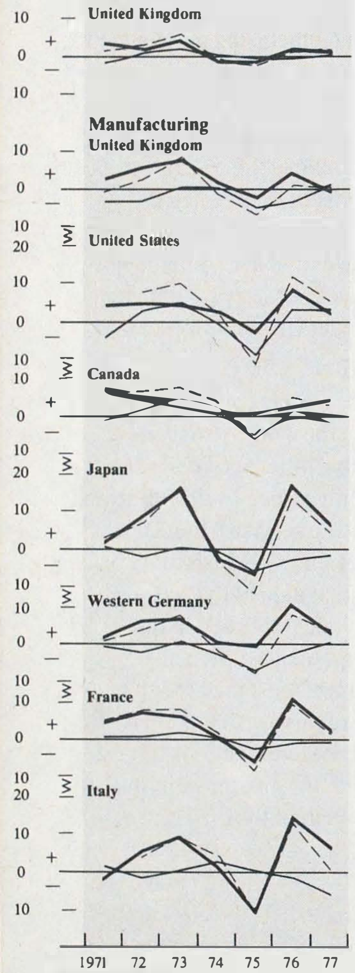
There was some growth in employment in the first quarter, mainly in services, after a slow decline in the preceding six months, but apparently little since; consequently, there has been little overall change over the past year. Employment in production fell by around 10,000 in both April and May, and, since this sector accounts for more than 40% of total employment, a significant overall rise between March and June seems unlikely. As with unemployment, a reduction in male employment has been offset by a rise in female employment. Thus the total number of employees (employed plus registered unemployed) has apparently changed very little over the last year, despite a rise of around 200,000 in the population of working age.

[1] See the March *Bulletin*, page 12.

Output, employment and productivity

The recovery in output and productivity since 1975 has been swifter abroad than in the United Kingdom.

Percentage change on previous year
—Productivity (P)
—Manufacturing employment (E)
-- Manufacturing output (O)



Trend rate of growth, per cent per annum

		1960-73	1973-77
Whole economy: United Kingdom	P	2.7	0.1
	E	0.1	−0.2
	O	2.7	−0.1
Manufacturing: United Kingdom	P	3.4	—
	E	- 0.4	−1.8
	O	3.0	−1.8
United States	P	3.4	2.7
	E	1.5	−1.1
	O	4.9	1.6
Canada	P	4.0	2.4
	E	1.9	−1.0
	O	5.9	1.4
Japan	P	8.8	3.5
	E	3.1	−2.9
	O	12.0	0.5
Western Germany	P	5.0	3.6
	E	0.3	−3.3
	O	5.3	0.4
France	P	5.6	2.0
	E	0.3	−1.1
	O	5.9	0.9
Italy	P	5.2	2.4
	E	0.8	−0.9
	O	6.1	1.5

The growth in the number of female employees—about 70,000—appears broadly consistent with known demographic changes, although it suggests that the proportion of women of working age who are either in or seeking employment may now be rising less rapidly than in recent years. By contrast, the reduction in the number of male employees—also about 70,000—is difficult to reconcile with the increase in the number of men of working age. An increase in the numbers in full-time education and an expansion of the Government's youth opportunities programme go some way to reconciling these differences but they still leave a considerable gap unexplained. One possible explanation may be earlier retirement. Another may be that high rates of unemployment and declining real incomes have led some male workers into self-employment, the numbers of which are not accurately known; this might cast further light on skill shortages. [1] Skilled workers might be the most likely candidates to venture and succeed in self-employment. There may also have been a fall in the number of people doing two jobs.

Government current spending rising again

General government final consumption [2] in the first quarter of 1978 was 1.5% higher than in the corresponding period of 1977, with much of the growth coming in the second half of the period. Expenditure in 1977/78 as a whole was nearly the same as in 1976/77. Gross domestic fixed capital formation by the public sector [3] has continued to fall steeply since a peak in the first quarter of 1976. The fall over the year up to the first quarter of 1978 was nearly 18%, bringing the total fall over two years to nearly 29%. Within the total, however, general government fixed investment has begun to pick up since the third quarter of 1977.

Total public expenditure [4] is now expected to grow by about 5% between 1977/78 and 1978/79, somewhat less than was predicted at the time of the Budget. This is primarily because the shortfall in 1977/78 was less than expected, leaving a higher base level of expenditure at the start of 1978/79.

The PSBR on target

The public sector borrowing requirement (PSBR) for the first quarter of 1978/79 was £2.2 billion unadjusted, £1.7 billion seasonally adjusted, suggesting that the path of the PSBR is within the Government's announced limit of £8.5 billion for the whole year. Borrowing by local authorities was low in the June quarter, and may well be low in the current quarter also, but it is expected to pick up later.

One longer-term change in the composition of the PSBR, however, is much lower net borrowing outside the public sector by public corporations; this arises partly from their much increased trading surpluses and partly from the planned programme of repayment (either early or at maturity) of foreign currency loans. These repayments will have to be offset by additional on-lending to public corporations by central government (adding in turn to the central government borrowing requirement); there will be no effect on the PSBR as a whole.

