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# THE UK ECONOMY

## Note by the Bank of England

### Recent developments

1. Domestic output rose quite rapidly in early 1978, and for the year as a whole, GDP was 3% higher than in 1977. In the first quarter of this year, production was affected by unusually severe weather and by a dispute in the road haulage industry. By the end of the quarter, however, production had recovered and, indeed, was somewhat higher than in the latter part of last year. The pick-up in output has been accompanied by a fall in unemployment – from over 6% at the peak in late 1977 to 5½% by the end of 1978, with apparently a continuing, though slower, decline so far this year. The main impetus to the economy has come from consumer spending, but private industrial fixed investment has also grown strongly, by over 10% between 1977 and 1978 to reach its highest-ever level in real terms. In addition, inventory investment has been heavy and probably accounts for part of the substantial increase in imports. Exports were relatively subdued last year, reflecting the sluggish expansion of world trade. But, despite some weakening in the trade surplus on goods other than oil – from just over £1 billion in 1977 to about £850 million in 1978 – the overall current account surplus increased slightly, to some £450 million. The main factor was a continuing build-up in oil production from the North Sea, which amounted last year to 53 million tons. Though the trade balance worsened sharply in the early months of 1979 this was, at least in part, a consequence of the industrial disruption in the UK. Other factors affecting exports perhaps to the extent of £100 million a month, were the disturbances in Iran and the imposition of import controls in Nigeria. Notwithstanding the deficit on current account, and the net repayment of some $1½ billion of official borrowing, the UK's foreign exchange reserves rose by $1¼ billion in the first five months of 1979. Including a revaluation to market rates of $4½ billion, the reserves stood at $21½ billion at the end of May.

2. Price inflation eased markedly between mid 1977 and mid 1978, but since then has edged up slowly. The change in retail prices over twelve months now stands at just over 10%. A continuing rapid increase in labour costs has been the main influence on the underlying trend of prices. Average earnings rose by about 14% in the year to July 1978 and the rise to July this year will probably be roughly the same.

But the acceleration of inflation in recent months is mainly attributable to higher oil and raw material prices, though their effec on domestic prices has been moderated by the strength of the exchange rate.

3. Sterling's effective rate was notably stable throughout 1977 and 1978, and then, this year, appreciated by 5½% between the end of February and mid-April. It has remained firm since. The UK's approaching self-sufficiency in oil increasingly insulates the balance of payments from the effects of higher oil prices, and this relatively favoured position, allied with relatively high interest rates, has probably been the main consideration supporting the rate.

4. The Public Sector Borrowing Requirement in the fiscal year 1978/79 was about £9¼ billion, equivalent to some 5½% of GDP. Public sector borrowing in the last two fiscal years has been roughly half as large in terms of GDP as in the previous two. In his Budget speech of April 1978 the then Chancellor announced a target rate of increase in the broad monetary aggregate, sterling M3, of 8-12% for the year to mid-April 1979. This target was rolled forward in November by six months. Short-term interest rates rose sharply in the spring of last year mainly reflecting increased public and private demand for credit. MLR was up to 9% by mid-May. In the autumn it was raised again to 12½% partly in response to rising interest rates abroad. It was further increased to 14% this February, as anxiety grew about prospects for domestic inflation. But the market's more extreme fears on this score proved unfounded, and there followed large sales of gilt-edged stock and inflows into sterling, accompanied by a reduction in MLR to 12% by April. In the year to mid-April, sterling M3 is now estimated to have risen by 11½ per cent, seasonally adjusted. The increase in the latest seven months to mid-May, at an annual rate, was 13%.

## The outlook

5. The period ahead may well be somewhat more difficult for the world economy. World trade growth is likely to remain subdued; and there are signs that the period of declining rates of inflation has come to an end. Higher oil prices will have adverse effects both on the general level of prices and on most countries' balance of payments.

These influences are likely to weaken demand and make countries cautious about taking any offsetting measures.

6. The UK is bound to feel the effects of this poorer international climate, though in respect of oil and gas supplies and the balance of payments it is relatively well placed. Output in the UK is unlikely to show much increase in the next year or so, and may actually fall. Inflation will accelerate further this year, though it should moderate in 1980. The external current account is likely to remain close to balance. North Sea oil will again be important in supporting the trade account. Production is estimated at some 70 to 80 million tonnes in 1979 and is expected to surpass domestic consumption, currently running at about 80 million tonnes a year, before the end of 1980. On top of this, UK continental shelf gas production - almost all of which is supplied to the British Gas Corporation - is running at the equivalent of about 35 million tonnes of oil equivalent a year. UK gas reserves are substantial and are currently estimated at 650 to 1800 million tonnes of crude oil equivalent. Total government revenue from North Sea oil and gas in 1979-80 are estimated at almost £1½ billion.

7. Besides the immediate difficulties arising from the world environment, the UK continues to suffer from more deep-seated economic problems - in particular, a relatively weak industrial performance stemming from poor productivity, and, partly as a consequence, a tendency towards relatively high rates of inflation. The Budget introduced by the new Administration in June 1979 is designed as a first step towards a remedy, aiming to overcome inflation with firm fiscal and monetary policies and, at the same time, shifting the fiscal structure so as to encourage the private sector producer. Cuts in public spending should make room for such a shift of resources into private enterprise. The Chancellor has adopted a limit on public sector borrowing for the fiscal year 1979/80 of £8¼ billion and accompanied it with a target for the growth of sterling M3 of 7-11% at an annual rate over the ten months from mid-June this year to mid-April 1980.

June 1979