Chapter 6

The Balance of Payments

by

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1. The purpose of this chapter is to consider the balance of payments in its entirety, paying particular attention to what for want of a better term may be called the "non-trade" items. A detailed discussion of trade itself (i.e., exports and imports of goods and services) can be found in the next chapter.

2. The approach in previous reports has been to propose a 'target' for the balance of trade in the light of projected movements in autonomous non-trade items (long-term investment, trade credit, and international property income and transfers) and of an explicit concept of external balance, expressed as either a preferred or a feasible movement in U.K. net short-term liabilities. But the U.K. has moved so far from external balance in 1973, and promises to remain so far from balance in the medium term, that an attempt to examine the implications of balance in the sense proposed earlier would be highly academic. The problem now, in view of the magnitude of alternative trade deficits projected for the period (see appendix table 11) is rather to set limits to the amount of overall imbalance that can be tolerated. Thus, the relevant questions now are - how large can trade deficits be and for how long can they persist before all possible sources of external finance are exhausted? How much more 'voluntary' financing of deficits can be counted on before the major strain has to be taken by the reserves and emergency official borrowing is required?(1) How soon must the imbalance be corrected if a cogent case for assistance is to be made to official creditors overseas?

3. The short answers to these questions are as follows. Beginning at the end of 1973, it is most reasonable to expect that trade deficits accumulating to a maximum total of some £10,000 million (succeeding annual deficits being measured at the projected prices of the year in which they are incurred) could be financed if necessary. This estimate does not include finance that may be available as a result of higher prices for imported oil. Not all of the money could be raised in a single year, and about one-half would be emergency short and medium term borrowing. With deficits of over £3,000 million projected for 1974 in chapter 7, there is an immediate need for official overseas assistance. The achievement of at least a small trade surplus by about 1978 must be in prospect very shortly.

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(1) 'Voluntary' financing may be defined as loans or extensions of credit which do not entail an official U.K. undertaking, explicit or implicit, that the deficits will shortly be corrected.

The Balance of Payments since 1971

4. The principal components of the balance of payments since 1960 are given for individual years in appendix table 5. It can be seen there that the current balance, having improved steadily in the period following the 1967 devaluation until 1971, has in the last two years experienced a massive swing from heavy surplus into even heavier deficit. The net effect of 'autonomous' capital items (long term investment[1] and trade credit) has been to reduce the 'basic balance' on average by rather over £100 million per annum since 1967, owing mainly to expansion of net trade credit. However, it has been possible to protect the reserves from the main consequences of the deterioration in external payments since 1971 through the resort to large-scale Eurocurrency borrowing engineered by the Treasury.

5. A detailed analysis of the 'currency flow' (i.e. the balance of all external transactions to be financed from the reserves or through official borrowing) in 1972 and 1973, compared with the average of the previous three years, can be found in Table 1 below. The figures for 1973 are our own provisional estimates and some are subject to considerable revision. Particularly noteworthy among the non-trade items are the fall-off in U.K. private investment overseas following the extremely high outflow in 1972, which largely reflects portfolio and oil disinvestment in the second half of the year, and has a counterpart in a reduction of overseas currency borrowing, from which portfolio investment is largely financed; unexpectedly modest expansion of net trade credit, bearing in mind the outflows of preceding years; and the massive build-up in 1973 of Eurocurrency borrowing by U.K. banks to finance public sector loans under the exchange cover scheme introduced by the Treasury in March 1973.[2] Part of the increased overseas investment in the U.K. public sector shown higher in the table also comes under the exchange cover scheme. Finally the

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(1) In this report, long-term investment overseas is counted net of all foreign borrowing secured for the purpose of financing such investment, including the relevant overseas currency borrowing by U.K. banks, although some of this is technically short-term in nature. On the other hand, overseas currency borrowing by U.K. banks to finance loans to the U.K. public sector under the Treasury's exchange cover scheme is counted as a special short-term financing item, although some is technically medium-term in character. Reasons for this treatment will be discussed later.

(2) This replaced an earlier scheme introduced in 1969. The main innovation in the recent scheme which has made it attractive for Eurocurrency borrowers appears to be that it lowered the minimum average life for eligible borrowing from 10 to five years. A mere £137 million was borrowed under the earlier scheme, all of it before July 1971.