The Budget tax reductions, apart from the relatively minor adjustment of tax allowances, were not implemented early enough to affect tax revenue for the first quarter of the financial year. The major proposal, a new lower rate tax band, will affect revenue only from the current quarter.

The outcome of opposition amendments on taxation proposals during the passage of the Finance Bill was to reduce forecast government revenue for 1978/79 by about a further £450 million. A package of measures announced on 8th June was designed to restore both this revenue shortfall and confidence in the capital markets. Among the proposals was an

[1] See the June *Bulletin*, page 158.

[2] This paragraph is expressed in terms of National Accounts definitions, constant (1970) prices, and seasonally adjusted.

[3] General government plus public corporations.

[4] As defined in the 1978 Public Expenditure White Paper (*The Government's expenditure plans, 1978/79 to 1981/82*, Cmnd. 7049).

increase of $2\frac{1}{2}$% in the national insurance surcharge on employers, but this was subsequently reduced to $1\frac{1}{2}$% as a result of Parliamentary pressure; the surcharge will realise about £300 million during this financial year and about £900 million in a full year.

Trading positions of selected public corporations

£ millions

	Fixed assets[a]	Profits[b]			*Percentage rate of return*
		1975/76	1976/77	1977/78	
	A	*B*	*C*	*D*	*E(= D/A)*
Post Office	6,410	148 (348)	401 (667)[c]	368 (718)	*5.7*
Electricity Council	5,826	(65)	(206)	132 (292)	*2.3*
British Steel Corporation	2,874	(−255)	(− 95)	(−443)	*(−15.4)*
British Gas Corporation	1,651	(25)	32 (135)	180 (325)	*10.9*
National Coal Board	1,001	(7)	(29)	(22)	*(2.2)*
British Airways	819	(− 19)	(75)	(39)	*(4.8)*
British Rail	765	(− 61)	(− 30)	(27)	*(3.5)*

[a] Historic cost valuation at end-accounting year 1977/78 (end-calendar year 1977 in the case of British Rail). Historic cost valuation seriously undervalues certain kinds of assets, in particular those with long lives (i.e. land and freehold buildings) acquired a long time ago. This phenomenon is particularly important in British Rail's case, where the valuation of their entire operational land is only £24 million. The figures for percentage rate of return in column *E* should therefore be treated with caution.

[b] Before tax, but after government compensation for price restraint and, in the case of British Rail, passenger transport subsidies. Profits are, where possible, given after provision for supplementary depreciation; figures in brackets refer to profits before supplementary depreciation.

[c] Before provision of £101 million for elimination of profit above the price code reference level.

Current balance

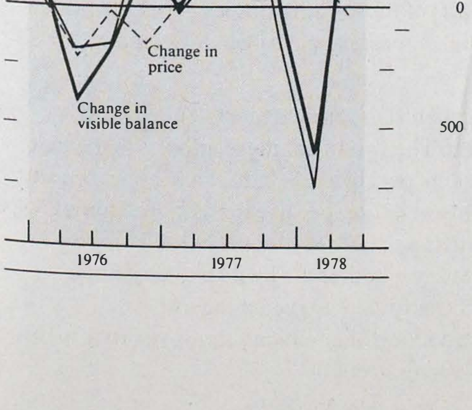
£ millions

	1977		1978	
	3rd qtr	4th qtr	1st qtr	2nd qtr
Visible balance	+ 31	− 5	−612	−135
of which:				
Oil balance	*−602*	*−657*	*−646*	*−420*
SNAPS [a] *balance*	*+166*	*+ 54*	*− 32*	*+155*
Underlying non-oil balance	*+467*	*+598*	*+ 66*	*+130*
Invisible balance	+543	+512	+295	+333
Current balance	+574	+507	−317	+198

[a] Ships, North Sea production installations, aircraft and precious stones.

Price and volume components of visible balance changes

The sharp changes in the visible balance since the middle of 1977 have been mainly a reflection of movements in the balance of resources.



Higher profits of nationalised industries

The improved trading position of many major nationalised industries which had become apparent through their increasing gross trading surpluses has been reflected in several recently published results for the accounting year 1977/78 (see table).

The current account: some improvement but a poor half-year

A current account surplus in the second quarter partially offset the unexpected deficit of the first (see table). Almost all of the improvement came from oil and erratic items.[1] The terms of trade deteriorated, but there was a strong improvement in the balance of resources in goods, which had fallen in the previous two quarters (see chart).

None the less, the £84 million current deficit in the first half of 1978 was disappointing after the surplus of more than £1 billion in the previous half year. Most of the deterioration resulted from imports (excluding oil and erratic items) rising three times as fast as exports. This was aggravated by a decline of one third in the invisible surplus.

The world economy still growing slowly

The world economy is still depressed. Although the rate of growth of the OECD area has picked up a little since the second half of last year (when it was only 3% at an annual rate), recent developments suggest that growth this year will be no faster than the $3\frac{1}{2}$% achieved in 1977.

