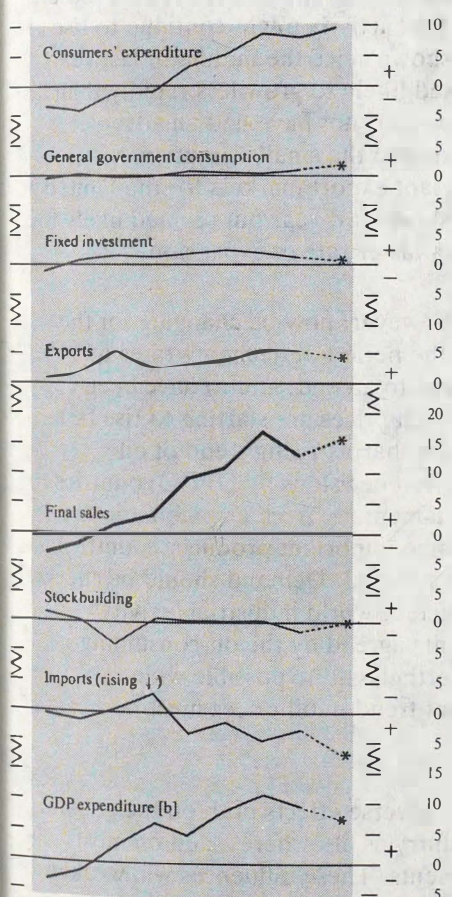
Economic commentary

Changes in components of GDP[a]

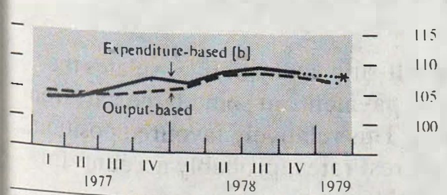
Output fell slightly in the first quarter.

Seasonally adjusted — £00 millions at 1975 market prices



Indices of GDP

Seasonally adjusted — 1975=100



* Bank estimate for the first quarter of 1979.

[a] Changes since the fourth quarter of 1976.

[b] At factor cost.

Introduction

It is difficult to form a clear view of trends in the economy over the early part of this year. Industry was seriously disrupted in January by the road haulage dispute, and the aftermath has had an uncertain effect on a number of important indicators.

In the first quarter, the output measure of **GDP** fell by almost 1% (see chart). **Consumers' expenditure** is estimated to have risen by 1%, but mainly because of high spending on fuel in the unusually cold weather. Industrial **fixed investment** was almost unchanged from the fourth quarter, and investment intentions seem to have weakened slightly. Industrial **stockbuilding** was heavier than might have been expected, but, even so, was not much higher than in the fourth quarter. Meanwhile, the bad weather hit **housebuilding** in both the public and private sectors, with housing starts down by about a third. The **trade figures** showed the effects not only of disruption in the United Kingdom but also abroad, notably in Iran. The present, still incomplete, estimates indicate a sharp fall in the volume of exports—perhaps partly matching the rise in industry's stocks of finished goods—and an increase in imports.

Around the end of the quarter, output and consumer demand seem to have picked up—perhaps a temporary reaction from depressed conditions earlier in the year, or, in the case of spending, in expectation of indirect tax increases in the Budget. **Retail sales** rose 4% in April (to their highest since April 1975) and slipped only slightly in May. **New car registrations** have also been buoyant: in March and April they were 30% higher than the average for November to February, and they remained high in May.

The present pay round still seems likely to yield a rise in **earnings** over the year to July close to the 14% recorded in stage three. But several important settlements remain to be concluded; and many public sector settlements have included undertakings on comparability which will increase earnings later. The pace of the rise in earnings, far outstripping any improvement in productivity, has meant continuing upward pressure on prices, further weakening in trading competitiveness and, probably, a renewed squeeze on already narrow **profit margins**. The upturn in raw material, and especially oil, prices is also contributing to the acceleration in **inflation**. The effect was, however, moderated by the strength of **sterling**, which appreciated by 5½% in effective terms between the end of February and mid-April and has remained firm since.

The pace of **monetary expansion** has been faster since the end of 1978, largely because demand for bank credit has been buoyant. After accelerating significantly around the turn of the year, the growth of sterling M_3 slowed down again in banking February, and in banking March this measure of the money stock actually fell. In the next two banking months, however, the increases in sterling M_3 were in the range 1%–1½%, so that by May the increase over the target period since last October had risen to 13% (at an annual rate). In his Budget speech on 12th June, the Chancellor of the Exchequer announced an increase in minimum lending rate (MLR) to 14%, an extension of the supplementary special deposits scheme, and a target of 7%–11% at an annual rate for the increase in sterling M_3 over the ten banking months to April 1980.

General assessment

The period ahead may well be somewhat more difficult for the world economy, and correspondingly for the UK economy.

The world scene

Although growth in the United States has been well maintained, it now seems reasonable to expect a period of slower growth there, with the possibility that there will be an actual fall in activity later this year. In most other industrial countries, there were, until recently, signs that activity might continue to rise at the somewhat faster pace shown since the middle of last year. Even so, world trade seemed likely to grow less rapidly than last year. This alone might, however, not have had an adverse impact on this country's exports: the smaller industrial countries, which are important export markets for the United Kingdom, grew relatively slowly last year but seemed likely to be in a position to resume a faster rate of expansion.

The world situation may, however, now be changing for the worse. In most countries, the period of declining rates of inflation seems to have come to an end, and to have been succeeded by a phase in which prices are starting to rise faster. In addition, there is now the sharply rising trend of oil prices—stemming in part from decisions by OPEC countries to raise prices, but more fundamentally from a combination of restrictions on output in some important producer countries, and continuing high world demand. Demand should be checked later in the year if, as expected, world industrial activity slackens and as the restraints agreed by the oil-consuming countries take effect. Nevertheless, the possible wide repercussions of the present trend in oil prices must be a cause for concern.

Higher oil prices will have adverse effects both on the general level of prices—in this country as elsewhere—and on most countries' balance of payments. These influences will weaken demand and make countries very cautious about taking any offsetting measures. The prospects for world expansion therefore now seem distinctly more restrained.

This country's approaching self-sufficiency in oil insulates the United Kingdom's balance of payments in some large part from the effect of higher oil prices. This relatively favoured position, allied with relatively high interest rates, probably accounts for the strength of sterling so far this year.

Exchange controls

The strengthening of the UK external position as a result of North Sea oil has made the case for extensive exchange controls less cogent. The relaxations announced in the Budget represent a major loosening of the controls which the Bank, on behalf of the Government, has operated—with the indispensable co-operation of the banks, industry and the public—for the past forty years. For much of this period, UK exchange controls have been among the most severe of those operated by Western industrial countries.

Exchange control has aimed to strengthen the United Kingdom's external balance sheet by improving its liquidity, or preventing its worsening—by favouring an increase in official reserves rather than in private external assets; and by lessening vulnerability to volatile capital movements. These aims have only been—and could only be—partially achieved. Exchange control gives the authorities some greater control over the exchange rate against downward pressure. But it has not in recent times been applied to non-resident holdings, and, while it may have lessened, it far from removes vulnerability to volatile flows.

These advantages have, however, been obtained at the expense of longer-term considerations. The general advantages of freedom for investment flows have long been recognised; and such considerations underlie the various international obligations, including in particular those arising from membership of the European Economic Community (EEC), to which this country has subscribed. The retention of exchange control has entailed some sacrifice of longer-term investment opportunities, a consideration now especially critical given the need to convert the benefits of North Sea production into durable form.