Table 1: Balance of Payments and Currency Flow
(£ million at current prices)

	1969-71 Average	1972	1973[1]
Balance of trade	+443	-109	-1721
Interest, profits and dividends (net)	+510	+456	+705
Transfers (net)	-221	-264	-442
Current balance	+733	+83	-1458
Capital transfers[2]	-	-	-60
Long-term capital flows			
Official long-term (net)	-189	-255	-293
Overseas investment in U.K. public sector[3]	+56	+113	+186
Overseas investment in U.K. private sector	+802	+721	+1076
U.K. private investment overseas	-778	-1472	-1106
Overseas currency borrowing by U.K. banks to finance U.K. overseas investment	+177	+720	+360
Trade credit (net)	-198	-109	-105
'Basic Balance'	+603	-119	-1400
Overseas currency borrowing by U.K. banks to finance loans to U.K. public sector	-[4]	-[4]	+1000
Other investment and capital flows[5]	+1150	-1066	+621
Total currency flow	+1753	-1265	+221

(1) Individual items estimated with the help of 3 quarters' published figures.

(2) Payments under the guarantee clauses of the Sterling Agreements

(3) Excluding investment in U.K. government stocks by central monetary institutions and international organisations: includes direct borrowing by public authorities under the exchange cover scheme.

(4) Not separately reported, but officially described as relatively small.

(5) Including the whole of the Balancing Item.

extreme volatility of "other investment and capital flows", to which has been added the Balancing Item,[1] should be noted.

6. The net currency outflow in 1972 and 1973 (£1044 million) has been financed partly by withdrawing an official currency swap, which after repayment of the outstanding I.M.F. loan yielded £449 million in 1972, partly by an allocation of Special Drawing Rights of £124 million in 1972, and partly by net drawing on the official reserves totalling £471 million. Nevertheless because of sterling depreciation the reserves, if valued at the market rate of £1 = $2.324 at end-December 1973 rather than the official parity rate (i.e. £1 = $2.895), have actually risen from £2,526 at end-1971 to £2,787 at end-1973, implying net upward revaluations of £732 million.[2][3]

Scope for Deficits 1974-77

7. In the equivalent exercise twelve months ago it was suggested that the U.K. could if necessary run basic payments deficits averaging at most some £600 million at 1963 import values (i.e. about £1300 million at current prices projected this year) between 1973 and 1976.[4] Developments last year have proved this view to be

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(1) This represents the net errors and omissions in the accounts. Fluctuations in this item are thought to be attributable partly to timing errors in the recording of transactions and payments, and partly to unrecorded short-term capital flows including 'leads and lags' in the timing of payments. Values of the item have been as follows (£ million p.a.):

1960-68	1969-71	1972	1973 (est.)
+38	+276	-592	+600

(2) This figure differs from the sum of 'D' for 1972 and 1973 in appendix Table 5 because the latter also includes the effect of S.D.R. allocations, (+£124 million), as well as revaluations in U.K. banks' net foreign currency liabilities (estimated at roughly -£70 million, reflecting an increase in the sterling equivalent of the net liabilities) and in U.K. Government stocks held by C.M.I.'s (estimated at +£220m., reflecting a decrease in the market value of these liabilities).

(3) The purchasing power of the reserves in terms of import volumes has of course fallen (by about 12 per cent) since end-1971.

(4) Prospects for Economic Management 1972-76, pp.III 12-13.

wrong; it is now clear that the maximum tolerable deficit under emergency conditions in the next few years should be put at a much higher average figure than this. They have also greatly added to the forecasting uncertainties in what was previously an extremely uncertain area.

8. The two most important developments referred to are the emergence of large-scale Eurocurrency borrowing by U.K. public authorities and nationalised industries under the exchange cover scheme and the steps taken by essentially all the oil producing and exporting countries to increase their tax and royalty revenues from exported oil. These developments together raise the possibility of greatly increased overseas finance for U.K. payments deficits in the medium term. (The second also implies, of course, that greater overseas finance will be needed unless the higher cost of imported oil can be substantially met in other ways, which is highly unlikely in the short run.) Prudence dictates that, however attractive this apparently elastic source of finance may seem as a painless way of accommodating deficits, some attention should be given to the practical and advisable limits of borrowing and to the likely costs involved.

