Economic commentary

Introduction

Most indicators suggest that in recent months the expansion in UK economic activity, which was very marked in the second quarter, has moderated. There has been little change in the rate of inflation, and the current account of the balance of payments has been in rough balance. Growth in sterling M_3 has been slightly below the 8%–12% target range; short-term interest rates have risen sharply.

Revised figures suggest a rather more buoyant picture during the first half of the year than was apparent earlier. After rising by close to 1% in the first quarter, output grew unusually strongly, by 2%, in the second. This acceleration was reflected in relatively heavy stockbuilding and a dip in imports. The underlying rate of expansion has probably been more modest —just over 3% per annum. This continues to be based mainly upon consumer spending, which, fuelled by rising real incomes, rose by nearly 6% over the year to September (and by 2% in the third quarter). Exports have been rising at a similar rate, despite fairly subdued growth in world economic activity and trade. Thus, with business fixed investment increasing at about 10% per annum in 1978, overall demand has been growing strongly for more than a year (see chart). As in previous cycles, however, imports have risen extremely—particularly those of finished manufactures, which in the third quarter were over 17% higher than a year earlier (see page 496).

Prices this year have, if anything, risen more slowly than expected. For some months now, the increase in retail prices compared with a year previously has been at or below 8%. Several factors helped to contain the rise in prices (see page 490). World prices have been relatively stable. This, combined with a virtually unchanged effective exchange rate, has meant that there has been scarcely any increase in the prices of industrial materials. In addition, competitive pressures seem to have restrained the growth of wholesale output prices. This has not been an unmixed blessing; company profits have been squeezed, so that there has been some deterioration in profitability since late 1977, despite a significant increase in output (see page 493).

The trade figures continue to display the erratic pattern that has been seen throughout the year, with substantial current account surpluses and deficits in successive months. In the third quarter, there was a current account deficit of £25 million, compared with a surplus of £125 million in the second. For the year to October, the current account was in balance, making it likely that 1978 will end up in rough balance also, against earlier expectations of a surplus.

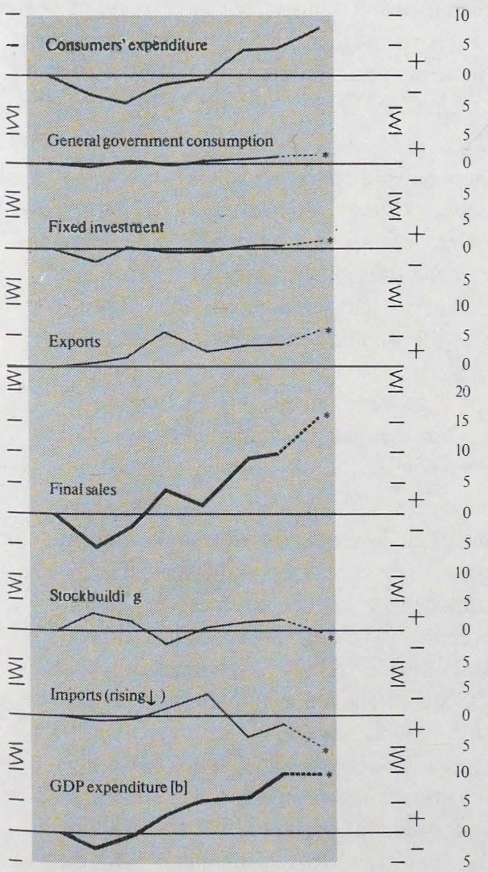
Despite the considerable volatility of the foreign exchange markets, the effective exchange rate has been relatively stable in recent months—as it has been for nearly two years. On the announcement of the dollar stabilisation measures, the effective rate fell from 63.3 to 62.3; even so, it remained within 1% of the end-September level (62.7) throughout October and November. The dollar/sterling rate has fluctuated more—rising from \$1.93 in July to a peak of \$2.10 at one point on 31st October before returning to around \$1.96–\$1.98. The UK official reserves fell from \$16.4 billion at the end of August to \$15.7 billion three months later, but this was more than accounted for by net repayments of official debt, including a further early repayment of \$1 billion to the International Monetary Fund on 30th October.

During the six months from mid-April, sterling M_3 rose by just over $3\frac{1}{2}$%—slightly below the rate implied by the 8%–12% target for the year. However, the figures probably understate the underlying rate of monetary growth (see page 499). On 9th November, the Chancellor announced the adoption of an 8%–12% target for the year from mid-October. On the same day, minimum lending rate was raised from 10% to $12\frac{1}{2}$%, partly reflecting

Changes in components of GDP [a]

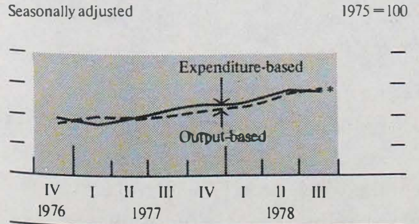
After a sharp rise in the second quarter, GDP is estimated to have changed little in the third.

Seasonally adjusted — £00 millions at 1975 market prices



Indices of GDP

Seasonally adjusted — 1975 = 100



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

the rise in market rates which had occurred in previous weeks and partly to establish a new level appropriate for the continuing restraint of monetary expansion.

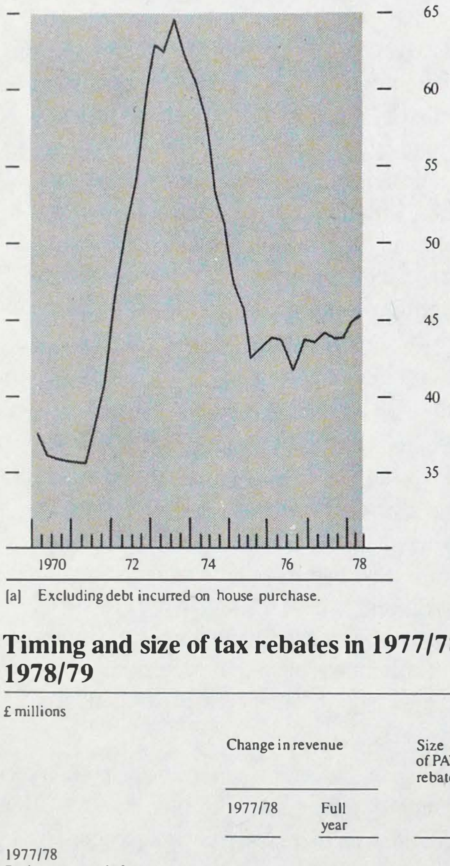
The world economy has continued to grow slowly this year. Total output of the OECD area has revived a little since the second half of last year, but growth for 1978 as a whole will probably have been no faster than in 1977 ($3\frac{3}{4}$%).

The US economy has continued to grow quite strongly. Real GNP increased in the third quarter by 5% (annual rate) compared with the average for the first half of the year when the quarterly path was distorted by the weather and strikes. With industrial production continuing to rise steadily, the economy is likely to have grown this year by nearly 4%. The West German economy expanded significantly faster in the second quarter, after being depressed earlier in the year. Since then growth has continued, and should reach 3%–$3\frac{1}{2}$% for the year as a whole. In the other main overseas economies, both total output and industrial production have been growing more slowly since the first quarter. Inflationary pressures remain troublesome in several countries, notably in the United States where the rate of inflation has accelerated in recent months.

Consumer indebtedness

Despite the sharp rise in spending on durables in the past year, there has been little increase in the ratio between persons' outstanding debt and personal disposable income.

Persons' outstanding debt [a] as a percentage of personal disposable income



[a] Excluding debt incurred on house purchase.

Can the consumer boom continue? [1]

After a pause in the second quarter, the volume of consumer spending rose by almost 2% in the third, with increases in all categories of retail sales. Spending on durable goods has risen particularly strongly—over 12% during the past year; this has been accompanied by a 30% rise in the amount of debt outstanding to finance houses and retailers, and an increase of 24% in bank lending to persons. As a percentage of personal disposable income, however, consumer indebtedness has remained remarkably stable in recent years (see chart), well below the peak of 1973 (when interest payments could be set off against tax).

The strong growth in consumer spending has been based upon a sustained rise in real incomes—$7\frac{1}{2}$% between the second quarters of 1977 and 1978. The timing of the various tax changes over the past year or so, however, has distorted the path of real personal disposable income and made quarterly comparisons hazardous. In the second quarter, for example, real personal disposable income rose by 3%, after a fall of almost 1% in the first. The second quarter figure was boosted, however, by a bunching of pay settlements towards the end of stage three and by increased personal allowances from the Budget, while the first quarter decline followed the heavy tax rebates paid at the end of 1977.

Real incomes will continue to grow, although the extent of the rise will obviously depend on wage and price developments over the coming months. The small number of settlements so far concluded under stage four may keep the growth of earnings down in the fourth quarter as it appears to have done in the third; but the tax rebates and increases in pensions and child benefits payable in November will offset this. These changes and those in 1977/78 and earlier in 1978/79 are set out in the table. In all, real personal disposable income may rise by as much as 4% in the second half of 1978. The growth of disposable income since the middle of last year has been more than sufficient to finance the rise in consumption. The savings ratio which had been under 14% in the second quarter of 1977 was over 15% a year later, and with continuing rapid growth in real incomes it is unlikely to fall back for some time.