Growth of the US economy remained relatively buoyant although the prospects are less encouraging. Real GDP rose sharply in the second quarter, but the first quarter figures had been depressed by strikes and bad weather and this recovery was less than most forecasters had been expecting; the Administration have again revised their forecast for growth in 1978 downwards, to $3\frac{1}{2}$%–4%. The West German economy remains depressed. Total output barely rose in the first quarter, and although, as in the United States, this partly reflected the effect of bad weather and strikes, activity since then has not revived much. [2] Industrial production in the second quarter was no higher than in the first. In the other main overseas economies, Japan, France and Italy, where total output and industrial production accelerated in the first quarter, growth has slowed down since. In the smaller European economies, which together grew by only 2% last year, activity slowed down further in the early part of this year as the effects of deflationary policies continued to make themselves felt. Industrial production was particularly depressed. Unemployment in the industrial countries has continued to rise surprisingly slowly, given the sluggish pace of activity, although there are signs that it is rising faster now in a number of countries.

World trade continues to revive

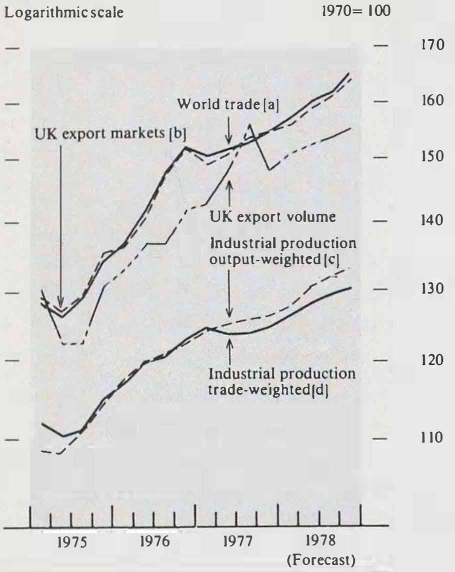
Although output in most industrial countries has continued to increase only slowly, the growth in the volume of world trade has accelerated a little since its abrupt slowdown in the first half of last year, and it was probably growing at about 5% per annum in the first half of this year, about the same as in the second half of 1977. Faster growth of imports into the United States, Japan and some of the larger European economies helped to maintain the growth of world trade, whereas imports by OPEC, which were a sustaining factor in the second half of last year, rose less fast; imports into the smaller OECD economies have fallen, probably reflecting continued attempts by some countries to restrain demand.

[1] Ships, aircraft, precious stones and North Sea production installations.

[2] The proposed stimulatory measures announced after the Bonn Summit in July relate principally to 1979.

OECD industrial production, world trade and UK export markets

UK export markets may continue to expand steadily through the rest of 1978.



[a] World import volume: world-weighted.
[b] World import volume: UK trade-weighted.
[c] OECD industrial production (excluding construction): GNP-weighted.
[d] OECD industrial production (excluding construction): world trade-weighted.

Growth of UK export markets

Per cent

	Share of world imports[a] in 1977	Share of UK exports in 1977	Growth of total imports volume in UK export markets. Change on previous period at annual rate		
			1977		1978
			1st half	2nd half	1st half[b]
UK export markets					
United States	15.1	9.7	+16¼	+ ½	+ 8
Canada	4.1	2.2	+ 5½	− 8½	− 4
Japan	6.9	1.5	− 4½	+ 1½	+ 9
Western Germany	9.8	7.8	− 3¾	+14¼	+11½
France	6.8	6.7	− 7¼	+ 3¾	+ 7
Italy	4.6	3.0	+ 3¼	−11½	− 7
Netherlands	4.5	6.7	− 4½	+ 2½	+ 3
Belgium	3.9	5.7	+ 6¼	− ¾	+ 9
Other OECD Europe	18.0	25.0	− 7¼	+ 6¼	− 2
Australia, New Zealand, South Africa	2.3	5.1	− 5½	− 5	+ 6
OPEC	8.8	13.5	+ 3	+13½	+ 4
Less developed countries	15.2	13.1	+ 5	+ 8¾	+ 6
Growth of UK export markets			—	+ 5¼	+ 4
Growth of UK export volume			+ 9¼	+ 7	+ ¾

[a] Excluding United Kingdom.
[b] Estimates/forecasts.

Composition of imports of industrial materials

Percentage change in volume on previous quarter

	Weights	1977		1978	
		3rd qtr	4th qtr	1st qtr	2nd qtr
Industrial materials (excluding precious stones)	100	+4.5	−3.4	+12.5	−3.2
of which:					
Basic materials	*30*	*+1.8*	*−1.8*	*+ 6.4*	*−4.3*
Chemicals	*18*	*+0.7*	*−5.2*	*+19.5*	*+2.6*
Other semi-manufactures (excluding precious stones)	*52*	*+7.7*	*−3.6*	*+13.0*	*−4.1*

For the most part, the countries with slower growth of imports so far this year were also important UK export markets (see chart and table). As a result, total UK export markets were probably only growing at about 4% per annum in the first half, more slowly than in the second half of 1977. They may, however, grow faster in the second half of this year. The rise in trade in manufactures (weighted by UK markets) appears to have followed a similar pattern, slowing down in the first half of 1978 to an annual rate of about 5½%; this also seems likely to accelerate during the remainder of the year.