9. The following table presents some guesses as to the size of the various sources of private and official finance available for financing deficits to 1977. For the moment, the question of oil producers' revenues is ignored. It is assumed for the purpose of arriving at these figures that the sterling/dollar exchange rate is maintained at the end-1973 level.

Table 2: Availability of finance for U.K. payments deficits, 1974-77

(£ million at current prices)

Official reserves	1800	
I.M.F. conditional drawing rights	1150	
Other U.K. official borrowing	4500	
Less reduction in net sterling liabilities	-1500	
Eurocurrency borrowing to finance public sector loans	5900	
	11850	(say 12,000)

10. At end-1973, the official reserves, valued at market exchange rates, stood at nearly £2,800 million. It is assumed that they could if necessary be reduced to £1,000 million, their approximate level at end-1968, but not below that for any length of time.

11. I.M.F. conditional drawing rights, representing the whole of the U.K.'s credit tranche at the I.M.F., presently intact, are limited by the size of the U.K.'s quota

at the fund, which is unlikely to increase in the foreseeable future.[1]

12. The estimate of 'other U.K. official borrowing' is based on the total amount of such borrowing, mainly in the form of Central Bank swaps, outstanding at the end of 1968, the high-point of borrowing associated with sterling devaluation in 1967 (some £2,300 million). This amount has been raised in proportion to the growth in the total current-price G.D.P. of O.E.C.D. countries, in the hope that these countries, which provided essentially the whole of such assistance in 1968, could be persuaded to do so again at approximately the same rate in comparison with their resources. The figure is, of course, intended as no more than an illustration of possible orders of magnitude.

13. The negative figure for the change in net sterling liabilities is based on the belief that large net withdrawals can be expected in overseas sterling holdings in a period of heavy and sustained U.K. payments deficits, especially if members of the overseas sterling area are themselves experiencing payments deficits on account of higher oil prices. Since end-1968, exchange reserves held in sterling have increased by about £1,500 million to some £3,500 million (at nominal values), owing partly to the effect of the Sterling Agreements concluded in that year, while other holdings have increased by some £800 million to £2,200 million. The Sterling Agreements expired in September 1973 and although some (probably most of those with O.S.A. members) have been extended for 6 months, their longer term future seems highly uncertain. Several important holders have announced their intentions of reducing their sterling assets substantially and although this may take time and be partially offset by 'recycled' inflows, the prospects are not conducive to stability in the net amounts outstanding.

14. Even without the huge element of uncertainty added by the oil situation, it is hard to gauge the practical limit to future U.K. borrowing on the Eurocurrency market. This market has assumed massive proportions in recent years; total deposits amounted to some $90,000 million (not including inter-bank deposits) in September 1972, of which banks in the U.K. accounted for about half. Between 1968 and 1972 the market has expanded by some $15,000 million per annum and growth in 1973 was probably of the order of $20,000 million. Although it is generally agreed that emergence of the market was associated in part with heavy U.S. payments deficits in the mid-1960's together with U.S. exchange controls and ceilings imposed on interest rates payable on deposits with U.S. banks first imposed in 1963 and subsequently tightened until 1970, most commentators believe that it is now firmly established as a self-sustaining international banking system and will not be

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(1) S.D.R.'s and automatic drawing rights are included in the official reserves.

adversely affected by impending U.S. surpluses and easing of monetary restrictions. Such is its efficiency and flexibility that the market is expected to continue to expand and provide an attractive medium for absorbing liquid assets of U.S. residents in competition with U.S. domestic banks, after the relaxation of U.S. exchange controls on 1 January 1974.

