CORRECTION

Bank of England Quarterly Bulletin

Volume 19 No.4 December 1979

Economic commentary

Page 361

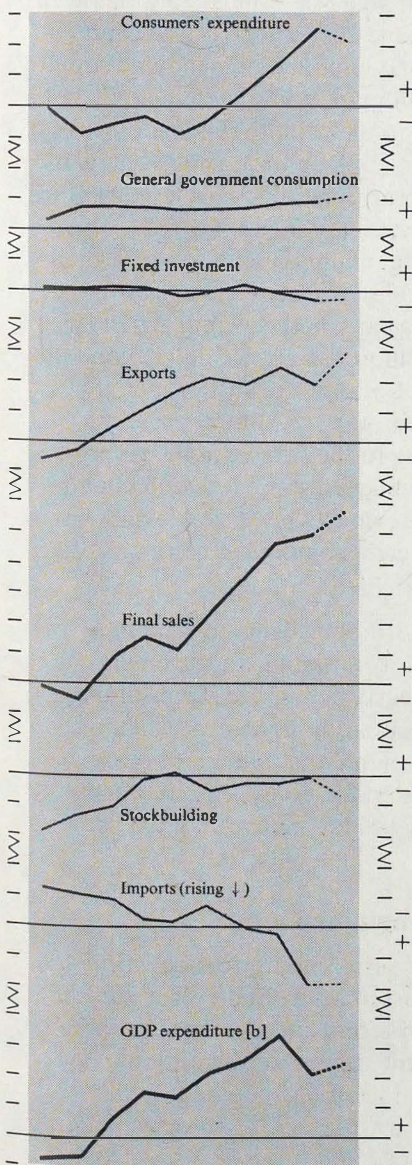
Table: Financial flows of oil-exporting countries

The table is denominated in US$ billions and not in £ billions as shown.

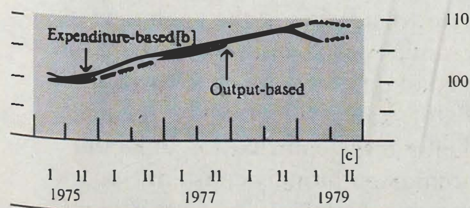
Economic commentary

Changes in components of GDP[a]

The trend of demand now seems to be levelling off.



Indices of GDP



[a] Changes since 1974 second half.
[b] At factor cost.
[c] Bank estimate.

Introduction

The world outlook remains depressed, and may become more so if oil prices rise further. Output in the United Kingdom fell quite sharply in the third quarter, only partly because of the engineering strike. The demand for labour already seems to have turned down.

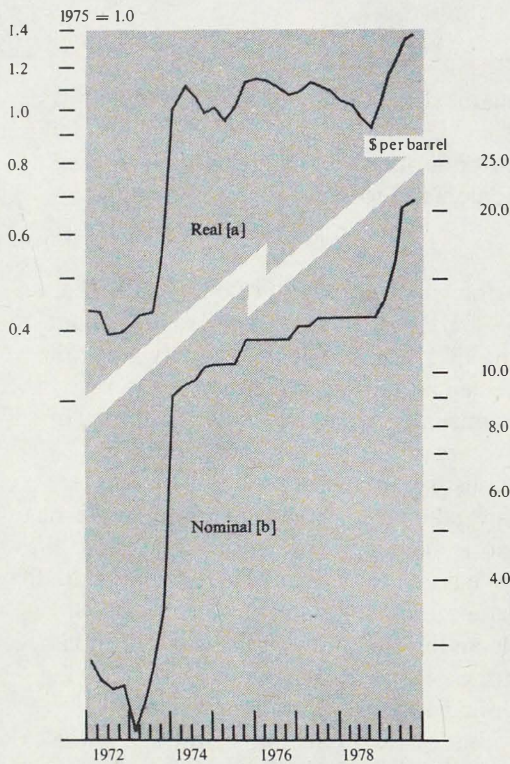
After several years during which the trend of output has been fairly steadily upward—GDP rose at an average rate of about 2% a year between mid-1975 and mid-1979—activity may now be starting to slacken (see chart). The rapid increase in real personal incomes and consumer spending, the main source of buoyancy in the last two years, is probably weakening, as prices respond to previous pay increases and to the acceleration in raw material costs. At the same time, domestic suppliers are feeling more sharply the effect of a worsened competitive position. Weaker competitiveness has contributed to a further financial squeeze on companies, which may already have been reflected in spending on fixed assets and is likely soon to affect stocks. It has also meant some underlying deterioration in the United Kingdom's trading position—despite the growing output of North Sea oil—although in the third quarter there was quite a marked recovery in visible trade after the erratic and substantial shift into deficit in the first half-year.

No clear pattern has emerged yet in the new pay round: but so far there is little sign of a lower level of settlements than last year. Price inflation has been held back to some extent by the appreciation of sterling, but the year-on-year increase in retail prices continues to drift upwards, reaching 17¼% in October, equivalent to about 13%–14% if the Budget tax changes are excluded. This upward trend reflects rising crude oil and other commodity prices (partly offset by the strong exchange rate) and higher wage costs.

Monetary growth has been above the top end of the present target range. The measures announced on 15th November, which included an increase in minimum lending rate from 14% to 17%, were designed to reinforce the steps already taken in the Budget to curb monetary expansion. The lifting of the remaining exchange control restrictions, however, sharpens some of the questions which have been raised over the mechanism of monetary control. More immediately, diversification out of sterling and the repayment of foreign currency borrowing may have had some contractionary effect on domestic money holdings, although this will have been offset or reduced to the extent that the outflows were financed by new domestic credit or were reflected in depreciation of the exchange rate. Sterling did, in fact, weaken quite sharply immediately after the lifting of controls, with the effective rate index falling to 66.1 by 5th November. Thereafter, partly because of the uncertain situation in world currency markets resulting from events in Iran and partly because of the rise in UK interest rates, most of the decline was reversed.

Oil prices

Oil prices have risen by about 70% in nominal terms this year.



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

[b] Average contract price.

Measures of inflation in six major overseas economies[a]

Average percentage change from a year earlier

	1978		1979		
	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Consumer price index	6.8	7.1	7.6	8.3	9.1
TFE deflator	6.0	6.3	6.9	7.6	..
GNP deflator	7.1	7.0	7.5	7.4	..

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

Factors contributing to the increase in TFE deflators in four overseas economies[a]

Average percentage change from a year earlier

	1978		1979	
	3rd qtr	4th qtr	1st qtr	2nd qtr
Increase in TFE deflator	5.5	5.7	6.2	6.8
of which:				
Import costs	*0.1*	*0.8*	*1.0*	*1.8*
Labour costs	*2.9*	*2.5*	*2.5*	*3.1*
Other[b]	*2.5*	*2.4*	*2.7*	*1.9*

[a] United States, Canada, Japan and Western Germany. GNP-weighted.

[b] Including profits, and net indirect taxes and subsidies.

Oil prices continue to rise

After a measure of stability in the third quarter, when oil prices settled within the range of $18–23.50 per barrel agreed at the OPEC meeting in June, there was a recurrence during the autumn of the price leap-frogging seen earlier in the year. This upset the balance between different grades of crude oil and, in some cases, meant breaking through the ceiling of $23.50. As a result, Saudi Arabia, which is currently producing about 30% of total OPEC output, became even more out of line, with its 'marker' price still set at $18 per barrel.

If there are no further increases before the end of the year, oil prices will by then be, on average, some 70% higher in nominal terms than a year earlier; while the price of oil in real terms, which by the end of last year was almost 20% below its 1974 peak, will probably be some 20% above it (see chart). Although stocks now seem adequate, and demand and supply appear to be in balance, the oil market has been unsettled by recent political developments in the Middle East, and prices in the spot market—which is attracting an increasing volume of oil—remain very high. Next year, with the expected downturn in the world economy and an increase in non-OPEC production, there may be some fall in demand for OPEC oil, but prices will remain vulnerable to relatively small swings in demand and supply. It is not clear whether Saudi Arabia will maintain production at 9.5 million barrels per day beyond the end of this year; and a number of other countries may, for a variety of reasons, reduce their output. Although the consuming countries belonging to the International Energy Agency (IEA) have already achieved some reduction in oil consumption this year from previously projected levels, this in part reflects slower than expected economic growth.

A relatively tight oil supply position is likely to remain a feature of the world economy. Continuing and stronger conservation measures will clearly be needed if consuming countries are to adapt to this situation in an orderly manner. Against this background, the member countries of the IEA agreed on 10th December to aim for no increase in oil imports next year, and for only a very limited increase up to 1985.

A poor outlook for the world economy

The likely impact of this year's rise in oil prices on world economic prospects was discussed in the September *Bulletin* (pages 250–52); and, in broad terms, the view set out there probably still holds good. Some aspects of the outlook have, however, changed with more recent developments.

The average rate of increase in consumer prices in the main overseas countries reached 11% in the third quarter (taking the change on the second quarter, seasonally adjusted, at an annual rate), almost double what it was at the beginning of the year. Higher commodity, and especially oil, prices were the main factor. Up to the second quarter, domestic costs, as reflected in the GNP deflator, had accelerated hardly at all (see table); and within the total the contribution of labour costs also seems to have remained broadly constant (see second table). Inflation may now level off, or even begin to ease slightly, but could still remain around 10% on average well into next year.

