CORRECTIONS

Bank of England Quarterly Bulletin

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Economic commentary

Page 17, second paragraph, lines 1 and 5: for 'M_3' read 'M_1'.

Financial review

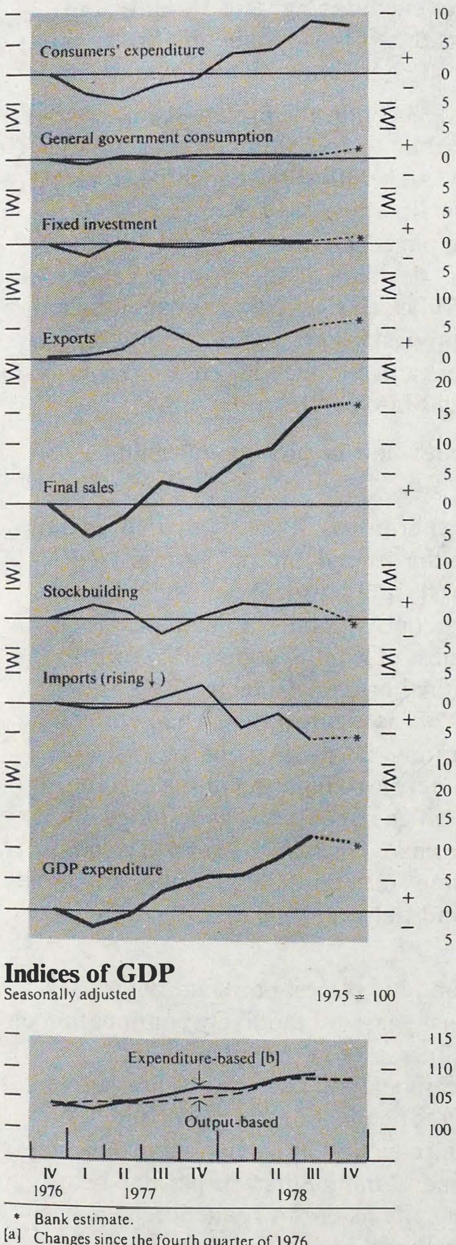
Page 26, second paragraph, line 9: for '2%' read '$2\frac{7}{8}$%'.

Economic commentary

Introduction

The strong growth of final demand which had been sustained since late 1977 seems to have paused in the fourth quarter (see chart). Domestic output probably fell slightly. Price inflation, after several months of stability, accelerated slightly towards the end of the year (see page 4), but mainly in response to seasonal increases in food prices and to higher mortgage costs rather than stage four pay settlements, the effects of which are yet to be felt. There was a modest surplus on the current account for 1978 as a whole, at present put at about £250 million (see page 13); the trend so far this year is difficult to distinguish because the trade figures for January and February were distorted by the road haulage dispute. Monetary growth has been somewhat faster in the period since October, the new base for the sterling M_3 target, than in the middle of last year (see page 16). To help to keep monetary growth in line with the target and to match the increase in market rates which had already occurred, minimum lending rate was raised by 1½% to 14% on 8th February; but, following substantial sales of gilt-edged stocks and some easing of market rates, it was cut to 13% on 1st March. Sterling's effective exchange rate has remained broadly stable.

Changes in components of GDP [a]
GDP was little changed in the fourth quarter.
Seasonally adjusted — £00 millions at 1975 market prices



Indices of GDP
Seasonally adjusted — 1975 = 100

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

Though it is not yet possible to gauge the overall rise in earnings which will emerge from the current pay round, it will clearly exceed the level implied by the Government's original 5% guidelines (see page 4). This will mean considerable pressure on unit labour costs and on already low profit margins, and will probably be translated quickly into higher prices. Other factors, in particular the strengthening of commodity prices and the tight oil supply position brought about by the disruption in Iran, are also likely to put upward pressure on prices over the coming months.

The slower growth of domestic demand in the fourth quarter of last year mainly reflected some tailing-off in private consumption; this in turn stemmed from a much slower increase in real personal disposable incomes during the second half of the year. The rapid rise in earnings in stage four is likely to mean some temporary revival in consumer spending, which may, however, weaken quite rapidly as prices respond to the acceleration in costs. Other components of demand were also subdued in the fourth quarter, industrial investment falling by just over 1% and stockbuilding to around half the average rate earlier in the year. Exports and imports (excluding the contribution from North Sea oil) were little changed in the fourth quarter in volume terms, but the deterioration in cost competitiveness implied by settlements during the current pay round is likely to mean some weakening in the non-oil external resource balance this year.

The current account moved back into surplus, estimated at £400 million, in the fourth quarter. This meant a surplus for 1978 as a whole of about £250 million, much the same as in 1977 (£300 million) but a good deal smaller than some forecasts earlier in the year had suggested. This was partly because of an unexpectedly marked weakening of the invisible balance, especially of the travel, shipping and transfers components (see page 14).

Earnings in stage four

Because of delays in settlements, by mid-February the Department of Employment's monitoring had covered only some

2 million employees, about ¾ million less than at the same time last year. In the first five months of stage four, up to December, average earnings rose by only 3½%, but at that time only about 1 million workers in major groups had settled. Some later settlements, most notably those for manual workers at Ford's, for tanker drivers, for the lorry drivers and for the water workers, provided for increases well above 10%, although a substantial number of workers also had settled for less than 10%, often however in conjunction with a productivity deal. At this stage, it is hardly possible to gauge the eventual outcome of the pay round. There have been more encouraging signs recently, but earlier hopes that settlements this year would be not far from last year's increase in retail prices (8%) seem unlikely to be realised.

Most settlements so far have been in the private sector. As yet, there have been few in the public sector, although several groups, including the local authority and health service manual workers and the ambulancemen, have already passed their normal settlement date (see table on page 12). These groups, together with the miners, are currently deciding on offers on basic rates of around 10%. The outcome will clearly have an important bearing on negotiations involving, amongst others, the electricity supply workers, railwaymen, teachers and white-collar civil servants whose settlement dates fall in March and April.

After some easing, inflation may now be picking up again overseas . . .

The rate of increase in consumer prices in the six main overseas economies subsided again in the second half of last year (see chart). Initially this decline reflected seasonal factors, but by the end of the third quarter the underlying rate of inflation was also falling as the renewed weakness of non-oil commodity prices began to work through into final prices (see table). The price of oil continued to fall in terms of most currencies, while unit labour costs were rising only moderately. By the last quarter of 1978, the underlying rate of consumer price inflation in these countries was around 7%, an average which concealed a wide range of performance: in Western Germany and Japan, rates of inflation are now lower than at any time since the 1960s, while fairly rapid inflation persists in France and Italy, and is gathering pace in the United States.

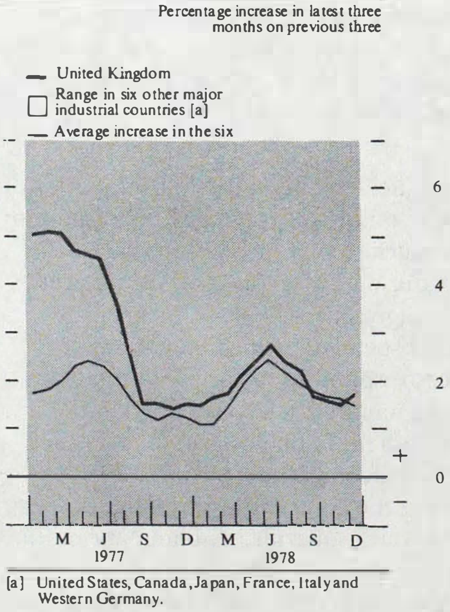
The strengthening of commodity prices, particularly those of metals, towards the end of last year and the likely continuation of this trend, together with the increases in the price of oil announced by OPEC in December, will put upward pressure on consumer prices during 1979. The position has now been significantly worsened by the reduction in Iranian oil production so far this year to a level some 4¾ million barrels per day below the same period in 1978. The effects of this reduction have been accentuated by an exceptionally cold winter in Europe. As a result, world spot oil prices have risen sharply above those on long-term contracts. Further upward pressure on oil prices is likely, especially if consumer countries attempt to follow the normal seasonal pattern of rebuilding stocks during the summer, unless Iranian exports are resumed on a substantial scale in the second quarter.

. . . and also in this country

Increases in the retail price index in the last three months have been in the range ¾%–1½%, notably faster than in earlier months. There have been marked increases in the prices of seasonal foods, in the mortgage rate and in motoring costs, TV licence fees and rail fares. These have brought a sharp acceleration in the rate of increase measured over three months (see chart on next page),

Consumer prices in the main OECD countries

Prices abroad have, on average, continued to rise slowly.