15. On the other hand, there are signs that finance will not be as readily obtainable on easy terms in the future as it was in 1973, when numerous developing countries, in addition to the U.K. and Italy, were heavy borrowers. It is thought that interest margins often as low as ½ per cent above interbank rate in 1973 left little profit for the lending banks and that margins must rise appreciably in 1974 if the market is to remain viable. The aggressive entry of Japanese banks as prominent lenders was a feature of 1973 but it looks as though Japan will switch from being a lender to borrower in the near future, and despite the enormous potential scale of Arab deposits following the raising of oil prices, this new factor cannot be counted on to make the overall borrowing situation easier, since demand for loans by oil importers will rise pari passu, as will be seen in due course.

16. Even before allowing for large new Eurocurrency deposits resulting from higher O.P.E.C. oil revenues, there is little reason to think that the U.K. could not continue to borrow substantial amounts on the Eurocurrency market for a number of years ahead, but it would not be practical to look for vast increases in this type of borrowing, whether to finance overseas investment, or, in the present context, to finance domestic expenditure for balance of payments reasons. Moreover, there are strong arguments on grounds of prudence for wishing to minimise overseas currency borrowing for this purpose and if possible avoid it altogether, except as a very temporary expedient, for interest must be paid and ultimately the cost of debt repayment must be met, unless the scale of new borrowing is to rise indefinitely. Past interest rates have admittedly been extremely low in real terms, but they will almost certainly increase and in any case the interest cost payable in respect of a given stream of borrowing maintained indefinitely would in due course (perhaps 10 - 15 years, depending on inflation) rise to exceed the capital inflow. There is furthermore the risk that is run by the Authorities in providing exchange cover for the borrowing. This would add very substantially to the servicing and repayment cost in the event of sterling depreciation. To the extent that Eurocurrency borrowing is utilised to build up earning assets overseas, or domestic manufacturing industries with high export-earning capacity, or even to accumulate much-needed official reserves, the policy can be justified, provided that it does not create serious liquidity problems for the borrowing country or its banks. But the main consequence of the present policy has so far been that it has enabled the

maintenance of public and private consumption at levels higher than they would have been without it; only if accompanied by effective measures to improve the balance of trade can a continuation of the policy be defended.

17. It has been assumed for the purposes of this exercise that net Eurocurrency borrowing via U.K. banks to finance payments deficits can if necessary be continued in real terms for the next four years at the annual rate experienced on average after the first quarter of 1973 - i.e., at about £1,200 million per annum at 1973 prices.(1) Figures for individual years can be found in appendix table 5. It is further assumed that net borrowing will be progressively reduced after that date, although continued if necessary at levels roughly equivalent to associated interest payments (so as not to put too great an immediate strain on the recovering balance of payments). The prospect is then that cumulative finance of the order of £6,000 million can if necessary be obtained from this source between 1974-77, while prudence suggests that the inflow should if possible be steadily reduced thereafter.

18. The implication of the foregoing estimates in combination is that finance for cumulative payments deficits of the order of not much more than £12,000 million will be available to 1977. Unless a high level of Eurocurrency borrowing is maintained, relatively little further net financing can be looked for after that date, for the need to commence repayments of 1974's instalments of official short-term borrowing will arise about then. And the outlook for the succeeding period is one of very heavy debt repayment and restoration of reserves for a number of years.

19. All these figures assume that sterling will recover fairly soon from its present rate against the dollar ($2.18 on 17 January 1974) to roughly its rate at end-1973 ($2.32), which does not seem implausible if and when the 3-day week is relaxed and prospects for large scale private and official assistance for deficits are assured. Should sterling fail to recover, the current price sterling equivalents of the financing items in table 2 will rise in roughly inverse proportion to the depreciation from the end-73 rate, but this does not mean that depreciation would assist the U.K.'s financing problem. For one thing, depreciation would tend to raise import prices, so that the import purchasing power of reserves or foreign currency borrowing would not be much affected. Secondly, actual or notional revaluation payments would arise in respect of foreign currency liabilities or guaranteed sterling liabilities which would sooner or later impose a cost on the balance of payments, either as capital transfers (in the case of payments under the sterling guarantees) or as increased costs of loan repayments (in the case of overseas currency borrowing). In principle, allowances for the latter are included

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(1) This ignores the question of higher oil prices and revenues, dealt with below.

in column 'D' in appendix table 5, and have the effect of increasing the size of deficits to be financed. 'D' is shown as zero there for 1974-77 because it is assumed for this exercise that sterling will recover to about $2.32, but if depreciation below that rate were assumed, quite sizeable negative entries would be called for in 'D' after 1973, reflecting the excess of upward revaluations of net overseas currency liabilities built up during the period over revaluations in the (depleted) official reserves.