Average earnings in manufacturing in six major overseas economies[a]

Percentage change from a year earlier

	Nominal				Real[b]			
	1978	1979			1978	1979		
	4th qtr	1st qtr	2nd qtr	3rd qtr[c]	4th qtr	1st qtr	2nd qtr	3rd qtr[c]
United States	9.1	8.9	8.7	8.6	0.2	−0.8	−2.0	−3.0
Canada	6.9	7.6	9.0	8.9	−1.7	−1.5	−0.4	0.6
Japan	5.6	5.7	7.1	8.9	1.7	2.6	3.7	5.0
Western Germany	5.7	4.9	4.9	4.8	3.3	1.7	1.2	−0.1
France	13.4	12.9	13.4	12.3	3.6	2.5	3.0	1.4
Italy	14.9	15.7	17.0	18.9	3.0	2.5	3.0	4.0
Average[d]	8.5	8.4	8.8	9.1	1.3	0.7	0.5	—

[a] Figures for Western Germany, France and Italy refer to wage rates.
[b] Nominal earnings deflated by the consumer price index.
[c] Figures for Canada, Japan and Italy extend only to August.
[d] GNP-weighted.

Financial flows of oil-exporting countries[a]

£ billions

	1975	1976	1977	1978	1979[b]	
					1st half	3rd qtr
Oil revenues	97	113	129	124	67	58
Total merchandise exports	115	141	155	147	84	58
Total merchandise imports	61	73	90	104	46	27
Net invisibles, including official transfers	− 23	− 32	− 38	− 42	− 22	− 11
Current balance	31	36	26	1	16	20
Net external borrowing etc.	4	2	8	13	..	..
Surplus available for investment	35	38	34	14	..	..
Identified surplus from 'deployment' table[c]	35	37	33	13	10	..

[a] Figures cover the thirteen members of OPEC plus Bahrain, Brunei, Oman, and Trinidad and Tobago. Estimates in this table are derived from various sources and are not necessarily consistent, partly because of rounding. In addition, oil revenues are estimated on a 'cash' basis: they include, during the third quarter of 1979, the effects of reduced credit terms. The other lines within the current account are on a 'transactions' basis.
[b] Estimates for 1979 are provisional.
[c] See page 389.

World trade and UK export markets[a]

Percentage change from previous period at an annual rate

	1979			1980
	Year	1st half	2nd half	1st half
World trade	5.7	5.4	6.6	−0.3
UK export markets	4.8	3.4	8.5	2.2

[a] Second half of 1979 partly estimated; first half of 1980 forecast.

The fairly steady pace of money wage increases, at a time when prices have been accelerating, has meant that, over the last year, the growth of real incomes has slowed down (see first table). So far, the squeeze has been most pronounced in Western Germany and the United States, but it has also been felt, to a lesser extent, in France. With pay negotiations taking place against a background of weakening activity and rising unemployment, the pressure on real earnings seems likely to continue, although the position will vary from country to country.

Slow growth in real personal incomes will, in turn, restrain consumer spending and demand more generally, but recession seems to be emerging rather more slowly than had at first seemed likely. Output growth in the main overseas countries weakened less in the first half of this year than had been expected, and in most countries domestic demand in 1979 as a whole now seems likely to turn out rather stronger. This is particularly true of the United States, where GNP rose much more sharply in the third quarter than had been expected; the decline in GNP in the fourth quarter may, however, be correspondingly greater. More generally, although the recession may have been postponed, it seems unlikely to be any less severe than previously thought. Indeed, in recent months, there have been unexpectedly steep rises in interest rates in every major country (see page 383), which, if anything, may leave world demand more depressed than earlier projections had suggested. All in all, domestic demand in the main overseas economies may show no growth at all between the first halves of 1979 and 1980, although their combined GNP may still receive an appreciable boost from the external sector.

A significant contribution to this is likely to come from increased exports to the oil-exporting countries.[1] These countries' imports now seem to have fallen much more in the first half of 1979 (by around 15%) than was originally estimated. In the case of Iran and Nigeria, which together accounted for three quarters of the decline, a downturn had been expected; but elsewhere, too, falls or at best sluggish growth in import volume were common, a reflection of policies originally imposed to deal with deteriorating current accounts and worsening inflation. One consequence has been to raise substantially the prospective size of the oil-exporting countries' current account surplus this year (see second table). During the first half of 1979, the surplus was probably running at an annual rate of over $30 billion; but between mid-1979 and mid-1980 it could increase to around $70 billion. This period may, however, see the surplus at its peak: thereafter, the volume of these countries' imports will probably be rising, and both the volume and price of oil exports may be constrained by the weakness of world activity and the conservation efforts of consuming countries.

Despite the slump in oil-exporting countries imports (and a slower growth of imports into other developing countries), the growth of world trade remained close to 5% in the first half of 1979 (see third table), mainly because of a revival of imports into the smaller European countries and continued strong growth in some major countries. In the second half, the pace may have been sustained by a recovery in imports into the oil-

[1] Defined as the thirteen members of OPEC plus Bahrain, Brunei, Oman, and Trinidad and Tobago.

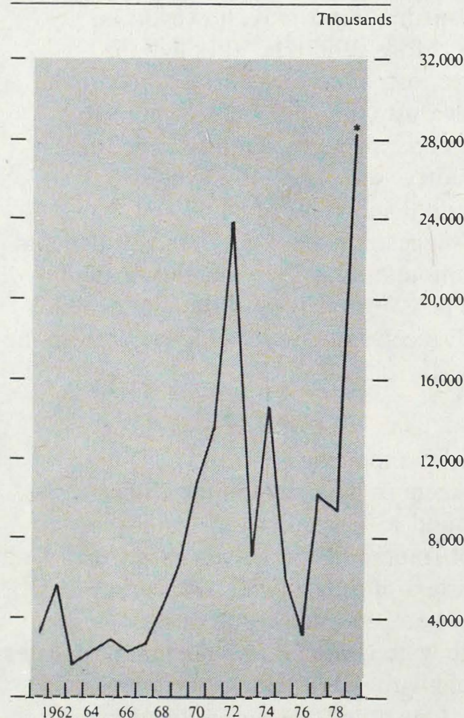
exporting countries. By the first half of next year, however, with most OECD economies (together accounting for three quarters of world trade) slowing down sharply, the growth of world trade may come to a halt. But UK export markets still seem likely to be less badly hit than world trade in general. Almost one half of UK exports go to the oil-exporting countries and the smaller European countries, and these markets should help to cushion the United Kingdom compared with countries trading more with North America and Japan. But, as a corollary, the United Kingdom can be expected to benefit rather less from any recovery in these major economies towards the end of the year, particularly as many smaller OECD countries may be forced to curtail import growth to reduce large external deficits.

UK output lower, partly because of strikes . . .

The output estimate of GDP fell by about 2% in the third quarter, partly reflecting the engineering dispute which lasted throughout August and September. Manufacturing output in the third quarter fell by about 5%. Because industrial disputes have affected output in three of the last four quarters, it is difficult to get a clear view of the underlying trend. After a period of fairly rapid growth between mid-1977 and mid-1978, the pace seems to have slackened over the last year, though GDP probably remained on a modestly rising trend until the summer. Now, however, there are some indications—and, judging from the recent Confederation of British Industry surveys, it seems to be industry's own view—that the trend of output will soon begin to turn down, or may indeed have already done so.

Working days lost through industrial disputes

The number of days lost has risen sharply this year.



* Estimate for fourth quarter.

The number of working days lost this year through strikes (see chart) is already larger than for any year since the general strike of 1926. This is largely because of the recent engineering dispute which involved, at times, up to 1¼ million workers and accounted for about 13 million working days lost. The immediate loss of output involved was probably of the order of ¾% of one quarter's GDP, though the net effect of the dispute will probably be smaller, because part of the lost output may be made good later. (This appears to have happened, for example, after the disputes in other industries in the first quarter.) Nevertheless, some once-for-all loss is likely, and, with overall disruption on the scale of the last twelve months, the presumption must be that some customers will have switched to alternative sources of supply overseas.

Working days lost in seven countries through industrial disputes per 1,000 employees[a]

Annual averages for	10 years 1968–1977	5 years 1968–1972	5 years 1973–1977
United States	1,340	1,530	1,103
Canada	1,893	1,726	2,060
Japan	241	228	254
France	308	280	330
Italy	1,914	1,910	1,918
Western Germany	53	76	30
United Kingdom	850	996	704

[a] Mining, manufacturing, construction and transport.

Despite the bad strike record this year, an analysis of the previous ten years does not show the United Kingdom to be particularly strike-prone (see table). Although France and, more particularly, both Western Germany and Japan, have a very much better record than the United Kingdom, the United States, Canada and Italy fared appreciably worse. These comparative figures do not necessarily, however, reflect the overall disruptive effect of strikes on an economy, which depends also on such factors as the number of strikes, the sectors in which they occur and the degree of disruptive action in advance of a strike. There is some indication that the United Kingdom's record in terms of numbers of strikes is relatively bad, and this may have led to overall disruption out of proportion to the total of days lost.