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

Costs and prices [a] in six major overseas countries[b]

Percentage changes on previous quarter

	1978 1st qtr	2nd qtr	3rd qtr	4th qtr
Oil prices[c]	-2.0	-1.5	-3.3	-0.3
Other commodity prices[d]	+4.3	+2.3	-3.0	+7.4
Unit labour costs[e]	+1.0	+1.5	+1.4[f]	+1.5[f]
Consumer prices	+1.4	+2.3	+1.8	+1.5

[a] In national currencies.

[b] United States, Canada, Japan, Western Germany, France and Italy; weighted by GNP in 1977.

[c] Average OPEC price.

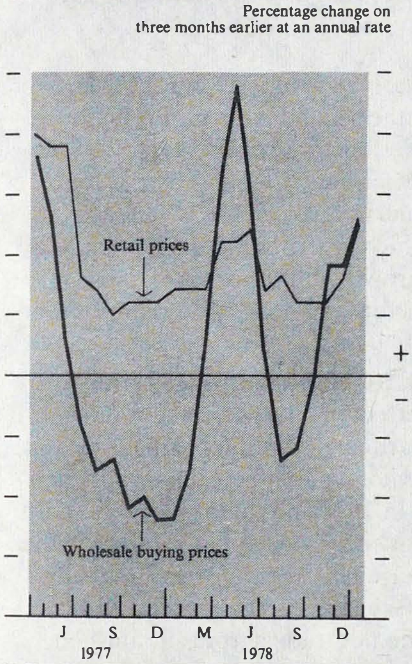
[d] The Economist 'all items' index.

[e] IMF 'normalised unit labour costs'.

[f] Estimate.

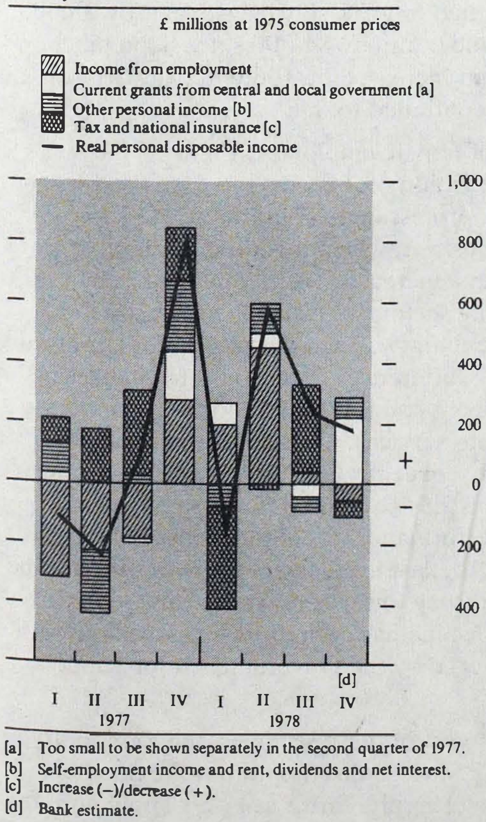
Prices

The rate of increase in both wholesale buying and retail prices has picked up in recent months.



Main components of changes in real personal disposable income

Income in the fourth quarter of 1978 is estimated to have been about 5% higher than a year earlier.



[a] Too small to be shown separately in the second quarter of 1977.
[b] Self-employment income and rent, dividends and net interest.
[c] Increase (−)/decrease (+).
[d] Bank estimate.

even before the normal seasonal jump in April, suggesting that the year-on-year increase in retail prices (over 9% in January compared with less than 8% in October) may reach 10% by the summer.

This year, prices seem bound to be significantly affected by increasing labour costs. Earnings rose by about 14% in the year to the third quarter of 1978, while output per head rose by a little over 3%. Unit labour costs, in consequence, rose by around 10% compared with 8% in the previous year.[1] Domestic prices will also be affected by the upturn in import costs. The appreciation of sterling against the dollar, although less than that of some currencies, helped to keep the increase in commodity prices (including oil)—expressed in sterling terms—to 8% during 1978. Manufacturers' buying prices, which for most of last year were lower than in the corresponding month of 1977, turned up in the final quarter, and by January were also 8% higher than a year earlier. Moreover, as the chart shows, the increase over three months earlier, has risen steeply since July and, at an annual rate, reached 13½% in January. More than half this increase reflected higher oil contract prices following the first stage of the latest OPEC increase. (The effect of the disruption of oil production in Iran is yet to be felt.) Selling prices have so far shown little acceleration, perhaps partly because of strong competitive pressures in the home market. Apart from a small spurt in December, the year-on-year increase has been below 8% since August and comparisons over three or six months show a similar picture. With profit margins under increasing pressure from costs, this stability in selling prices is unlikely to persist much longer.

A pause in the growth of personal income and spending[2]

The rapid growth of real incomes—real personal disposable income was 8¼% higher in the second quarter of 1978 than a year earlier—tailed off in the latter part of last year, but has probably resumed quite strongly in early 1979. Real earnings will receive a boost in the first half of this year from the implementation of delayed pay settlements, but there is likely to be some slowing down in the second half, as prices come to reflect present increases in unit labour costs and perhaps also some acceleration in import prices. Furthermore, reductions in the real burden of direct taxation—an important factor in the growth of real incomes in the last two years (see chart)—are less likely this year. Nevertheless for 1979 as a whole, real personal disposable income may be some 4%–5% higher than in 1978.

After increasing by over 2½% in the third quarter of last year—to 1½% above the previous peak in the first quarter of 1973—the volume of consumer spending fell by ½% in the fourth. Even so, it was almost 5½% higher than a year earlier. Although retail sales were as buoyant in the fourth quarter as in the third, there were sharp falls in spending on motor vehicles (−21%) and on fuel and light (−5½%). But spending on durable goods in 1978 as a whole was over 16% higher than in 1977, with spending on motor vehicles up by 25%. This growth of expenditure on durables was accompanied by a marked increase in consumer credit, both from banks and from finance houses and retailers.

With renewed growth in real incomes, consumer spending is likely to pick up again, at least temporarily, but will probably not rise as fast as in 1978. Spending on durable goods in particular is not expected to rise by nearly as much this year as last, partly at least because of the increased cost of credit. There seems little

[1] The rise would have been larger still if North Sea activities and construction—where much of the growth in output occurred—were excluded.

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

prospect that consumption will be boosted by a reduction in saving this year. The savings ratio in 1978 was on average 14% (although it probably rose to around 15% in the fourth quarter) and is expected to be little changed on average during 1979.

Output levels off

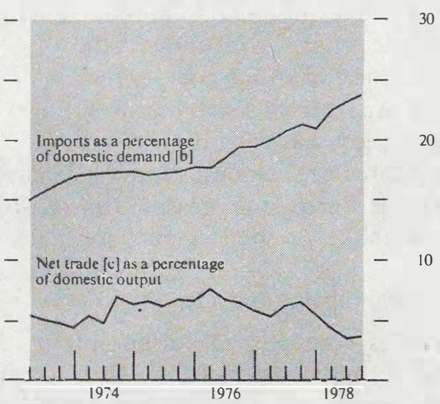
GDP increased rapidly in the early part of last year, but showed almost no further growth after the second quarter. Preliminary figures suggest a slight fall in the fourth quarter when output was adversely affected (probably by a little under ½%) by the Ford dispute. Over the year to the fourth quarter, GDP increased by about 3%, about one fifth of which is attributable to North Sea activities. This overall rate of growth will probably not be sustained in 1979—when an increase of nearer 2% seems more likely.

Manufacturing output fell by 2% in the fourth quarter, suggesting—even without the effect of strikes—a slight downturn in activity since last summer, particularly in the engineering and metal industries. In 1978 as a whole, manufacturing production was only about ¾% higher than in 1977, no doubt partly because of some weakening in competitiveness, which has reinforced the tendency for much of any increase in demand for manufactured goods to be met from imports (see chart). The marked contraction (in real terms) of the net trade surplus in finished manufactures in recent quarters (see chart) is expected to continue, offsetting any potential boost to production from domestic demand. Recent survey evidence suggests that manufacturers themselves take a fairly gloomy view of prospects. The Confederation of British Industry, in their latest quarterly survey, reported a deterioration in business confidence, with the outcome of the current pay round causing most concern. A substantial rise in earnings is likely to mean further erosion of competitiveness and consequent constraints on output and employment.

Import penetration and net trade in finished manufactured goods [a]

For finished manufactures, import penetration grew in 1978 and there was a decline in the net trade balance.

Percentages based on 1975 prices



[a] Excludes ships, North Sea production installations and aircraft.
[b] Bank estimate.
[c] Exports minus imports: Bank estimate.

The labour market

Total employment continued to grow slowly last year, by 25,000 between June and September and by 84,000 since September 1977. Female employment increased by 106,000 over the year while male employment continued to fall.