The strengthening of the external position in the last few years has altered the balance of the argument. The effective exchange rate for sterling has risen substantially and the external balance is stronger. The reserves have risen from the $7 billion or so which was typical of the early 1970s ($4 billion at the end of 1976) to $17 billion excluding (or over $21½ billion including) the revaluation in March of the gold and non-dollar components. On the liabilities side, while $22 billion of official debt is still outstanding, this is contractual, and medium or long-term. Moreover, official holdings of sterling have effectively been reduced to working levels; and the United Kingdom is committed to keeping them there. Sterling is, however, still a currency which is widely held and traded in, and private holdings remain important. There is thus more scope for volatile movements in sterling than in all but a few other currencies.

After forty years in which controls have been continuously in operation, it is difficult to assess in advance the exact reaction to major relaxations; and the recent relaxations therefore stopped well short of complete abolition. But they represent a major first step in areas where there appeared to be a long-term benefit to the United Kingdom, or where controls have proved particularly irksome or difficult to administer.

Control of monetary expansion and prospects for the economy

The likely shape of the Budget measures announced last week, reflecting the objectives of the new Government, has been clear for some time. The longer-term effects of the considerable reduction in income tax and the restraint of public spending should prove to be widely beneficial to enterprise and the economy. The measures involve large changes of emphasis, so that past experience may be an imperfect guide in assessing the immediate impact on the economy.

In the period since mid-October, the monetary indicators have been suggesting a rather fast expansionary trend. The growth of sterling M_3, translated on to an annual basis, has fluctuated around the top of the target range; and the growth of M_1 has also been fast. The aim is now to hold the growth of sterling M_3 within the slightly lower new target range, which is for an annual rate of growth of 7%–11% in the ten-month period from mid-June to mid-April next year, and to obtain an early adjustment to this slower rate of growth.

Several factors should help in achieving the necessary restraint. First, the aim of holding the public sector borrowing requirement (PSBR) to £8¼ billion in the financial year 1979/80 will assist monetary control. Comparison with last year's outturn of £9¼ billion must take account of the inclusion in budgetary receipts this year of £1 billion on account of the proceeds of proposed sales of various publicly-owned assets. Sales of such assets will in some degree be competitive with sales of gilt-edged stocks, but they are likely to find a readier market than would offers of additional gilt-edged stocks over and above what will now be needed to finance the PSBR. During the second half of the year, the Government's financing needs will be considerably affected by the timing of tax receipts; the Exchequer will benefit from August onwards from higher indirect taxes; but the reduction of income tax will affect the Exchequer mostly in the course of the last quarter of the calendar year. Also important to monetary control will be restraint on the growth of bank lending, recently a major expansionary element. Support for the necessary monetary restraint is provided by the rise in MLR by 2% to 14%.

After the moderately rapid expansion of GDP that took place early in 1978, there has been a check this year; and there may be little expansion in the period immediately ahead, before the longer-term impact on the economy, springing from the fiscal and monetary approach underlying the Budget, begins to take effect.

With earnings rising faster than prices, and with tax reductions in the 1978 Budget, consumers' expenditure rose strongly for much of that year. This year, as prices come to reflect more fully recent increases in earnings and the rise in oil prices, real purchasing power may grow more slowly and consumers' spending less fast. As a result of the cuts in public spending, government purchases and employment should fall a little. Weak demand will affect not only domestic output but imports, the rise in which should therefore also be restrained; and the current balance of payments might, after the deficit in the first quarter, return to balance or small surplus. Such a balance of payments performance would, however, given all the circumstances, be very poor. Until the underlying trend can be improved, the balance of payments may be an uncomfortably close constraint on faster expansion.

Apart from the effects of the Budget, which will entail a once-for-all rise in the retail price index of some 4%, the prospect for the rest of this year seems to be that retail prices will rise little, if anything, faster than in earlier months. The effects of the Budget on inflation and on the economy need to be looked at as a whole. The impact on individuals will differ according to personal circumstances and patterns of expenditure, but in general, taken as a whole, the effect in the remainder of the financial year on tax-payers' spending power will be favourable, with the effect of increases in indirect taxation being more than offset by the smaller sums deducted as income tax.

The chances of reducing the pace of inflation next year will depend in large part on what happens to wage costs. Wage negotiations will undoubtedly be affected by the general economic climate. The ability of business to pay higher wages will vary greatly from industry to industry, but in general it seems probable that profits will suffer a check. It could well be then that in many sectors the rise in wage earnings in the next round will be less than in the round now being completed. That is what is needed to bring inflation down; and the prospect of economic growth in later years will be greatly enhanced if it is achieved.

Output: a quick recovery from strikes but no underlying growth

Output in the first quarter was affected by the road haulage dispute and the severe weather. The output measure of GDP fell by almost 1%. Parts of manufacturing industry, especially chemicals and metal manufacturing, were badly hit by the haulage dispute, and recorded manufacturing output fell by 10% in January. Production recovered in February to its December level and there was a further rise in March, but for the quarter as a whole manufacturing output was $1\frac{1}{2}$% lower than in the fourth quarter. Construction output also suffered, mainly because of the bad weather; over the quarter it fell by $10\frac{1}{2}$%. Output figures for the early part of this year should, however, be interpreted with caution. Some 70% of manufacturing output is measured by delivery data rather than value-added. For this reason, the recorded output figures may have exaggerated the effect of the haulage strike on production. Delayed deliveries were probably matched by a build-up of stocks of finished goods and, while the quarterly figures incorporated in the GDP estimates are adjusted as far as possible to take such stock changes into account, these adjustments cannot be made at all precisely for the monthly figures.

Over the past three years, a significant part of the growth in output has resulted from increased production of North Sea oil, with a corresponding improvement in the oil trade balance (see table). Manufacturing output has increased very little in this period, and most of the growth in the non-oil economy has been concentrated in 'other services'.[1] On the demand side, the main stimuli to growth have been consumers' expenditure and stockbuilding. Fixed investment has hardly risen since 1975.

Until recently, manufacturers seem to have been rather pessimistic about the business outlook. The very moderate growth in production last year ($\frac{1}{2}$%) was insufficient to improve the utilisation of capacity on most measures, although the Confederation of British Industries' (CBI) April Survey reported a further fall in the proportion of firms working below a satisfactory full rate of operation. This proportion has been declining fairly steadily since late 1977 and is now at its lowest since the middle of 1974. In recent weeks, there has been some evidence of an improvement in business confidence; but with weakening competitiveness and only modest prospective growth of world demand (see page 120), manufacturing output is likely to remain subdued during the remainder of this year.

[1] 'Other services' comprises insurance, banking and financial services; ownership of dwellings; professional and scientific s rvices; miscellaneous services; and public administration and defence.