Total exports grow but manufactures lag

The volume of UK exports of manufactures (excluding erratic items) increased by about 1% in the second quarter, somewhat less than in the first. Exports of road vehicles and chemicals rose strongly, more than offsetting a decline in exports of other manufactures, including textiles. Even so, the overall volume of manufactured exports was still below the record of the third quarter of 1977. Export performance in manufactures in the first half of this year was not as impressive as in 1977 when the United Kingdom gained market share: between the first halves of 1977 and 1978, manufactured export volume rose by 2¾% compared with the estimated 6% increase in the UK-weighted volume of world trade in manufactures. In July, the volume of manufactured exports rose strongly, suggesting that the third quarter may show at least as much of an increase as the previous two quarters.

The volume of non-manufactured exports rose by over 6% in the second quarter, and in the first half of 1978 was no less than 15% above the average for 1977. Agricultural exports slipped only marginally from the exceptionally high figure of the first quarter, while exports of basic materials were a record. In both cases, exports in the first half of 1978 have been considerably higher than expected. This buoyant performance continued in July. The volume of fuel exports rose by almost 13% in the second quarter to a new peak, mainly reflecting an increase in crude oil exports.

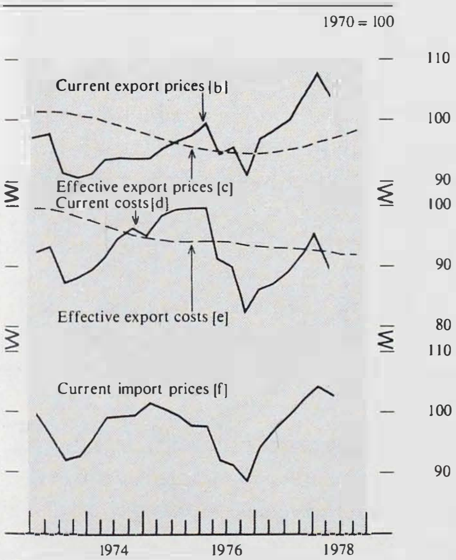
Some fall in imports of industrial materials, apart from chemicals

The substantial rise in the volume of imports of industrial materials, excluding precious stones, in the first quarter (see table), was earlier thought to have been partly the result of UK firms taking advantage of the high exchange rate and low commodity prices at the end of last year to build up stocks of imported goods. This might have suggested some fall in import volume as sterling depreciated in subsequent months. In the event, industrial production picked up faster than expected, suggesting that demand for these imports was probably greater than assumed and that any stocks which may have been built up will probably have been utilised rapidly. In the second quarter there was thus only a modest fall (4¼%) in the volume of these imports (excluding chemicals). If industrial production continues to rise, imports of industrial materials are unlikely to fall back much further. Indeed, the current strength of sterling against the US dollar may encourage imports of those commodities generally priced in dollars—a development which appears to have been reflected in the figures for July.

Within imports of industrial materials, one category—chemicals—did not fall in the second quarter. The volume of these imports in the first half-year was 14½% above the same period a year earlier and appears quite steady from month to month. In a very competitive market, the strength of sterling at the end of 1977 and in the first three months of 1978 may have been crucial and it is difficult to say whether the lower exchange rate experienced since March will be sufficient to regain the lost competitiveness. Domestic production of chemicals, however, rose in the first half of 1978, with exports rising strongly.

Measures of competitiveness[a]

There is likely to be a growing divergence between effective export price and cost competitiveness in 1978.



[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. This measure is applicable to both exports and imports.
[e] As in [c] but with relative unit labour costs replacing relative export prices.
[f] Ratio of UK price of manufacturing output to import prices of finished manufactures.

Imports of finished manufactures still rising rapidly

Imports of finished manufactured goods (excluding erratic items) rose by 4½% in volume in the second quarter after a rise of over 7% in the previous quarter; this growth was maintained in July. Such a strong upward trend was not surprising because it was expected that domestic demand for manufactured goods would rise quite strongly; but it is noteworthy that imports of consumer goods were not predominant: the volume of imports of machinery rose by 7% in the second quarter compared with a rise of under 2% for road vehicles and a fall of over 2% in imports of clothing and footwear.

Competitiveness

The chart shows movements in UK export and import competitiveness as given by measures of relative unit labour costs and relative prices, both in the current period and in *effective* terms—the net effect of current and past changes. The fall in the exchange rate in the second quarter had a significant impact on all measures of current competitiveness, but has had little impact on the effective export measures. The paths of effective export price and cost competitiveness for the rest of 1978 are now largely determined, and the divergence between the measures can be seen to be continuing. Imports seem to react much faster to changes in competitiveness, and the current indicators give a reasonable guide to the effective position.