Timing and size of tax rebates in 1977/78 and 1978/79

£ millions

	Change in revenue		Size of PAYE rebate[a]	Paid in
	1977/78	Full year		
1977/78				
Budget proposals for personal allowances	776	970	100	May
Budget proposals for tax bands	164	275	30	May
Further amendments to personal allowances (Chancellor's statement of 15.7.77)	400[b]	490[b]	130	August
Reduction of basic rate from 35% to 34%	400[b]	490[b]	130	August
Further amendments to personal allowances (Chancellor's statement of 26.10.77)	940	1,150[b]	600	November
1978/79	1978/79			
Budget proposals for personal allowances	472	572	40	May
Budget proposals for lower rate tax band and higher rate bands	1,433	1,775	350	July
Further amendment of higher rate bands	105	150	70	November
Reduction of basic rate from 34% to 33%	340	370	170	November

[a] Estimated, assuming PAYE accounts for 80% of the rebate.
[b] Estimated.

Timing of other major changes in 1978/79:

	Effect on PSBR		Date of change
	1978/79	Full year	
National insurance surcharge increased from 2% to $3\frac{1}{2}$%	300	900	October
Pensions increase	− 500	− 1,200	November
Child benefit increase (to be increased again in April 1979)	− 165	− 400	November

Earnings in stage three

Average earnings rose by about 14% during stage three, compared with about 8% during stage two. The 10% guideline soon came to be regarded as an entitlement by most groups of workers. Only 1% of employees [2] settled for less. Productivity deals were negotiated by some 10% of employees and were most widespread in the production industries, where earnings on

[1] This section is in seasonally-adjusted terms.
[2] According to the Confederation of British Industry's monitoring of pay settlements.

average rose by nearly 16% in stage three. Such deals probably added a further 1%–2% to the overall increase in earnings, leaving a substantial amount in excess of the guideline (some 2%–3%) attributable to various forms of wage drift and other factors.

The present pay round

The prospect for stage four remains uncertain. In the first two months, earnings rose by only $\frac{1}{2}$%, reflecting the small number of settlements to date. The Confederation of British Industry reported that less than a third of the expected number of employees had been covered by settlements concluded by 24th November. Over 90% of these had settled for increases within the Government's guidelines, but most of the claims outstanding (affecting over 3$\frac{1}{4}$ million employees) are for 20% or more.

Earnings differentials

The chart, based on the Department of Employment's annual April earnings survey, shows weekly earnings at various points in the income distribution, both before and after tax, and adjusted for price changes. Post-tax real earnings, which had fallen between April 1975 and April 1977 at all income levels, recovered all these losses in the year to April 1978. The gains were fairly evenly spread. The ratio of earnings at the top of the income distribution to those at the bottom was little different in April 1978 from a year earlier. While the pre-tax distribution widened slightly, this was offset by the introduction of the lower rate tax band, worth proportionately more to the lower paid. Over the past 4–5 years, there has been a pronounced narrowing in the post-tax real earnings distribution, with the ratio of the highest decile [1] to the lowest falling by around 10%.

Despite the relatively slower rate of increase in public sector pay during recent stages of incomes policy, the gains obtained by the public sector in earlier years have not been wholly eroded. From approximate equality of male earnings in public and private sectors in the early 1970s, [2] the public sector's relative position improved in every year except one (from 1972 to 1973) until 1976, when it was ahead by nearly 11%.

The move towards equal pay for male and female employees and the flat rate provisions of some recent incomes policies could both be expected to result in an improvement in the pay of women relative to that of men. Except in the most recent year [3] and in 1972–73, women's relative pay has improved throughout the 1970s, probably reflecting the effects of equal pay legislation. Women's relative pay, however, rose only slightly in the year from April 1976, and fell in the latest year—probably because of distortions caused by delayed settlements in the public sector. In the private sector, the small improvement in women's relative pay from 1976 to 1977 continued in 1978.

Prices rise slowly overseas

The continued slow rise in the export prices [4] of manufactures of the main industrial countries (see table) has been a moderating factor on the rise in UK consumer prices this year.

These countries have, of course, benefited, as has the United Kingdom, from the movements in oil and other commodity prices. Although other commodity prices rose a little in the first half of this year, they fell again in the third quarter; oil prices have continued to fall in terms of most currencies; and there has been only very modest growth in unit labour costs. Prices of manufactured exports have probably continued to rise only slowly since the middle of the year.

Consumer prices abroad, however, have been rising faster than those of manufactured exports. The average rate of increase in the six largest

[1] The ratio of earnings of those one tenth of the way from the top of the income distribution to the earnings of those one tenth of the way from the bottom.

[2] As shown by the *New Earnings Survey*.

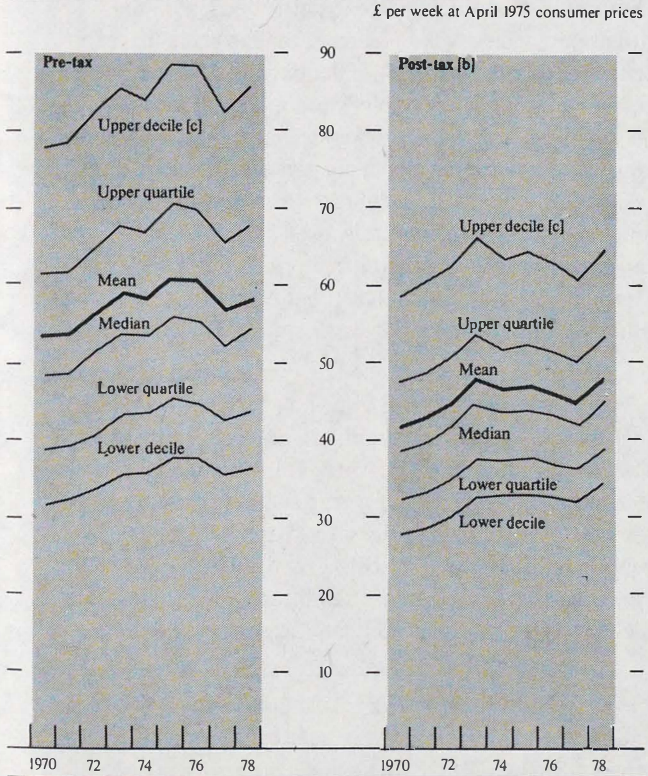
[3] April 1977–April 1978.

[4] In local currencies and weighted by share of UK manufactured imports.

Real weekly earnings[a]

In the year to April 1978, post-tax real earnings in all income groups recovered the losses sustained in the previous two years.

£ per week at April 1975 consumer prices



[a] The figures for each year are as at April. Earnings have been converted to 1975 prices using the deflator of total consumers' expenditure; patterns of consumption vary at different income levels, so the deflator may not be entirely appropriate at each level.

[b] The appropriate tax and national insurance deductions have been made (and child benefit added) as for a married man with two children not entitled to other deductions. All changes in tax rates and allowances in 1978/79 are assumed to have taken place in April 1978. Social security and other benefits are not included because their net impact on income is unclear.

[c] The highest decile refers to the point in the earnings distribution—in terms of numbers of employees—which is 10% below the top. Thus, in April 1978, earnings at the highest decile were £129.5 a week before tax; 10% of adult male employees earned more than this. Similarly the upper quartile refers to earnings 25% below the top (£102.6); the median refers to earnings 50% below the top (£82.0); the lower quartile to earnings 75% below the top (£66.1); and the lowest decile to earnings 90% below the top (£54.8).

Costs and export prices of manufactures in eight major overseas countries[a] in domestic currencies

Percentage changes on previous period

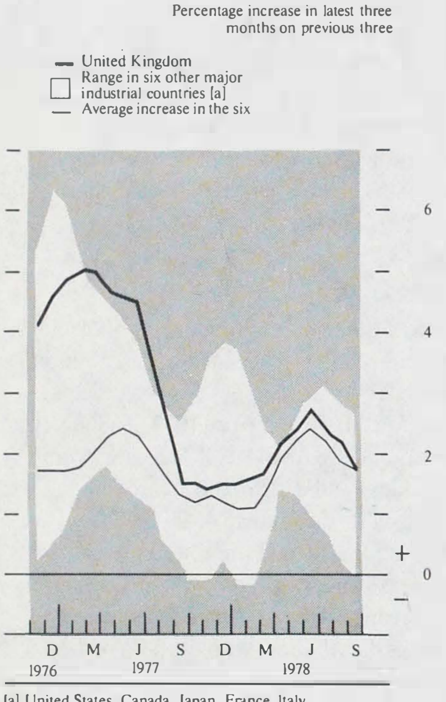
	1976		1977				1978		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Oil prices[b]	− 0.3	− 2.2	8.2	− 1.0	0.3	− 2.5	− 4.8	− 1.2	− 3.7
Other commodity prices[b]	5.1	—	17.7	5.2	− 15.1	− 2.0	1.3	2.8	− 3.6
Unit labour costs	2.5	1.2	1.0	2.5	1.9	3.1	—	0.1	1.5
Domestic prices of manufactures	2.3	1.5	1.9	1.3	0.6	0.6	0.9	1.3	0.9
Export prices of manufactures	2.4	2.1	1.7	0.2	1.3	0.5	0.8	0.6	..

[a] United States, Canada, Japan, Western Germany, France, Italy, the Netherlands and Belgium; weighted by share of UK manufactured imports.

[b] US dollar prices converted to national currencies.

Consumer prices in the main OECD countries

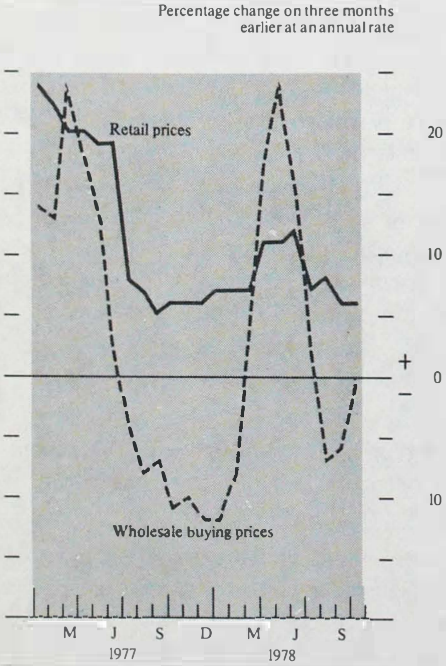
Seasonal influences have moderated the average rate of price inflation since the middle of the year.