The relative strength of female employment reflects the changing industrial composition of the workforce. In the year to September, the financial, professional, scientific and miscellaneous service industries, which together account for more than seven million workers, increased their employment by 1½%, while in the manufacturing sector, which is of similar size, employment fell by more than ½%. Such divergent movements are partly the result of timing differences in response to changes in output, but they also reflect a longer-term trend away from industrial employment into services, where the employment of women is relatively highly concentrated. Within manufacturing, the metal and textile industries accounted for most of the lost jobs. The productivity performance of both industries has been comparatively poor over the last five years, but the recent decline in employment goes some way towards reversing this trend. In the textile industry, the decline has perhaps been associated with a fall in the numbers covered by the Government's job support measures.

Applications for the largest of these schemes, the Temporary Employment Subsidy (TES) close this month but the numbers covered are already falling sharply. Firms can only apply once for support under the scheme, so that there would be, in any case, a tendency for coverage to reach a peak and then decline. In addition, however, the terms of the scheme were tightened last spring for applicants from the textiles, clothing and footwear industries, the scheme's major beneficiaries. Support in these sectors may therefore have been particularly affected. On the other hand, the introduction last year of a new scheme for these industries, to encourage short-time working as an alternative to cyclical redundancy, coupled with a more general scheme due to replace TES in April and some further expansion of the Small Firms Employment Subsidy, probably means that the overall support to employment has been little affected.

After falling by more than 100,000 in the year to December, the number of unemployed increased by about 20,000 in both January and February. The weakness of total employment makes the earlier decline rather surprising (see the December 1978 *Bulletin*, page 494) but the latest increases probably owe more to severe weather conditions and the effects of industrial disputes than to any sudden reversal of the underlying trend. Nevertheless, with no appreciable growth in output since last summer, it is quite likely that unemployment will begin to rise later this year.

Productivity growth remains weak

The slow growth of manufacturing output in recent years has been accompanied by some further worsening in the United Kingdom's already poor productivity performance. From the immediate post-war period until 1973, manufacturing output rose at an average rate of 3% a year and productivity at an average rate of some $3\frac{1}{2}$% a year. But in 1978, manufacturing output was still some $4\frac{1}{2}$% lower than in 1973 and, despite the loss of more than 500,000 jobs, the average growth of productivity over the five years 1973–78 slowed to about $\frac{1}{2}$% a year. A weakening in productivity growth since 1973 is common to most other industrial countries (see table), but the United Kingdom started from a lower base.

Output and productivity growth in manufacturing industry

Per cent per annum

	Output		Productivity[a]	
	1960–73	1973–78	1960–73	1973–78
United Kingdom	3.0	−0.9	3.6	0.6
United States	4.9	2.5	3.4	2.2
Canada	5.9	2.8	4.0	3.2
Japan	12.0	0.8	8.8	3.7
Western Germany	5.3	0.8	5.0	3.3
France	5.9	1.4	5.6	2.7
Italy	6.1	2.2	5.2	1.4

[a] Defined as output per man not output per man hour.

The reasons for the unusually slow response of employment to the recent depressed level of activity are not wholly clear. Employers frequently face legal and moral pressures when reducing their labour force—especially when unemployment is rising—as well as significant financial costs. Natural wastage provides a means of avoiding, or at least reducing, large-scale redundancies, albeit at the cost of retaining some surplus labour; and high wastage rates, when the economy is growing, allow firms to adjust their manpower relatively quickly. But when the economy is severely depressed and natural wastage is at its lowest, employers may take a long time to reduce employment in line with output. Government intervention in the labour market may well have increased employers' reluctance to shed labour. The Redundancy Payments Act 1965 and the 'unfair dismissal' provisions of the Industrial Relations Act 1971[1] have probably both raised the cost of dismissing workers. More recently, the introduction of a variety of wage subsidy schemes, for example the TES, as part of the selective employment measures has provided a direct financial incentive to retain labour. It is also possible that the long-run rate of productivity growth has slowed down because of depressed investment and more rapid obsolescence of some types of existing capital.

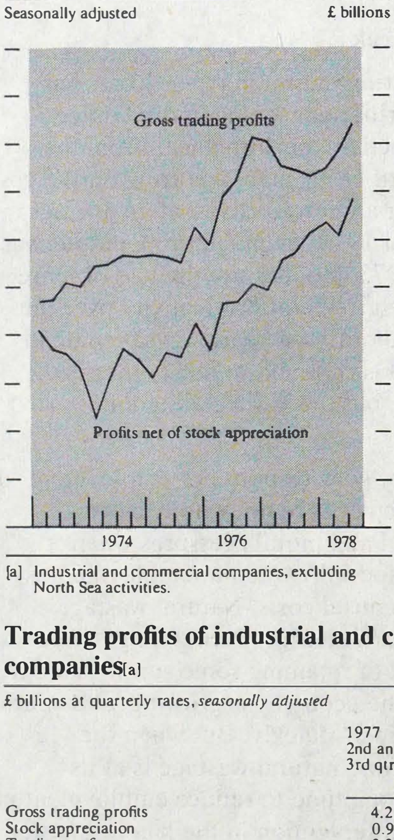
The recent productivity performance of individual industries within the manufacturing sector has varied considerably, reflecting, in part, the different cyclical fluctuations in output in each industry. But the selective employment measures have also

[1] Retained in the Trades Union and Labour Relations Act 1974 and extended in the Employment Protection Act 1975.

had some effect on these inter-industry differences. In the textile industry, where a quarter of all TES workers were located, a long-run decline in the workforce was halted in 1976 and partly reversed in 1977, by which time the proportion of the industry's workforce covered by TES had increased to nearly 10%. The severe decline in output is, therefore, fully reflected in the productivity performance. In contrast, in the clothing and footwear industry, where TES coverage has been equally extensive, output growth has been sustained while total employment has continued to fall. Different demand conditions have no doubt been partly responsible; but wage subsidies have perhaps enabled international competitiveness to be improved so that, for some industries, the overall stimulus to output may have been greater than that to employment.

Profits [a]

Profits have risen in cash terms but their share of national income has been barely maintained.



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

Trading profits of industrial and commercial companies[a]

£ billions at quarterly rates, *seasonally adjusted*

	1977 2nd and 3rd qtrs	1977 4th qtr and 1978 1st qtr	1978 2nd and 3rd qtrs
Gross trading profits	4.2	4.2	4.7
Stock appreciation	0.9	0.6	0.9
Trading profits	3.3	3.6	3.8
of which:			
North Sea	*0.4*	*0.5*	*0.6*
non-North Sea	*2.8*	*3.1*	*3.2*
non-North Sea net of capital consumption at replacement cost ('real' profits)[b]	*1.4*	*1.6*	*1.6*
Share of non-North Sea 'real' profits in companies' value-added (percentage)[b]	12.7	13.4	12.6
'Real' non-North Sea rate of return (percentage)[b]	4.1	4.3	4.1

[a] Figures may not add because of rounding.

[b] Bank estimates.

Profits rise in cash terms but profitability remains weak

Companies' profits (net of stock appreciation and excluding profits from North Sea operations) picked up sharply in the third quarter of last year after a set-back in the second (see chart). Such quarterly movements can, however, be quite erratic, and the recent course of profits is probably better represented by a comparison of the middle two quarters of last year with the previous two (see table). On this comparison, there was an increase of only 3½%, a marked deceleration from the 10½% increase over the previous half year; and if further allowance is made for capital consumption at replacement cost, profits actually fell slightly in the latest half-year. A significant contributory factor was probably the upturn in raw material costs in the second quarter after the fall in the previous six months. The acceleration in raw material costs continued in the latter part of last year, when profits were also under pressure from the increase in the national insurance surcharge and the slackening in activity. Despite the relatively slow growth of earnings, profits may therefore have weakened again in the fourth quarter.

Over 1978 as a whole, the real pre-tax rate of return for non-North Sea companies was probably about 4%, much the same as in 1977 and still very low by comparison with rates of return up to 1973.

Cash flow[1] in the second and third quarters of 1978 was little changed from the previous half-year. With fixed investment in cash terms a good deal higher than in 1977, and with continued stockbuilding, the financial deficit of the industrial and commercial company sector reached £2½ billion for the first three quarters, exceeding the deficit for the whole of 1977.

The financial deficit of North Sea companies has been declining slowly, so that the deficit of other companies, which was just under £1¾ billion in 1977, probably reached about £2 billion in the first three quarters of last year. The Central Statistical Office have recently introduced the concept of the 'net borrowing requirement'[2] as an alternative measure of companies' financing needs. This was £1½ billion for all industrial and commercial companies in 1977, and about the same in the first three quarters of 1978. The widening financial deficit has been an important factor in halting the improvement in liquidity which began in the second half of 1977. The Department of Industry's (D.o.I.) survey of large companies, after showing a small increase in net liquid assets in the second quarter, recorded quite a sharp

[1] Undistributed income less stock appreciation, plus net capital transfers.