The terms of trade [1]

As suggested in the June *Bulletin,* the merchandise terms of trade [2] fell in the second quarter. The extent of the decline (just under ½%) would have been greater but for a relatively sharp rise in the export unit value index in May, mainly reflecting a temporarily high price for diamonds. The recent fall in the terms of trade reflects the lagged effects of the appreciation of sterling in 1977 in moderating the growth of export prices, together with the initial impact on import prices of the depreciation of sterling in the second quarter. In the absence of further depreciation, or of any significant increase in the prices of commodities relative to those of finished goods (which would lower the terms of trade because the United Kingdom is a net importer of the former), the terms of trade for goods are unlikely to decline significantly over the next quarter or so.

Invisibles

The estimated invisibles surplus in the second quarter was around £330 million (seasonally adjusted). While higher than in the first quarter (now revised upwards to £295 million), this is well below the 1977 average (£500 million).

A major factor in the reduced surplus in the first half of 1978 was sizable government transfers, particularly to the EEC budget under the transitional arrangements which lead to payment of a full share by the United Kingdom in 1980. Private transfer payments were higher on average than in 1977, as last winter's exchange control relaxations continued to affect emigrants' transfers. The deficit on sea transport services which appeared at the end of 1977 widened progressively, and, as expected, travel payments by UK residents have increased markedly this year.

On the other hand, the surplus on interest, profits and dividends has improved this year. The outflow on general government account was comparatively low, with earnings on the official reserves remaining strong. In the non-government sector, the net position on oil account is estimated to have improved, with UK companies' earnings on their investments abroad rising and foreign oil companies' earnings in the United Kingdom falling despite their growing North Sea oil production, probably in part because of increased tax liabilities.

[1] A research article on page 365 discusses movements in various measures of the terms of trade since the early 1960s.
[2] Export prices as a percentage of import prices.

Capital flows

£ millions: *not seasonally adjusted*

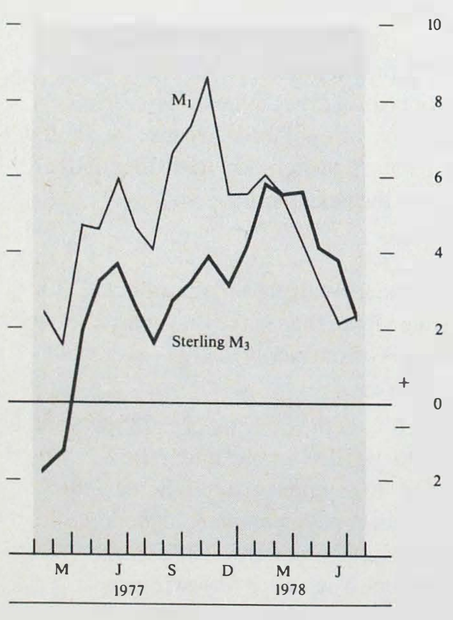
	1977		1978	
	3rd qtr	4th qtr	1st qtr	2nd qtr
Current balance	**+ 598**	**+ 523**	**− 429**	**+ 323**
Overseas investment in United Kingdom:				
Public sector	+ 289	+ 474	− 3	− 15
Private sector	+ 776	+ 471	+ 1,000	+ 426
UK private investment overseas	− 444	− 443	− 677	− 300
UK banks' net external liabilities in foreign currencies	+ 189	+ 480	+ 115	− 532
Exchange reserves in sterling:				
Countries	+ 80	− 89	+ 147	− 278
International organisations	− 6	+ 204	+ 13	+ 45
Private sterling balances	+ 323	+ 599	− 59	− 154
Other identified capital flows (net)	− 17	− 319	− 457	− 331
Balance on investment and other capital flows	**+1,190**	**+1,377**	**+ 79**	**−1,139**
Balancing item	+ 820	+ 32	+ 523	− 678
Balance for official financing	**+2,608**	**+1,932**	**+ 173**	**−1,494**

Money stock

Both M_1 and sterling M_3 have been rising more slowly over the past three months.

Seasonally adjusted

Percentage change on three months earlier



Net capital outflows

There was an unfavourable swing of more than £1 billion in identified capital flows between the first and second quarters (see table). Inflows on inward oil and direct investment were much reduced, there was a large fall in UK banks' net external foreign currency liabilities and a significant run-down of both official and private sterling balances. On the other hand, UK private investment abroad fell, largely because of net disinvestment by UK oil companies. For the first time for more than two years, the balancing item in the second quarter was negative.

Most of the net outflow occurred at the beginning of the quarter as the authorities intervened strongly in support of sterling and the reserves fell sharply. The measures announced on 8th June had little immediate impact on the exchange market but, in line with other major currencies, sterling began to strengthen in mid-June when the US dollar came under intense pressure.[1] The improved sentiment allowed the authorities to take into the reserves a small amount of foreign currency.

Over the second quarter as a whole, official reserves fell by $3,778 million which included an early repayment to the International Monetary Fund of $943 million and further net repayments of public sector foreign currency loans of some $353 million.[1] In July and August, the reserves fell by a further $137 million after net repayments of official borrowing of $314 million.

Monetary growth slows down[2]

Since the measures announced on 8th June, the growth of sterling M_3 has decelerated (see chart). In the first three months—to mid-July—of the new 'target' year, sterling M_3 rose by $2\frac{1}{4}$%, comfortably within the 8%–12% target for the year.