Changes in components of expenditure and output

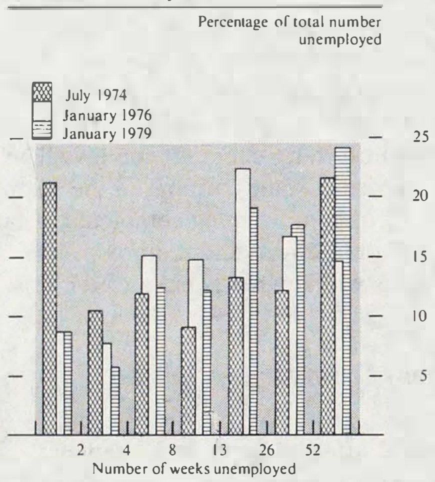
£ millions: 1975 prices

	Change on previous year			Cumulative change 1975–78[a]	
	1976	1977	1978		
Expenditure					
Current consumption[b]	650	− 750	3,800	3,700	*4.0*
Capital formation:					
Fixed investment:					
Manufacturing	− 200	250	250	300	*0.3*
Housing	—	− 300	100	− 200	*−0.2*
Other (inc. North Sea)	50	− 400	200	− 150	*−0.2*
Stockbuilding	1,900	700	—	2,600	*2.8*
Net real trade balance:					
Oil	100	1,100	500	1,700	*1.8*
Non-oil	1,150	900	−1,250	800	*0.9*
GDP (expenditure estimate)[c]	3,250	1,550	2,950	7,750	*8.4*
Output					
North Sea oil[d]	400	1,050	650	2,100	*2.3*
Manufacturing	550	450	100	1,100	*1.2*
Other	950	900	2,050	3,900	*4.2*
GDP (output estimate)	1,900	2,400	2,800	7,100	*7.7*

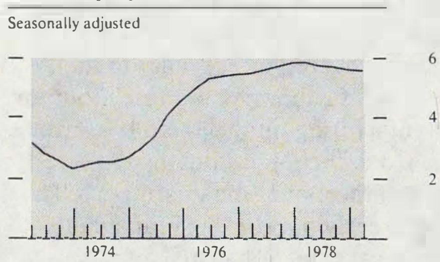
[a] Figures in italics refer to the contribution in percentage points to the percentage growth of GDP.
[b] Consumers' expenditure plus general government consumption.
[c] Components are at market prices; the figures for the expenditure estimate of GDP also include the factor cost adjustment.
[d] Bank estimate.

Unemployment: analysis by duration[a]

Long-term unemployment has increased over the last three years.



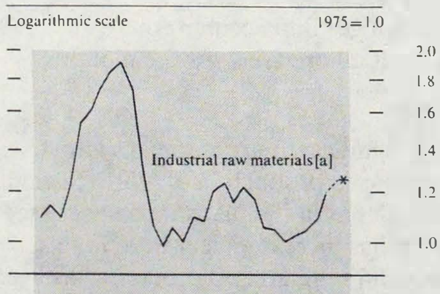
Percentage of workforce registered as unemployed[b]



[a] Great Britain.
[b] United Kingdom.

Raw material and oil prices (in real terms)

Oil prices have maintained, in real terms, the level reached in 1974; but the real price of other raw materials is little higher than in the early seventies.



* Bank estimate for the second quarter of 1979.

[a] The Economist dollar commodity price index for industrial materials (used with permission) divided by the dollar price of world exports of manufactures.

[b] The dollar price of crude oil divided by the dollar price of world exports of manufactures.

Unemployment: further improvement uncertain

With the recent sluggishness of output (apart from oil), the trend in unemployment so far this year seems to have been less strongly downward than during 1978. Indeed, unless the recovery in non-oil output is re-established, unemployment may even begin to rise later in the year. The unemployment figures in recent months, however, have been unusually erratic, and there is no evidence of such a turn-round at present. Unemployment [1] rose by some 47,000 between December and February, no doubt mainly because of the unusually severe weather and the effects of industrial disruption. By May, however, it had fallen back again to some 13,000 below the December figure and more than 75,000 below the figure for May last year.

One feature of the continuing high level of unemployment has been an increase in the average period spent on the register. When unemployment is low, the register generally includes a relatively high proportion of long-term unemployed, i.e. people who, for various reasons, have particular difficulties in finding work. As unemployment rises, this proportion of long-term unemployed may initially decline but will rise again if a high rate of unemployment is sustained for some time. These characteristics are illustrated in the chart. Unemployment was relatively low in July 1974, having fallen quite sharply over the previous two years, and the proportion unemployed for more than a year was 22%. Over the next eighteen months, total unemployment rose by some 600,000, while those unemployed for more than a year increased by only 60,000. In the following three years, total unemployment showed a fairly small net increase, but the number of long-term unemployed virtually doubled. Nearly 25% of those at present unemployed have been out of work for more than a year, and over 40% for at least six months.

The growth of total employment in the year to December is estimated to have been 186,000, an increase of more than $\frac{3}{4}$%. Women accounted for all but 16,000 of the rise, reflecting, perhaps, the relative strength of the service sector, the preference of some employers (because of employment protection legislation) for taking on part-time workers, and the apparently greater willingness of female workers to fill vacancies offering relatively low rates of pay. Nevertheless, by far the largest part of the fall of 101,000 in registered unemployment in this period has been amongst men, suggesting perhaps some growth in the numbers of self-employed and also a tendency towards earlier male retirement, thus creating vacancies without any increase in overall employment.

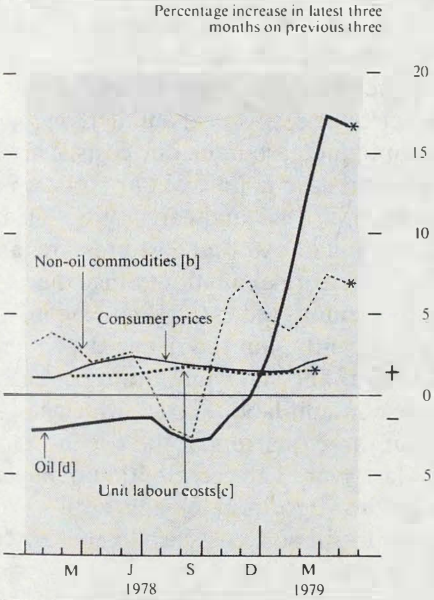
Oil prices

Oil prices rose steeply in the first quarter as a result of the disruption to Iranian supplies and an abnormally severe winter in many of the major consuming countries. Prices have continued to rise in the second quarter (see chart). With the unified OPEC pricing structure no longer operating, individual producing countries have responded to the continuing imbalance of supply and demand by imposing surcharges on their output, so that crude oil prices, in dollar terms, are now on average over 30% higher than in the fourth quarter of last year.

In the first quarter, Iranian oil production averaged little more than 1 million barrels per day (mbpd) compared with normal

[1] Seasonally adjusted and excluding school-leavers.

Costs and prices in major overseas countries[a]
Most of the recent rises in oil and other commodity prices have yet to feed through into consumer prices.



* Bank estimate for the last plot shown.

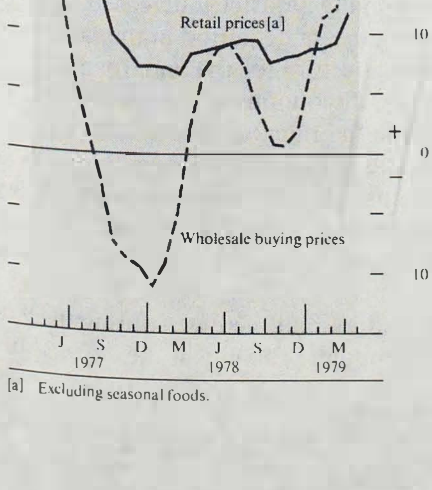
[a] United States, Canada, Japan, France, Italy and Western Germany: in national currencies. GNP-weighted.

[b] Based on the Economist all-items dollar commodity price index, used with permission.

[c] Adjusted for cyclical influences: based on IMF indices available only quarterly.

[d] Average OPEC price.

Wholesale and retail prices
Costs and prices have risen faster in recent months.