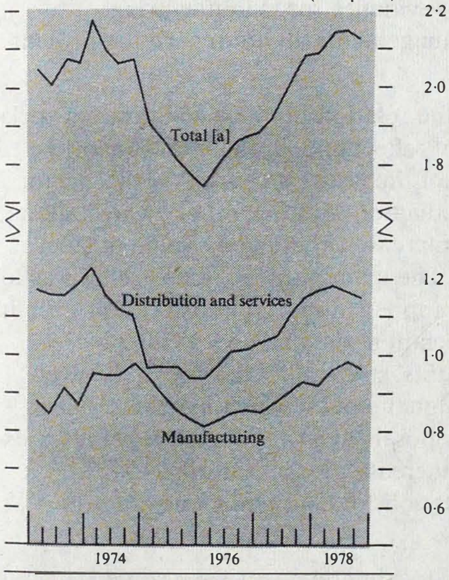
[2] The net borrowing requirement is defined as companies' financial deficit (net acquisition of financial assets) modified to reflect actual cash flows in respect of net unremitted profits, trade credit and similar accruals, and after long-term investment abroad and acquisitions of company securities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

decline in the third. In the early part of 1979, companies have faced additional cost inflation, and their output has in some cases been restricted by strikes and bad weather which can only have had a damaging effect on profits. Some companies, particularly in the retail sector, may have experienced a temporary boost to liquidity as their stocks were run down, but this improvement will be reversed as stocks are rebuilt.

Industrial investment

Industrial investment levelled off last year.

Seasonally adjusted £ billions (1975 prices)

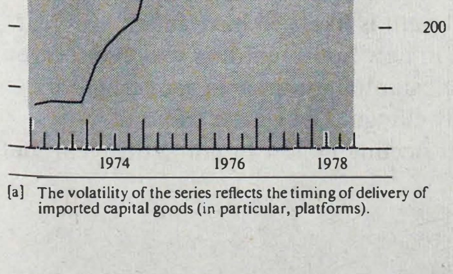


[a] Manufacturing, and distribution and services.

Investment in oil and gas production [a]

Investment in oil and gas production has accounted for about 10% of total investment (excluding housing) since 1975.

Seasonally adjusted £ millions (1975 prices)



[a] The volatility of the series reflects the timing of delivery of imported capital goods (in particular, platforms).

Industrial investment levels off

Industrial investment[1] fell by about 1½% in the fourth quarter, both in manufacturing and in distribution and services. Between the first and second halves of last year, investment rose by only 1%—a marked slackening from the pace of growth in 1977 and the early part of 1978. Nevertheless, in 1978 as a whole, industrial investment rose by 7½% (see chart), only slightly less than projected in the D.o.I. investment intentions survey of January last year. The increase in manufacturing investment, however, was significantly less than indicated by the survey (7½%[2] compared with the projected 10%–13%); the increase in investment in distribution and services was correspondingly larger. A similar pattern of over and under-prediction appeared in 1977 and may reflect both the rapid growth of leasing over the last two years and respondents' uncertainty—at the time of completing the survey—whether to buy or lease an asset.[3] Leasing business grew strongly in 1977, and the latest Equipment Leasing Association (ELA) figures indicate a further large increase—about 65% in cash terms [4]—in 1978. Much of the growth has been in vehicle leasing, which has been boosted by the relaxation of the Control of Hiring Order: deposits on leased cars were reduced from about ten months' rental to about three. Leased assets now represent some 10% of total industrial investment. Leasing business, however, seems often to be a substitute for direct purchase and may not lead to much net increase in capital spending.

Growth in industrial investment may be resumed this year, if only rather modestly. For example, the January D.o.I. intentions survey indicated a rise of 5½%.[5] But companies' investment intentions seem to have been weakening during the latter part of last year; and more recent developments (industrial stoppages, uncertainties about the future course of inflation and higher interest rates) may have led to some further downward revision.

North Sea investment[6] (which is not included in 'industrial investment') rose steeply until 1975 and has since remained at an annual rate of just under £2 billion at 1975 prices (see chart). This represents about 10% of total investment spending other than on housing and over 15% of private non-residential investment. Much of the capital expenditure associated with the development of new oil fields has already been undertaken, and a large part of the projected rise in oil production in coming years will be associated with increased production from existing fields, rather than from new fields coming into operation. This slower development of new fields over the next two or three years is likely to be reflected in lower North Sea investment.

[1] Manufacturing, and distribution and services.
[2] Manufacturing investment by private industry alone rose by perhaps 12%–13%.
[3] In the national accounts, leased assets are allocated to the purchaser (generally within the distribution and services sector), rather than the user.
[4] After allowing for increased membership of the ELA.
[5] A central estimate. The D.o.I. survey indicated growth of 4%–8% in manufacturing investment and 3%–7% in distribution and services investment.
[6] An article on the financing of North Sea oil appears on page 31.

Stockbuilding unexpectedly buoyant

Stocks rose substantially in each of the first three quarters of 1978 but less rapidly in the fourth quarter. Provisional figures show a big increase in work in progress at the end of the year, largely offset by a fall in manufacturers' stocks of finished goods. The extent of stockbuilding during 1978 (probably around £1½ billion at 1975 prices) was largely unexpected and, even in retrospect, is difficult to explain. About one third of it occurred in the stocks of 'other industries', a large and heterogeneous category including construction where it is likely that much of the rise in the first three quarters was concentrated (matching the substantial rise in that industry's output). Of the remaining increase, the rise in work in progress in manufacturing industry can be associated with the higher level of output; but the net increase over the year in stocks of finished goods held by manufacturers is more puzzling. Despite the cutback in the fourth quarter, stock/sales ratios for finished goods remain historically high (see chart). But survey evidence for manufacturing companies suggests that managements do not regard the present level of stocks as excessive.

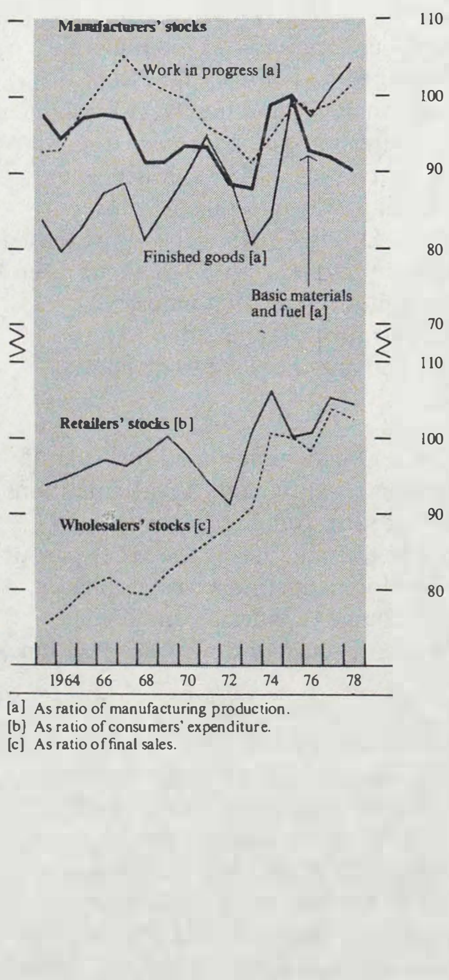
The apparent change in the relationship between desired stocks and the level of activity may reflect only partial adjustment by companies to the recession of the last few years. Another factor has probably been the introduction of 'stock relief', which allows firms to claim tax relief on increases in the book value of stocks in excess of 15% of profits. The main purpose of this relief was to avoid the taxation of stock appreciation; but in its present form it also acts to give 'free depreciation' on increases in the physical level of stocks. On both counts, stock relief has probably given firms an incentive to hold higher stocks, which may have been further enhanced by the proposals to write off past relief after six years. Finally, some of the increase in stocks during 1978 probably arose from expectations of continuing buoyancy in demand.

However, a reduction in stockbuilding—or even some destocking—now seems the likely response to future growth of demand. The recent rise in interest rates has substantially increased the cost of holding stocks and imposed a further burden on companies' cash flow at a time when profitability may already be weakening. Even so, it may be some time before a clear indication of any downward adjustment of stocks emerges. The industrial disruption of early 1979 probably distorted the normal pattern of stock holdings, and the after-effects may persist for some time.

Stock/output ratios

Stock/output ratios for finished goods remained high in 1978.

Ratios at 1975 prices; 1975 = 100



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

Housebuilding still weak[1]

Investment in housing—which fell steeply during 1977 and the first half of 1978—rose by 5% in real terms in the third quarter, a 15% rise in the public sector more than compensating for a 4% fall in the private sector. Compared with a year earlier, however, total investment fell by 5½%; and the prospect for this year is at best one of only limited growth.