During April and May, conditions had been generally difficult in financial markets. Bank lending to the private sector had also begun to rise more rapidly; in the three months to mid-May it had increased by nearly £525 million a month,[3] double the rate of the previous three months. Thus on 8th June, the Government announced a package of fiscal and monetary measures, including an increase in minimum lending rate (MLR) from 9% to 10%, and the reimposition of the supplementary special deposits scheme.[4] This was sufficient to stimulate a heavy demand for gilt-edged stock, and within a week the authorities had sold a large amount. These sales were the chief factor restraining the previously rapid growth in sterling M_3.

Private sector purchases of national savings held up well in the three months to mid-July, even after the June rise in MLR, largely because maximum permitted holdings of the fourteenth issue of national savings certificates were increased with effect from 1st July. Moreover, although the central government borrowing requirement (CGBR) was much the same as in the previous three months, net borrowing by the rest of the public sector fell. Bank lending to the private sector, however, accelerated sharply, continuing to rise rapidly in the month to mid-July, the first full month after the announcement of the reintroduction of the supplementary special deposits scheme.

Domestic credit expansion in the three months to mid-July was less rapid, and, at £1.6 billion, was broadly consistent with the limit of £6 billion for 1978/79 agreed with the International Monetary Fund (see table on opposite page).

The stabilisation and subsequent rise in interest rates during the first half of 1978 was reflected in a further deceleration in the rate of growth of M_1 which rose by only $2\frac{1}{4}$% in the three months to mid-July, compared with $4\frac{1}{2}$% in the previous three months.

[1] See page 352.
[2] Figures in this section are seasonally adjusted.
[3] Most of the increase in bank lending in the three months to mid-May went directly or indirectly to finance consumer spending (see page 334); even allowing for special factors, lending to manufacturing industry rose only slightly.
[4] See below and page 357. The scheme was extended for a further eight months on 17th August (see page 358).

DCE and the money stock[a]

£ millions: *seasonally adjusted*; mid-month

	Apr.– July 77	July– Oct. 77	Oct. 77– Jan. 78	Jan.– Apr. 78	Apr.– July 78
Central government borrowing requirement	+1,231	+ 240	+1,576	+1,864	+1,785
Net purchases (–) of central government debt by non-bank private sector	–1,856	–2,456	–1,718	–1,042	–2,267
Other public sector[b]	+ 247	+ 676	– 39	+ 410	+ 43
Bank lending to:					
UK private sector[c]	+ 969	+1,259	+ 726	+1,106	+1,854
Overseas	+ 158	+ 208	+ 225	+ 625	+ 142
Domestic credit expansion	**+ 749**	**– 73**	**+ 770**	**+2,963**	**+1,557**
External foreign currency finance (increase –)	+ 820	+1,523	+ 697	– 276	– 289
Other	– 549	– 126	+ 278	– 214	– 201
Sterling M_3	**+1,020**	**+1,324**	**+1,745**	**+2,473**	**+1,067**
Percentage change in sterling M_3	*+ 2.5*	*+ 3.2*	*+ 4.1*	*+ 5.6*	*+ 2.3*
M_1	**+ 882**	**+1,470**	**+1,175**	**+ 986**	**+ 534**
Percentage change in M_1	*+ 4.6*	*+ 7.3*	*+ 5.5*	*+ 4.4*	*+ 2.3*

[a] Further details are shown in Table 11.3 in the statistical annex.

[b] Contribution to the public sector borrowing requirement by the rest of the public sector, less purchases of other public sector debt by the non-bank private sector.

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

Reserve ratios and 'the corset'

The supplementary special deposits scheme ('the corset') contributes to monetary control by restraining the growth of the main category of bank deposits—interest-bearing eligible liabilities—which the banks are in a position to influence. To avoid penalties for growth in these liabilities in excess of the limits specified, the banks have to restrain the growth of their assets while remaining free (subject to the need to maintain the minimum reserve asset ratio and to the general guidance on priority lending) to determine their composition. The penalty-free limit for the growth of interest-bearing eligible liabilities for August–October implied some reduction from the level ruling in May, following extremely rapid growth in previous months.

Two factors have complicated the task of the banks. First, the underlying demand for credit is much stronger than when the scheme was previously in operation,[1] making it harder for the banks to reduce lending. Secondly, the banks were under reserve asset pressure as a result of a combination of factors in June and July, including large sales of gilt-edged stocks by the authorities, a small CGBR (unadjusted) and a sharp rise in the note circulation. This led them to bid for funds on the inter-bank market in order to finance the purchase of additional reserve assets. The authorities took steps both to relieve reserve asset pressure (see further on page 349) and to prevent short-term interest rates from rising even further than they did. Even so, the pressure was still sufficient to raise inter-bank rates relative to base rates during June and July. As much of the clearing banks' lending is related to base rates, borrowers switched from other banks (which charge market-related rates) to the clearing banks, thereby worsening the position of the latter under the supplementary special deposits scheme.