20. It is not possible at this stage to make any forecast of the size of guarantee payments on sterling liabilities after March 1974 in the event of depreciation, as the future of the Sterling Agreements is highly uncertain; while it is reasonable to expect that some agreements will be renewed, it is impossible to guess what guarantee rate will be agreed on.

21. Neither is it possible at this stage to foresee the size of new S.D.R. allocations in the next few years, except to say that they will probably be quite small in relation to the magnitudes outlined in Table 2.

22. In view of the size of the non-oil trade deficit projected for 1974, it is important to consider the maximum rate at which finance could be raised next year. Assuming that official reserves are drawn on to the fullest extent feasible, that Eurocurrency borrowing to finance domestic investment can be increased moderately beyond its 1973 level in real terms, and that substantial reductions will occur in the sterling balances, the maximum of finance available from 'unconditional' sources in 1974 would be roughly £2,000 million or slightly more.(1) It is reasonable to expect that emergency assistance through I.M.F. and Central Bank lines of credit of at least an equivalent amount could also be raised in the year, but it is important to recognise that such assistance would be conditional on the provision of fairly firm undertakings concerning repayment, including a convincing set of proposals for dealing with the imbalance.

The Oil Situation

23. The major concern here is with the financial effects of the oil situation; supply effects were discussed in Chapter 2.

24. As a result of the recent increases in the posted prices of crude oil, stemming from the increases imposed by the Arab members of O.P.E.C. in October 1973 and January 1974, it is estimated that the annual average c.i.f. price of crude oil

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(1) Not including any effects of the oil situation. It may be noted that 'exchange reserves in Sterling' fell by over £400 million in the third quarter of 1973, and have probably fallen further in the final quarter.

to all importing countries will rise from some $4.25 per barrel in 1973 to probably $9.5-10.5 in 1974 (the actual outcome depending on the actions of Non-Arab producers and on the movement of the c.i.f. component, including the oil company profit margin). Thereafter the most reasonable expectation is that prices will rise more or less in step with the average price of world manufactured exports. As a direct consequence of these developments, oil importers will in future be paying rather over twice as much for their oil as they might otherwise have expected, and oil exporters will experience increases in their revenues on a truly staggering scale.

25. It can be estimated that the annual surplus revenues of O.P.E.C. members (i.e. the difference between total O.P.E.C. revenues from crude oil and their expenditures on imports of goods and services) will rise, mainly as a result of the price increases, from about $7 thousand million in 1973 to about $60 thousand million in 1974 and $100 thousand million in 1977. This estimate assumes an increase in the volume of their oil exports of about 4 per cent per annum 1973-76 (compared with expansion 1970-73 of about 9 per cent annually), and an increase in the value of O.P.E.C. imports of about 30 per cent p.a. Allowing for interest, this implies that O.P.E.C. countries will be accumulating foreign assets at the rate of roughly $120 thousand million per annum by 1977. The counterpart will be that the rest of the world will be in collective current account deficit to O.P.E.C. by corresponding amounts. The enormous shift in the international ownership of wealth that these figures represent is unprecedented; it quite dwarfs the series of U.S. payments deficits of the 1960's, culminating as they did in the record deficit of $30,000 million in 1971 (on a 'reserve transactions' basis).

26. As several commentators have observed, a major question in considering forecasts of the preceding type is - what sort of asset can be offered to O.P.E.C. members that they will wish to hold? This will present a difficult challenge to the oil consuming countries, but it will have to be solved if the producers are to be induced to part with oil at the projected rate, rather than keep it in the ground. In the short term, assuming that increases of more or less the projected order do indeed materialise, oil producers will have no alternative but to hold their surplus revenues in the form of relatively liquid assets in one or other of the world's financial centres, namely New York, London, or on a smaller scale, Zurich and other continental centres. Since most oil is paid for in dollars or sterling, this means that there will be an immediate and massive shift in the ownership of dollar and sterling bank accounts and other liquid dollar and sterling assets, whether held as 'domestic' deposits and securities of the U.S.A. or the U.K., or in the Eurocurrency market. It also means that if the oil is to be paid for by the importing countries, the deposits representing O.P.E.C. surplus revenues must be

on-lent to importing countries in rough accordance with their relative oil imports. The mechanism by which this is done will challenge the flexibility of the international monetary system and the ingenuity of organisations like the World Bank, which in co-operation must overcome the problem of providing immediate finance for importers with low reserves and credit worthiness.