Changes in employment and unemployment

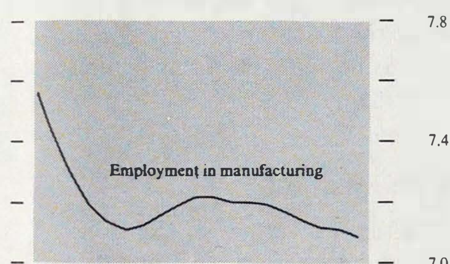
December 1977–June 1979: thousands; *seasonally adjusted*

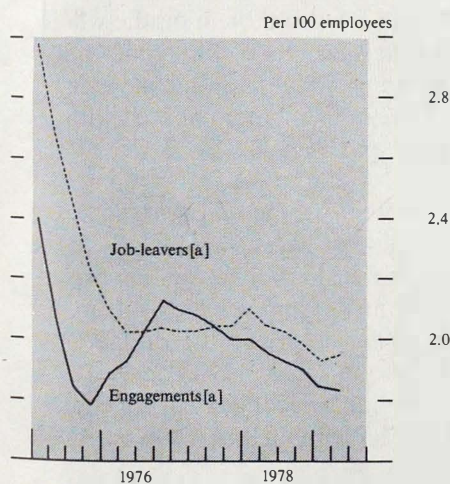
	Employment	Unemployment
Males	− 6	−135
Females	+230	− 7
Total	**+224**	**−142**

Employment and labour turnover in manufacturing

The number of job-leavers has been low in recent years and fell further during 1978.

Seasonally adjusted Millions of employees





[a] Four-quarter moving average.

. . . and unemployment rising again

The steady decline in unemployment, which began some two years ago, ended during the summer and, since September, has been partly reversed. Falling unemployment has been accompanied by a relatively modest rise in employment—of around 225,000 between the end of 1977 and June this year. This is much smaller in relation to the fall in unemployment over the period (140,000) than past relationships would have indicated.

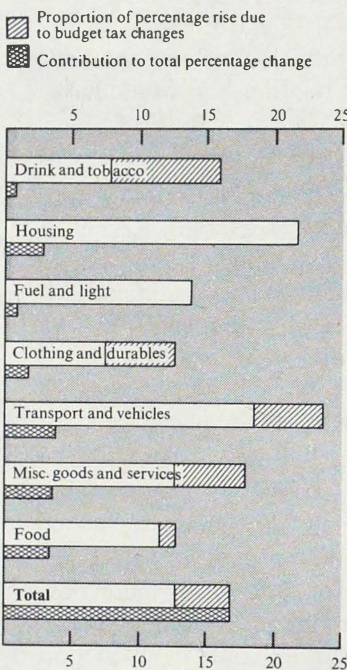
The apparently small net increase in the labour supply seems to conceal large compositional changes (see table). Recent employment growth has been entirely confined to women, yet the reduction in female unemployment has been minimal. In contrast, male employment and unemployment each fell. One reason may be that many men left the labour force through early retirement as part of the Job Release Scheme; others may have found forms of employment which have gone unrecorded.

The disparity between changes in male and female employment probably also reflects the strength of the service sector relative to many of the older manufacturing industries, where the bulk of the employees are men. In addition, employers may have found that vacancies could be filled more cheaply by women, and that the higher wastage rates accompanying this choice provided extra flexibility in a period when prospects were uncertain. Wastage rates in manufacturing have, in fact, fallen significantly since early last year. Meanwhile, the rate at which new employees are engaged has sunk to the level of mid-1975 (see chart). Yet, while in that year there was a net loss of around 500,000 jobs, the decline over the latest twelve months has been only about 100,000. After allowing for a decline in the number of redundancies—an average of 18,000 per month in 1975 as against 10,000 in the first nine months of this year—it seems that employees in manufacturing industry are now less likely to leave their jobs voluntarily than at any time in the past five years. This clearly raises particular difficulties for firms attempting to sustain productivity and keep down unit costs in a period when output is growing slowly or declining, and may quite soon force firms to review their attitude towards redundancies.

Pay: no clear pattern so far

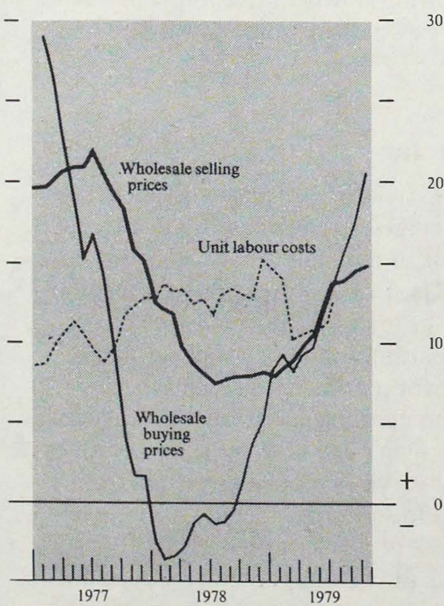
The outcome of the last pay round is difficult to assess because of delayed settlements and staged pay increases. The recorded rise in earnings over the year to mid-July was 16½%. Because of back-pay to teachers and police, and other distortions, the underlying increase was lower than this, probably in the range 15%–16%. Since July, the earnings index has fallen, mainly because of the engineering workers' stoppages; but the underlying rate of increase in earnings has probably remained around 16%. However, this figure excludes most of the effect of staged increases to public service employees arising from comparability studies linked to settlements made during the 1978–79 pay round. Estimates of this 'over-hang' are necessarily uncertain (results of the comparability studies for some major groups, including nurses and teachers, have not yet been published) but it could add some 2% to overall earnings over the next twelve months.

Contributions to changes in retail prices September 1978 to September 1979



Earnings and prices

Inflation has accelerated somewhat, mainly because of the surge in raw material costs.



Relatively few major groups have settled in the current pay round so far, and no clear pattern of settlements or claims has yet emerged. Some groups have been seeking to re-establish what they see as their correct place in the pay league, and others, such as the miners, have sought a return to old settlement anniversaries. Some recent settlements have been at rates close to 20%; but elsewhere much lower figures have been accepted, e.g. where it has been clear that a company was financially weak. There are also indications that on occasion settlements are being underpinned by some form of indexation or re-opening provision. The National Engineering Agreement, which should have been renewed in April, but was not actually negotiated until October, involved a reduction of one hour in the normal working week (to come into effect in November 1981) on top of increases in the basic minimum wage rates. Many current claims also include demands for a shorter working week, and it is possible that the engineering agreement may be the first step in a general move to shorter hours, though there is no sign yet of this being a widespread feature of settlements.

Only slight acceleration in inflation

Since the jump of 4.3% in the retail prices index (RPI) in July—largely due to the Budget increases in VAT and other indirect taxes—the monthly increases, although on the whole lower than in the first half of the year, have been somewhat higher than a year earlier, and the twelve-month change in retail prices has risen, to 17¼% in October compared with 15½% in July and 8½% at the end of 1978.

In the twelve months to September, as the first chart shows, the largest increases were in the cost of housing, mostly in the first half of this year (reflecting the sharp increases in costs to owner-occupiers[1]), and in transport and vehicles, mostly in the third quarter (reflecting higher oil prices, the Budget increase in petrol duty and a rise in some public transport fares). So far this year, the tax and price index has, of course, risen appreciably less than the RPI. In October, it was 14¾% higher than in October 1978.

The strengthening of sterling around the middle of the year, coupled with some levelling off in world commodity prices, meant an easing in the rate of increase in industry's raw material costs. Thus, despite the continuing rise in crude oil prices, manufacturers' buying prices rose by less than 3% between June and September, against 7¼% in the previous three months. With the exchange rate weakening somewhat during the autumn, part of this benefit will have been lost; but the effect will have been mitigated by some easing in world commodity prices and by the pick-up in sterling during November. Nevertheless, buying prices are now some 20% higher than a year ago (see chart). On top of this, the continuing rapid increase in earnings will probably mean some further, though perhaps fairly modest, increase in the rate of inflation in coming months.

Personal incomes buoyant . . .

Real personal disposable income (RPDI) rose by over 6% in the year to the second quarter of 1979, after an 8½% increase

[1] See the September *Bulletin*, page 255.

during the previous twelve months. This rapid growth, which followed a period of several years when real incomes remained stagnant, has been the main factor underlying the strong upturn in consumer spending since mid-1977. More recently, however, real earnings have fallen and, in the third quarter, the growth of real disposable incomes was probably checked. Later in the year, disposable incomes will have been boosted by the payment of income tax rebates; but during 1980, the trend in RPDI and, with it, consumer spending seem likely to level off.

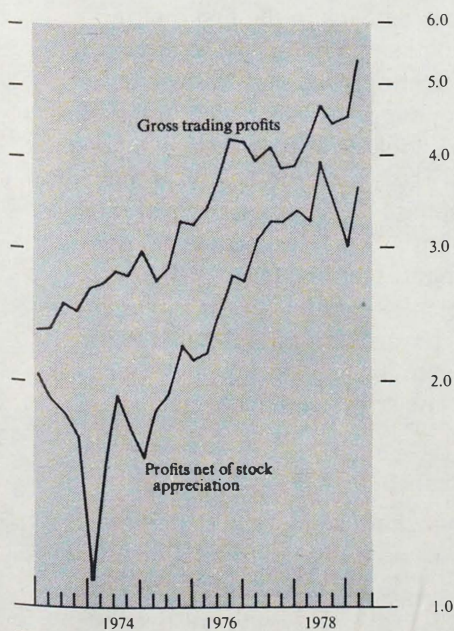
For most of 1978 and in the first quarter of this year, movements in consumer spending followed quite closely changes in RPDI. Since then, however, there have been sharp changes in the saving ratio as a result of the pre-Budget spending boom and the reaction afterwards (consumer spending rose by 4% in the second quarter and fell by the same amount in the third). Over the last year, spending on durables has been particularly buoyant. Such spending is, however, traditionally more volatile and more cyclically variable than other kinds of expenditure. It may also have been boosted, over the last year or two, by an attempt to make good the stock of durables, which in relation to income was declining.