Assessment

The revival in demand noted earlier in the year has continued during the summer. It is clear that the main stimulus has been the upturn in consumer spending, generated by an increase in earnings rather faster than that of prices and by cuts in direct taxation, in association with a considerable rise in the volume of consumer credit. Although the response from output may not be broadly based, it has for some time been sufficient to take up modest amounts of slack in some sectors of the economy. Even so, the rise in output and employment has not matched the pace of the recovery in demand: a significant part of increased spending has been met directly by imports. Industrial materials have accounted for much of the overall rise in imports, but there has also been a marked increase in purchases of finished manufactured goods from abroad.

The annual rate of price inflation has been broadly unchanged for some months: it is not only essential to prevent any renewed increase, but it must also be the aim to reduce it further. After the painful experience of the last few years, it now seems to be widely recognised that monetary restraint and moderation in pay settlements are essential and mutually reinforcing constituents in the control of inflation. Monetary conditions after the fiscal and monetary measures of 8th June have been more satisfactory: substantial further sales of government stocks were made following the ensuing recovery in market confidence; and the supplementary special deposits scheme, subsequently extended on 17th August (see page 358) for a further eight months, is acting to restrain the rise in bank lending. As a result, growth of sterling M_3 up to July was well within the target range, and provisional indications suggest that its growth up to August may have been below the range; and the pace of domestic credit expansion has

[1] December 1973–February 1975, and November 1976–August 1977.

markedly fallen away. If the demand for bank credit continues to be strong, some low priority borrowers may experience difficulty in obtaining funds, at least for a time, but the extended scheme should leave the banks room to make adequate lending to priority customers. On the foreign exchange markets there has been no great change in the effective rate for sterling.

The recovery in living standards is welcome but further improvement will be sustainable only if it does not attract excessive imports and is, on the contrary, accompanied by steadily rising production and exports and, in due course, by a full response from productive investment. The scope for fostering faster growth by demand management is, in present circumstances, limited by the constraints imposed by inflation and the balance of payments. In the longer term, an improvement in the supply side of the economy is of crucial importance to the United Kingdom's future economic performance and living standards. In this respect there are a number of questions which arise for discussion—which indeed apply in one form or another to many other industrial countries also.

In recent years the growth of productivity has been unusually slow, most notably in the industrial sector—which, though only part of the economy, is an important part. Recession usually produces a temporary phase of slow productivity growth. It is therefore a major question whether the slow growth of productivity observed in industry in the recent past is the result of the present recession, or whether it reflects a longer-term deceleration in the underlying rate of economic growth.

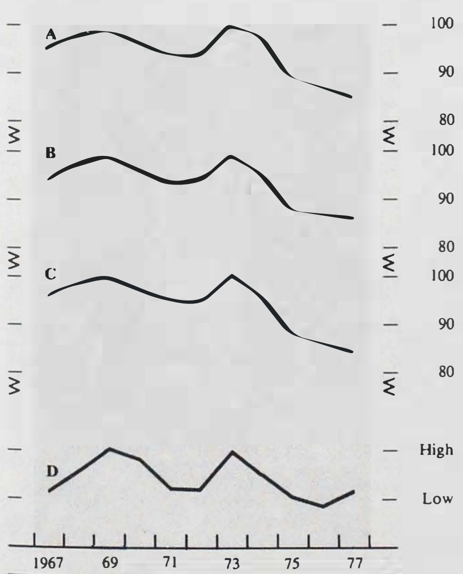
One reason for posing this question is the puzzling trend of unemployment. For instance, with output growing relatively slowly (barely $2\frac{1}{2}\%$ between the first halves of last year and this), unemployment would be expected to have risen. But contrary to many predictions it is now lower than last autumn, and unfilled vacancies higher. Though the Government's job protection measures have helped to keep the level of unemployment substantially lower than it would otherwise have been, they probably did not affect the change in its level very much in the last twelve months. An explanation might therefore be that the underlying growth of productivity has become much slower. It is also disturbing that the supply of skilled labour has remained as short as it appears to be, and that import penetration has continued to increase so rapidly in many sectors of manufacturing industry, even at this stage of the recovery in demand. Here, too, the explanation might be that there is less spare capacity than the previous trend of productivity would imply. If this were true, it would be another indication of the importance of improving the supply side of the economy.

It will hardly be possible to get a clear answer to the question of how far the underlying growth of productivity has slowed down, and to the associated question of how large a margin there now is of unused capacity, except by experience as the recovery proceeds: in the meantime there is room for different views. The experience of previous recessions suggests that, despite the temporary check to actual output, the growth of potential output continues along its old trend rate; and that there is considerable stability in these growth rates in different countries. Arguing from this experience, it could be held that potential productivity has probably continued to grow at near the old rate, and that the observed slow growth of productivity is therefore for the most part a temporary dip associated with the recession. On this view, on a somewhat mechanical calculation, there would now be up to 20% of spare capacity in manufacturing.