27. While the details of how this can be done are not relevant here, several points must be made. Firstly, oil importers must not resist a collective deterioration of their current accounts with oil exporters, for such action would be self-defeating and merely lead to competitive deflation among the former. In principle, the correct solution would be for each oil importer to allow its current account to deteriorate (compared with what it would otherwise be) in exact correspondence to the deterioration in its 'oil' account (i.e., the additional cost of its oil imports, less any addition to exports to oil producers, compared with what would otherwise be expected). But it may happen that some countries are fortunate enough to attract larger capital inflows (whether of a short or long-term character) in the new circumstances than they otherwise would, because the asset preferences of O.P.E.C. Governments in their new era of affluence may be somewhat different from those whose assets they acquire. Even so, there would not be a case for these fortunate countries to incur much larger current account deficits than they otherwise would - thereby absorbing exports from those less fortunate and transferring the necessary oil purchasing power to the latter in that way. Except in so far as it might stimulate a rise in primary product prices, there are strong practical as well as moral objections to this policy. On practical grounds, there is no presumption that the extra exports would come from the heaviest oil-importers and if not, the problem of getting purchasing power into the appropriate hands would be no nearer solution. On moral grounds, it would be objectionable for countries with highly developed capital markets and high creditworthiness to take advantage of the O.P.E.C. action to pre-empt additional resources from less creditworthy and less developed economies.

28. Hence while the U.K. together with the U.S.A. and other O.E.C.D. countries may experience increased capital inflows in 1974 and subsequent years as O.P.E.C. countries seek relatively remunerative and secure investment outlets for their surplus reserves, the temptation to utilise these inflows as finance for trade deficits, other than those stemming from oil, should be avoided. The right course will be to re-lend the excess funds directly or through appropriate intermediaries to countries with oil deficits for which finance cannot otherwise be found. For these reasons, the financial upheaval associated with the oil situation should not be looked upon as giving a new lease of life to U.K. payments deficits; the correct

course will be to aim to reduce the basic payments deficit by 1977 to something near the estimated U.K. oil deficit in that period, as defined earlier: the implications of this objective for the balance of trade depend inter alia on the projected behaviour of 'autonomous' non-trade items, discussed below.

Autonomous non-trade items

29. The components of the balance of payments discussed in this section are 'autonomous' in the sense that, for the most part, they are determined by forces and objectives other than the state of the balance of payments itself, although they may, like trade, be influenced by official policy designed to correct an imbalance. The distinction can perhaps be illustrated by reference to the difference between the treatment in this exercise of Eurocurrency borrowing to finance U.K. overseas investment, and that to finance U.K. public expenditure under the exchange cover scheme. The former is seen as a largely autonomous capital inflow determined by such factors as the rate of overseas investment proposed by British industrial companies and financial institutions and the relative availability and cost of finance in the Eurocurrency and other capital markets. Of course, the operation of U.K. exchange control which compels investors to seek external finance if they wish to avoid the premium for investment dollars is a factor explaining the close link between net portfolio investment and Eurocurrency borrowing, but it has no direct effect on the volume of such borrowing. On the other hand, Eurocurrency borrowing to finance U.K. public expenditure is seen as an expedient undertaken for balance of payments reasons, and is therefore an 'induced' rather than an autonomous inflow.

30. Projections of the principal non-trade flows for 1974 and 1977 are given in table 3, together with preliminary estimates for 1973. Summary figures for intervening years are given in appendix table 5.