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

Wholesale buying prices and retail prices

The rise in retail prices over the last twelve months has been remarkably steady.



overseas economies [1] has slowed down again recently (see chart), but seasonal factors probably account for at least some of the decline; the underlying rate of price inflation appears to be running at an annual rate of around 8%, compared with about 6% a year ago. Although consumer prices have risen very little recently in those countries benefiting from the effects of currency appreciation on import costs, this has been more than offset by acceleration elsewhere, especially in the United States and France.

Favourable UK price developments too

Despite the much faster growth of earnings during stage three, the rise in retail prices has not accelerated much this year, partly because of the favourable trend of import prices. Manufacturers' buying prices have for the most part been lower this year than last, reflecting the fall back in commodity prices and the greater strength of sterling against the US dollar. After rising sharply in the second quarter when sterling weakened, buying prices fell back again in the third (see chart) but picked up again in October and November when the index was $3\frac{3}{4}$% higher than a year earlier. The acceleration in unit labour costs, which rose by over 7% between the first and third quarters, has not yet shown up in output prices. Selling prices, $7\frac{1}{2}$% higher in October than a year earlier, have continued to rise moderately, implying that profit margins have been squeezed in the past six months.

The increase in retail prices over the preceding twelve months has been remarkably stable, at around 8%, for some months now. There was a stronger increase in the second quarter (see chart) largely because of the increase in local authority rent and rates in April. This has since levelled off, helped, in recent months, by lower prices for seasonal foods following the good harvest. Other factors restraining prices this year have been the absence of increases in indirect taxes (see below) and unchanged gas and telecommunications charges. In the coming months, however, unfavourable influences will include higher mortgage rates and seasonal rises in food prices.

The increases in the retail price index for goods and services produced by nationalised industries in the past year have been broadly in line with those for retail prices in general. But there has been little pressure on prices from the two most profitable nationalised industries—Post Office telecommunications and gas (see the table on page 341 of the September *Bulletin*). Charges of the former have remained broadly unchanged since 1975, and of the latter since April 1977. Increases in line with other prices might have added about $\frac{1}{4}$% to the twelve-month increase in the retail price index.

Prices and indirect taxes

Certain important indirect taxes are levied on the quantity rather than the value of the goods consumed, in particular the duties on alcohol, tobacco and road fuel, and motor vehicle licences (which together yielded some £$7\frac{1}{2}$ billion revenue in 1977/78, 21% of total tax revenue). If these duties are not increased in line with other price rises, indirect tax receipts decline in real terms; although goods subject to these duties become cheaper relative to other goods, the shift, if any, towards consumption of these goods is insufficient to make up the revenue forgone by not raising the rates of duty. With the exception of the duty on higher tar cigarettes, none of these specific duties was increased in the April Budget because the consequent increase in the retail price index was thought to be inconsistent with the overriding priority of controlling inflation. Some £600 million of revenue was forgone as a result of this decision.

Government spending turns up

Public spending [2] on goods and services declined over the two years to the middle of 1978 but it is now likely to turn up, and growth of about 2% is

[1] In local currencies and weighted by share of GNP.

[2] This paragraph is expressed in terms of national accounts definitions, constant (1975) prices, seasonally adjusted. The rebasing of the national accounts at 1975 prices has not significantly altered the picture presented by the data based at 1970 prices.

expected during 1979. Government current expenditure in the second quarter of 1978 was 2% higher than in the corresponding period of 1977, and has been growing steadily at an annual rate of 2½% since the last quarter of 1977. Public sector fixed capital formation in the second quarter of 1978 was 10½% lower than a year earlier, continuing the fall since the peak in the first quarter of 1976; the decline since then amounts to nearly 30%.

Total public expenditure [1] is expected to rise by about 5% in real terms between 1977/78 and 1978/79 and by a planned 2% per annum thereafter. Recently announced increases in public expenditure this year, for example the Christmas bonus for pensioners, are being met from the contingency reserve for 1978/79, of which about £50 million [2] now remains.

Public borrowing within forecast

The public sector borrowing requirement (PSBR) in the third quarter of 1978 was £2.1 billion, seasonally adjusted, bringing the total for the first half of this financial year to £3.9 billion. This suggests an outturn for 1978/79 as a whole of £8 billion [3] (£0.5 billion less than the Budget forecast). Borrowing can be expected to be a little higher in the second half of the year; increases in pensions and child benefits and further tax rebates (arising from Opposition amendments to the Finance Bill) were payable in November, [4] although the rebates are largely offset by the increase in the national insurance surcharge which took effect in October.

There has been a wide margin of error in forecasts of the PSBR in recent years, averaging (in the case of Budget forecasts) some £2½ billion over the past five years, after adjusting for mid-year policy changes (see table). Many of the errors arose from the difficulty of predicting the effects both of rapidly changing rates of inflation and of major policy changes.

Government deficits: comparisons with other countries

During the last two years, the UK general government financial deficit has amounted to 3%–4% of GDP, very little different from those of the other main OECD countries (see table). Apart from Italy, all the countries shown have had deficits falling within the range of 1%–5% of nominal GDP.

In recent years, the general government sector in all the main OECD countries has been in deficit. This contrasts with earlier years when the position was less uniform, with a rough balance between governments in deficit and governments in surplus. The sharp change that took place in 1974 and 1975 has not been reversed, with governments continuing to support weak demand.

Conventional public sector accounting makes no allowance for the effect of inflation on the real value of outstanding government debt, so that published figures give a somewhat misleading indication of the balance of public sector transactions in real terms and therefore of the impact of budgets on activity. [5] No attempt has been made in the table to adjust for the effects of inflation; accordingly no inferences can be drawn from it about the stance of fiscal policy in the various countries.

The concept of the general government deficit is widely used for international comparisons, but there is a considerable difference between it and the UK concept of the PSBR. The latter measure (which is not similarly emphasised in other countries) comprises the balance of the consolidated accounts of both general government and public enterprises, plus public sector net lending to the private and overseas sectors. Since the United Kingdom has a relatively large public enterprise sector, and as there has recently been quite substantial net lending to the private and overseas

Errors in the Budget forecasts of the PSBR

£ billions; *percentage in italics*

	PSBR			Differences					
	Budget forecast[a]	Outturn	Difference[b]	Revenue		Expenditure		Financial transactions
	(1)	(2)	(3)	(4)		(5)		(6)
1973/74	4.4	4.4	—	0.9	*3*	1.9	*6*	−1.0
1974/75	3.9	7.9	4.1	1.2	*3*	5.5	*15*	−0.2
1975/76	9.1	10.6	1.5	2.5	*5½*	3.2	*6*	0.8
1976/77	11.9	8.6	−3.3	3.0	*5½*	—		−0.3
1977/78	9.7	5.5	−4.2	2.0	*3*	−0.9	*−1*	−1.2

Sources: Forecasts from *Financial Statement and Budget Reports*, 1973/74 to 1977/78; outturns from *Financial Statistics*.

[a] Adjusted for the measures taken in July and November 1974 (affecting 1974/75), December 1976 (affecting 1976/77) and July and October 1977 (affecting 1977/78); other mid-year measures (e.g. July 1976) did not significantly affect the year in question.

[b] 3 = 2 − 1 or 5 − 4 + 6; small discrepancies are due to rounding.

International comparison of government deficits[a]

Percentage of GDP at market prices

	1975	1976	1977	1978[b]
United States	4.2	2.1	1.1	¾
Japan[c]	4.0	3.7	4.2	5½
Western Germany	5.8	3.7	2.7	4
France	2.2	0.8	1.2	2
United Kingdom	4.8	4.9	3.3	3¾
Canada	2.3	1.8	2.7	3
Italy	14.5	9.8	9.8	11½
Average[d]	4.6	2.9	2.4	2¾

Source: *OECD Economic Outlook*, July 1978.

[a] The figures are based on the United Nations system of national accounts (SNA). This allows a degree of comparability which is not possible using figures based on individual countries' national accounts. For details of definition, and further discussion of international comparisons of this sort, see:
United Nations, *A System of National Accounts*, (New York, 1968).
HM Treasury, 'International Comparisons of Public Sector Financial Balances', *Economic Trends*, May 1976.
Mark Wasserman, 'Public Sector Budget Balances', *OECD Economic Outlook, Occasional Studies*, July 1976.

[b] Estimates.

[c] Fiscal years.

[d] GDP weighted.

General government financial deficit and PSBR

Percentage of GDP at market prices

	1975[a]	1976	1977
General government financial deficit	4.8	4.9	3.3
Public sector borrowing requirement	10.1	7.6	4.1

Source: Central Statistical Office.

[a] The particularly large difference in 1975 is mainly due to the effect of price restraint on the nationalised industries' trading performance, and their resultant heavy borrowing.

[1] As defined in the 1978 Public Expenditure White Paper (*The Government's expenditure plans, 1978/79 to 1981/82*, Cmnd. 7049), but expressed in 1978 survey prices; this includes transfer payments and financial transactions as well as expenditure on goods and services.

[2] At 1978 survey prices.

[3] See the Treasury's *Economic Progress Report*, November 1978.

[4] The effects of tax changes over the last two years are set out in the table on page 488.

[5] See, for example, the article by Miss C. V. Downton in the September 1977 *Bulletin*, page 319.

sectors, the difference between the general government deficit and the PSBR has been considerable in recent years (see table on the previous page).

