

Chapter 1

The performance of the economy — past and future

The level of unemployment in Britain in 1956 was about 250,000 or 1% of the labour force. Ten years later it was still only 350,000. By 1976 it was 1¼ millions or 5%. This year, 1981, it is likely to average 2½ millions or 10%. Within another three or four years it may easily reach 15%. These figures *exclude* unemployed school leavers, elderly people forced into premature retirement, and the many married women discouraged from even trying to find work. They also exclude 600,000 people in industry who were on short-time at the beginning of 1981 and an equally large amount of 'concealed unemployment' in service industries.

In an industrial economy which is self-sufficient in oil the present state of mass unemployment and low productivity is scandalous. Our oil resources have been misused with a vengeance. While living standards have so far been more-or-less maintained, there has been a large cutback in the rate of investment, the productive base of our society is contracting and our national income has started to fall.

There need be no mystery about the reasons for this state of affairs. The deterioration of the economy is perfectly explicable and has been regularly foreseen in these *Reviews* since the first issue, published in 1975. Indeed it was foreshadowed in working papers and articles written as far back as 1972. What went wrong was not primarily a matter of finance, the money supply or wage bargaining. It was the inability of UK industries to keep the growth of their export earnings ahead of the process of import penetration — in other words, a progressive falling behind in international competition. Our charge against successive governments throughout the 1970s was always that in their differing and even contradictory preoccupations with finance and inflation, they failed to come to grips with this underlying phenomenon.

In this chapter we shall once again set out what has happened, why it happened, what the consequences of current policies are likely to be, and the inadequacy of orthodox alternatives. If the assessment is to be realistic it has to take account of a wide range of evidence including official statistics on spending, income, output, employ-

ment, trade, the balance of payments, finance, the public accounts, prices, earnings and so on. Such sources of information are not 100% accurate. The figures in our tables indicate orders of magnitude, not exact estimates and predictions. But they are organised systematically in a comprehensive accounting framework, which has been analysed and projected using an explicit model of the institutional processes by which the evolution of the economy is constrained*.

The first part of the chapter examines how and why the economy has drifted into a chronic state of 'stagflation' over the past twenty-five years. The second part considers prospects for the next few years if government policies set out in the March budget are persevered with, and assesses orthodox alternatives to the government's own strategy.

1.1 The ending of economic growth

The decade 1956-66 was the last sustained period of full employment in Britain and now seems like a golden age. As Table 1.1 shows, domestic output rose by an average of nearly 3% per year with industry setting the pace (the output of manufacturing, not shown separately in the table, rose by 3.3% per year). For all the propaganda to the effect that high demand and low unemployment inevitably lead to growing inflation, prices rose at an average rate of 3% per year over the decade and the retail price index increased by less than 4% in the final year. The lower half of Table 1.1 summarises how growth of national income was allocated between the main components of demand. Private consumption grew at 2.9% per year, sufficient to 'double the standard of living in twenty-five years'. Public consumption grew less fast (by only 1½% per year) but this conceals the fact that defence expenditure fell absolutely, making possible an increase in expenditure on other public services at about 3½%

*See the Statistical Appendix for summary accounts, notes and definitions. The model used for analysis and projection is described in 'Technical Manual of the CEPG model of the UK economy', seventh edition, by K. J. Coutts, T. F. Cripps and M. K. Anyadike-Danes, May 1981.

Table 1.1 Growth of national income and spending

(average growth rates in real terms – % per year)

	1956-66	1966-76	1976-79	1979-81
Industrial output (excluding North Sea)	3.1	1.1	1.1	-8.1
Other domestic output	2.6	2.8	1.7	0.4
Total output (excluding North Sea)	2.8	2.1	1.5	-2.8
National income	2.9	1.8	2.7	-1.1
Private consumption	2.9	2.0	3.1	0.6
Public consumption	1.4	2.7	1.0	0.8
Fixed investment	5.7	2.2	0.0	-6.3
Total domestic spending (excluding stockbuilding)	3.0	2.2	2.0	-0.6

Note: The growth rates are calculated on data at 1975 prices; figures for 1981 are estimated on a post-budget projection. Data for all tables in this chapter are derived from CEPG accounts based on a range of official sources (see Statistical Appendix for notes and definitions).

per year throughout the decade. More strikingly, fixed investment rose at an average rate of nearly 6% per year, increasing by more than 70% over the whole period.