31. The general procedure adopted was that individual components (in considerably finer detail than that shown) were projected in real terms, using a variety of different methods. Projections in real terms were then expressed at current prices assuming an average rate of inflation in sterling values of slightly under 6 per cent per year, 1973-77, for all items.(1) This is admittedly a fairly arbitrary approach, but since the margins of error in forecasting are relatively large the precise rates of inflation chosen are probably not important. A sizeable sterling

(1) For items essentially fixed in overseas currency terms, such as the U.K.'s contribution to the E.E.C., this procedure is consistent with assuming, say, 6 per cent annual inflation in E.E.C. countries and zero depreciation of sterling or, alternatively, say, 4 per cent annual inflation in the E.E.C. and 2 per cent annual depreciation in sterling.

Table 3 Projections of non-trade flows

(£m. at current prices)

	1973[1]	1974	1977	Annual Change 1974-77 in real terms[2] %
Property income from/to abroad				
Credits	2159	2330	3104	5.0
Debits				
Interest and profit on inward investment in North Sea oil[3]	-	-28	-298	..
Interest on higher borrowing to finance deficits, 1973-77	-39	-160	-664	..
Other	-1415	-1444	-1877	4.1
Net	705	697	265	
Transfers				
Contributions to E.E.C. (net)	-85	-81	-298	..
Other official (net)	-247	-274	-358	4.4
Private	-110	-129	-202	10.7
Net	-442	-484	-858	
Long-term capital				
Official long-term (net)	-293	-336	-432	3.7
Overseas investment in U.K. public sector	186	197	318	11.9
Overseas investment in U.K. private sector				
In North Sea oil exploration and development	165	259	215	..
Other	911	938	1361	8.0
U.K. private investment overseas[4]	-746	-1002	-1392	6.5
Net	223	56	70	
Trade credit (net)	-105	-250	-450	..
Total of above	381	19	-973	..

(1) Estimated actual, as in Table 1.

(2) See the notes to appendix table 5.

(3) Includes an allowance for reduction in earnings of U.K. oil companies attributable to reductions in U.K. imports of oil.

(4) Net of associated overseas currency borrowing by U.K. banks.

depreciation in the period (i.e. of more than a few per cent per year) would of course raise the values of items wholly or largely fixed in overseas currencies by a roughly proportionate amount. As noted earlier in connection with financing items, such a revaluation would not affect the import purchasing power of, for example, net property income from overseas because depreciation would also raise the sterling prices of imports.

32. It should further be noted that whereas 1973 figures are estimates of actual levels, the projections of non-trade flows both here and in the appendix table are in most cases trend or at least partially smoothed values, so that they are not precisely comparable with the 1973 figures.

33. The main features of the projections are as follows:

(i) Net property income from abroad is expected to be reduced very sharply by 1977. The principal cause is expected to be the heavy outflow of interest payable on the additional foreign borrowing needed to finance deficits in the period 1973-76, starting with interest on last year's Eurocurrency borrowing. In this table, interest at about 8 per cent has been calculated on borrowing commensurate with overall payments deficits implied by growth of G.D.P. at 2 per cent per year - i.e. some £8,500 million by end-1977 (not counting drawings on the reserves). A second important factor is expected to be the emergence of large interest and profits payable on foreign investment in North Sea oil - the latter appearing as a separate item of long-term capital lower in the table. Both series are derived from a special study of the prospects for North Sea oil. The estimate of profits etc. is of course extremely uncertain, depending as it does not only on actual investment from overseas sources but also on the rate at which output materialises and the price and cost structure that emerge. Bearing in mind recent developments on the oil front, the estimates of both earnings and investment in 1977 are probably on the low side.

(ii) Net transfers are expected to move further into deficit. A major factor here is the projected increase in the U.K.'s contribution to the E.E.C. budget.

(iii) Net long-term capital movements are expected to remain in slight surplus. This represents something of a shift from the view taken last year, when it was suggested that a substantial net outflow would emerge by about 1974. Reasons for the change in forecast are primarily that net inward investment in North Sea oil exploration and development is now expected to be substantially larger and to persist for longer than originally thought, although still expected to diminish by 1977 as a larger share of gross investment is financed from depreciation

provisions (which are not a capital inflow, since both investment and earnings are reckoned 'net'); and that foreign borrowing of various kinds is expected to account for a considerably larger share of private investment overseas than previously thought. Thus, part of the explanation for the higher rate projected for private inward investment is that this item includes a rapidly rising amount of long-term overseas currency borrowing directly by British companies to finance mainly direct investment overseas. This inflow probably amounted to about £300 million in 1973, and has been projected to grow in real terms rather faster than the projected growth of direct investment overseas (10.3 per cent p.a. 1974-77, before deducting associated foreign currency borrowing).