Despite the rise in the third quarter, public sector housing investment remains depressed. Starts in the fourth quarter were 8% lower than in the third, and completions also fell slightly; overall, public sector investment is likely to have fallen last year by about 10%. The decline in new housebuilding was even larger but was partly offset by a substantial increase in spending on improvements to existing dwellings. The recent trend of approvals suggests a further decline in new building this year, but

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

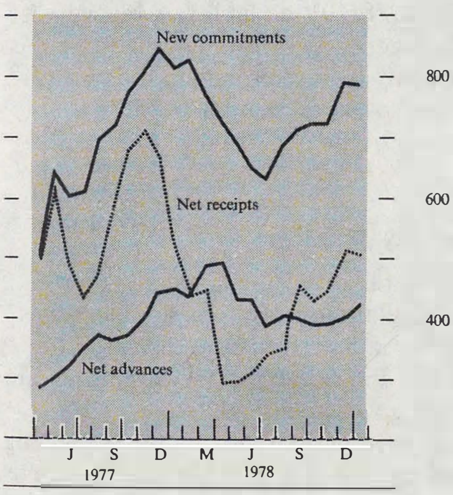
again this may not be fully reflected in total public housing investment if spending on improvements remains buoyant.

Prospects in the private sector are uncertain. The recovery that might have been expected as a result of the strong growth in personal incomes and the increased profitability of housebuilding is threatened by the general rise in interest rates, which has raised the cost to private builders of holding land and has worsened the competitive position of the building societies.

Building society funds

Net receipts rose slightly during the fourth quarter, but even so were barely sufficient to finance net advances of £400 million a month.

Seasonally adjusted £ millions



Net receipts by the societies in the fourth quarter, although higher than in the third, were still only just sufficient to finance net advances at around the third quarter level of £400 million per month (see chart), and liquidity remained at just under 18%, the lowest for two years. Although societies raised deposit rates from 1st December, these were still below those on some competing assets; and, although inflows held up well in January, higher market interest rates and the new issue of national savings certificates available from the end of January make it likely that inflows will fall in the first quarter. With liquidity already low, new commitments are unlikely to reach the guideline figure of £700 million per month (excluding peripheral lending) in the first quarter. The recent stability of lending (see chart), combined with the rapid rise in house prices,[1] has already led to a substantial reduction in the real amount of credit available for house purchases. With some 90% of new sales financed by building society mortgages, the cost and availability of finance are likely to have an important effect on house prices and, through expectations, on housebuilding activity. Although, after more than a year of rising real incomes, some purchasers may be more inclined to augment their borrowings with their own savings, a shortage of building society funds will inevitably dampen demand. In consequence, it is likely that house prices will rise less rapidly this year than last and that there will be a reduction in new building.

The PSBR

The public sector borrowing requirement (PSBR) in the fourth quarter of 1978 was £2.7 billion, seasonally adjusted, bringing the total for the first three quarters of 1978/79 to £6.6 billion. Increased borrowing in the second half of the financial year was expected as a result of the tax rebates and increases in pensions and child benefits paid in November (only partly offset by the increase in the national insurance surcharge in October[2]). In addition, there was the Christmas bonus for pensioners of £100 million paid in December. While the margins of error in forecasts of the PSBR can be large,[3] it now seems likely that the outturn for the PSBR in 1978/79 will fall within the range of £8–8½ billion suggested by the Budget and November Industry Act forecasts.

Public spending in 1978[4]

Public spending on goods and services changed little over the first three quarters of 1978. General government[5] final consumption in the third quarter was only 1½% higher than in the same period of 1977. Public sector fixed investment also changed little last year. The decline which began in early 1976 has probably come to an end, and modest growth is expected from now on.

[1] In the fourth quarter, average house prices (at the mortgage approval stage) were 26% higher than a year earlier.

[2] See the table on page 488 of the December 1978 *Bulletin*.

[3] See the December 1978 *Bulletin*, page 491.

[4] This paragraph is expressed in terms of national accounts definitions, constant (1975) prices, seasonally adjusted.

[5] Central government and local authorities.

Public sector gross domestic fixed-capital formation

£ millions at 1978 survey prices

	General government[a]	Nationalised industries[b]
Outturns		
1975/76	7,668	4,352
1976/77	7,071	4,154
1977/78	5,850	3,734
1978/79 (estimated)	5,772	3,652
Plans		
1979/80	6,024	3,731
1980/81	6,086	3,873
1981/82	6,034	4,061
1982/83	5,985	4,336

[a] Including certain public corporations---see page 249 of the White Paper.

[b] Including general allowance for shortfall—see page 176 of the White Paper.

Public sector wage round: 'normal'[a] settlement dates

		Number [b] (thousands)	Monthly total
November	Local authority manual workers	1,100	1,100
December	Health service (ancillary staff)	220	
	Water authorities (manual)	30	250
January	Ambulance staff	20	
	Health service (works and maintenance staff)	30	
	British Steel (manual)	120	
	British Gas (manual)	40	
	British Airways	60	
	Post Office (manual)	220	490
March	National Coal Board	300	
	Electricity (manual)	100	400
April	Civil service (clerical)	550	
	Health service (nurses and midwives)	440	
	Health service (medical and technical)	150	
	Health service (administrative)	120	
	Armed forces	320	
	Teachers	560	
	British Rail	240	
	Post Office (clerical)	50	2,430
May	Electricity (clerical)	50	50
July	Civil service (industrial)	180	
	Local authorities (administrative)	250	
	British Gas (clerical)	50	
	Post Office (engineering)	130	610
September	Police (including civilians)	150	150
	Other nationalised industries and public corporations		500

[a] Based on reported settlements in 1977 and 1978.

[b] Full-time equivalents where possible.

The public expenditure White Paper[1]

This year's White Paper shows few major changes from last year's. The intention that public spending should increase by around 2% a year in volume terms is reaffirmed. The main increases since the last White Paper are in the provisions for child benefit, employment services (in particular the permanent short-time working arrangements), the national health service, education and law and order; all of these increases have either been offset by reductions elsewhere (mainly in the estimated borrowing needs of the nationalised industries) or allocated from the contingency reserve. The plans include a contingency reserve rising from £0.8 billion in 1979/80 to £2.5 billion (at 1978 survey prices) in 1982/83; it remains the Government's policy to use this contingency reserve as a control figure, within which any decisions which add to spending programmes will be contained.

The decline in the volume of public sector fixed investment since 1975/76 continued into 1978/79 (see table). A recovery is expected in 1979/80, although general government investment is not expected to grow significantly thereafter, and in the case of nationalised industries the level of investment in 1975/76 is not expected to be reached again until the end of the survey period.

Cash limits and public sector pay

Cash limits cover nearly all central government spending on wages and salaries directly; local authorities' spending on wages and salaries is also covered, but indirectly via the cash limit on the Rate Support Grant (RSG) and supplementary grants paid to local authorities by the central government; while the nationalised industries are covered more indirectly (by subjecting their external financing requirements to a cash limit). The cash limit provision for spending on wages and salaries in 1978/79 is unlikely to be exceeded, as the majority of pay settlements took place early in the financial year (see table) and were within the Government's guidelines for stage three of pay policy. One possible and important exception may be the local authority manual workers' pay settlement which was due in November and will affect the last five months of 1978/79.

Cash limits for the forthcoming financial year are usually set in the period leading up to the Budget, although the limit placed on the RSG and supplementary grants is usually based on the RSG settlement announced the previous November. In respect of pay, cash limits for 1979/80 will be set in accordance with the policy stated in last July's White Paper,[2] together with the £3.50 underpinning announced subsequently. The cash limit on the RSG will be increased in respect of the Government's contribution to the offer made in February to the local authority manual workers. The Government have said[3] that they will review other cases as settlements are reached. The general principle for central government expenditure on manpower will be that a substantial proportion of any cost above the provisions made will have to be absorbed within the existing cash limit. In respect of other costs, cash limits for both central government and local authorities will not be increased to allow for price increases higher than those in the November Industry Act forecast.

[1] *The Government's expenditure plans, 1979/80 to 1982/83*, Cmnd. 7439, HM Stationery Office, January 1979.

[2] *Winning the battle against inflation*, Cmnd. 7293, HM Stationery Office, July 1978.

[3] See Hansard, 23rd February 1979.