Housebuilding still sluggish, but prices rising [1]

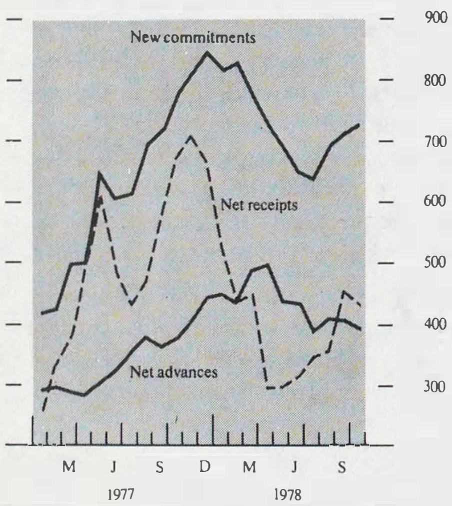
There was a further fall—of 3½%—in the volume of residential investment in the second quarter, reflecting the continued decline in public sector housebuilding and an apparent end to the recovery in the private sector. The contraction in the public sector partly reflects underspending by local authorities. Approvals this year are again running well below target, and, with starts down by 13% in the third quarter, public sector housebuilding is likely to have remained depressed for the remainder of the year.

Last year's recovery in private sector investment has not been maintained. After a fall of over 5% in the first quarter, there was no increase in investment in the second when it was 3¼% lower than a year earlier. On the other hand, a sharp increase in work in progress brought a 12% rise in private sector housing output in the second quarter; some of this was the result of better weather after an unusually wet first quarter; another factor may have been higher spending on house improvements, stimulated by higher real incomes and the rise—for a time—in mortgage lending for this purpose. Improved prospects for builders were doubtless also responsible, although their confidence does not seem to have been maintained. Starts and completions fell by 8% and 7% respectively in the third quarter, and the July Private Enterprise Housing Enquiry forecast of 155,000 starts in 1978 seems unlikely to be reached. House prices meanwhile, have continued to rise rapidly, by 9½% in the third quarter (21% year-on-year). Price rises could still be reflecting the stronger market earlier in the year when earnings were rising quickly and building society lending reached a peak (see chart); in recent months, after a decline in inflows, societies' lending has dropped back and, after allowing for peripheral lending, [2] has been more in line with the agreed guideline of £640 million a month. Although net receipts improved somewhat in September and October, they have been barely sufficient to allow societies to maintain their lending without further drawing on their liquidity. Accordingly, the building societies responded quickly to the 2½% rise in minimum lending rate on 9th November, by recommending an increase in the share rate from 6.7% [3] to 8% from 1st December.

A consequence of the rapid increase in house prices this year, coupled with the cutback in lending, has been a substantial decline in the real volume of advances for house purchase, which was some 25% lower in the third quarter than in the first. It is perhaps surprising that this does not as yet seem to have led to a slowdown in the rate of increase of prices, perhaps because higher real personal incomes have led to a strengthening of underlying demand in the owner-occupied market. The 2% increase in the mortgage rate, however, may lessen the pressure on prices by reducing the amounts which prospective purchasers can afford to borrow.

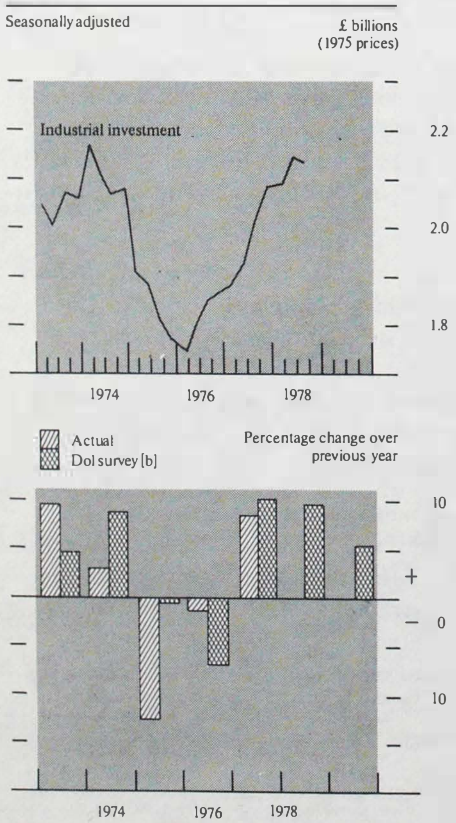
Building society funds

The recovery in net receipts in the third quarter has led to some increase in commitments.



Investment intentions and outcome [a]

Industrial investment may grow more slowly during the coming year.



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

[b] The chart shows the results of the first main survey which is published in October of the year prior to the year under consideration.

Growth in industrial investment may slow down

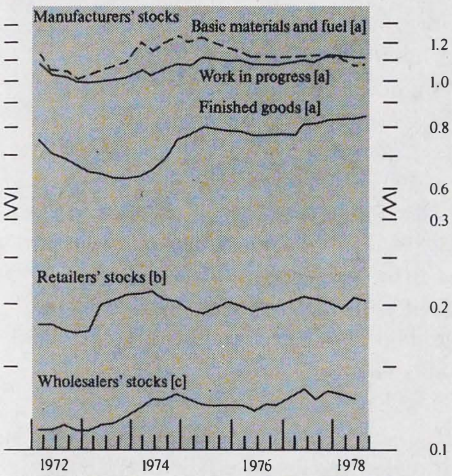
The rapid growth of industrial investment [4] during the past year may be slowing down. The latest figures show little change in the third quarter, but in the year to date, there has been a rise of 9½% over a year earlier. The recent growth has been broadly in line with the Department of Industry (DoI) investment intentions surveys of late 1976 and early 1977—which were regarded at the time as surprisingly buoyant. The most recent (October) survey, however, suggested that industrial investment may rise by 5½% in 1979, implying only modest growth from now on. Such a slackening might seem surprising after the appreciable pick-up in economic activity this year, but the recent deterioration of companies' financial position argues for a subdued outlook; moreover, recent CBI surveys have recorded only a modest improvement in business confidence.

[1] This section is in seasonally-adjusted terms.
[2] Lending for improvements, extensions, etc.
[3] Net of tax at the basic rate.
[4] Investment in manufacturing, and distribution and services.

Stock/output ratios

Stock/output ratios have changed little in recent years, but remain historically high.

Logarithmic scale | Ratios at 1975 prices

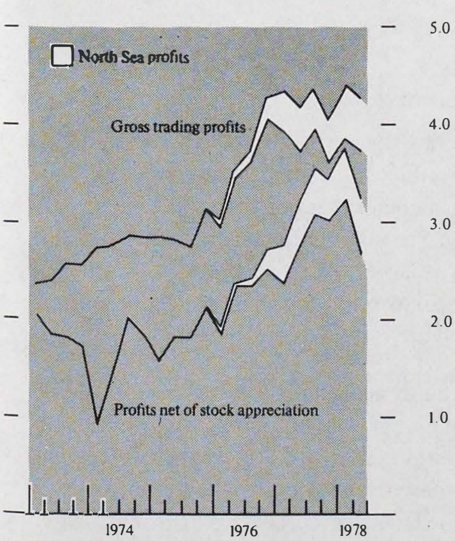


[a] As ratio of manufacturing production.
[b] As ratio of consumers' expenditure.
[c] As ratio of final sales.

Industrial and commercial companies' profits

Profits have weakened since the end of last year.

Seasonally adjusted | £ billions



Financial position of companies

£ billions

		Income, net of stock appreciation[a]	Dividend and interest payments	Tax payments	Undistri-buted income	Capital expen-diture	Financial deficit
1975	1st half	4.8	2.5	0.6	1.7	2.1	−0.4
	2nd half	5.6	2.5	0.6	2.5	2.8	−0.3
1976	1st half	6.1	2.6	0.4	3.1	3.5	−0.4
	2nd half	7.2	3.0	0.5	3.7	4.6	−0.9
1977	1st half	7.6	3.1	0.8	3.7	5.4	−1.7
	2nd half	8.3	2.9	1.0	4.4	5.1	−0.7
1978	1st half	8.6	3.1	1.1	4.4	6.4	−2.0

[a] Gross trading profits (net of stock appreciation), rent and non-trading income, income from abroad (net of profits due abroad) and net receipts of capital transfers.

Lower stockbuilding

Output is likely to have grown more slowly than final sales in the third quarter because of slower stockbuilding. Stocks held by manufacturers and distributors are provisionally estimated to have risen by £132 million (1975 prices) in the third quarter, less than half the increase in the second quarter. Some reduction in the rate of stockbuilding was to be expected after the large build-up in the first half of the year.

The difference between the two quarters is almost entirely due to lower growth of manufacturers' stocks, mainly affecting work in progress and stocks of finished goods. The change in work in progress is probably associated with the corresponding movements in manufacturing production—output was little changed in the third quarter after the sharp increase in the second. Some reduction in stocks of finished goods might have been expected this year since stock /output ratios have been historically high, but the relative stability in this ratio in recent years (see chart) may suggest that any overhang of stocks is rather small. Survey evidence supports the view that there will be some reduction in manufacturers' stocks of finished goods in the short term.

Stocks of materials and fuels held by manufacturers fell back slightly in the third quarter—the sixth successive quarterly decline. This path is difficult to rationalise, given the surge in imports of industrial materials combined with only modest growth of manufacturing output—but may reflect differing allocations of goods in the stocks and imports figures.

Retailers' stocks rose more slowly in the third quarter, perhaps reflecting the sharp rise in retail sales. Wholesalers' stocks increased slightly, offsetting a reduction in the second quarter.