. . . but company profits under pressure

Profits of industrial and commercial companies, before depreciation but net of stock appreciation and excluding North Sea activities, fell by about 10% between the second half of 1978 and the first half of this year (see chart). For these companies, the real pre-tax rate of return on net trading assets fell from 5% to 3½% over the same period. Part of the downturn no doubt reflected the industrial disruption during the early part of this year. But increasing cost and competitive pressures were probably also important; and the latter may have intensified in the second half of the year. Besides any further weakening of profits, companies' cash flow will have been adversely affected in recent months by appreciably higher interest rates. As indicated in the September *Bulletin* (page 257), the prospect seems to be for a marked increase in non-North Sea companies' financial deficit.

Company profits [a]

Profits net of stock appreciation may now be weakening.

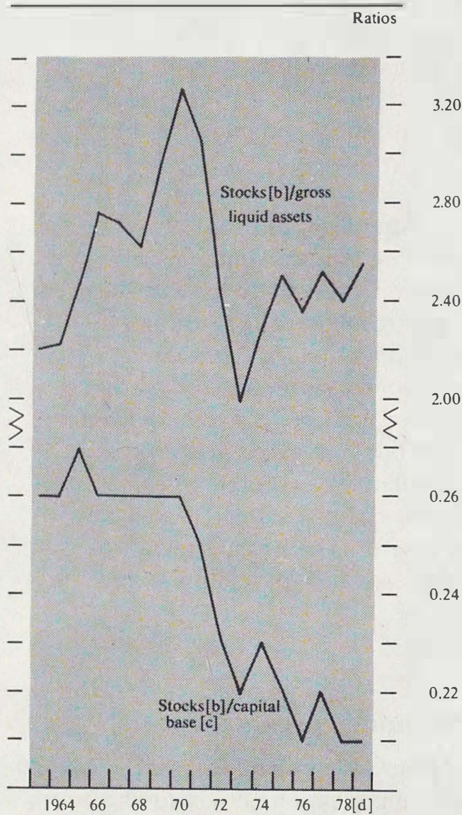


[a] Excluding North Sea activities.

Profitability, especially in manufacturing, is likely to be under pressure for three main reasons. First, the outlook for the growth of demand is poor and has, if anything, worsened in recent months. Secondly, cost pressures have intensified. Manufacturers' raw material costs have risen by over 20% this year, despite the strength of sterling, compared with only about 5% during 1978. Unit labour costs have also been accelerating. Given the likely prospect for wage and cost inflation (see above), companies may seek to achieve some relief through increased productivity, but at best this may not emerge for some time, especially in a period of falling output. Finally, UK companies' international competitiveness—at least on the conventional measures involving relative costs and prices—has continued to deteriorate in 1979, affecting both exporting and import-competing firms, many of which fall within the manufacturing sector. Continuing low productivity growth, and the current and lagged effects of high inflation, together mean that the competitive position of UK industry is likely to deteriorate further in the months ahead.

Stock ratios [a]

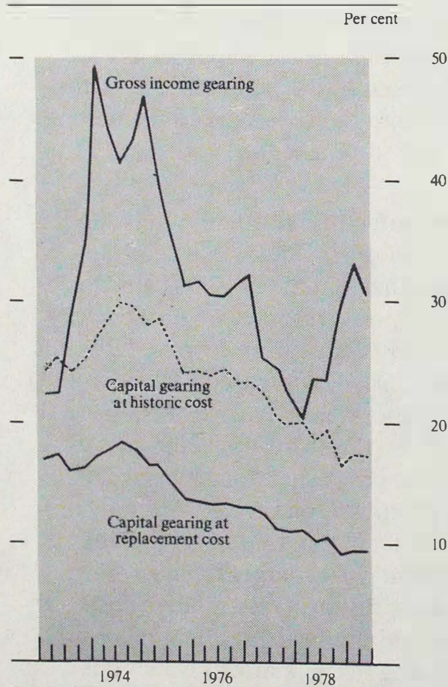
Balance-sheet structure does not seem to have responded significantly to the introduction of stock relief in 1974.



[a] All industrial and commercial companies.
[b] At book value.
[c] Replacement cost of net fixed assets plus book value of stocks.
[d] Bank estimate.

Capital and income gearing [a]

Capital gearing has been improving; but income gearing has worsened.



[a] All industrial and commercial companies.

Within companies' own spending, the October Department of Industry (D.o.I.) investment intentions survey showed a sharp downward revision since June in manufacturing investment plans. Such investment is now projected to fall by up to 3% this year, and by as much as 7% next year, although the outlook may be less gloomy if leased assets are taken into account. (In the first three quarters of this year manufacturing investment was 2% lower than in the same period last year but investment by the distribution and service industries, which includes the purchase of assets subsequently leased to manufacturing industry, was 8% higher.) While stockbuilding has continued, it may have been to an increasing extent involuntary, suggesting a sharp downward adjustment in stocks in the near future. It has been argued that the unexpected strength of stockbuilding in recent years, and apparently 'excessive' stock holdings in relation to the level of activity, may have stemmed partly from the introduction of stock relief in 1974. As the chart shows, however, the ratio of stock holdings to other assets provides little or no support for this idea. The rise in stock/output ratios may therefore owe as much or more to cyclical influences as to stock relief.

Companies' financial deficit in the first half of the year was nearly £2½ billion, and even this may be an understatement bearing in mind the size of unidentified transactions during the period. The net borrowing requirement,[1] which is struck after including these transactions, was £4 billion, its highest half-yearly total in nominal terms, though well below its highest in real terms.

Whatever weakening in companies' financial position may now be going on or may be in prospect, companies' balance sheets seem to have started from a reasonably strong position. Both replacement cost and historic cost capital gearing have been on a downward trend since 1974, and this has continued into 1979, albeit with a temporary setback in the first quarter. Company liquidity also remains in a relatively healthy state, although it has been deteriorating since mid-1978, and the latest D.o.I. liquidity survey suggests a sharp fall in the third quarter. On the other hand, looking at cash flow, companies' income gearing—which may be a better indicator of immediate pressures—has risen in response to increased interest rates (see chart). In the first half of 1979, gross income gearing—the ratio of gross interest payments to companies' cash flow before dividend and interest payments—was higher than at any time since the middle of 1975. The sharp rise in interest rates in recent months, combined with a rising stock of debt, suggest that income gearing will increase in coming quarters.

Housebuilding remains depressed

Housebuilding was slow to pick up from the disruptions of last winter, and when recovery came it proved to be short-lived. Housing starts increased by 27% in the second quarter but since then they have fallen sharply, and total new dwellings commenced in the first ten months of the year were nearly 20% fewer than in the corresponding period of 1978. The low rate of approvals for public authority housing has constrained the growth of public sector starts, but the position in the private sector has also been depressed.

[1] The net borrowing requirement is defined as companies' financial deficit (net acquisition of financial assets) modified to reflect actual cash flows in respect of unremitted profits, trade credit and similar accruals, and after long-term investment abroad and acquisition of company securities from other sectors.

The availability of land, and delays over planning permission, remain important constraints on new work, but a growing proportion of builders are now reporting some slackening in the demand for new houses. Shortage of mortgage finance is seen as an increasing brake on the market, although, by itself, this seems to have had a limited effect in reducing the rate of increase of house prices. In the third quarter, prices rose by 7%, making the rise over the year to end-September around 30%. More recently, however, there have been some indications that the pace may be slackening.

Building society receipts rose sharply in the three months August to October with the result that the societies' liquidity improved. This occurred despite the fact that deposit and share rates were relatively unattractive, and reflected vigorous marketing of term shares and, in the latest month, the channelling into building societies of a proportion of the recent income tax rebates. But with the further marked worsening of their competitive position in November, following the steep rise in competing interest rates, the societies increased their share rate to 10½% (net of standard rate tax) and their mortgage rate to a record 15%. It remains to be seen whether this will dampen mortgage demand.

Public spending in 1980/81

On 1st November, the Government announced its plans for public spending in 1980/81.[1] Total public expenditure—current, capital and transfer payments—is projected to be broadly the same next year in volume terms as the expected outturn for 1979/80. The distribution of spending between individual programmes is, however, expected to differ. Thus, defence spending is shown as rising by 3%, following the commitment made to NATO by the previous administration, while expenditure on law and order is to increase by over 3½%. Britain's net contribution to the EEC and to the European Investment Bank is planned to rise by nearly 9%, reflecting the ending of the present transitional arrangements. But reductions in other expenditure covered by the 'overseas aid and other overseas services' programme leaves total expenditure on the programme only 2½% higher. Total borrowing by the nationalised industries is expected to fall by £450 million, while central government lending to these bodies is planned to fall by £800 million (all at 1979 survey prices). The reduced need of the nationalised industries for external financing to some extent reflects both the fact that the payment of many telephone bills due in the current financial year will be delayed until 1980/81 and also a move to 'economic' pricing by the nationalised industries. Expenditure on roads and transport, housing and education is projected to fall in 1980/81, in each case by around 5%. Over half the cut in the education budget is accounted for by savings of some £240 million on school meals, milk and transport—but it should be noted that the number of children of school age next year is expected to fall by some 3%.