[a] Excluding seasonal foods.

production of over 5½ mbpd. This reduction—equivalent to around 15% of total OPEC production—led to sharp increases in the price of the small amount of oil traded on the spot market, and to surcharges being imposed by some producer countries on the official price of oil agreed at the OPEC meeting last December. Prices, which had been scheduled to rise by only 5%, were on average 9% higher in the first quarter than in the fourth. Against this background, a meeting of OPEC at the end of March decided to impose immediately the prices originally scheduled for the fourth quarter of this year—an increase in the basic crude price of 14½% compared with the fourth quarter of 1978; on top of this, most OPEC members (but not Saudi Arabia) took up the option to impose substantial premiums which have pushed the average increase in prices up still further.

Although Iranian production has now built up to around 4 mbpd, some other producers have cut back output; and, with consumer countries rebuilding stocks, a continuing, though not acute, oil shortage is likely in the second half of this year. The position would, however, be greatly eased if the member countries of the International Energy Agency should achieve their agreed target of reducing world demand for oil by the end of the year by 5%. Looking further ahead, with some slowdown expected in the growth of the world economy—itself partly a result of this year's jump in the real price of oil—the following two years may see the return of a more balanced energy market and greater price stability.

Consumer prices abroad begin to accelerate

During the early months of the year, consumer prices in the major overseas economies as a whole began to rise more rapidly (see chart). Seasonal factors appear to have contributed slightly to this, but the main causes have been the acceleration of raw material costs (particularly those of non-ferrous metals) [1] and the rise in the average price of oil, first as the dollar strengthened towards the end of last year and then with the increases in the dollar price of oil charged by OPEC members (see above). In general it appears that wage costs have as yet played little part in bringing about the faster rate of inflation. Some recent wage settlements in the United States have put pressure on the Administration's guidelines, but the rise in average earnings has not so far accelerated markedly. In Japan the annual wage increases recently negotiated were virtually identical to last year's, while those in Western Germany were a full percentage point lower.

Looking ahead, recent oil and commodity price increases have yet to be fully reflected in final prices. The scale of these increases makes it unlikely that the underlying rate of increase of consumer prices will slacken much in the coming months.

UK prices: mounting cost pressures

Manufacturers' wholesale buying prices have been rising rapidly (see chart). The increase over the six months to April was 8½%, despite an appreciation of sterling in effective terms of 7¼%.[2] The movements in oil and commodity prices have already been noted; they will be the main factors behind a sharp increase in buying prices—probably about 6%—in the

[1] See page 133.

[2] Monthly average for April compared with October 1978.

Prices

Percentage increase over previous year

	1977				1978				1979
	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr	1st qtr[a]
Unit labour costs[b]	10.7	10.8	9.5	9.9	10.7	10.2	11.1	14.0	13.8
Import prices[c]	25.8	17.4	13.3	6.3	2.2	3.5	3.2	3.5	5.7
Consumer prices[d]	15.2	16.3	15.7	12.4	10.4	8.1	8.0	8.0	9.1

[a] Bank estimates.

[b] Excludes effects of North Sea production on GDP.

[c] Includes North Sea production used as import substitute.

[d] Deflator of consumers' expenditure.

second quarter. Manufacturers' selling prices have also accelerated, increasing by 5½% over the six months to April. Some indication that the acceleration is likely to continue is given by the last Price Commission index: in April the increase in this index over the previous six months was equivalent to nearly 13% at an annual rate, compared with 12% in March, 10% in February and 8¾% in January.

The twelve-month increase in retail prices—which has been on an upward trend for some months—rose to just over 10% in April. The acceleration of inflation was accentuated during the spring by the impact of higher fuel and raw material prices, notably the rapid rise in petrol prices—but the underlying trend reflects chiefly the rapid increase in labour costs. The table shows that the rate of increase in unit labour costs, which stayed around 10% per annum in 1977 and early 1978, failed to respond to the marked easing of external cost pressures and the sharp reduction in consumer price inflation. Since the beginning of the current pay round, the rate of increase in wages has not changed significantly, but the rise in the national insurance surcharge in October and stagnant output per head have meant a faster increase in unit labour costs, which has probably contributed about three quarters of the rise in consumer prices over the last year. The contribution of import prices to inflation has been disproportionately low until recently, but in coming months import costs are likely to exert greater upward pressure on prices.

No significant slowdown in earnings

When the present pay round began in August last year, inflation appeared to have levelled out at around 8% per annum.[1] There were some, but perhaps not very firm, grounds for expecting a further improvement by the end of the round. If wages had remained within the previous Government's 5% guideline—probably implying a rise in earnings of around 8%—inflation might indeed have eased further, and real incomes would probably have shown a modest increase. However, despite the factors—principally the appreciation of the exchange rate—which pointed to some moderation in the rise in prices, wage claims and settlements for most of the pay round were no lower than in stage three.

The eventual outturn for the round, however, remains difficult to foresee from the published earnings figures, largely because these have been distorted by delays in settlements,[2] and by back-payments. From July to March, the index of average earnings (which is not seasonally adjusted) increased by 7.3%, compared with 6.8% during the same period in the last round, suggesting that the eventual outturn for the underlying increase in earnings (that is, discounting the effects of back pay) in this round may be in the range 13%–16%, though obviously this partly depends upon settlements still to come. These include the settlements for 100,000 power workers, two million engineering workers, and 500,000 local authority white-collar staff.

One factor which has helped to limit increases during the latter part of the current round, though probably at the expense of

[1] See the June 1978 *Bulletin*, page 170.

[2] By late May, the CBI had details of settlements covering 6.7 million employees compared with 11.6 million by the same time last year. Part of this shortfall, however, is probably due to a decline—following the change of Government and the ending of the stage four arrangements—in the proportion of settlements notified to the CBI.

Relative public sector pay[a]

	Central government	Local authorities
1970	102.0	101.7
1971	105.5	104.0
1972	105.5	107.1
1973	97.6	104.8
1974	106.3	105.1
1975	108.0	112.4
1976	114.0	114.8
1977	111.6	110.6
1978[b]	104.0	102.2
1979	102.0	100.0

Source: *New Earnings Survey*, Department of Employment; 1979 figures Bank estimates.

[a] Pay of full-time adult males in the non-trading public sector as a percentage of male private sector pay–April each year.

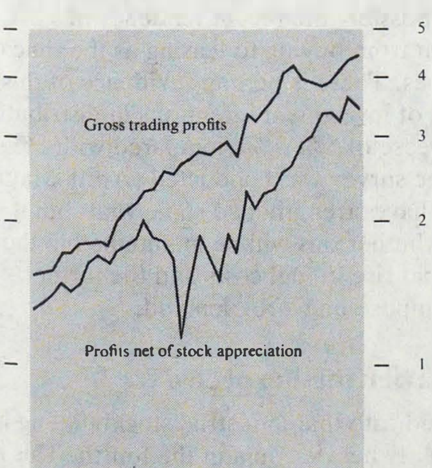
[b] The figures for public sector relative pay in April 1978 may be artificially low because several public sector groups delayed settling until after their normal (April) date.

Profits[a]

Profits continued to grow at a modest pace in 1978.

Seasonally adjusted
Logarithmic scale

£ billions



[a] Industrial and commercial companies, excluding North Sea activities.