Against this it can be argued that the present recession is deeper and has lasted longer than previous post-war recessions. And even before the recession, gross investment was already falling below its previously established trend, and net investment probably even more so; this is likely to have reduced the underlying rate of productivity. One attempt to quantify this effect suggests that the rate of growth in manufacturing has been reduced by about a third since 1970:[1] this in turn might suggest that there is now 10%–15% of spare capacity in manufacturing.

It is, however, uncertain how much credence should be placed on the precise results of such calculations attempting to estimate the effect of investment on the growth of potential output. Estimates of physical investment are known to be subject to wide margins of error; the concept of potential output is elusive and not capable of unambiguous measurement; and, though this is a traditional area of research in economics, it has not proved possible to distinguish with any degree of confidence the separate effects of labour and capital on potential output. Moreover, net investment in any one year is a small proportion only of the existing stock of capital, so that the impact in a single year of a reduction of investment is bound to be small. But over a number of years a sustained shortfall of investment seems likely to have some significant effect on the growth of productive capacity. Even so, most indicators suggest that capacity ulilisation has fallen since the last peak in 1973; and that the margin of unutilised capacity is now considerable (see chart).

Some indicators of capacity utilisation in UK manufacturing industry[a]



[a] The chart shows actual output as a proportion of capacity output, as estimated in various indirect ways:

Line **A** uses the estimate of capacity output made by Artus and Turner (see footnote to text). The possible unreliability of the method, based on an attempt to fit a production function to the historical data, has been indicated in the text.

Line **B** is derived from rougher, unpublished estimates made in the Bank, based on movements in capital/output ratios.

Line **C** is based on interpolation between successive peaks of actual output, whatever degree of capacity utilisation each represents, and extrapolation from the last peak.

Line **D** is based on the proportion of firms reporting less than full capacity working in the CBI quarterly Industrial Trends Survey: it should indicate changes in the degree of capacity utilisation, but does not provide a direct quantitative measure.

In the last few years, industry has been subject, not only to recession, but to some large shifts in relative prices, which may also have affected industrial capability. The large rise between 1972 and 1974 in the prices of industrial materials relative to those of finished manufactures has now been substantially reversed; but most of the sharp rise in the relative price of energy in 1973–74 has remained. One result, in part due to the rise in the price of oil, has been a substantial fall in petroleum consumption in industry. Higher fuel costs must also have modified the attractiveness of different products and processes; and may have made some energy-intensive products and processes obsolete. Though the scale of effect can only be guessed at, this also may have reduced potential output.

If the capability of the UK economy has been reduced in these ways, it has to be remembered that other industrial countries have been affected similarly. All industrial countries have experienced an unusually long and severe recession, in which investment has been depressed more, and for longer, than usual. All countries too have been affected by the rise in the relative price of fuel. It has also to be emphasised that these unfavourable effects apply principally to the industrial sector which is only half the economy. In the case of the United Kingdom, moreover, these unfavourable effects have been accompanied by the progressive exploitation of North Sea energy resources—an advantage not enjoyed by most other industrial countries.

There has been some recent suggestion that a more fundamental and long-term deceleration is taking place in the rate of output and capital accumulation in industrial countries. This may be unduly pessimistic. If productivity has been growing more slowly as a result of lower investment, there seems no reason why it should not be helped if investment picks up; and the present recovery in manufacturing investment, if sustained, should quicken the improvement in the growth of productive potential.

It would, however, be unrealistic to look for an early return to past trends. The deterioration in the real profitability of industrial companies, most especially in the years immediately following 1973, has been documented in earlier issues of the *Bulletin*.[2] Much of the deterioration is due to the prolonged weakness of demand during the recession; but there have been other factors too. Manufacturers as a whole may have been unable to pass on higher input costs fully; or have been insufficiently

[1] J. R. Artus and A. G. Turner, 'Measures of Potential Output in Manufacturing for Ten Industrial Countries, 1955-80'; mimeographed: Research Department, International Monetary Fund. This paper estimates that there was a marked deceleration in the growth of potential output in UK manufacturing industry in the early 1970s—from 3¾% a year in the decade 1960–1970 to about two thirds this rate since 1970.

[2] See the March 1976 *Bulletin*, page 36 and the June 1977 *Bulletin*, page 156.

aware, with historic cost accounting, of the need to do so—with the result that profitability measured in real terms has fallen far below earlier levels, and, despite some recovery, still remains so. Whatever the causes, the consequences may be important. Many producers may now be slower to increase supply in the face of a revival of demand for their products than was earlier the case with better profit conditions. And uncertainties stemming from experience of high and variable inflation and of the recession in demand may also have reduced producers' responsiveness to increased demand, at least until it is clear that the increase will endure.

Though this country is as well placed as most others, it may take time for the rhythm of recovery to get established. While the general aim must be the progressive reduction of the margin of unutilised resources, policies directed towards this aim can only proceed with caution—given the limitations imposed by the balance of payments and the dangers of inflation. A moderate, continuing growth of demand could, however, provide the opportunity for greater adaptability on the supply side; and, if accompanied by an improvement of real profitability from its present inadequate level, could contribute towards a faster and sustainable rate of economic growth in the longer run.