Current account: some improvement

After the large current account deficit (now estimated at £1.8 billion) in the first half of the year, there was a considerable recovery in the third quarter, when the deficit fell to £0.2 billion (see table). As the table shows, changes in the current

[1] *The Government's expenditure plans, 1980/81*, Cmnd. 7746 (HM Stationery Office, November 1979).

Balance of payments

£ millions; *seasonally adjusted*

	1978			1979		
	Year	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Visible balance	−1,175	−367	− 39	−1,579	−714	−397
of which:						
Oil balance	*−2,015*	*−501*	*−480*	*− 234*	*−227*	*−166*
SNAPS balance[a]	*+ 322*	*− 38*	*+213*	*+ 57*	*+ 31*	*+ 21*
Underlying non-oil balance	*+ 518*	*+172*	*+228*	*−1,402*	*−518*	*−252*
Invisible balance	+2,207	+666	+653	+ 372	+107	+186
Current balance	**+1,032**	**+299**	**+614**	**−1,207**	**−607**	**−211**

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

account so far this year have largely been associated with movements in the underlying non-oil balance; these movements in turn, especially in the first half of the year, reflected changes in the volume of trade rather than in prices. In October, the deficit on visible trade widened appreciably, but this may prove to have been erratic. The terms of trade were fairly stable during the first half of the year but have since declined somewhat.

As noted below, trade figures in the first two quarters were strongly influenced by temporary disruptions, and a better view of the trend may be obtained by comparing the third quarter of this year with the corresponding period in 1978. On this basis, the current account has worsened by some £½ billion. The visible balance changed little over the period, an improvement of some £¼ billion in the oil balance being offset by a deterioration on non-oil trade, largely because the growth of manufactured imports has been considerably faster than that of manufactured exports (see table). On the other hand, the invisible surplus narrowed by about £½ billion (see below).

Changes in trade volumes[a]

Percentage change from same period in previous year

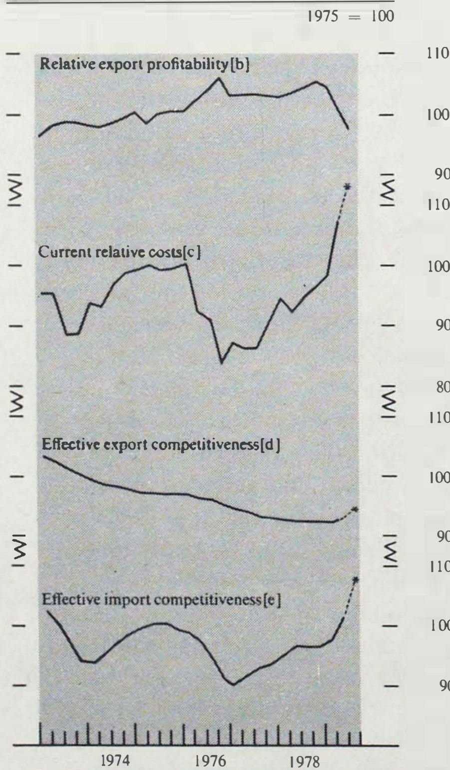
	1978			1979		
	Year	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr
Exports	+ 4.5	+ 1.9	+ 7.9	− 7.5	+ 9.6	+ 5.2
of which:						
Manufactures[b]	*+ 3.1*	*+ 1.9*	*+ 5.1*	*−11.4*	*+ 9.9*	*+ 3.1*
Fuels	*+26.2*	*+23.6*	*+50.8*	*+37.9*	*+37.1*	*+27.5*
Other	*+ 3.5*	*− 4.4*	*+ 7.0*	*− 7.3*	*+ 0.1*	*+ 4.9*
Imports	+ 7.7	+ 9.5	+11.3	+ 4.1	+13.6	+11.0
of which:						
Manufactures[b]	*+14.2*	*+13.9*	*+18.8*	*+11.4*	*+26.2*	*+17.6*
Fuels	*− 2.5*	*+ 3.0*	*+ 7.2*	*− 9.7*	*+ 9.1*	*− 5.0*
Other	*+ 2.3*	*+ 5.7*	*+ 1.2*	*− 1.8*	*− 3.3*	*+ 5.9*

[a] Overseas trade statistics basis.

[b] Excluding erratic items, i.e. ships, North Sea production installations, aircraft and precious stones.

Competitiveness[a]

Both import and export competitiveness have worsened substantially this year.



* Bank estimate.

[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] A weighted average of current and past relative costs, the weights being derived from coefficients in an equation explaining the volume of manufactured exports.

[e] 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.

Exports hold up well in the third quarter

After the supply disruptions early in the year resulting from the road haulage dispute and the interruption of exports to Iran and Nigeria, it was not unexpected that some of the 'lost' exports would be made good in the second quarter. But, despite adverse movements in relative cost competitiveness and a continuing worsening in relative export profitability (see chart), the buoyancy continued into the third quarter, with non-oil export volume falling by only ¾%; and in the first three quarters of this year taken together, the volume of non-oil exports was actually some ½% higher than in the corresponding period of 1978.

Most categories of exports (other than fuels) moved broadly together in the third quarter; road vehicles were, however, significantly out of line, falling by just over 7% in volume terms. The decline in the relative profitability of selling abroad suggests that exporters have allowed their profit margins to absorb part of the weakening in their cost-competitive position in order to maintain export volume. The index of relative profitability was lower in the third quarter than at any time since the first quarter of 1973.

In October, exports were clearly hit by the engineering dispute. The sectors at the centre of the dispute, machinery and road vehicles, were naturally the most affected, and total exports of manufactures (excluding erratic items) fell in volume terms by 6½%. Even with the dispute over, prospects for the next six months are not very encouraging. Recent surveys, which show export order books already falling, suggest a weakening by the first quarter of next year; by then, the effects of recent losses of competitiveness may begin to show up more clearly.

Imports level off

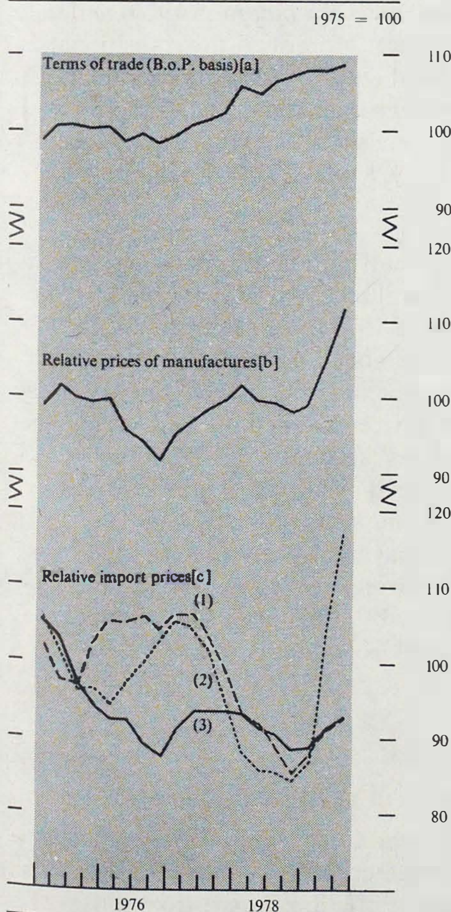
The volume of non-oil imports rose by 11½% between the second half of 1978 and the first half of 1979 (9% including oil). Although the volume of non-oil imports in the third quarter was below the exceptionally high figure for the second

quarter, it was well above the average for the first half of the year as a whole, and some 15% higher than in the third quarter of 1978. Imports of chemicals and road vehicles, which were among the largest contributors to the rise in import volume in the first half of the year, showed marked falls in the third quarter. But imports of finished manufactures as a whole continued to rise, with an especially sharp increase in imports of machinery.

Though imports of finished goods have been broadly in line with expectations, imports of industrial materials remain, even after the fall in the third quarter, higher than might have been expected. It is unlikely that this can be accounted for merely by temporary stockbuilding in response to recent exchange-rate movements. Other factors, in particular competitiveness, have no doubt also played a part.

Terms of trade

The terms of trade have been fairly stable in recent quarters.



[a] Ratio of export unit value index to import unit value index (balance of payments basis).

[b] Ratio of UK import prices of manufactures to prices of manufacturing output (excluding food, drink and tobacco).

[c] Ratio of UK import prices of (1) basic materials, (2) fuels and (3) food, drink and tobacco to UK import prices of finished manufactures.

Stable terms of trade

The terms of trade in goods (the ratio of the export unit value index to the import unit value index) rose appreciably in 1977 and 1978 but were relatively stable over the first half of this year (see chart). This stability was, however, the result of two opposing influences. On the one hand, prices were rising faster in the United Kingdom than abroad, a disparity reinforced by the appreciation of sterling. This tended to raise export prices relative to import prices because the influence of domestic prices in the determination of trade prices seems to be greater on the export side. On the other hand, there was an increase during 1979 in primary product prices relative to those for finished goods: this lowered the UK terms of trade because primary products account for a greater proportion of UK imports than of UK exports. In recent months, however, the fluctuations of sterling have upset this balance of opposing influences.