Growth of UK export markets

Per cent

	Share of world imports[a] in 1977	Share of UK exports in 1977	Growth of total import volume in UK export markets. Change on previous period at an annual rate		
			1978		
			Year	1st half	2nd half
UK export markets					
United States	15.1	9.7	+7½	+ 6¼	+10
Canada	4.1	2.2	+3¾	+ 5¾	+12
Japan	6.9	1.5	+9¼[b]	+ 3	+29[b]
Western Germany	9.8	7.8	+8½	+ 7½	+10
France	6.8	6.7	+6	+ 4	+14
Italy	4.6	3.0	+1	+ 2½	+12
Netherlands	4.5	6.7	+1½	—	+ 4½
Belgium	3.9	5.7	+3¼	+ 2¾	+ 8
Other OECD Europe	18.0	25.0	−1	− 5¾	+ 1½
Australia, New Zealand, South Africa	2.3	5.1	+2	+10¼	+ 4½
OPEC	8.8	13.5	+7	+ 3½	+ 5½
Other developing countries	15.2	13.1	+7	+ 6	+ 6
Growth of UK export markets			+4	+ 2¼	+ 6½
Growth of UK export volume			+3	—	+ 8½
Growth of world trade			+5	+ 3	+ 8¾

[a] Excluding United Kingdom.

[b] Including emergency imports. Without these, Japan's imports in 1978 would have risen by only 6¼% (16% in the second half) and the growth of UK export markets and world trade would have been slightly smaller.

Current balance

£ millions: *seasonally adjusted*

	1977	1978				
	Year	Year	1st qtr	2nd qtr	3rd qtr	4th qtr
Visible balance	−1,744	−1,175	−596	−173	−367	− 39
of which:						
oil balance	−2,791	−2,015	−620	−414	−501	−480
SNAPS balance[a]	− 59	+ 321	− 48	+194	− 38	+213
underlying non-oil balance	+1,106	+ 525	+ 72	+ 47	+172	+228
Invisible balance	+2,042	+1,429	+255	+319	+418	+437
Current balance	+ 298	+ 254	−341	+146	+ 51	+398

[a] See footnote [2] on this page.

UK export markets: signs of some strengthening[1]

World trade rose by around 5% in 1978 as a whole, much the same as in 1977, but considerably faster—8¾% at an annual rate—in the second half of the year than in either of the two previous half-years. This acceleration was confined to the OECD area but was quite widespread within it. Elsewhere in the world, in contrast, the growth of imports slowed down markedly in the first half of last year, and continued at only a modest pace in the second half.

Total UK export markets in 1978 showed a pattern similar to world trade as a whole, although the overall increase was rather less. In the first half of the year this was largely due to the cutback in imports by the OPEC countries and by the smaller OECD economies—both important UK export markets; in the second half, it owed more to the substantial increase in Japanese imports (associated with the emergency programme) which feature more heavily in world trade than in UK export markets. For manufactures alone, however, UK export markets were more buoyant, especially in the second quarter; in the twelve months to the end of the third quarter, these markets are estimated to have grown by some 7%.

In 1979 as a whole, despite a slower growth of output, OECD imports may grow faster than last year, as may world trade. This is because the slowdown in output is expected to be concentrated in the relatively closed economy of the United States, whereas the more open economies of Europe may be expanding more rapidly. Faster growth of imports in Europe would be of particular benefit to the United Kingdom, and our export markets this year may grow as fast as world trade, and as fast or faster than last year.

The current balance in 1978: weaker than expected

Provisional estimates for 1978 indicate a small current account surplus of about £250 million (see table); but this figure may well be revised in the light of later estimates, particularly for invisibles (see below). This is much the same as the 1977 surplus (some £300 million) but well below forecasts earlier in the year of a surplus of around £1 billion. To a large extent, the shortfall is due to a smaller surplus on services than had been foreseen, and somewhat larger official outward transfers. The outcome on visible trade (a deficit of just over £1 billion) was more nearly in line with expectations, despite lower than expected North Sea oil production.

Exports lose market share

Manufactured export performance was not very encouraging in 1978. The volume of manufactured exports (excluding erratic items)[2] rose by 2½%, while the estimated growth in the UK-weighted volume of world trade in manufactures was about 7%. The volume of chemical exports jumped by 10% and may be associated with the strong import growth in this category—an indication perhaps of increasing specialisation. Exports of machinery and transport equipment on the other hand were unchanged in volume terms, as were exports of semi-manufactures (other than chemicals). Weakening competitiveness in 1978 has probably not yet had any significant adverse effect on exports: there appears to be a long lag between changes in competitiveness and the response of export volume,[3] and this suggests that some weight must still be given to the gains in competitiveness during 1976.

[1] All figures in this section are in volume terms and seasonally adjusted.

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

[3] See the article 'Measures of competitiveness in international trade' in the June 1978 *Bulletin*, page 181.

Price and volume components of changes in the visible balance

£ millions, balance of payments basis, *seasonally adjusted*

	1977			1978			
	2nd qtr	3rd qtr	4th qtr	1st qtr	2nd qtr	3rd qtr	4th qtr
Change in visible balance[a]	+502	+281	+111	−470	+175	+ 37	+ 92
of which: [b]							
price component	*+ 90*	*+127*	*+105*	*+146*	*−190*	*+148*	*+ 57*
volume component	*+412*	*+154*	*+ 6*	*−616*	*+365*	*−111*	*+ 35*

[a] Excluding erratic items (ships, North Sea production installations, aircraft and precious stones).

[b] This breakdown cannot be made with precision; the numbers should therefore be treated as orders of magnitude only.

The terms of trade[1] have been rising since the beginning of 1977. This trend was interrupted briefly in early 1978 when sterling depreciated, but the upward movement resumed in mid-year (see table). Year-on-year, the terms of trade rose by 4½% in 1978. This reflected the stability of sterling over a period when, in general, UK prices were rising somewhat faster than those abroad, as well as the weakness of primary product prices. For example, the unit value index for imports of industrial materials relative to that for finished manufactures declined by 5½% in 1978 compared with 1977. The latter effect tends to raise the terms of trade because the United Kingdom is a net importer of primary products and a net exporter of finished goods.

Rapid growth of imports

Imports of industrial materials in 1978 were much higher than the rather weak recovery in industrial production would have indicated. Excluding precious stones, they rose by 10¼% in volume terms. While there is evidence of a secular tendency for these imports to grow over time, irrespective of changes in activity or competitiveness, this effect is significantly weaker than for imports of finished manufactures; and there is little sign of unusually heavy stockbuilding of raw materials which might have offered an explanation.

The volume of imports of finished manufactures (excluding ships, aircraft and miscellaneous items) rose by 14½% in 1978. The underlying rise may have been slightly larger, because the volume of imports of road vehicles, which had shown little change over the first three quarters, fell by 10% in the fourth, reflecting the impact of the industrial dispute at Ford's. Though the increase in imports of finished manufactures was large, it was much in line with expectations and may be regarded as the counterpart of the sluggish recovery in manufacturing production. Had competitiveness been maintained, 1979 might have seen a more robust domestic supply response following last year's rapid increase in domestic demand. But competitiveness deteriorated in both cost and price terms during 1978—which helped to boost the growth of imports—and may deteriorate further this year.

Invisibles

The overall surplus on invisible transactions was little changed in the fourth quarter, but over 1978 as a whole it fell by £600 million to £1.4 billion. Nevertheless, it was sufficient to offset the deficit on visible trade. Transfer payments abroad rose sharply, while a small improvement in net receipts from interest, profits and dividends (IPD) was partly offset by a small fall in net receipts from services.

The net transfers position was particularly aggravated by the increased cost of UK subscriptions to the EEC, which doubled the Government's EEC transfer deficit to over £900 million. Private transfer payments were also higher, following the relaxations at the end of 1977 on personal transfers.

The most striking feature within services was the deterioration in the shipping and travel accounts. Shipping earnings were particularly affected by reduced UK tanker activity and by greater use of overseas chartered ships. On travel account, there was very little increase in spending by visitors to this country, while UK spending abroad rose by 31%.

Increased payments to the EEC, larger IPD debits on oil account and higher interest rates are likely to put the invisibles surplus under further pressure in 1979.

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

Over the years, invisibles have provided a regular and increasing surplus to set against a customary deficit on visible trade within the current account. The decline since 1976 has, therefore, become a matter of growing interest and concern.

Although the surplus is undoubtedly under increasing pressure, for example because of increases in profits remitted abroad by foreign oil companies operating in the North Sea, early estimates have in general been understated; between 1962 and 1977, the net annual surplus was revised upwards in every year apart from 1964 and 1975 (see table). For instance, early estimates for 1977 showed an invisible surplus of £1.6 billion. Since then, revisions, as new data became available, have progressively enlarged this surplus to over £2 billion.