Profits

£ billions at quarterly rates: *seasonally adjusted*

	1977	1978	
	2nd half	1st half	2nd half
Gross trading profits	4.3	4.6	5.0
Stock appreciation	0.7	0.7	0.9
Trading profits	3.6	3.8	4.1
of which:			
North Sea	*0.4*	*0.5*	*0.6*
Non-North Sea	*3.2*	*3.3*	*3.5*
Non-North Sea net of capital consumption at replacement cost	1.7	1.8	2.0
Real non-North Sea rate of return *(per cent)*	*4.7*	*4.6*	*4.8*

some substantial pay rises next year, has been the introduction of comparability studies for many groups in the non-trading public sector (e.g. the local authority manual workers and the teachers). The first comparability payments have in some cases been made 'on account', with more to come—depending on the outcome of the studies—from 1st August. Comparability exercises could have a significant effect: if relative earnings in the non-trading public sector were to be restored to the average position in April over the years 1970–78 (see table) this would lift earnings in the non-trading public sector by around 5% and directly add 1% to the overall earnings index. But if relative public sector pay were to be restored to the position at one of the more favourable dates, the effect on earnings could be twice as large.

Personal income and spending—some recovery

Consumers' expenditure, which had been unexpectedly buoyant in the third quarter of 1978, fell slightly in the fourth. It remained subdued in the early part of this year, rising by only 1% in the first quarter and this mainly because of higher spending on fuel in the unusually cold weather. Retail sales seem to have been quite badly hit by the road haulage dispute, falling by about 4% in January, but in February and March they returned to something near their average for the second half of last year; and in April they rose by a further 4%, perhaps partly because it was expected that indirect taxes would be increased in the Budget. New car registrations also picked up sharply: in March and April they were 30% higher than the average for November to February.

Real personal disposable income rose by some $1\frac{1}{2}$% in the fourth quarter, rather faster than some early indicators suggested. Growth may have slackened during the early part of this year, because of delays in pay settlements, but has probably picked up recently as the pace of settlements has quickened. In the short term, these fluctuations will have been further accentuated by receipts of back-pay.

Profitability again under pressure

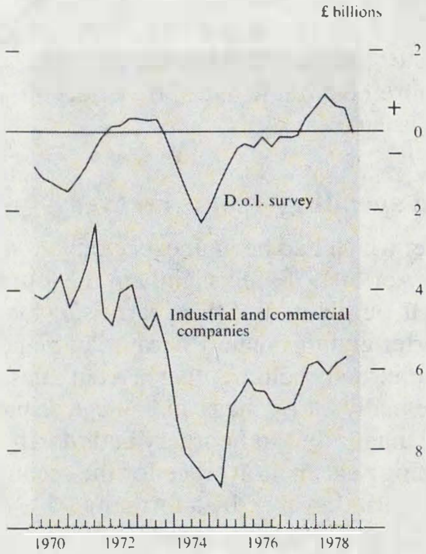
Trading profits of industrial and commercial companies, net of stock appreciation, were 7% higher in the second half of 1978 than in the previous six months (see chart and table). However, when companies engaged in North Sea operations are excluded, and approximate adjustment is made for capital consumption at replacement cost, the corresponding growth may have been somewhat less.[1]

For the year as a whole, non-North Sea companies' real rate of return was probably about $4\frac{3}{4}$% before tax, little changed from 1977. But by the end of 1978 various factors were combining to erode profitability: increasing raw material costs (reflected in an 18% increase in stock appreciation in the second half); a firmer exchange rate (squeezing competitiveness at home and abroad); the increase in the national insurance surcharge; and the stagnation of output and productivity. The squeeze on profitability has probably continued in 1979. Sharp increases in the price of oil have exacerbated cost pressures. Profitability will also have been adversely affected in the first quarter by industrial disruption. The prospect is that the pressure on the

[1] Longer-term trends in the performance and financial position of companies are described in the supplementary note on page 183.

Corporate liquidity[a]

Corporate liquidity deteriorated in the early part of this year.



[a] Real net current assets (deflated by the TFE deflator).

profitability and financial position of companies will continue. Meanwhile, the improvement in company liquidity, which was particularly marked in the second half of 1977, came to an end last year. Although the quarterly path shown by the Department of Industry's (D.o.I.) liquidity survey (which covers some 230 large companies) differs from that implied by estimates for all industrial and commercial companies (see chart), the overall impression is that company liquidity changed little in 1978. The latest D.o.I. survey, however, indicates that there was an appreciable weakening in liquidity in the first quarter of this year, reducing it to its lowest level since mid-1977; the deterioration was no doubt exacerbated by the effects of industrial disruption.

Industrial investment slowing down?

Industrial investment was almost unchanged between the fourth and first quarters, a fall of 4% in manufacturing being offset by an increase in the distribution and services sector. It seems more likely that the weakening in manufacturing investment reflected industrial disruption, and the effects of bad weather on new construction work, rather than the sudden onset of a cyclical downturn. And, as in the past, the relative strength of service industry investment may indicate a further expansion of leasing activity.[1] Nevertheless, industrial investment in total is likely to rise less this year than last.

The June D.o.I. investment intentions survey shows a downward revision of manufacturing investment plans for this year (a rise of 2%–5%, compared with 4%–8% in the January survey). This may reflect a worsening view of prospects for the world economy and possibly the recent tendency of respondents to switch from buying to leasing as the time of acquisition approaches. There is perhaps evidence of this in the apparent firming of investment intentions in distribution and services (an increase of 5%–7%, compared with 3%–7% in January). Since the survey was conducted (April–May), confidence seems to have strengthened somewhat; but it remains to be seen whether this will be maintained in the face of the continuing rapid rise in fuel costs and the further constraint this may impose on world demand.

Stockbuilding heavier than expected

Provisional figures indicate that industrial stockbuilding in the first quarter was slightly heavier than in the fourth. This is a somewhat unexpected outturn, bearing in mind that industrial disruption in January probably led to a net reduction of stocks. It appears, therefore, that firms were generally able to offset any strike effects on their stocks before the end of the quarter. In the case of retailers' stocks, where the substantial rise in the first quarter was particularly surprising, the explanation may be that stocks were being built up towards the end of the period in the expectation of a pre-Budget surge in spending.

Stocks rose by some £950 million (at 1975 prices) in 1978, an increase similar to that in the previous year.[2] The rise was particularly concentrated in two sectors—retailing, and work in progress in manufacturing industry. Some rise in retailers' stocks was expected, to match the growth of consumers'

[1] See the March *Bulletin*, page 9.

[2] This rise was much smaller than had been originally estimated: revisions to the figures have resulted in the reallocation of £400 million of expenditure on housing from stockbuilding to fixed investment.

expenditure, but the size of the increase suggests some overestimation of the increase in spending. The substantial rise in manufacturers' work in progress is more difficult to explain, given an increase in manufacturing output last year of only $\frac{1}{2}\%$.

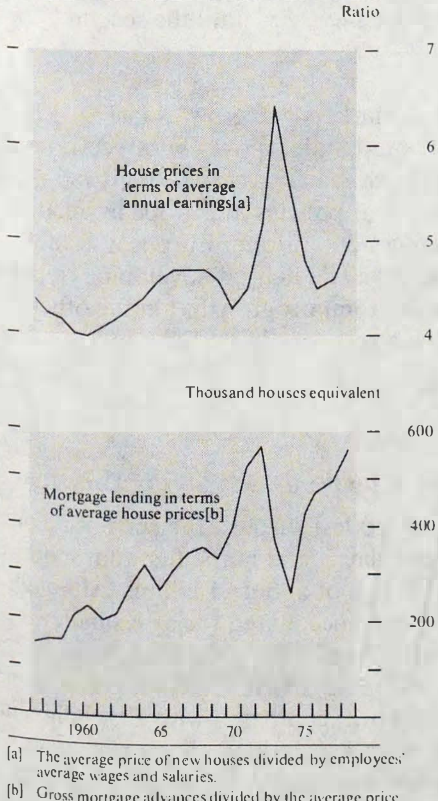
House prices and housebuilding

House prices rose rapidly last year. In January 1978, the average price of houses on which building society mortgages were approved was about £14,500, 8.2% higher than twelve months earlier. By January 1979, the average price of houses at the mortgage-approval stage had increased by nearly £4,000, or 27%. The increase affected all types of property, and was experienced throughout the country, although it was strongest in London and the South East. The rate of increase appears to have slowed slightly during the winter months, but may now be picking up again, with house prices increasing by about $1\frac{1}{2}\%$–2% a month.