Profits weaken because of cost pressures

Companies' profits (net of stock appreciation) [1] fell sharply in the second quarter. The faster growth of unit labour costs and an upturn in the sterling price of imported raw materials—as sterling weakened earlier in the year—more than offset the beneficial effect of a revival in domestic activity. The squeezing of profit margins must reflect a delay in the response of prices to these cost pressures; and, for some time now, competition from imports may have been restraining price increases. While the sharp acceleration in costs in the second quarter may give an unduly depressed impression of profitability, there seems little doubt that the recovery in cash profits since mid-1975 (see chart) came to a halt in late 1977 and has not resumed. The chief reason has almost certainly been the acceleration of the growth of unit labour costs during stage three.

There may have been a modest improvement in cash profits in the second half of the year; economic activity has continued to recover and cost pressures, helped by the recent stability of sterling, may have eased. Even so, companies' real rate of return (excluding North Sea activities) seems likely to fall back, for 1978 as a whole, to the lowest level of recent years. [2]The outlook for profits during the coming year will largely depend on the course of earnings during stage four.

Undistributed income [3] has been little changed over the last year. The impact of the sharp rise in dividend payments in 1977 was more than offset by falling interest charges (see table), but the rise in interest rates in the early part of this year has increased this call on companies' income. Tax payments have also risen particularly rapidly over the past two years with the, albeit modest, recovery in profits.

Companies' financial deficit widened in the early part of this year and in the second quarter alone totalled £1.4 billion—on the scale, in nominal terms, of the quarterly deficits of 1974. Perhaps reflecting this, bank borrowing (particularly by manufacturing industry) picked up sharply in the second quarter. Company liquidity, however, has improved substantially

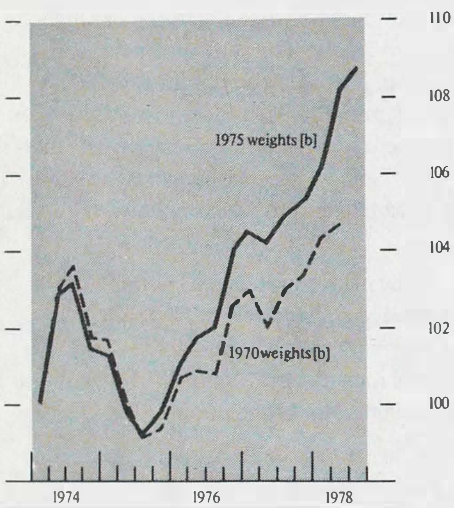
[1] Excluding those earned on North Sea activities.
[2] An article 'Measures of real profitability' appears on page 513.
[3] Net of stock appreciation, plus net capital transfers.

between the second quarters of 1977 and 1978, but the DoI survey indicates some erosion since.

Gross domestic product (output estimate) [a]

Latest figures indicate growth of 9½% over the last three years.

Seasonally adjusted 1975 = 100
Logarithmic scale



[a] Differences between the two series in the second quarter of 1978 arise partly because the provisional figure in the 1970 series has not been revised in the light of the latest data. No figure is available in the 1970 series for the third quarter.

[b] Based on price and output data, in 1975 and 1970 respectively.

Patchy growth of output

The output-based measure of GDP rose by 0.5% in the third quarter after a 2% increase in the second, and is now 3.6% higher than in the same quarter last year. The rise in activity in the third quarter occurred largely in services, particularly distribution, reflecting the continued buoyancy of retail sales; industrial production slipped back slightly after the spurt in the spring.

The pick-up in industrial production this year has occurred only to a limited extent in manufacturing, where there has been no consistent pattern of growth among individual industries, and where movements from month to month have been rather uneven. In the third quarter, manufacturing output was little changed, and output in the fourth quarter will be affected adversely by the industrial dispute at Ford's: vehicle production is estimated to have fallen by over 25% in October. With that dispute settled, there is likely to be further slow growth into the first half of next year—a view supported by the most recent CBI survey, which indicates that business confidence, while remaining fairly muted, has improved slightly over the last four months.

Output of the mining and quarrying sector (which includes North Sea activities) rose by 2¼% in the third quarter after the 10½% increase in the second. The rebasing of the national accounts has increased the weight given in the industrial production index to the growth of North Sea oil production; this has led to substantially higher figures for the growth of output in 1976 and 1977 on the new basis. Construction output may have slipped back slightly in the third quarter after unusually strong growth—about 6%—in the second, but is still well above the level of the latter half of 1977.

Employment and unemployment

Changes between June 1977 and June 1978: United Kingdom; *not seasonally adjusted*

Thousands

	Males	Females	Total
Employed labour force [a]	− 37	+ 69	+ 32
Registered unemployed [b]	− 28	+ 24	− 4
Working population	− 65	+ 93	+ 28
For comparison: estimated total labour force [c]	*+40*	*+153*	*+193*

[a] Including HM Forces; self-employment assumed unchanged.
[b] Excluding adult students, including school-leavers.
[c] Great Britain, excluding students.

More women at work but fewer men

There continues to be evidence of tightening in the labour market although, at present, as much because of a reduced flow in the numbers actively seeking employment as of any sustained expansion in the demand for labour. Unemployment has fallen, virtually continuously, since October 1977, and by November was more than 90,000 lower than a year earlier. Yet employment appears to be increasing only slowly and, in the year to June, grew by far less than the expected increase in the labour supply.

This disparity has been particularly acute among men (see table). Male employment and unemployment have both been falling, suggesting a decline in the total number of men available for work, yet the number who are of working age is believed to have risen. Since a high, and normally stable, proportion of these join the labour force, some growth in the latter was expected. Part of the explanation may be that self-employment has increased, partly because of the recent upturn in the construction industry. Earlier retirement may also have been an influence.

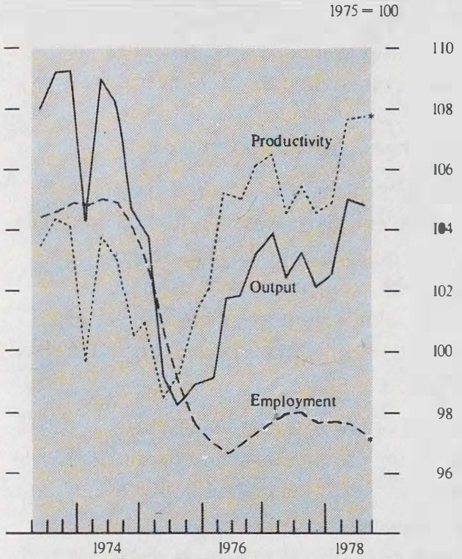
The pattern for women is less surprising. Taken together, employment and unemployment have increased by less than expected, but activity rates amongst women have always been relatively volatile and the labour force projections correspondingly uncertain. Activity rates for women have increased rapidly in recent years, no doubt partly in response to equal pay legislation and the greater availability of part-time employment.

Productivity still growing slowly

Output per head has been increasing by around 3% per annum since 1975. Employment varied little in this period, so that productivity has closely

Output, employment and productivity in manufacturing industry

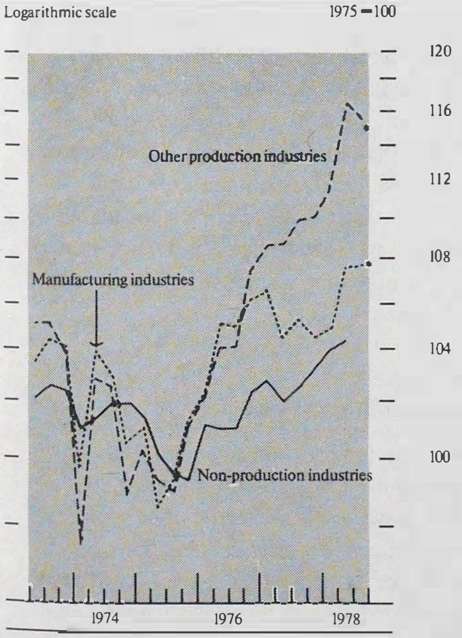
Growth of productivity is still constrained by the slow recovery of output.



* Bank estimate for third quarter of 1978.

Output per head

Productivity has risen faster in the past year mainly outside manufacturing.



* Bank estimate for third quarter of 1978.

Growth of UK export markets

Per cent

	Share of world imports[a] in 1977	Share of UK exports in 1977	Growth of total import volume in UK export markets. Change on previous period at annual rate	
			1977 2nd half	1978 1st half
UK export markets				
United States	15.1	9.7	+ 2½	+ 9¾
Canada	4.1	2.2	− 8	+ 6
Japan	6.9	1.5	+ 3	+ 3
Western Germany	9.8	7.8	+ 9	+ 8½
France	6.8	6.7	+ 3½	+ 3
Italy	4.6	3.0	− 11½	+ 2½
Netherlands	4.5	6.7	+ ¾	+ 6
Belgium	3.9	5.7	− 6	+ 5¼
Other OECD Europe	18.0	25.0	+ 3½	− 5½
Australia, New Zealand, South Africa	2.3	5.1	− 15	+ 10
OPEC	8.8	13.5	+ 14½	—
Other developing countries	15.2	13.1	+ 17	+ 15
Growth of UK export markets			+ 4¾	+ 3¾
Growth of UK export volume			+ 7¼	+ ½

[a] Excluding United Kingdom.

followed movements in output (see chart). Within manufacturing industry, cautious recovery is still keeping the growth of productivity below its pre-1974 trend rate. This year, output per head in manufacturing appears to have been about 2½% higher than a year earlier—when it was little higher than in 1973. Elsewhere, productivity growth has been more buoyant (see chart). The expansion of oil production from the North Sea and the recent strength of construction have raised output per head in production industries outside manufacturing by around 6% in the past year and by about 5% per annum since 1975. Outside the industrial sector, where productivity growth is generally less rapid, improvements in the past year have been relatively strong. The longer-run trend of employment away from manufacturing to services may lead to slightly lower overall productivity growth. At present, however, cyclical influences rather than long-run trends remain dominant.