The relative price of domestic and foreign manufactures—the first of the influences on the terms of trade noted above—is illustrated in the chart. This ratio has risen strongly since 1976, except during the last three quarters of 1978 when the appreciation of sterling was temporarily reversed. Various measures of relative primary product prices are also shown in the chart: all have risen this year.

The same two factors also indicate why the terms of trade rose strongly in 1977 and 1978: during most of this period there was a relatively fast rate of price increase in the United Kingdom, which coincided with a period of relatively weak prices for primary products.

Invisibles

First estimates suggest an invisibles surplus of nearly £200 million in the third quarter compared with about £100 million (revised from exact balance) in the second (see table on the following page). The balance on private services improved by over £100 million, more than half of which came from financial services, but the deficit on private transfers widened by about £75 million, mainly, it seems, as a result of the relaxation in June of exchange controls on emigrants' transfers. The balance on interest, profits and dividends (IPD) remained in deficit for the second successive quarter: the overseas earnings of UK companies increased, but the earnings of foreign oil companies

Components of the invisibles balance

£ millions; *seasonally adjusted*

	1976	1977	1978	1979		
				1st qtr	2nd qtr	3rd qtr
Net services	+2.257	+2,991	+3,289	+667	+739	+ 882
of which:						
Private sector and public corporations	*+2,924*	*+3,722*	*+3,986*	*+874*	*+955*	*+1,066*
General government	*− 667*	*− 731*	*− 697*	*−207*	*−216*	*− 184*
Net transfers	− 797	−1.155	−1,918	−515	−574	− 646
of which:						
Private sector	*− 13*	*− 44*	*− 218*	*− 65*	*− 51*	*− 125*
General government	*− 784*	*−1,111*	*−1,700*	*−450*	*−523*	*− 521*
Net interest, profits and dividends	+1,299	+ 201	+ 836	+220	− 58	− 50
Net invisibles balance	**+2,759**	**+2,037**	**+2,207**	**+372**	**+107**	**+ 186**

in the United Kingdom and the interest paid by UK banks on overseas residents' deposits were also higher.

Invisibles have generally yielded a significant and increasing surplus to set against any deficit on visible trade. The recent decline in this surplus (see table) is therefore a matter of some concern. Although early estimates of the invisibles balance are often revised upwards,[1] occasionally by as much as £½ billion for a full year, it is unlikely that, even after revision, surpluses on the scale of the recent past will be restored.

Two main factors underlie the weakening of the surplus. Foremost is the rapid increase in payments abroad of IPD by oil companies operating in the North Sea: in earlier years, heavy exploration expenses meant small profits; more recently, profits have been rising rapidly as production has built up, while interest payments have been reflecting the substantial overseas financing undertaken in earlier years. Consequently, oil IPD payments overseas, which were some £½ billion in 1978, may rise to around £2 billion in 1980.[2] The second factor is the mounting flow of government transfers to the EEC: in net terms, these amounted to nearly £1 billion in 1978 (compared with £¼ billion in 1976) and they have continued to rise this year. Moreover, the transitional arrangements for phasing in the UK contribution to the EEC budget—which terminate at the end of the year—have mitigated the impact on the invisibles account: without them, net transfers to the EEC in 1978 would have totalled £1¼ billion.

On the other hand, the net contribution of private services to the invisibles account has, until recently, grown rapidly, from a surplus of some £1 billion in 1973 to nearly £4 billion in 1978. The most buoyant sectors have been travel, and financial and other services. In the first three quarters of 1979, however, the overall surplus on private services levelled off, as increased net earnings on the 'other services' account were offset by higher net payments on travel and civil aviation. As with visible trade, worsening competitiveness has probably been an important factor, but travel payments have, no doubt, also been affected by the recent strong growth of UK personal incomes, which has led to a substantial increase in both the number of overseas visits by UK residents and the average amount spent on each visit.

Lifting of exchange control restrictions

On Tuesday, 23rd October, the Chancellor of the Exchequer announced the lifting, with effect from the following day, of all remaining exchange control restrictions, apart from those required to continue economic sanctions against Rhodesia.[3] This was the third stage in a programme under which virtually all controls on the financing of direct investment had already been abolished and a start made on the relaxation of controls on outward portfolio investment (the earlier measures had been announced in the Budget on 12th June, and on 18th July—see the September *Bulletin*, pages 260 and 274).

Exchange controls had been in force in the United Kingdom for more than forty years, but the tightness and effect of the

[1] See *Economic Trends*, August 1979, page 109.

[2] See the September *Bulletin*, page 283.

[3] These restrictions were lifted with effect from 13th December.

controls had varied considerably over time.[1] As it stood before the Budget, the system of controls restricted only capital transactions by UK residents and had three principal effects:

- With one minor exception, it prevented the use of 'official exchange' (i.e. resident transactions in a form capable of affecting either the United Kingdom's official reserves or the exchange rate for sterling in the official foreign exchange market) for outward portfolio investment and for the purchase of holiday homes abroad. Aggregate holdings of such assets were in principle limited to the existing stock,[2] and the assets generally changed hands between residents at a premium reflecting the excess of demand over available supply.
- It blocked or restricted some channels for short-term speculation against sterling by confining access to the forward foreign exchange market to cover for firm commercial contracts, by rules restricting advance payment for imports and requiring the repatriation of export proceeds, and by severely restricting the borrowing of sterling by non-residents.
- For the rest, it deferred access to official exchange, most notably in respect of direct investment abroad (which had mostly to be financed by borrowing foreign currency—such borrowing then being serviced from the profits arising from the investment).

In consequence, the changes made since June will have widened the scope for transactions by residents which potentially affect the exchange rate for sterling or the official reserves. More importantly, however, they have removed distortions in the flow of capital into overseas assets.

A private sector capital outflow

There were large capital outflows from the non-bank private sector during the third quarter, partly because of the relaxation of exchange controls in June and July. These outflows were, however, outweighed by inflows to the public and banking sectors (see table); and indeed net capital inflows exceeded the relatively small current account deficit.

The inflow to UK government debt came from both private and official holders; while the net foreign currency inflow to the banks was to a large extent matched by switching into sterling. This has now happened for three quarters running and may partly reflect continuing confidence in the strength of the exchange rate. It may, however, also have been induced by pressure from the 'corset'. A bank with net spot assets in foreign currency can fund sterling lending without increasing its eligible liabilities by running down its net foreign currency position to zero. If, however, it moves beyond this point, to a net spot liability, this further 'switching in' means a rise in eligible liabilities and counts against the corset limit. By the end of the third quarter, the scope for 'switching in' outside the constraint of the corset had been considerably reduced.

As the table shows, external and foreign currency transactions have recently had a large contractionary effect on sterling M_3.

[1] Some account of the early history of exchange control was given in an article in the September 1967 *Bulletin*, page 245.

[2] The stock was in fact capable of being increased in certain ways, e.g. by increases in capital values of existing holdings, but it could also be diminished (e.g. by the '25% surrender rule', until its abolition in December 1977).

Capital flows

£ millions; *not seasonally adjusted*

	1978	1979		
	4th qtr	1st qtr	2nd qtr	3rd qtr
Current balance	**+596**	**−1,355**	**− 562**	**− 155**
Exchange reserves in sterling:				
Countries	−181	+ 135	+ 155	+ 321
International organisations	+124	+ 6	− 63	+ 99
Private sterling balances:				
British government securities	+ 18	+ 264	+ 45	+ 423
Other banking and money-market liabilities	+356	+ 474	+ 347	+ 452
Net foreign currency borrowing by UK banks	− 7	+ 941	+ 378	+ 677
Other capital flows, net (including balancing item)	−921	+ 220	+ 460	−1,519
Balance for official financing	**− 15**	**+ 685**	**+ 760**	**+ 298**

External and foreign currency finance

£ millions; *not seasonally adjusted*

	1978	1979		
	4th qtr	1st qtr	2nd qtr	3rd qtr
Current balance (surplus +)	+596	−1,355	−562	− 155
Bank lending in sterling to overseas (increase −)	− 73	+ 76	+ 24	− 107
Public sector foreign currency deposits (increase −)	− 44	− 10	− 5	− 1
Private sector external and foreign currency transactions	−510	+ 797	+421	−1,170
of which:				
Net foreign currency borrowing from UK banks (borrowing less deposits; increase +)	*+ 8*	*+ 440*	*−228*	*+ 323*
Net borrowing from abroad[a] *(residual; increase +)*	*−518*	*+ 357*	*+649*	*−1,493*
Total external and foreign currency finance (=effect on sterling M3)	**− 31**	**− 492**	**−122**	**−1,433**

[a] Also includes public sector lending abroad (increase −), and some investment overseas by UK banks (increase +).