(iv) Despite its somewhat puzzling behaviour in 1973, when net outflows were considerably lower than could be predicted on the basis of previous years, the net expansion of trade credit has been projected to increase heavily by 1977. The critical uncertainty in this field is the movement in the total of export credit outstanding in relation to the value of exports. Having grown fairly steadily from some 20 per cent in the mid-1960's to 24 per cent in 1972 , the ratio of credit to exports fell back sharply in 1973 to 21 per cent. Even if the ratio stays unchanged at this reduced level, the value of additions to export credit must quickly rise to over £800 million in 1974, owing to the enormous projected rise in export values. The expansion in import credit received will be proportionately about as great, but since import credit is much smaller in relation to import values the net effect is a large expansion in credit granted over credit received. The figures actually chosen in fact imply an immediate further fall in the export credit ratio in 1974, followed by a slow return to the 1973 level by 1977. This is as conservative a view as seems reasonable, without assuming that U.K. exporters will in future be selling very much less on credit, or for very much shorter credit periods, than they have in recent years, for which very little ground can be adduced.

34. The outcome of these various estimates is that the autonomous non-trade items, taken together, will move from modest surplus in 1973 to heavy deficit in 1977. Inevitably this forecast is subject to very wide margins of error. The most that can be said is that, given overall payments deficits on the projected scale, the negative balance of non-trade items will probably be between £700 million and £1200 million in 1977, unless they are subject to corrective action - such as the tightening rather than relaxation of exchange controls on investment in the E.E.C.

Implications for the balance of trade

35. The implications of all these projections for the balance of trade to 1977 are summarised in table 4:

Table 4: Maximum tolerable U.K. trade deficits, 1974-77

(£ million at current prices: annual averages)

Maximum finance for payments deficits[a]	3,000
Balance of non-trade items	-500
'Tolerable' trade deficits[a]	2,500

(a) Excluding the impact of higher oil prices and associated deficit financing.

36. In other words, before any consideration is given to the impact of higher oil prices, deficits totalling about £10,000 million could be financed in the next four years. But after that time the net amount of new borrowing available will be sharply reduced unless Eurocurrency borrowing on an increasing scale is contemplated and unless repayment of official short-term loans, for example from the I.M.F., can be postponed for an unusually long interval. Moreover, if the projections in the previous section are roughly right, the non-trade items will themselves be imposing an increasingly heavy burden by 1977. For these reasons, it is imperative that, while trade deficits of the order of £2,500 million per year could be sustained in 1974 and 1975, they should be made to decline substantially towards the end of the period and if possible be transformed to surpluses by about 1978.

37. As was seen in Chapter 2, the U.K.'s oil import bill is expected to increase from roughly £1,700 million in 1973 to about £3,600 in 1974, falling gradually thereafter to around £2,400 million in 1977 as the volume of oil imports declines. That is to say, the U.K. deficit on account of higher oil prices (not including increases ascribable to 'normal' inflation) will be running at roughly £1700 million in 1974, reducing to some £200 million in 1977. It was argued earlier that, in the initial stages at least (i.e. before O.P.E.C. countries can absorb considerably increased exports), the U.K. along with other oil importers should react by attempting to borrow surplus O.P.E.C. reserves to the extent of this special oil deficit rather than by seeking to correct it. If so, the estimate for maximum tolerable trade deficits in the next four years should be increased by roughly £1,000 million per year - to some £3500 million, including the oil deficit. The importance of eliminating the entire trade deficit after 1977 still holds, for by that time the O.P.E.C. countries will be in a position to absorb substantially higher levels of exports in relation to their revenues, and in any case the amount of future assistance that the U.K. could conscientiously seek from O.P.E.C. as from other countries by that time will be relatively small.