UK exports: slow growth of markets

The volume of world trade rose a little in the second half of 1977, despite the slow growth of industrial countries' output. Since then, it has probably been growing at about the same rate. Faster growth of imports into North America and some of the larger European economies helped sustain the growth of trade in the first half of this year, as did the continued rapid rise in the imports of the non-oil developing countries. This was partly offset by a sharp fall in the imports of the smaller European OECD economies (largely reflecting restrictive policies) and a check to the growth of OPEC imports in the face of deteriorating current payments positions. For this year as a whole, total world trade has probably grown no faster than in 1977.

The countries experiencing much slower growth of imports this year include important UK export markets (particularly OPEC and the smaller European economies, see table). As a result, total UK export markets have grown more slowly this year than last, despite signs of recovery recently. Markets for UK manufactures followed a similar pattern to total UK export markets during 1977 but were much more depressed in the first half of 1978.

Exports rise strongly in the third quarter

The volume of exports (excluding erratic items [1]) rose by just over 5% in the third quarter, a quarterly rate unprecedented in recent years. Manufactures (again excluding erratic items) rose at about the same rate. This strong performance took the volume of manufactured exports to 2½% above the previous peak (in the same quarter last year).

With world trade still probably growing relatively slowly, there must have been a significant increase in the United Kingdom's market share. Taking a longer perspective and comparing the volume of exports so far this year with the same period last year, manufactures have risen by about 3% against an estimated rise of 3½%–4% in the volume of world trade in manufactures. [2] Such a performance is not inconsistent with the normal historical relationship between UK exports and world trade: the UK share of world markets has generally fallen slowly when world trade has grown slowly, but more rapidly when the growth in world trade has begun to accelerate.

The main feature continues to be the strength of non-manufactured exports, the volume of which rose by nearly 6% in the third quarter—principally because of the growth of exports of crude oil, which have been 28% higher in value so far this year than last, most of this reflecting volume growth.

The growth in total exports during the third quarter was geographically widespread, but exports to the oil-exporting countries fell back. Exports to other developing countries, however, more than made up for this shortfall. Compared with the first nine months of 1977, exports to the EEC countries have risen strongly, but exports to other Western European markets have actually fallen in value during the same period.

[1] Ships, aircraft, precious stones and North Sea production installations.
[2] Weighted by the composition of UK exports.

In terms of bilateral balances, it is particularly with the EEC countries that the United Kingdom has lost ground. The composition of this deterioration shows that the principal area of concern is manufactured goods; non-manufactures have actually shown substantial improvement. This again underlines this country's apparent inability to compete against other industralised countries in these important markets; the upturn in domestic demand this year may have exacerbated this weakness.

Imports of industrial materials surge again

Imports, too, rose very strongly in the third quarter—by 7% in volume terms (excluding erratic items). Much of the rise was in industrial materials, which had fallen back in the previous quarter from the peak reached early in the year. The strongest rate of growth was in imports of 'other semi-manufactures' which rose by 8½% in volume; imports of basic materials increased marginally but by no more than might have been expected in view of the rise in manufacturing production.

When the latest figures for imports of raw materials and semi-manufactured goods and manufacturing production are compared with data for the same stage in previous cycles, it is striking that, although the rise in output has been much more modest than in the 1972–73 cycle, the rise in imports of semi-manufactures has been almost as rapid as it was five years ago (see table). Compared with the 1967–68 cycle—which the current upturn more closely resembles in strength—the increase in semi-manufactures has still been surprisingly rapid in the light of the modest growth of manufacturing output.

There have been some significant changes in the composition of imports of semi-manufactures over the past year. Imports of textiles have been rising, and the balance on textile trade falling, mainly on account of trade with the EEC rather than with developing countries. There has also been a large rise in both imports and exports of organic chemicals, despite adverse movements in competitiveness, suggesting that further international specialisation within that category is taking place—perhaps because of the increasing availability of UK oil supplies. Nevertheless, the overall trade balance in semi-manufactures has continued to worsen over the last four quarters, perhaps in part reflecting some loss of relative price competitiveness.

Domestic production, expenditure and imports in three cyclical upswings

Percentage change per annum

	Manufacturing production	Imports	
		Basic materials	Semi-manufactures
1967 3rd qtr-1968 4th qtr	+6.7		+3.1
1972 1st qtr-1973 3rd qtr	+9.7	+10.8	+17.2
1977 2nd qtr-1978 3rd qtr	+1.9	+ 2.2	+16.9

	Total final expenditure	Imports of finished manufactures
1967 3rd qtr-1968 4th qtr	+3.8	+17.4
1972 1st qtr-1973 3rd qtr	+6.8	+27.2
1977 2nd qtr-1978 3rd qtr	+3.7	+17.2

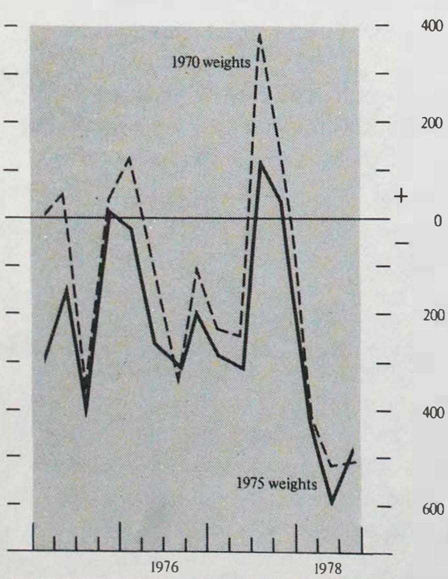
Imports of finished manufactures continue to rise

The growth in imports of finished manufactures continued unabated in the third quarter, when they were about 17½% higher in volume than a year ago (excluding erratic items). This growth is, however, not much higher than might have been expected from recent experience. Comparing performance during the current cyclical upturn with experience during the previous two upswings, the relationship between the growth of total final expenditure and that of imports of finished manufactures remains broadly in line with previous experience (see table).

Balance of resources, excluding fuels, using 1970 and 1975 weights[a]

There has been little divergence between the two measures once the scales have been made comparable.

£ millions at 1975 prices



[a] Overseas trade statistics basis.

Little change in the balance of real resources excluding oil, but a further rise in the terms of trade

The balance of resources in goods devoted to foreign trade [1] continued its upward trend when measured in 1975 prices, though more weakly than in 1976 and 1977, but was little changed in 1970 prices. This reflects in large part the much higher weight given to trade in oil by the series based on the pattern of trade and prices in 1975. Excluding oil, the balance of resources has followed a similar path using each weighting pattern, once the scales of the two series have been made comparable (see chart).

The terms of trade [2] rose by ½% in the third quarter, making a 4% rise over the year. This rise has offset, to some extent, a recent deterioration in the balance of resources. The increase in the terms of trade reflects some

[1] The volume of exports less the volume of imports.

[2] The ratio of export prices (unit value index) to import prices.

weakening in the prices of primary products (of which the United Kingdom is a net importer) relative to those of finished goods (of which the United Kingdom is a net exporter) as well as the impact of the strength of sterling in moderating the rise in import prices.

Invisibles

The estimated surplus in the third quarter was £316 million, much the same as the revised second quarter figure. The average surplus for the first three quarters of this year, however, was only some £280 million, compared with a quarterly average of £530 million in 1977. About half of this decline reflected higher government transfers to the EEC.

There was, however, an improvement in the third quarter of over £90 million in the net surplus on services; the deficits on government services, sea transport and North Sea services, in particular, all narrowed; the surplus on tourism, however, fell, largely because of increased travel abroad by UK residents.

The surplus on interest, profits and dividends changed little: smaller earnings from the reserves were almost matched by reduced payments on official overseas borrowing; banks' euro-currency earnings recovered strongly, but were partly offset by increased UK profits of foreign (non-oil) companies. The net position on oil account is not yet showing the expected deterioration, as production difficulties in the North Sea and higher tax liabilities of foreign oil companies have depressed the size of repatriated profits.

Current account in rough balance

In the first ten months of 1978 the current account was roughly in balance, and is likely to remain so for the year as a whole. While overall visible trade has been approximately in line with expectations despite rather lower North Sea oil production, the balance on invisible trade has been rather lower than expected.

Oil and the balance of payments

Despite some interruption in the middle of this year, the balance of payments contribution from North Sea oil continues to grow as production builds up. Production is currently running at a rate sufficient to meet over 60% of domestic consumption, and will have been of net assistance to the current balance by an estimated £$2\frac{1}{2}$ billion in 1978 compared with £2 billion in 1977. Imports of goods and services directly for North Sea development, however, are estimated at around £$1\frac{1}{4}$ billion, but these will have been financed mainly by capital inflows, so their net impact on the balance of payments will have been small. In 1979 and 1980, production is expected to build up to self-sufficiency, and the balance of trade in oil should, therefore, rise sharply, but by this time will be partly offset by the oil companies' increasing interest payments and profits due abroad. The overall positive effect on the balance of payments (the balance for official financing) is expected to rise from £2 billion in 1977 to £4 billion in 1980.