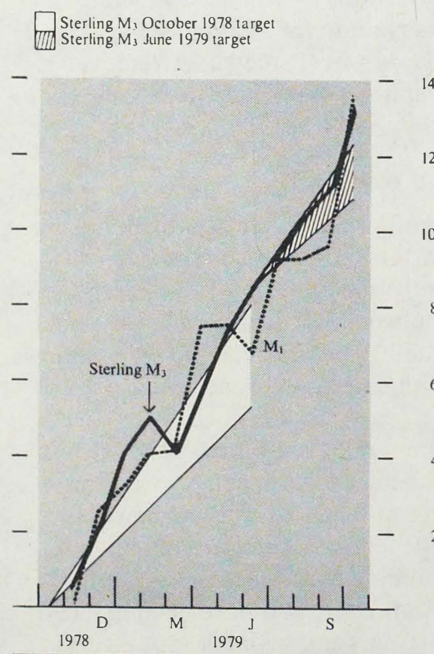
A good deal of the capital outflow probably stemmed from the exchange control relaxations announced in the summer, but it is impossible to estimate the balance of payments effects of relaxation with any precision. Assuming that the main impact was on the financing, rather than the volume, of overseas investment, a very rough measure of the effect may be obtained by looking at the fall in net borrowing for overseas investment from its average level in recent quarters. Such a calculation suggests that there may have been an additional outflow of around £1 billion following the measures, mainly reflecting the repayment of borrowing. Since this borrowing would have been repayable at some point in time, the main effect of the measures may be seen as bringing forward outflows which would in any case have taken place.

It is too early yet to assess the effect of the lifting of exchange controls announced in October. Investors will take time to adapt fully to the new environment, and there is considerable doubt about how much of any adjustment will take the form of pressure on the balance of payments and how much will come about through a fall in relative UK security prices.

Monetary developments

Monetary objectives

Monetary growth has been very strong in recent months.



Monetary growth in the late summer and early autumn was rapid, and, with a sharp rise in October, the increase in sterling M_3 during the first four months of the present target period reached an annual rate of over 14%, compared with the 7%–11% target range (see chart). In the year to mid-October, the recorded rate of increase of sterling M_3 was over 13%, against the 8%–12% target for that period set last autumn, and the underlying rate of growth was almost certainly faster. M_1 growth has also been rapid in recent months.

Against this background, and with increasing concern about inflationary trends, disturbingly high wage settlements, and also much higher interest rates abroad than at the time of the June Budget, market interest rates began to rise. In these circumstances, the authorities judged that a significant increase in minimum lending rate (MLR) was necessary. Accordingly, MLR was raised by three percentage points to a record 17% on 15th November. At the same time, it was announced that the target for sterling M_3, of 7%–11% at an annual rate, had been extended to cover the sixteen months from mid-June 1979 to mid-October 1980. By not rolling forward the base for the new target, the Chancellor made clear his determination not to accommodate the recent surge in monetary growth. It was also announced on 15th November that the supplementary special deposits scheme would be extended for a further period of six months, to June 1980, with the penalty-free rate of growth of interest-bearing liabilities continuing at 1% per month.[1]

Bank lending to the private sector has continued to be a major expansionary influence on monetary growth (see table on opposite page) and, after an erratically low figure for banking September, the banking October figure was the largest on record. Further, throughout the period from June, the so-called 'bill leak' (whereby commercial bills, guaranteed by the banks, are substituted for the banks' own lending) continued at a significant rate. There has been little sign, therefore, of any slackening in the underlying demand for credit. Borrowing

[1] The Bank's notice is reproduced on page 391.

DCE and the money stock[a]

£ millions; *seasonally adjusted*

Mid-month	July 78– Oct. 78	Oct. 78– Jan. 79	Jan. 79– Apr. 79	Apr. 79– July 79	July 79– Oct. 79
Central government borrowing requirement	+2,162	+2,239	+2,082	+2,889	+2,865
Net purchases (−) of central government debt by non-bank private sector	−1,412	−1,982	−3,579	−2,813	−1,173
Other public sector[b]	− 552	+ 366	+ 766	+ 37	− 289
Bank lending in sterling to:					
UK private sector[c]	+ 724	+1,400	+2,393	+2,226	+2,071
Overseas sector	− 4	+ 82	− 110	− 18	+ 57
Domestic credit expansion	**+ 918**	**+2,105**	**+1,552**	**+2,321**	**+3,531**
External and foreign currency finance (increase −)	− 22	+ 62	− 495	− 151	−1,257
Other	− 325	− 155	− 272	− 413	− 314
Sterling M_3	**+ 571**	**+2,012**	**+ 785**	**+1,757**	**+1,960**
Percentage change in sterling M_3	*+ 1.2*	*+ 4.1*	*+ 1.6*	*+ 3.4*	*+ 3.7*
M_1	**+ 636**	**+ 841**	**+1,015**	**+ 468**	**+1,048**
Percentage change in M_1	*+ 2.6*	*+ 3.4*	*+ 3.9*	*+ 1.7*	*+ 3.9*

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

[b] Contribution to the PSBR 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.

to finance consumer spending may have eased somewhat after the Budget, but lending to companies seems to have continued at a high rate, presumably reflecting growing pressure on profitability and cash flow (though the timing of the Budget tax changes may have meant erratic month-to-month variations in companies' need for funds). In addition, the relaxation of exchange controls has probably meant some, maybe significant, stimulus to the demand for domestic credit. The first stage of relaxation, in June, permitted companies to repay existing foreign currency loans and to make new investment abroad more easily. A number of companies made use of these new opportunities, prompted perhaps by the strength of sterling, and the consequent purchases of foreign currency may have been financed in part with sterling borrowed from UK banks.

The central government borrowing requirement (CGBR) was much the same in the three months to mid-October as in the previous three, but the Budget tax changes and a highly variable flow of on-lending to the rest of the public sector made the individual monthly figures very volatile. Thus, after a low CGBR in banking August, the September figure—boosted by the first tax rebates stemming from the Budget—was the largest on record, and the October figure, though smaller, was much larger than had been forecast. Sales of central government debt to the non-bank private sector, at £1.2 billion, were less than half as large in these three months as in the previous three. In part, this was the result of official policy in October when, on the expectation that the CGBR would be small, no significant sales of stock had been sought. Buying-in and redemption of maturing stocks also helped to reduce net sales of gilt-edged stocks, though there were still considerable proceeds from instalments on stocks issued earlier. National savings, which were generally offering uncompetitive rates, continued to yield low net receipts in this period, and there were net surrenders of certificates of tax deposit.

External factors were sharply contractionary over the three months to mid-October. With the current account apparently in modest deficit, this is likely to have largely reflected outflows resulting from the relaxations in exchange control mentioned above. As indicated earlier, the net contractionary effect on sterling M_3 is likely to have been reduced by higher bank borrowing and, in some part, by lower net sales of public sector debt.

After a sharp increase in July, immediately following the steep rise in indirect taxes announced in the Budget, M_1 was unchanged in banking August, rose only slightly in September but then increased by over 3% in October, making an annual rate of growth since June of nearly 20%. However, given that the rise in prices over that period was very sharp, on account of the change in VAT rates, such a rate of growth is probably not surprising, particularly as much of the October increase was in the interest-bearing component of M_1 (perhaps reflecting funds built up ahead of investment in the gilt-edged market).

The measures of 15th November were intended to reassure financial markets of the Government's resolve to keep monetary growth under control. The immediate effect was to allow a resumption of the funding programme, and substantial

sales of gilt-edged stocks were made in the week after the measures. In the coming months, the outlook will also be helped by a prospective sharp fall—aided, among other factors, by sales of public sector assets—in the public sector borrowing requirement from the high levels recorded in the first two quarters of the financial year. However, for the rate of monetary expansion to come down to, and remain at, an acceptable level, it will also be necessary for the rate of growth of bank lending to ease significantly.

Assessment

This Assessment seeks to gauge the prospects for the economy in 1980 as a basis for considering the problems for financial policy that may arise. The next year or two is likely to be a difficult time for British industry; but if it provided the opportunity to get inflation under control, that would lay the foundation for a sustained recovery later. The inevitable uncertainties make it all the more necessary to maintain firm monetary control.

The economy

The course of the economy this year has been uneven because of industrial dislocation and because of the effect of the Budget on the timing of consumer spending. But the underlying trend of economic expansion seems to have flattened out. Most forecasts foresee this flat trend now giving way to recession. Turning points are, however, well known to be difficult to identify. For instance, the US economy has for some time been widely expected to turn down, but the onset of recession has repeatedly failed to appear at the time expected. A recession in the United States will probably still develop; even so, the example serves to illustrate the limitations of foresight in general and of economic forecasts in particular.

Systematic economic forecasts build on the idea that developments in the recent past are likely to have further consequences in the period to come. Though it is not possible to forecast the course of events with any close degree of exactitude, it seems worth setting out the nature of the forces likely to be at work.

Over the last five years, there have been some general influences which have tended to reduce the rate of economic growth. In this country, as in others, productivity growth has slowed down; and in the face of heightened inflationary dangers almost all governments have felt forced to pursue cautious fiscal and monetary policies. The effect on the UK economy has been the greater because of the recent erosion of cost competitiveness, which has adversely affected exports, imports and domestic output.

On this general trend have been superimposed more erratic factors. Two have recently been important in sustaining demand; their unwinding now threatens to check demand quite sharply.