Invisibles

£ millions

	1973	1974	1975	1976	1977
Total invisible surplus:					
Original estimates	907	1,431	1,498	2,169	1,577
Latest figures	1,384	1,644	1,381	2,464	2,042
Revision	+477	+213	−117	+295	+465

Because of the nature and coverage of invisible transactions, it is impossible to provide firm statistics immediately. The latest figures are, in most cases, estimates or projections based on earlier surveys, many of which are undertaken only annually and in some cases even less frequently, with the results being carried back into earlier figures as appropriate. Revisions, sometimes several quarters in arrears, are therefore inevitable, and this means that the estimates of the invisibles balance, especially those given with the monthly trade figures, should be treated with particular caution.

A small balance for official financing

Sterling was again firm in the fourth quarter. Its effective rate rose by 2%, largely reflecting the continuing weakness of the dollar. The reserves fell by $800 million but this was mostly the counterpart of net repayments of official debt (see below and page 25).

A current account surplus of £460 million before seasonal adjustment was almost exactly matched by a net outflow on capital account (see table). Speculation in advance of the decision by the Irish Government to participate in the European Monetary System led to large purchases of Irish securities by UK residents (see page 27). Overseas private sterling balances rose sharply in the fourth quarter, perhaps reflecting the dollar's weakness. Sterling holdings of international organisations rose by £125 million, mainly because of a UK contribution to the International Development Association.

Capital flows

£ millions, *not seasonally adjusted*

	1977	1978			
	Year	1st qtr	2nd qtr	3rd qtr	4th qtr
Current balance	**+ 298**	**−583**	**+ 204**	**+173**	**+460**
Official long-term capital	− 291	− 57	− 14	− 42	−235
Exchange reserves in sterling:					
Countries	− 242	+147	− 276	− 3	−177
International organisations	+ 223	+ 13	+ 45	+ 8	+124
Private sterling balances	+1,471	− 59	− 156	+159	+360
Outward portfolio investment	+ 57	− 21	− 203	−177	−251
Other identified capital flows	+3,384	+ 69	−1,200	+129	−410
Balancing item	+2,461	+664	+ 106	− 37	+114
Balance for official financing	**+7,361**	**+173**	**−1,494**	**+210**	**− 15**

External debt management

The United Kingdom incurred large overseas debts to finance balance of payments deficits in the years 1973–76, and facilities mainly arranged to provide such finance continued to be drawn down in 1977 (see table).

Net public sector foreign borrowing 1973–1978[a]

$ billions

	1973	1974	1975	1976	1977	1978
HM Government	−0.1	1.4	0.8	2.8	4.1	−1.8
Other public sector	2.7	2.9	0.8	3.2	1.7	−0.9
of which, under exchange cover scheme	*2.5*	*2.6*	*0.8*	*3.3*	*0.4*	*−0.7*
	2.6	4.3	1.6	6.0	5.8	−2.7

[a] 'Foreign borrowing' in this context is as described in the additional notes to Table 17.2 in the statistical annex, i.e. it includes all external borrowings but excludes domestic marketable securities which may have been bought by non-residents.

In consequence, the total of UK official foreign borrowing outstanding, which at the end of 1972 had been only some $5 billion (largely accounted for by the long-term post-war debts), rose to $25.2 billion by the end of 1977. Moreover, the repayment schedule for this debt showed a large 'hump' in the period 1979 to 1984, when $19.6 billion (78%) was due for repayment. By the end of 1977, however, the improvement in the United Kingdom's external position had enabled policy to be directed towards reducing the total debt outstanding and to smoothing the 'hump'. The first two early repayments, totalling $80 million, took place in late 1977.

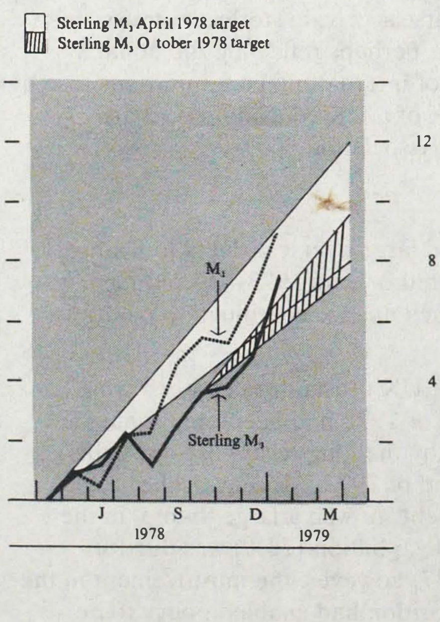
In 1978, in addition to scheduled repayments of $1.0 billion, loans totalling $3.6 billion were repaid early, all of which would otherwise have matured between 1979 and 1984. The most significant of these were the early repayments by the Government to the International Monetary Fund in April and October (amounting to $2.0 billion), and by the Electricity Council ($0.7 billion), the National Water Council ($0.3 billion), Glasgow City Council ($0.2 billion) and the Post Office ($0.2 billion). Total repayments thus amounted to $4.6 billion. However, new borrowing totalling $1.8 billion (including $0.35 billion by the Government by means of their bond issue in New York and $0.5 billion by the Electricity Council), mostly maturing after the 'hump' years, was arranged during the period, so that net repayments were some $2.7 billion. In terms of the amount outstanding, however, there was a fall of only $1.9 billion in 1978, to $23.3 billion. This difference results from the effect on outstanding debts in currencies other than the US dollar (about 25% of the total) of the decline in value of the US dollar; the effect is, however, offset to the extent that the Exchange Equalisation Account has been able to cover non-dollar liabilities with non-dollar assets.

As well as repaying loans early, the Government renegotiated the terms of the $1.5 billion syndicated credit drawn in 1977. Originally maturing between 1981 and 1984, it will now be repaid between 1985 and 1988; and the interest-rate spread[1] was reduced from ⅞%–1% to ⅝% throughout.

The proportion of debt falling due for repayment in the 'hump' years was reduced, by the end of 1978, to 69% ($16 billion).[2] The Government's policy of combining net repayments of debt year by year with new borrowing to space out the maturities was continued into 1979 with the announcement of a further early repayment by the Electricity Council of $0.5 billion, and the first issue by a nationalised industry (British Gas Corporation) of commercial paper in the United States.

Monetary objectives

Over the first nine months of the financial year, the growth of sterling M_3 was within, or below, the April 1978 target range.



Monetary developments[3]

Over the first nine months of the financial year, the growth of sterling M_3 was near the middle of the 8%–12% target range set last April (see chart). Growth in the first three months of the new target period from mid-October, however, was somewhat above the 8%–12% target range for the year to October 1979. This was partly because certain factors which had earlier served to reduce the recorded rate of growth of sterling M_3 (such as the collection of 'extra' income tax in the early part of 1978/79 before thereduced standard rate came into effect and large sales by the authorities of certificates of tax deposit) were now working in the other direction.

The rise in minimum lending rate (MLR) to 12½% on 9th November stimulated substantial sales of gilt-edged stocks (see page 22). Sales also held up reasonably well in December and January, despite growing uncertainties about the industrial outlook and prospects for inflation. Receipts from national savings, however, eased in this period, as investors were waiting for the eighteenth issue of national savings certificates which went on sale at the end of January. Although over the three banking months November–January taken together, net sales of certificates of tax deposit were negligible, this disguises substantial gross sales during banking December, when rates were very attractive, balanced by redemptions at the beginning of November and during January mainly for payment of petroleum revenue tax and corporation tax respectively.

The central government borrowing requirement in the three months to mid-January was somewhat higher than the average for the first half of the financial year. In part this reflected the payment of tax rebates following the Opposition amendments to the Finance Bill. On the other hand, there has been little net market borrowing by the rest of the public sector so far this year so that, although borrowing by the central government may be as

[1] See footnote [2] on page 28.
[2] See Table 17.2 in the statistical annex.
[3] Figures in this section are seasonally adjusted unless otherwise stated.

DCE and the money stock [a]

£ millions, *seasonally adjusted:* mid-month

	Oct. 77– Jan. 78	Jan. 78– Apr. 78	Apr. 78– July 78	July 78– Oct. 78	Oct. 78– Jan. 79
Central government borrowing requirement	+1,576	+1,864	+1,785	+2,001	+2,157
Net purchases (–) of central government debt by non-bank private sector	–1,718	–1,042	–2,277	–1,328	–2,010
Other public sector[b]	– 40	+ 418	+ 36	– 513	+ 365
Bank lending to:					
UK private sector[c]	+ 726	+1,106	+1,833	+ 820	+1,223
Overseas	+ 254	+ 643	+ 159	– 15	+ 88
Domestic credit expansion	**+ 798**	**+2,989**	**+1,536**	**+ 965**	**+1,823**
External and foreign currency finance (increase –)	+ 698	– 284	– 276	+ 62	+ 59
Other	+ 278	– 214	– 195	– 416	+ 4
Sterling M_3	**+1,774**	**+2,491**	**+1,065**	**+ 611**	**+1,886**
Percentage change in sterling M_3	*+ 4.2*	*+ 5.6*	*+ 2.3*	*+ 1.3*	*+ 3.9*
M_1	**+1,175**	**+ 986**	**+ 528**	**+ 774**	**+ 822**
Percentage change in M_1	*+ 5.5*	*+ 4.4*	*+ 2.2*	*+ 3.2*	*+ 3.3*

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

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

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

much as the £8 billion forecast in November for the PSBR as a whole, the contribution of the rest of the public sector to the PSBR could be small.