Current balance

£ millions

	1977		1978		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Visible balance	+ 31	− 5	− 642	− 182	− 342
of which:					
Oil balance	*− 602*	*− 657*	*− 642*	*− 398*	*− 511*
SNAPS[a] balance	*+ 165*	*+ 54*	*− 32*	*+ 156*	*− 24*
Underlying non-oil balance	*+ 468*	*+ 598*	*+ 32*	*+ 60*	*+ 193*
Invisible balance	+ 544	+ 596	+ 229	+ 308	+ 316
Current balance	+ 575	+ 591	− 413	+ 126	− 26

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

North Sea oil

£ billions

	1977	1978[a]	1979[a]	1980[a]
Value of production, *less* interest, profits and dividends	2	$2\frac{1}{2}$	$3\frac{1}{2}$	$4\frac{1}{4}$
Related imports[b]	$1\frac{1}{4}$	$1\frac{1}{4}$	$1\frac{1}{4}$	1
Effect on current account	$\frac{3}{4}$	$1\frac{1}{4}$	$2\frac{1}{4}$	$3\frac{1}{4}$
Effect on capital account	$1\frac{1}{4}$	1	1	$\frac{3}{4}$
Overall effect on the balance of payments	2	$2\frac{1}{4}$	$3\frac{1}{4}$	4

[a] Estimates/forecasts.

[b] Estimated imports of goods and services related to the North Sea oil programme.

The exchange rate and capital flows: sterling on the sidelines

During the second quarter, upward pressure on the exchange rate was absorbed partly by modest official intervention and partly by a small (2%) appreciation of the effective exchange rate. While sterling rose by 6% against the dollar in the third quarter, it was virtually unchanged against other currencies. Since September, some sharp fluctuations against the US dollar have had little impact on sterling's effective rate, which has stabilised since the fiscal and monetary measures of 8th June.

Capital flows

£ millions: *not seasonally adjusted*

	1977	1978		
	4th qtr	1st qtr	2nd qtr	3rd qtr
Current balance	**+ 602**	**– 554**	**+ 213**	**– 3**
Exchange reserves in sterling:				
Countries	– 89	+ 147	– 276	– 3
International organisations	+ 204	+ 13	+ 45	+ 8
Private sterling balances	+ 599	– 59	– 156	+ 159
UK banks' external sterling claims:				
UK export credit	– 176	– 46	– 292	+ 4
Other	+ 64	– 266	– 74	– 69
UK banks' net external foreign currency lending	+ 480	+ 115	– 955	+ 328
Other capital flows (including the balancing item)	+ 248	+ 823	+ 1	– 214
Balance for official financing	**+ 1,932**	**+ 173**	**– 1,494**	**+ 210**

International comparison of current account positions

$ billions: *seasonally adjusted*; annual rates

	1976	1977		1978	
	Year	1st half	2nd half	1st half	3rd qtr[a]
United States	4.3	– 10.8	– 19.8	– 20.4	– 10.4
Canada	– 3.8	– 4.2	– 3.8	– 3.8	– 5.2
Japan	3.7	10.2	11.6	20.4	18.8
France	– 6.0	– 4.2	– 2.4	2.0	1.6
Italy	– 2.9	0.4	4.2	5.0	– 3.6
Western Germany	3.9	5.0	2.6	6.2	7.2
United Kingdom	– 1.6	– 2.8	– 3.6	– 0.4	– 0.4
Other OECD	– 15.8	– 23.8	– 16.0	– 12.4	..
OECD	– 18.2	– 30.2	– 20.0	– 3.4	..
Oil exporting countries	36.9	36.6	28.8	12.0	..
Other developing countries	– 19.8	– 8.6	– 22.2	– 28.0	..

[a] Estimated.

In the third quarter, the current account was close to balance, and there was a small net capital inflow (compared with a net outflow of more than £1½ billion in the second quarter). Of identified capital flows, the net inflow from UK banks' euro-currency transactions was £325 million; this followed an outflow of close to £1 billion in the previous three months. This item reflects switching by the banks between sterling and foreign currency and also the counterparts of foreign currency transactions recorded elsewhere in the balance of payments, e.g. borrowing by the banks to finance UK investment overseas. In the second quarter, the banks switched funds into foreign currency, and there was a large build-up of their net foreign currency liabilities to UK residents, partly reflecting disinvestment overseas by the private sector. The proceeds of a large euro-bond issue made by National Westminster Bank Limited (a borrowing recorded as part of inward private investment) also tended to increase the banks' net external foreign currency assets. However, in the third quarter, the banks' overall positions were little changed, while UK residents' foreign currency deposits fell, thereby reducing the banks' net foreign currency claims on overseas residents.

Among other movements, a rise of £160 million in private sterling balances in the third quarter reversed an almost equal decline in the second. Official balances, which had also fallen in the quarter to June, hardly changed. There was also a small net repayment of UK banks' sterling export credit loans outstanding, compared with an increase in lending of nearly £300 million over the previous three months.

Official financing transactions continued to reflect the Government's policy of restructuring the United Kingdom's external debt. As foreshadowed in the Budget statement in April, the equivalent of £485 million was repaid early to the International Monetary Fund in October. Net repayments of exchange cover borrowing by the public sector totalled £130 million in the third quarter, but there were new net borrowings of £166 million in October. After a rise of £54 million in the third quarter, the reserves fell by £259 million in October. They fell a further £155 million in November, partly reflecting an early repayment of external borrowing by the British National Oil Corporation.

Current account balances abroad

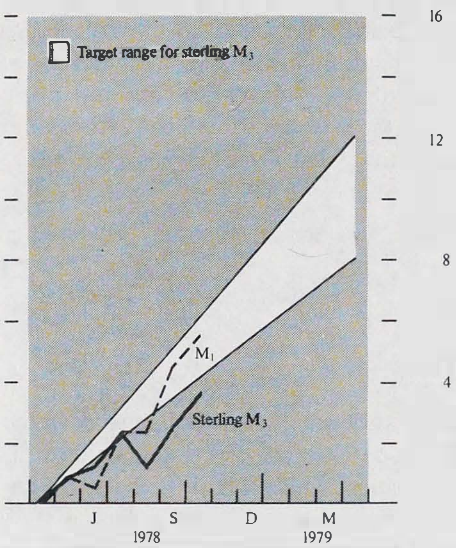
There have been marked changes in the pattern of imbalances in other countries' current accounts over the last eighteen months (see table). The OPEC surplus has been falling steadily and is likely to be less than $15 billion for 1978 as a whole, compared with nearly $33 billion in 1977 (see page 511). At the same time, the deficit of the non-oil developing countries has widened, because of a deterioration in the terms of trade and a temporary interruption to the growth of exports. Although these countries' deficit will probably reach about $27 billion this year, their financing position is expected to remain comfortable. In the first eight months of 1978, their reserves have risen by $8½ billion. On the other hand, the deficit of the OECD countries has been significantly reduced, thanks to an increase in the volume of net exports in the second half of last year and an improvement in their terms of trade in the first half of this. In the second quarter, the overall OECD current account moved into surplus.

Within the OECD area, however, imbalances worsened between the first halves of 1977 and 1978. On the one hand, the US deficit doubled, to reach $20½ billion at an annual rate, while, on the other, the substantial terms of trade gains arising from exchange rate appreciation helped push the surpluses of Japan and Western Germany to $20½ billion and $6¼ billion at annual rates respectively. France and Italy, however, which had accumulated large deficits since 1974, moved comfortably into surplus, while a number of the smaller OECD countries have managed to reduce their deficits. Moreover, the US deficit began to fall in the second quarter of this year, and in the third quarter it was estimated to have been only $10½ billion at an annual rate.

Monetary objectives

In the first half of the financial year, sterling M_3 was below the target range.

Seasonally adjusted — Percentage change since mid-April 1978



DCE and the money stock[a]

£ millions, *seasonally adjusted*; mid-month

	July–Oct. 77	Oct. 77–Jan. 78	Jan.–Apr. 78	Apr.–July 78	July–Oct. 78
Central government borrowing requirement	+ 240	+ 1,576	+ 1,864	+ 1,785	+ 2,001
Net purchases (–) of central government debt by non-bank private sector	– 2,456	– 1,718	– 1,042	– 2,277	– 1,329
Other public sector [b]	+ 676	– 40	+ 418	+ 36	– 515
Bank lending to:					
UK private sector [c]	+ 1,259	+ 726	+ 1,106	+ 1,833	+ 791
Overseas	+ 208	+ 254	+ 643	+ 154	+ 8
Domestic credit expansion	**– 73**	**+ 798**	**+ 2,989**	**+ 1,531**	**+ 956**
External and foreign currency finance (increase–)	+ 1,523	+ 698	– 284	– 275	+ 73
Other	– 126	+ 278	– 214	– 191	– 420
Sterling M_3	**+ 1,324**	**+ 1,774**	**+ 2,491**	**+ 1,065**	**+ 609**
Percentage change in sterling M_3	*+ 3.2*	*+ 4.2*	*+ 5.6*	*+ 2.3*	*+ 1.3*
M_1	**+ 1,470**	**+ 1,175**	**+ 986**	**+ 528**	**+ 776**
Percentage change in M_1	*+ 7.3*	*+ 5.5*	*+ 4.4*	*+ 2.2*	*+ 3.2*

[a] Further details are shown in Table 11 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.

Monetary developments [1]

Over the first six months of the financial year, the growth of sterling M_3 was below the target range for the year as a whole (see chart); during this period, M_1 increased more rapidly than sterling M_3 after rising less fast in the early months of 1978. Over the three months to mid-October, sterling M_3 rose by only $1\frac{1}{4}$%, as against some $2\frac{1}{4}$% in the preceeding three months (see table).

The outturn for the central government borrowing requirement (CGBR) from mid-April to mid-October came to nearly half that expected for the year as a whole at the time of the Budget.

Official sales of gilt-edged stocks in the three months to mid-October were smaller than in the previous three months, but the non-bank private sector also absorbed sizable sales by the banks. Sales of other forms of government debt held up well in the early part of the period; national savings continued to benefit from the increase in the limit on holdings of the fourteenth issue of national savings certificates. There were also, for the second year running, substantial sales of certificates of tax deposit in September and October, possibly helped by the introduction of a bonus (initially set at 1% per annum) on certificates held for over six months. [2] Although this added attraction may encourage companies to retain certificates for longer, some at least are likely to be encashed in the three months to mid-January to meet tax payments. To this extent, their effect in reducing sterling M_3 will only be temporary.