The present acceleration of inflation to a large extent reflects the fact that, throughout the last pay round, pay increases continued at a high rate. The effect on prices was for a time masked by other factors. The result was that for much of 1978

and into the first half of 1979, the rise in earnings exceeded the rise in prices by a considerable margin. The rise in real earnings, and consequent growth of consumer spending, was the main element in the brisk rise in total demand, and for the less marked rise in output, up to the middle of this year. That phase is now ended. With the faster rise in prices, consumers' real disposable incomes have ceased to rise rapidly; and that is the main reason for expecting that consumer spending will show little buoyancy for some time.

Secondly, stocks were built up in each of the years 1977 and 1978 and again this year. Output (and imports) were thus supported in a way which could not be sustained indefinitely, and which is indeed now likely to be reversed as demand shifts downwards. The resulting adjustment of stocks could be the largest component of any fall in total demand next year.

To these two major influences are likely to be added others going in the same direction. Public sector investment and private sector housebuilding are expected to continue to decline; and there is likely to be a fall in private industrial investment.

The world now faces a threat of further increases in the real price of oil: these would impose a further brake on the pace of world industrial expansion. Even apart from this, world trade seemed likely to grow at a rather slow rate. There is room for expert disagreement whether UK exports will share in any growth there is, or, on the other hand, whether reduced competitiveness will now work to prevent this. On a favourable view of exports—and given also that any fall in home demand would reduce imports—the current account could be near balance next year.

One conclusion from this analysis is that any recession which may now be in prospect would stem largely from causes lying well back in the past, so that the forces pulling the economy downwards for a while would be strongly entrenched. While some of these recessionary forces would be more than temporary, others would be essentially short-lived—likely to cause a sharp dip, not a continued downward slide, in activity. A stock adjustment typically lasts one or two years; and after that sort of period, an upward trend in consumers' real purchasing power will probably be resumed. While the timing of such adjustments cannot be predicted exactly, use of the Bank model suggests that GDP will decline by at least 1% or 2% in 1980, the impact being concentrated on manufacturing output; it also suggests that a recovery might set in by the end of 1981.

Whether that recovery is vigorous or limited will depend very much on the extent to which inflation has by then been reduced and productivity improved. If the competitiveness of British industry in international markets continued to weaken, that would go far to strangle the dynamic forces of expansion. Given the need for a strict monetary policy—and given also the additional strength lent to the exchange rate by the United Kingdom's position as an oil producer—rising costs are unlikely to be accompanied by a compensating fall in the exchange rate. The strength of the recovery will therefore depend on success in containing pressures on costs.

It seems reasonable to hope that consumer prices will rise less rapidly during 1980 than this year and that the price rise will

be further reduced in 1981. But past experience gives little guide to how quickly the pace of inflation will be reduced in the unusually weak demand conditions likely to prevail. After a phase when earnings have risen substantially faster than retail prices, there could now be a period when earnings rose more slowly than prices; and, as needs no emphasising, there is ample scope for higher productivity. Success in both directions will probably be needed if price inflation is to be reduced to small dimensions by a fairly early date: that would offer the surest hope of a vigorous recovery—both for individual firms, and for the economy as a whole.

The course of the PSBR

Forecasts of the public sector borrowing requirement (PSBR) depend in part on forecasts for the economy, and are subject to even larger error—as results for many past years demonstrate.

The outturn of the PSBR this year cannot yet be predicted closely, but it is estimated to be £8–8½ billion. In looking to next year, various factors will tend considerably to reduce the PSBR as compared with this year—apart from decisions on public spending, there will be the fact that last June's VAT increases will be in effect for a full year, and that this year's arrears of telephone bills will be made good.

Against these favourable factors there will be two sorts of influence: the effect of inflation, and the effect of any recession. The higher level of costs and prices next year will increase the general level of public sector incomings and outgoings and also the difference between them, namely the PSBR; but next year, because of the Clegg comparability awards, the increase over 1979/80 in certain public sector wages is likely to be larger than that in incomes in general, and thus in the tax base. A decline in activity next year, to the extent that it occurs, would tend to increase the PSBR—by reducing incomes and thus tax receipts and probably reducing the surpluses of the public corporations, while increasing social security outgoings on unemployment pay. The scale of these effects will depend on the pace of inflation, and the timing and extent of any recession, but they might more than offset the favourable influences. The actual PSBR for 1980/81 will reflect budget decisions yet to be taken.

The financial position of different sectors: the impact on monetary developments

The PSBR this financial year will follow an erratic course. In the first half of the year, it is estimated to have been £6½ billion—an annual rate of £13 billion. Present forecasts suggest that in the second half-year it should come down very sharply—special receipts are due in the second half of the financial year from which the Exchequer did not benefit in the first half: in particular, the proceeds of asset sales and accelerated payments of petroleum revenue tax. Higher receipts from VAT are also expected, offset however by the effect of lower rates of income tax.

The high PSBR in the first part of the year was accompanied by high lending by the banks, mostly to industry: such lending was associated with an exceptionally high net borrowing requirement of companies in this period. The combination of high public sector borrowing with high borrowing by

companies appears to go far to explain the unduly rapid monetary expansion this year.

Explanations of monetary expansion in terms of flows of funds can usefully be supplemented by consideration of the factors affecting the demand for money. In the course of this year, inflationary expectations will have been accelerating. While nominal interest rates have risen, they may at times have lagged behind the acceleration of inflationary expectations, so that, in this sense, rates of interest in real terms were reduced. This could have increased the public's disposition to hold money.

The recent rise in interest rates will help to achieve a marked slow-down in the growth of sterling M_3 in the period to October 1980. This should be facilitated also, in the coming few months, by the prospective low level of the PSBR. Past experience does not, however, reveal a close relationship, at least in the short term, between the rate of increase of the money stock and the size of the PSBR, since there may be important offsets to the latter's monetary effects. During the rest of this financial year, companies' demand for bank borrowing may well remain high—even though moderated by higher interest rates. The course of monetary developments will also be affected, not only by developments in the PSBR and interest rates, but also by the effect on financial markets of developments in industry and the world economy.

The financial position of companies is likely, in any eventuality, to be tight next year. If the level of activity keeps up, this would probably be because companies did not greatly trim back on stockholding and on fixed-investment expenditure; and, given that profits are likely to be under pressure from foreign competition both abroad and in domestic markets, that would probably impose great strain on companies' financial position. Firms, in this situation, might find themselves becoming increasingly reluctant to take on more debt and their bankers possibly more cautious in lending.

If, as is more likely, firms in fact cut back on spending, this will not only reduce the level of activity, but could also greatly reduce the calls on their finances. Thus, in a recession arising in this way, the counterpart to any increase in the PSBR might, indeed, show up largely as a reduced deficit for the company sector. Though the public sector would need to borrow more, companies would probably need to borrow less from the banks, or have more funds available for investment, than would otherwise be the case.

These changes in the financial position of the private sector, brought about by a recession, should at least ease the problem of financing any increase in the PSBR resulting from a decline in activity. Account needs to be taken of these interrelations in assessing the possible monetary effects of a decline in activity—though these effects might well appear only with some delay, probably later in the year. In the somewhat parallel situation of the United States, the forecast decline in activity might well be expected, in the circumstances of that country, later to bring some decline in interest rates. The course of nominal interest rates in this country will inevitably be largely determined by how quickly the pace of inflation eases.

The effects of removal of exchange controls

The removal of exchange controls will, in general, mean that the United Kingdom becomes more closely a part of the world financial market. This may in some degree alter the background conditions in which this country's monetary policy operates.

The removal of controls has given banks and other institutions, and individuals, a new, more liberal climate; and there is likely to be some delay before they fully respond. Adjustment to the new conditions could involve not only effects on capital flows, but, perhaps more importantly, adjustments of the price of financial assets in the United Kingdom relative to those abroad. The removal of controls means that UK investors can now alter their portfolios until they have equalised the expected real yield—allowing for inflation and exchange risks—from holding assets denominated in any currency. The adjustment of their portfolios could mean sales of sterling assets—or smaller purchases—and a fall in the prices of sterling assets, to the point where foreign investors were attracted and a new balance was reached. But UK markets hitherto have been far from segregated from international influences; and it may be that the prices of sterling assets are already near a stable relationship with those in other countries.

The abolition of controls will clearly make it harder for the authorities in this country to rely, in the operation of monetary policy, on direct controls and constraints on financial intermediaries in this country, since increased possibilities are open for off-shore financial intermediation to develop. More generally, closer integration with international money and capital markets is likely to make it less possible to sustain interest rates in this country which—after allowing for differences in expected inflation rates—are out of line with those abroad; and tendencies towards divergence could be reflected in greater degree on the exchange rate. In this sense, the course of monetary developments here may be influenced to a greater extent than hitherto by developments abroad. The change may, however, be a difference of degree only. Conditions in different financial centres will undoubtedly continue to diverge. Moreover, London has in any event long been an important part of the international financial world, and it will be no new development for policy to be subject to a degree of international constraint.

Conclusions

The many uncertainties on the international scene may prevent any rapid expansion in the world economy for some time ahead. In this country, as in the United States, it is possible, though not certain, that there will be some decline in activity next year. The prospects of a clear recovery from such a decline, and hopes of expansion in the longer run, will depend on getting inflation down to appreciably smaller proportions. It remains, therefore, crucially important that monetary expansion be kept within the limits of the targets that have been laid down. The uncertainties facing the economy, and the difficulties of making economic or financial forecasts, make it all the more important that monetary policy should follow a clear and consistent line.