Bank lending showed signs of some acceleration in the period November–January compared with the previous three months when corset pressures were more severe. With the easing of those pressures, there was little incentive for further disintermediation through acceptances taken up outside the banking sector; this factor had earlier served to reduce the recorded figures for bank lending and sterling M_3.[1] There has been no evidence of any further significant disintermediation of this type since October, although maturing bills have been largely replaced; this may help to account for the slightly faster growth in recorded bank lending. There was no firm evidence by January of increased demand for bank lending to meet higher financing requirements brought about by the industrial disruption. If such demand materialises, it is likely to occur later as depleted stocks are rebuilt.

M_3 rose at the same rate during the three months to mid-January as it had during the previous three. A large part of the rise to January was in the interest-bearing element, which may reflect a temporary build-up of funds awaiting investment in the gilt-edged market. The non-interest-bearing component of M_3 rose more slowly, probably reflecting the rises in interest rates during 1978.

From mid-January, money-market rates began to move up sharply with the deterioration in the prospects for inflation (see page 20). Accordingly, on 8th February, MLR was raised to 14% to bring it into line with market rates and to provide support for monetary restraint. Following the increase, the authorities were again able to make substantial sales of gilt-edged stock which helped to curb the growth of the money supply in banking February. To relieve the resulting pressure on the banks' reserve asset positions (already exacerbated by the revenue season when the central government generally runs a substantial surplus) special deposits equivalent to 2% of eligible liabilities were released on 19th February, 1% to be recalled on 9th March and 1% on 30th March. The immediate exhaustion of the two tap stocks issued on 22nd February should serve to moderate monetary expansion over the remainder of this financial year, and MLR was reduced to 13% on 1st March. The exhaustion of the tap stocks also put further pressure on the banks' reserve asset positions; accordingly, on 5th March, the 1% recall of special deposits scheduled for 9th March was cancelled.

Assessment

Attention during the opening months of this year has been preoccupied with the immediate problems for the economy, and for ordinary life, arising from industrial action by various groups of workers. Disruptive and disorderly though the immediate effects have been, output may in fact rebound quite quickly. More than temporary harm has nevertheless been done. The financial position of companies, none too strong in the first place, will inevitably have been worsened—probably with consequences for their ability to finance investment. And the standing of this country as a supplier to foreign markets must also have been further damaged.

The most serious result may, however, prove to be the effect on inflation. For it has for a long time been clear that this—together with the United Kingdom's poor productivity performance—was the major problem facing the economy; and it was apparent that progress in other directions depended on continued progress in reducing the rate of inflation. There has clearly been a set-back in this respect, and this Assessment

[1] See the December 1978 *Bulletin*, page 499.

attempts to take stock of the prospects and problems of the economy, as they now appear, in the year ahead.

The world environment

It is useful first to consider the way the world economy has been developing and what this will mean for this country. The major overseas economies were expanding last year at about the same rate as in 1977. Growth in GNP of around 4% was not far below trend, and was enough to prevent unemployment, already high, from rising any further. Indeed, industrial production, generally more volatile than output as a whole, showed some acceleration during 1978. Countries in surplus and deficit, with high and low inflation rates, and with more or less slack to take up, all shared in this expansion; while there was some shift in demand pressures among countries in a direction that would help to produce a more balanced pattern of trade, this did not go far. Payments imbalances between the major countries remained large; and the pace of inflation in different countries became, in some important cases, more diverse. In these circumstances, there were large movements in exchange rates the effects of which—though often at first perverse—should now be helpful to the adjustment process.

For 1979, account has to be taken of the consequences that events in Iran may have both for the supply and price of oil and more generally. Although it is too early to attempt a full assessment, it is already clear that a new element of uncertainty has been added to the outlook for world activity, inflation and exchange rates. Aside from this new factor, there have been a number of developments which would favour a better balanced evolution of the world economy this year. In the United States, interest rates have risen markedly in response to faster inflation and to the depreciation of the dollar. This could help to produce a slower growth of demand in the United States later in the year—a deceleration which may not be fully compensated by faster growth elsewhere—and hence slower growth in the major economies as a group. Although slower growth would not itself be advantageous, such a pattern of growth would, as the effects of last year's exchange rate upheavals work through, help to limit or reduce current account imbalances, and should thus be helpful also for exchange rate stability.

The world environment will affect this country in various ways, some more favourable than others. Notwithstanding a temporary check to world growth, UK export markets may—except for Iran—be relatively well-shielded. They grew less fast than other countries' last year, but this year the geographical configuration may be helpful; and demand in UK export markets may expand at least as fast as last year. Equally important for this country are the latest increases in commodity prices. How much events in Iran will affect the price of oil—and over what time scale—is difficult to predict. Given world demand prospects, the recent rise in the price of other commodities may not continue; but the effects of past increases on domestic prices have still to appear—an unfavourable influence not present last year.

The effect of wage increases

The wage round is still at a relatively early stage; and it is not possible yet to form any definite assessment of the average rate of wage settlement. The prospect is obviously worse than three months ago: last December it was suggested in this *Bulletin* that the rise in retail prices over the next twelve months might be no faster than the previous year's 8%. Recent wage settlements now make at least a somewhat faster pace of inflation inevitable for a time. Even if, as still seems likely, the acceleration remains moderate, the prospect of inflation now showing some increase represents a major set-back.

The prospects for expansion, as a result, now look less favourable than earlier. For some time it has seemed probable that the rate of growth next year would be no more than moderate. It now seems likely that over the next twelve months output will grow by no more than 2%—or by little more than 1% if North Sea production is excluded. For faster inflation is likely, on balance, to weaken consumer demand: though for a while higher wages may increase real purchasing power, this effect can only be relatively short-lived; and the savings ratio is likely to rise again, as it has in previous phases when prices have accelerated. Faster inflation is likely, too, to hamper exports and to make it more difficult to resist pressure from imports, and, by reducing profits, to discourage investment. In addition to these automatic effects, faster inflation forces policy to be more restrictive than it otherwise would have been.

Consequences for policy

Monetary policy at present envisages a growth of sterling M_3 at an annual rate of 8%–12%. Keeping the growth of the money supply to these limits in the face of a faster growth of money incomes than previously seemed probable, will exact a price in terms of higher interest rates than would otherwise have been necessary. It will clearly remain appropriate to provide for a continuing monetary expansion. But to accommodate inflation now by relaxing the thrust of monetary policy would be a signal that reduced priority was being given to containing inflation.

The stance of fiscal policy is also now bound to be particularly cautious. One element—in fact very relevant, even if apparently outside the central field—would be to ensure that higher costs incurred by the public corporations are not reflected in higher borrowing, so that their financial situation is not impaired. The operation of cash limits in general, as redefined in last month's announcement (see page 12), should result in some trimming of expenditure programmes, depending on how fast pay and prices rise. Given the need both to contain the size of the public sector borrowing requirement and to reduce the necessity for adding to the tax burden, there appears to be a clear case for containing more strictly the rise in public spending.

A firm stance of fiscal and monetary policies is all the more necessary, under present conditions, in order to prevent inflationary pressures from turning into an indefinite extension of inflation. It seems equally clear, however, that monetary control alone will be insufficient to prevent a powerful surge of wage inflation from working itself out in higher prices. The recent course of wage negotiations and the industrial action that accompanied them point clearly to the need for changes in the present methods of wage negotiation. It would be widely agreed on all sides to be desirable that the next wage round should be less disruptive than this year's. It has also to be recognised, however, that the institutions of wage negotiation have evolved over a long period. How any changes needed can best be made requires to be widely debated: not all changes that might be desirable could be looked for quickly.

The needed effort should be seen in an even wider and more positive context. The United Kingdom has long been a country where productivity grew relatively slowly; but, as figures quoted earlier in this commentary show (see page 7), the United Kingdom's performance has in the last five years become even poorer. There are many working practices which restrict the growth of productivity; and if the will were there, productivity could clearly be transformed. The consequences of failing to arrest this country's industrial decline are likely to become more pressing and obvious as time goes on. Now condemned to very slow growth, we might later even have to accept, if present trends continue, declines in real living standards. To break out of this situation seems bound to become a dominant concern over the next five years. Sustained increases in living standards can only come from higher productivity. The need, then, is not simply to arrest inflation, necessary though that is, but radically to improve both efficiency and thus also real wages.