While, in the long run, construction costs and the availability of land clearly have an important influence on house prices, in the short term, with the supply of houses nearly fixed, changes in prices must stem largely from changes in demand. The underlying demand for houses might be expected to depend on incomes and the cost of finance; but the extent to which this is translated into effective demand is likely to be influenced by the availability of finance, particularly of building society mortgages. The chart shows that, over the last twenty years, the ratio of average house prices to average earnings has for the most part fluctuated fairly narrowly between about 4 and 5; and that, where there has been a marked divergence from this range, notably in 1973, this has been accompanied by substantial growth of mortgage lending. At such times, the expectations of a continuing increase in house prices may themselves stimulate further demand for mortgages.

House prices

Prices rose strongly in 1978, and the upward trend seems likely to continue this year.



[a] The average price of new houses divided by employees' average wages and salaries.

[b] Gross mortgage advances divided by the average price of new houses in the fourth quarter of the previous year.

Economic conditions in 1978 favoured an increase in the underlying demand for housing: disposable incomes were $15\frac{1}{2}\%$ higher (in money terms) than in 1977, and in the six months to January 1978, the mortgage rate fell from $11\frac{1}{4}\%$ to $8\frac{1}{2}\%$, its lowest since April 1973. Building societies were able to finance this increase in underlying demand: in 1977, when the interest rates they offered had been very competitive, they had attracted a record inflow of over £6 billion. The societies' lending for house purchase (and, to a lesser extent, that of other institutions) rose sharply during the second half of 1977 and remained high throughout 1978, despite some weakening in the rate of inflows.

The recent rise in house prices may be expected to encourage some recovery in housebuilding, though part of the rise has been matched by increases in the cost of land, and probably does not, therefore, represent a widening of builders' profit margins. During 1978, there was indeed a modest upward trend in private housing starts, and the sharp reversal in the first quarter, when starts fell by 40%, is probably to be attributed mainly to the weather. On the other hand, public sector starts have been declining since late 1977 and may fall further this year.

Public spending and the PSBR[1]

Public spending on goods and services continued to decline in the fourth quarter of 1978, and was 1% lower than in the fourth quarter of 1977. General government final consumption rose by 1½% over the year, while public sector fixed investment fell by 10%, continuing the decline which began in 1976.

The public sector borrowing requirement (PSBR) in the first quarter of 1979 was £2.6 billion, bringing the total for the financial year to £9.2 billion, compared with the April 1978 Budget forecast of £8.5 billion (see table). The divergence of £0.7 billion is small compared with those in the previous five years.[2] The industrial action by civil servants which began in March affected receipts and repayments of VAT, payments to contractors by some government departments and some farming subsidy payments; income tax receipts, excise duties and social security payments were largely unaffected. The net effect on the PSBR in 1978/79 is reckoned to have been small.

Public sector borrowing in 1978/79[a]

£ billions

	Budget forecast (April 1978)	Outturn	Difference
Central government (less on-lending to the rest of the public sector)	4.9	6.0	1.0
Local authorities	1.8	1.3	−0.5
Public corporations	1.8	1.9	0.2
Total public sector borrowing requirement	**8.5**	**9.2**	**0.7**

[a] Figures may not add exactly because of rounding.

UK export markets now likely to grow more slowly

Growth in UK export markets was particularly fast in the second and fourth quarters of 1978, slower in the third, and slower too (on preliminary estimates) in the first months of this year. Taking the period as a whole, however, UK markets were considerably more buoyant than in the previous twelve months (see table). The faster growth in the year as a whole, and also the fluctuations from quarter to quarter, mainly reflected the pace of activity in Europe, where the upturn towards the end of 1978 clearly stimulated trade. OPEC imports are estimated to have fallen over this period, however, partly because of the disruption in Iran, but also because of a fall (in real terms) in oil revenues, which did not begin to benefit from the recent price increases until the second quarter.

It seems unlikely that UK markets will grow as fast in 1979. If, as widely forecast, the United States moves into recession, the volume of imports into North America may actually fall. Moreover, with more cautious policies in Europe as inflation increases or current balances deteriorate, European trade might also grow more slowly. The non-oil developing countries too may have to reduce their import growth. On the other hand, there is likely to be a recovery in OPEC imports, as oil revenues increase.

UK export markets

Per cent

	Share of UK exports	Growth of import volume: change on previous period	
		1st qtr 1977– 1st qtr 1978	1st qtr 1978– 1st qtr 1979[a]
North America	12	6¾	4½
Europe	55	−1½	9¼
Other developed countries	6	−6½	7¾
OPEC	13	8¼	−5
Non-oil developing countries	14	8½	9
Total export markets		1¾	6¾
Export markets for manufactures		3¼	7¼

[a] Partly estimated.

The current account: a large deficit so far this year

After some ten months of modest surplus, the current account deteriorated sharply in February, and in the first four months of this year, there was a deficit of about £1 billion. Although some of the weakening can be accounted for by a smaller contribution from invisibles (see below), the main source of the deterioration was a widening deficit on visible trade: some £1.5 billion in January to April, compared with £0.4 billion in the second half of 1978. With net trade in oil improving, as expected, the deterioration was wholly in non-oil trade, and mainly reflected adverse movements in the volume of exports and imports.

Current balance

£ millions: *seasonally adjusted*

	1977	1978				1979
	Year	Year	2nd qtr	3rd qtr	4th qtr	1st qtr
Visible balance	−1,744	−1,175	−173	−367	− 39	−1,181
of which:						
Oil balance	*−2,791*	*−2,015*	*−414*	*−501*	*−480*	*− 237*
SNAPS balance[a]	*− 59*	*+ 322*	*+195*	*− 38*	*+213*	*+ 150*
Underlying non-oil balance	*+1,106*	*+ 518*	*+ 46*	*+172*	*+228*	*−1,094*
Invisible balance	+2,115	+1,618	+381	+521	+489	+ 394
Current balance	**+ 371**	**+ 443**	**+208**	**+154**	**+450**	**− 787**

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

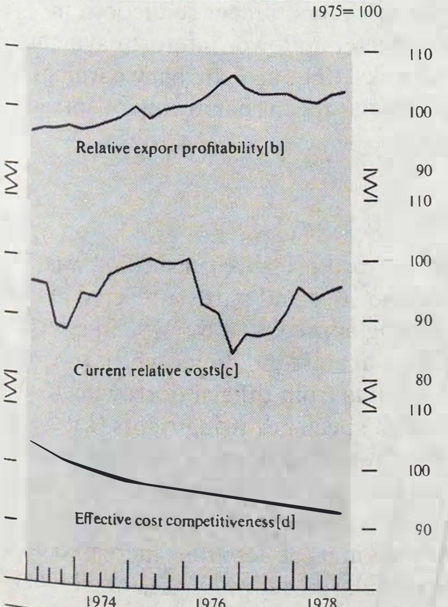
[1] All figures are seasonally adjusted.
[2] See the December 1978 *Bulletin*, page 491.