The problems facing policy-makers, seen from the vantage point of 1981, were quite small during most of the decade up to 1966. Imports of manufactures, though rising fast, were still very low. Imports of food and raw materials declined relative to national income. Britain's export performance was poor but the balance of payments did not become a major constraint on the growth of the economy until right at the end of the period.

After 1966 things took a marked turn for the worse. Over the next decade the growth of domestic output as a whole averaged only about 2% per year and that of industry little more than 1% per year. The national product was worth less after the early 1970s because of a large rise in prices paid for imports of oil and raw materials relative to prices received for our exports. The real national income rose by an average of about 1¼% per year. Within the decade between 1966 and 1976 there was one major attempt to get back to full employment by fiscal and monetary stimulation of spending. This notorious 'dash for growth' in 1972-73 resulted in a large balance of payments deficit. The growth of spending over the whole decade was less than in the previous decade, although in excess of the growth of income. The rate of inflation accelerated greatly.

The years since 1976 have started a new and disturbing chapter in the history of the British economy and government policy. During these years production of oil in the North Sea has begun in earnest and the maintenance of living standards has quickly come to depend on this production. At the same time full employment has been

unequivocally abandoned as a policy objective. Governments have concentrated instead on control of inflation and the stock of money. One effect of these policies and of North Sea oil has been to produce an unprecedented rise in the exchange rate for sterling, making British industries even less competitive in international markets than they were before.

Up to 1979, as the oil came in and sterling rose, the national income rose considerably, boosted by a terms of trade gain (see Table 1.2). Private consumption increased fast. But fixed investment did not rise at all, industrial output increased little and total domestic output, excluding North Sea oil, grew by an average of only 1½% per year. Much of the rise in private consumption went on imports. In 1979 the balance of payments was once again in deficit. The distressing elements in developments between 1976 and 1979 have since been greatly accentuated. Our figures for 1981 are forecasts, but prospects for the year as a whole are already clear from indicators for the first two months. Industrial production will have fallen by more than 15% in two years. Other domestic output will have more-or-less stopped growing. Total non-oil output will have fallen by more than 5%. The national income will have fallen less (only about 2%) solely because of a further terms of trade gain and a small rise in the volume of North Sea production. Consumption will have been maintained (perhaps marginally increased). But there will have been a large fall in investment. The severity of the recession in domestic output is such that registered unemployment, already 2½ million, is bound to go on rising.

The rate of inflation has recently slowed down. For one thing, the strength of sterling has held down import prices. For another, wage settlements have come under intense pressure as a result of the

Table 1.2 Reconciliation of output, income and expenditure

(£1975 billion)

	1956	1966	1976	1979	1981
Domestic output at 1975 market prices, excluding North Sea	65.3	86.3	106.4	111.2	105.0
North Sea output at 1975 market prices	0.0	0.0	0.6	3.2	3.5
Terms of trade gain or loss relative to 1975	1.1	2.4	- 0.7	2.5	5.3
Net income from abroad at 1975 purchasing power	0.5	0.5	0.5	- 1.1	- 0.7
Real national income at 1975 purchasing power	66.9	89.2	106.7	115.7	113.1
Domestic consumption and fixed investment at 1975 market prices	65.4	87.9	108.8	115.6	114.0
Stockbuilding at 1975 market prices	0.9	1.0	- 1.4	1.1	- 2.0
Current balance of payments at 1975 purchasing power	0.7	0.3	- 0.7	- 1.0	0.8

Note: 1975 purchasing power is defined in terms of the average price deflator for total domestic expenditure; figures for 1981 are estimated on a post-budget projection. The estimate for stockbuilding includes a residual error.

collapse of industrial profits, tight cash limits on public agencies and the general insecurity of jobs. Wage settlements have now fallen well below the level needed to keep up with rising prices and tax deductions. Nevertheless, the increase in consumer prices over the past year has still been greater than in the year before the present government came into office.