Bank lending in sterling to the private sector during the three months to mid-October was at a lower rate than in the previous three. Between mid-May and mid-August, the latest date for which a full analysis is available, there was some increase in lending to manufacturing; lending to finance consumer spending, either directly or indirectly, has continued at much the same rate as earlier in the year, but lending to financial companies and to services grew more slowly.

Although bank lending has been rising more slowly, banks have been facilitating the provision of an increasing amount of credit by way of acceptances. By accepting bills which are then discounted in the market, a bank can pass on the financing burden and relieve pressure on its interest-bearing eligible liabilities, which continue to be limited by the supplementary special deposits scheme (see the September *Bulletin*, page 357); to the extent that these bills are taken up by the non-bank private sector, the bank lending figures understate the underlying demand for credit. As a rough estimate, some £600 million of this disintermediation may have occurred between mid-May and mid-October. This is rather more than in previous periods when the supplementary special deposits scheme was in force.

The low growth of sterling M_3 in the first six months of 1978/79 partly reflects some of this disintermediation. M_1 grew more rapidly in this period —by some $5\frac{1}{2}$%. Within the total, both notes and coin and the non-interest-bearing element (which together make up some seven eighths of M_1) have been rising more rapidly, by 8%–$8\frac{1}{2}$%, no doubt reflecting the rise in nominal incomes.

When announcing the 1978/79 monetary target (in the Budget speech), the Chancellor indicated that the target would be reviewed and rolled forward at six-monthly intervals. This is intended to give the authorities some flexibility in avoiding problems caused by unexpected fluctuations towards the end of any target period, when there is insufficient time to bring growth back on trend—as occurred at the end of 1977/78. On 9th November, the Chancellor announced that the target for the growth of sterling M_3 for the year to October 1979 would be 8%–12%. Although these figures are the same as the previous target based on mid-April 1978, some tightening is implied as sterling M_3 in mid-October—the new base—was below the lower limit of the earlier target range. On the same day, minimum lending

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

[2] Payable only for the period in excess of six months and provided that the certificates are eventually surrendered in payment of tax.

rate was increased from 10% to 12½%—somewhat more than the rise in market rates in the preceding weeks would have indicated (see page 503).

Reserve ratios and the 'corset'

With the easing during August of the pressure on reserve assets which had occurred in June and July, [1] the banks had more scope to reduce their interest-bearing eligible liabilities and there was a very sharp fall. There was a further small fall in September. In October, however, with the reserve asset position of the clearing banks in particular tightening somewhat, interest-bearing eligible liabilities rose. Nevertheless August's fall meant that over the three months August to October (the first period in which the banks are liable for penalties), the banks collectively were some 1½% above the base and some 2½% below the penalty-free limit.

Assessment

Economic prospects throughout the world are likely to be dominated by the fact or the fear of continued inflation, despite the modest rates of growth of the last few years. Concern about inflation, similarly, is likely to limit the rate of expansion in the United Kingdom; the moderate pace of expansion followed, for the same reason, by other countries will also confine this country's room for manoeuvre.

In countries such as Western Germany and Japan, where prices have been rising only slowly, it has been judged possible to take expansionary measures without incurring the danger of starting inflation up again. In many other countries, the problem of inflation has been more severe, and the constraints on policy correspondingly stronger. In the United States, inflation has remained fairly high and has recently been edging up. This has been pushing up interest rates and, together with the earlier exceptional instability of the dollar, has led to a major shift in policy. There could be a check to demand which should help to restrain inflation. It should also help to reduce, and perhaps greatly reduce, the large US current payments deficit, and do much to underpin the stability of the dollar.

With some shift in emphasis from the United States to other OECD countries, world economic activity thus seems likely to expand only moderately in the coming year. UK export markets should, however, continue to grow, albeit modestly, as they have done this year; and at the same time the United Kingdom should benefit from a continued relative stability in world commodity prices.

The world scene, subdued though it is likely to be, would nevertheless allow the United Kingdom, if the opportunity is taken, to combine continued moderate expansion with reducing the rate of inflation — which still remains far too high to promise stability in future. The unusually slow growth in world commodity prices since mid-1977, combined with a stable exchange rate, has been an important factor keeping the growth in domestic prices to little more than half that of earnings; another factor has been the faster growth of productivity at home. Next year world prices and productivity trends are both likely to continue to be helpful. Profits have been squeezed; and the general level of pay settlements should be well below those in a few well-publicised disputes which have been followed by high settlements. The average increase in earnings in the current pay round seems likely to turn out less than last year's. If so, it is likely that inflation will be kept to the present pace, and if the increase in earnings were kept well within single figures the pace of inflation would be reduced materially.

[1] See the September *Bulletin*, page 345.

If inflation is thus contained, Bank forecasts suggest that the recent underlying rate of expansion of the economy is likely to continue. Consumers' purchasing power would continue to grow, albeit a little more slowly than recently. Combined with probable continuing growth in exports, final sales seem likely to rise a little less rapidly than in the last twelve months. With lower stockbuilding than earlier this year, but some slowing down in the growth of imports, output may continue to expand at a rate approaching 3% per annum—sufficient, perhaps, to prevent the level of unemployment from rising.

Faster growth of earnings would, however, put expansion at risk. In such circumstances, monetary policy could hardly be relaxed; and this, in combination with higher money incomes, would impose some brake on expansion. That aside, faster inflation would tend in due course to make consumers save a yet higher proportion of their income, and spend less. Exports—and goods competing with imports—would be made either less competitive, or less profitable. Again, the uncertainties, and lower profits, would reduce business investment.

If such a faster rate of inflation were allowed to go on, the discouragement to expansion would in due course become more severe. The prospect for economic activity will therefore depend on how fast earnings rise: there is, over time, likely to be a fairly direct trade-off between the rate of increase in earnings and the level of activity—and thus of unemployment.

It is less clear how far the balance of payments will, itself, be a further, separate constraint on growth. Given the general need for current account surpluses to provide for repayment of debt, and the large assistance from North Sea oil, this year's results are relatively disappointing. The figures for the first three quarters of the year are set out in the table on page 497. For the year as a whole, the result may turn out to be close to balance—compared with the current account surplus of about £1 billion which it seemed reasonable to expect earlier in the year.

Next year, along with other influences, the balance of payments should benefit from growing North Sea production, and from some further improvement in the terms of trade—though that cannot continue indefinitely. While balance of payments forecasts are notoriously unreliable, Bank estimates suggest that, with expansion in this country proceeding at about the present rate, the current account in 1979 will probably show a small surplus. A faster expansion of domestic demand, at a rate significantly in excess of the likely modest growth in the rest of the world, would probably not be possible without putting the balance of payments under strain.

The above considerations, therefore, reinforce the considerations discussed earlier relating to inflation, in pointing to the need for a clearly cautious bias as regards both fiscal and monetary policy.

The course of monetary expansion this year, though erratic, has been relatively satisfactory; but the policy of restraint, after the June measures, had to be reinforced in November. After growing rapidly in the closing months of 1977/78, sterling M_3 rose by only $3\frac{1}{2}$% in the first six months of the current financial year—somewhat below the 8%–12% target for the full year announced at the time of the April Budget. However, for a number of reasons already discussed (see page 499), the figures understated the underlying rate of monetary growth during this period; and the prospective increase in sterling M_3 seemed in danger of being unduly rapid. Furthermore, in the first half of the financial year, M_1 increased more rapidly than sterling M_3 (after rising less fast in the early months of 1978).

In these circumstances, minimum lending rate (MLR) was raised from 10% to $12\frac{1}{2}$% on 9th November. It was judged right that the rise in MLR should go somewhat further than the rise which had already taken place in market rates. These had risen sharply during October—partly, it seems, in response to the rise in US rates, and partly on account of domestic uncertainties, particularly over wage developments. Official sales of gilt-edged stock were substantial following the rise in interest rates, putting central government debt sales ahead of funding requirements. The public sector borrowing requirement has been running at or slightly below the forecast level; and the rate of growth of bank lending should be restrained by the increase in the cost of borrowing.

The monetary target for the next twelve months starts from the level of sterling M_3 in October, from which point the target range is 8%–12%. The action taken underlines the determination of the authorities to maintain firm monetary control. Adherence to these targets is intended to provide conditions in which exchange rate stability can be preserved, and continued reduction in the inflation rate can be pursued together with real expansion of the economy.

The European Economic Community has agreed to set up on 1st January a European Monetary System (EMS). This will have three broad elements: the establishment of an exchange rate régime with intervention margins; the promotion of a progressive convergence of the performance of member countries' economies, and the development of a new European financial framework involving the emergence of the European Currency Unit as a new monetary unit, the expansion of credit facilities, and ultimately the setting up of a European Monetary Fund. In the development of the new system, and in the discussions for this purpose, the United Kingdom has undertaken to play a full part as a member of the European Community.

If successful, the EMS should provide a system within which member countries can best pursue their aim of ensuring stable financial conditions for their own economies. The United Kingdom has decided not to participate in the new exchange rate régime on 1st January, though we have a right to join it at a later time if that should seem appropriate. In the longer run, exchange rate stability in Europe will depend less on any particular form of intervention arrangements than on each of the member countries pursuing domestic policies that are likely to produce stable exchange rates, and thus ensuring that the economy of each follows a path that is not divergent from its neighbours. For the last two years the United Kingdom has had a remarkable degree of exchange rate stability, and intends to pursue policies that will continue to ensure stability in the future.