Exports were on average about 8% lower in the first four months of this year, compared with the last six months of 1978, with the fall widely spread across different categories of goods. If allowance is made for distortions identified by the Department of Trade, the fall is much smaller, although it nevertheless represents a deterioration since the second half of last year when exports were rising at an annual rate of 6½%. Part of the decline reflects the continuing effects of the road haulage dispute, and part is explained by a reduction in exports to Iran and Nigeria which, taken together, were about £100 million in value terms below what had been expected. In addition, disruptions to the normal flow of trade documents have reduced recorded exports in the last few months but should lead to a higher level in May and June.

Import figures have also had to be compiled from incomplete data but, despite the reduced flow of documents, between the same periods they showed an increase of over 3% in volume terms. Imports of industrial materials were unchanged but the volume of imports of finished manufactures was 6% higher. Imports of road vehicles alone increased by over 30% in volume.

It is as yet too early to say how far the deterioration in export performance and the substantial jump in imports represents a deterioration in the underlying trend of visible trade and how far it reflects the special factors noted above.

Export competitiveness[a]
The effective competitiveness measure is only just beginning to reflect the losses in cost competitiveness over the last two years.



[a] Except for relative export profitability, a downward movement in a series indicates an improvement in competitiveness.
[b] Ratio of UK export prices of manufactures (excluding erratic items) to prices of manufacturing output (excluding food, drink and tobacco).
[c] Ratio of UK normalised unit labour costs to those of competitor countries: IMF series.
[d] Effective competitiveness is a weighted average of current and past relative costs, the weights being derived from coefficients in an equation explaining the volume of manufactured exports.

Competitiveness continues to weaken

The United Kingdom's trading competitiveness appears to have deteriorated fairly steadily since late 1976, and perhaps quite markedly in the first quarter of this year. The extent of the deterioration varies according to the measure chosen; and the most recent data, in particular those measures which involve comparisons with foreign costs and prices, are always liable to substantial revision. Nevertheless, the general picture is fairly clear. In terms of cost competitiveness—measured according to the International Monetary Fund's (IMF) index of relative normalised unit labour costs [1]—most, if not all, of the improvement during 1976 has now been reversed.

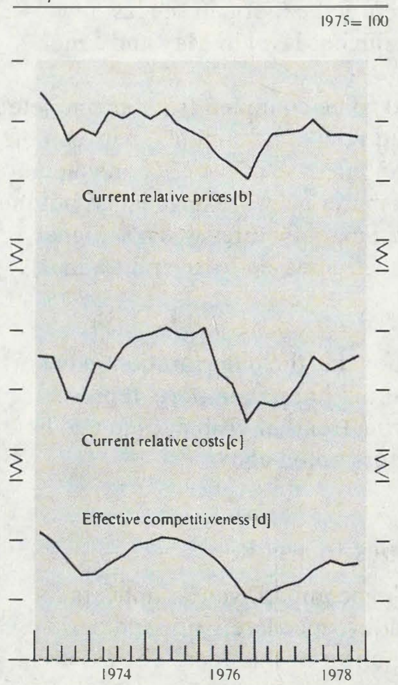
Exporters do not seem to have allowed this loss of cost competitiveness to cut into profit margins. In 1976, the substantial gain in cost competitiveness was reflected partly in higher margins, but also in improved price competitiveness. Since 1976, however, relative export profitability has been little changed (see chart), and cost and price competitiveness have moved quite closely together. This may reflect the general weakness of industrial profitability in recent years and the consequent lack of scope for, or at least unwillingness to see, any further decline.

Recent work in the Bank on the impact of competitiveness on trade performance has confirmed the results reported in the *Bulletin* a year ago.[1] Thus, in equations determining the volume of manufactured exports, changes in labour costs (on the IMF measure) appear to influence export volumes over a relatively long period (four years). At any time, therefore, effective (i.e. currently operative) competitiveness is taken to be a weighted average of both current and past levels of actual

[1] See, C. A. Enoch, 'Measures of competitiveness in international trade', June 1978 *Bulletin*, page 181.

Import competitiveness[a]

Losses in cost competitiveness have been accompanied by little change in price competitiveness since mid-1977.



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

[b] Ratio of UK prices of manufacturing output to import prices of finished manufactures (excluding erratic items).

[c] Ratio of UK normalised unit labour costs to those of competitor countries: IMF series.

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

Capital flows

£ millions, *not seasonally adjusted*

	1977	1978			1979
	Year	Year	3rd qtr	4th qtr	1st qtr
Current balance	**+ 371**	**+ 443**	**+314**	**+499**	**−870**
Exchange reserves in sterling:					
Countries	− 242	− 309	+ 1	−181	+135
International organisations	+ 223	+ 190	+ 8	+124	+ 6
Private sterling balances:					
Banking and money-market liabilities	+1,481	+ 301	+159	+356	+474
Gilt-edged stocks	+ 979	+ 15	− 20	+ 18	+264
UK banks' net external liabilities in foreign currencies	+ 384	− 519	+328	− 7	+941
Other identified capital flows (net)	+1,640	−2,048	−546	−992	−186
Balancing item	+2,525	+ 801	− 34	+168	− 79
Balance for official financing	**+7,361**	**−1,126**	**+210**	**− 15**	**+685**

competitiveness, the weights being determined by econometric estimation. For exports, though actual cost competitiveness was worsening throughout 1978, effective competitiveness continued to improve, as the favourable effects of the 1976 depreciation were still being absorbed. However, the influence of 1976 is now diminishing, while increasing weight is being given to more recent experience, which now seems to imply deterioration in effective export cost competitiveness during 1979. The position for imports of finished manufactures is less clear-cut,[1] but the lags seem to be very much shorter than for exports, and effective competitiveness for imports has, therefore, already shown an appreciable deterioration in both 1977 and 1978 (see chart).

Some narrowing of the surplus on invisibles

The invisibles surplus in the first quarter was estimated to be some £390 million, £95 million less than in the fourth, but about the same as the quarterly average for 1978 as a whole. A large part of the deterioration was attributable to net government transfers and services. Contributions to the EEC Budget were not much changed, but receipts were well down on the unusually high figure for the previous quarter.

The private sector's services balance also fell back. Although there was some improvement in financial and miscellaneous services, other components weakened, particularly civil aviation, which was affected by increased competition and higher fuel costs.

The balance on interest, profits and dividends, however, improved considerably. The tight supply situation which followed the disturbances in Iran provided a sharp boost to UK oil companies' overseas earnings, more than offsetting a strong rise in payments. In addition, while the official reserves benefited from higher interest rates, recent reductions in official borrowing were reflected in lower interest payments. On the other hand, UK banks' net euro-currency earnings fell abruptly, perhaps reflecting the recent narrowing of spreads [2] on lending.