1.2 Why growth came to an end

Why did the British economy shift from conditions of full employment and sustained (albeit relatively slow) economic growth with a very low rate of inflation, to conditions of mass unemployment, stagnant production and endemic double-figure inflation? Our thesis is that economic growth was brought to an end by Britain's increasingly disastrous performance in foreign trade and that the ending of economic growth in its turn caused both high unemployment and prolonged inflation. This thesis is not inconsistent with the general view, now widely advanced, that stagnation and inflation have been caused by deteriorating 'supply-side' conditions. But, being specific as to the aspect of the supply side which matters — namely foreign trade performance — our thesis also points to specific conclusions about government policies.

Our proposition is a strong one. We assert that in the medium term the foreign trade performance of the economy is the main determinant of the level of domestic spending, output and income. To clarify the link between trade performance and domestic economic growth let us first postulate that at any given time there is a certain level of domestic spending at which purchases of imports would be equal to exports and 'invisible' foreign exchange earnings — in other words the level of spending at which the balance of payments on current account would be in balance. We may call this the level of spending 'warranted' by the country's performance in foreign trade. As we shall see, Britain's 'warranted' level of domestic spending tended to stagnate after the mid-1960s as import penetration caught up with a poor export performance.

The level of spending can be pushed above the 'warranted' level (or held below it) if the government stimulates (or restrains) demand through its budget and monetary policies. If spending is pushed up, the balance of payments on current account will go into deficit; if spending is restrained it will go into surplus. (The precise criterion, as we noted many years ago, is whether government borrowing exceeds or falls short of the private sector's financial surplus.)

In practice the actual level of spending has fluctuated around the warranted level. The

Table 1.3 The balance of payments constraint

(average growth rates in real terms — % per year)

	1956-66	1966-76	1976-79	1979-81
Growth of export markets	7.9	8.7	5.9	4.0
Growth of UK market share (excluding exports of fuels)	-4.2	-2.4	-3.3	-6.8
Growth of non-fuel exports	3.4	6.1	2.4	-3.1
Growth of non-fuel exports after deducting their estimated import content	3.3	5.2	2.0	-3.7
Growth of net export and foreign exchange earnings including benefits of North Sea oil and gas	3.2	5.0	4.9	2.0
Growth of the average import content of domestic spending	0.8	4.0	1.3	2.2
Growth of domestic spending consistent with imports growing at the same rate as foreign exchange earnings	2.4	1.0	3.6	-0.2
Actual growth of domestic spending ^a	3.0	2.2	2.0	-0.6

^a Excluding stockbuilding.

Note: Trade and balance of payment items are deflated by the deflator for non-fuel exports. Domestic spending is measured at 1975 market prices. Non-fuel exports include exports of services. Imports are adjusted to include purchases from the North Sea for domestic use and to exclude imports for the North Sea and the estimated import content of changes in the volume of stocks and work-in-progress. The average import content of non-fuel exports is assumed to be the same as that of domestic spending excluding changes in stocks. Net export and foreign exchange earnings, including North Sea is equal to total exports of goods and services plus net income and current transfers from abroad plus sales from the North Sea for domestic use less imports from the North Sea and the estimated import content of non-fuel exports. The difference between 'covered' and actual domestic spending excluding stockbuilding is equal to the balance of payments on current account plus the estimated import content of changes in stocks, divided by the average import content of domestic spending.

cautious budgets of Jenkins between 1968 and 1970 held spending down and yielded a balance of payments surplus. The expansionary budgets and monetary policy of Barber in 1972-73 boosted spending and yielded a huge balance of payments deficit. Healey's conversion to fiscal and monetary conservatism between 1975 and 1977 brought the deficit down again. The present government's extreme sense of financial discipline has restrained spending to such a degree that the balance of payments on current account remains in surplus.

But while swings of fiscal and monetary policy, reflecting differing priorities and views, have influenced the level of spending from year to year, in the longer run the main determinant was the spending level 'warranted' by the economy's performance in foreign trade. The actual level of spending never diverges too far from this level

because it becomes impossible to finance ever-increasing balance of payments deficits while, on the other hand, there would be little point in sacrificing spending and employment to achieve ever-increasing balance of payments surpluses.