Capital flows

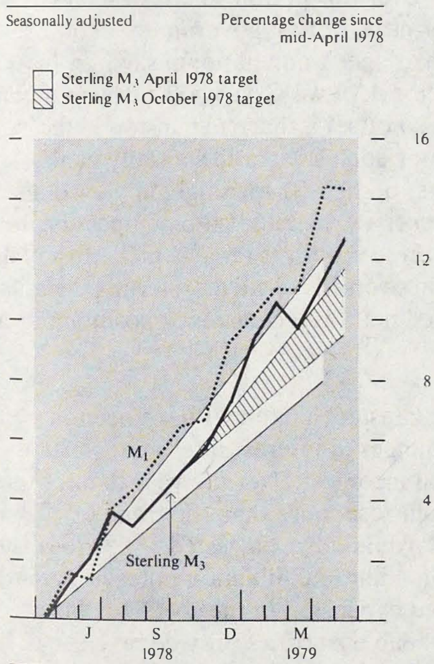
During the first quarter, upward pressure on sterling was partly absorbed by the authorities and partly reflected in a rise in the exchange rate: sterling appreciated by 3¼% in effective terms but rather less (1¼%) against the dollar which recovered sharply. Excluding net receipts from official borrowing (£75 million) and an allocation of special drawing rights (£195 million), the reserves rose by £685 million. First estimates of investment and other capital transactions show a net inflow of around £1.6 billion. Private overseas sterling holdings rose sharply: banking and money-market liabilities increased by £475 million, and there were large net purchases of gilt-edged stocks. Sterling balances of overseas central monetary institutions also rose, partly offsetting the fall in the previous quarter. Net external borrowing by UK banks in foreign currencies was more than £900 million, reflecting switching into sterling by the banks and a rise in their net foreign currency lending to the private sector.

[1] Recent work has again failed to identify any one clearly superior measure of competitiveness, and the preferred relationship involves both relative costs and relative prices, with equal weights and little lag.

[2] See page 134.

Monetary objectives

Money stock grew somewhat more rapidly in the second half of the year from mid-April 1978.



DCE and the money stock [a]

£ millions, *seasonally adjusted:* mid-month

	Jan. 78– Apr. 78	Apr. 78– July 78	July 78– Oct. 78	Oct. 78– Jan. 79	Jan. 79– Apr. 79
Central government borrowing requirement	+1,141	+2,098	+2,210	+2,298	+2,206
Net purchases (–) of central government debt by non-bank private sector	–1,032	–2,262	–1,412	–1,982	–3,580
Other public sector[b]	+ 385	+ 156	– 552	+ 371	+ 772
Bank lending to:					
UK private sector[c]	+1,230	+1,725	+ 724	+1,411	+2,385
Overseas	+ 647	+ 158	– 4	+ 82	– 111
Domestic credit expansion	**+2,371**	**+1,875**	**+ 966**	**+2,180**	**+1,672**
External and foreign currency finance (increase –)	– 375	– 157	– 20	+ 60	– 510
Other	– 206	– 80	– 329	– 152	– 288
Sterling M_3	**+1,790**	**+1,638**	**+ 617**	**+2,088**	**+ 874**
Percentage change in sterling M_3	*+ 4.0*	*+ 3.6*	*+ 1.3*	*+ 4.3*	*+ 1.7*
M_1	**+ 759**	**+ 885**	**+ 634**	**+ 832**	**+1,016**
Percentage change in M_1	*+ 3.4*	*+ 3.8*	*+ 2.6*	*+ 3.3*	*+ 4.0*

[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 local authority and public corporation debt by the non-bank private sector.

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

Inflows continued in April and May. The reserves fell by \$480 million (£234 million) in April, but this was after substantial net repayments of official borrowing, including a \$1 billion early repayment to the IMF (which completed the repayment of the United Kingdom's outstanding credit tranche drawings). In May, the reserves rose by \$65 million (£32 million) after further net repayments of official borrowing amounting to around \$240 million.

Monetary developments[1]

After rising rather rapidly in the first three months of 1978/79, the growth of sterling M_3 slowed down last summer. The pace accelerated again around the turn of the year, and though there was some moderation in the following months, growth in the first seven months of the new target period from mid-October was nevertheless quite rapid, some 13% at an annual rate, just above the target range (see chart). Over the year to mid-April, however, sterling M_3 rose by $10\frac{1}{2}$% (unadjusted), comfortably within the target range. M_1 rose more rapidly than sterling M_3 over that period.

Bank lending has been a major factor pushing up the rate of monetary expansion in recent months (see table). In some measure this was expected, as the financial aftermath of the industrial disruption in January. Borrowing by the construction industry and by agriculture may also have been increased by the unusually severe weather. Moreover, companies may have had to borrow to cover delays in VAT repayments and other government disbursements, brought about by the Civil Service strike. At times, too, it was probably attractive to use bank borrowing to finance purchases of certificates of tax deposit. So far as these influences have been responsible for the surge in bank lending, their effect may in time be reversed—quite quickly in the case of the Civil Service dispute, perhaps over a longer period in the case of the after-effects of the first quarter's disruption. On the other hand, there may have been some strengthening in the underlying demand for credit. Pressure on profit margins and liquidity may mean that companies' borrowing needs are now greater than in the latter part of 1978. There is also some evidence that in April and May a good deal of lending was, either directly or indirectly, associated with the upturn in consumer spending.

The pattern of the central government borrowing requirement was erratic over the three months mid-January to mid-April, though the overall total was much the same as in earlier quarters. This erratic pattern partly reflected the effects of the Civil Service strike which reduced the borrowing requirement in March but increased it by more in April. Market borrowing by the rest of the public sector, particularly local authorities, was higher than earlier in the financial year. Nevertheless, purchases of public sector debt by the non-bank private sector covered the public sector's total borrowing needs by a substantial margin. MLR had been raised from $12\frac{1}{2}$% to 14% on 8th February, in line with the rise in market rates which had been prompted by the apparently worsening prospect for pay restraint and the then current industrial disruption. The increase in MLR, and the subsequent recovery in confidence as some pay settlements turned out lower than had been feared, enabled the authorities to make substantial sales of

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

gilt-edged stock, culminating in a massive oversubscription of the two stocks issued on 22nd February. One result of this was a move to the issue of stocks by tender, though with a minimum price prescribed.[1] Market rates began to fall but, with continuing uncertainties over the future course of pay and fiscal policies, together with increasing evidence that bank lending was beginning to rise rapidly, the authorities were concerned that the decline should not be too fast. MLR was reduced to 13% on 1st March and to 12% on 5th April; the latter reduction, however, was partly for external reasons, in response to substantial inflows from abroad.

As well as sales of gilt-edged stocks of some £2½ billion to the non-bank private sector over this period, there were also sizable sales of other forms of central government debt, notably certificates of tax deposit and national savings. In total, sales of public sector debt were particularly large during these three months and so offset a sharp expansion in the other main components of domestic credit, notably bank lending. External factors, perhaps surprisingly in view of the sizable increase in the reserves, had a negative impact on the money supply over the three months to mid-April. Most of the increase reflected rises in overseas residents' sterling deposits and changes in the banks' net foreign currency position rather than inflows to the non-bank private sector.

M_1 still seems to be rising faster than might have been expected from recent changes in interest rates and, so far as they are known, nominal incomes. Over the year to mid-April, holdings of notes and coin rose more than the trend of consumers' expenditure would have suggested. The growth in the public's holdings of higher denomination notes has been held to indicate a marked expansion of the so-called 'black economy',[2] but the available statistics provide no clear evidence in support of this theory. The rise in the non-interest-bearing component of M_1 was also larger than expected, but this may have reflected increasing use of the relief from bank charges offered to those who maintain substantial credit balances. The rise in M_1 in banking April seems to have been erratically large, possibly because funds were accumulated on current accounts to meet VAT payments held up by the Civil Service strike. In banking May there was no increase in total M_1, and the non-interest-bearing component fell.

[1] See page 128.

[2] That is, economic activity carried out in such a way as to avoid taxation, e.g. by the use of banknotes for transactions which would normally be settled through the banking system, and so not captured by the normal statistics.