The above propositions have an important corollary. Government policies will only yield a permanent improvement in income and employment if they succeed in raising exports and/or reducing import penetration. Policies which harm exports or accelerate import penetration, whatever their merits or demerits in other respects, are bound to reduce income and employment.

In Table 1.3 we set out the trends of exports and import penetration which have governed the 'warranted' growth of domestic spending since the mid-1950s. To facilitate comparisons of developments before and after 1976 we treat the

North Sea as if the whole of its production were a source of foreign exchange earnings and, correspondingly, treat purchases of oil from the North Sea for domestic use as if they were imports. (We have also made a rough allowance for the import content of non-oil exports and adjusted the figures to exclude variations in imports associated with fluctuations in stocks.)

In the decade up to 1966 the growth of exports was disappointingly slow as UK producers continuously lost overseas markets to foreign competitors. Fortunately the ratio of imports to domestic spending also grew slowly. (Imports of manufactures, although rising fast, were still only a small proportion of the total.) Overall, exports and other foreign exchange earnings grew by just over 3% per year, well in excess of import penetration. Already, however, the growth of exports was inadequate to cover fully the rise in imports generated by the growth of domestic spending. There were balance of payments deficits in 1960 and 1964-5, the latter causing the government to curtail plans for economic expansion and to introduce an import surcharge as a short-term measure to hold import penetration back.

Between 1966 and 1976 there were increasingly severe balance of payments problems. The current account was in deficit for six years out of ten and the deficits towards the end were very large. Exports grew faster than before, aided by devaluation in 1967 and by the downward 'float' from 1972 to 1976 when sterling fell by 40% relative to an average of other major currencies. But import penetration accelerated as foreign manufactures acquired a substantial share of internal markets. The cost of imports was pushed up by the huge rise in oil prices in 1973-74. Overall, Britain's foreign trade position barely warranted any growth in domestic spending at all.

After an internal recession and a sharp rise in unemployment in 1971, the Conservative government stimulated domestic demand. This is what pushed the balance of payments into large deficits. Over the decade 1966-76 as a whole, domestic spending grew well in excess of the rate warranted by export performance and import penetration. Domestic output grew less than spending with industry, particularly, beginning to stagnate.

From the beginning of 1975 the Labour government, confronted with a large balance of payments deficit, faced a difficult choice. It could reduce the deficit and stabilise sterling by reversing fiscal policy and cutting back public expenditure plans, at the cost of domestic recession. Or it could sustain internal spending and allow the exchange rate to fall rapidly at the cost of accelerating inflation, already running at 25% per year. Or it could introduce import controls, at the cost of breaking with its allies and the EEC at a moment of severe recession in international trade.

The government's choice was made progressively. Public spending plans were cut in

several steps. Inflation was curbed by an incomes policy. The exchange rate was allowed to depreciate, but not too rapidly. Import controls were rejected. The result was a 9% fall in industrial output and a sudden rise in unemployment from 600,000 in 1974 to 1¼ million in 1976.

At the time it was widely hoped that this was a temporary setback. The arrival of North Sea oil was expected to usher in a new period of economic growth and prosperity. The balance of payments constraint would be lifted for many years to come. Even our own projections, regarded by others as far too gloomy, envisaged growth of output between 1976 and 1980 at an average rate of 3% a year (March 1976) or 4½% a year (March 1977) under 'conventional' policies. Our main concern was the temporary nature of the recovery which North Sea oil would engender. After 1980, once the volume of oil production neared its peak, the constraints imposed by a weakening performance in non-oil trade would once again make themselves felt.

The outcome has been even worse than we expected. The growth of non-oil exports slowed drastically and has now gone into reverse. Domestic spending rose slower between 1976 and 1979 than in the preceding decade and yet the balance of payments was still in deficit in 1979. Since 1979 Britain's foreign exchange earnings, including oil, have risen *less* than import penetration (see Table 1.3). Despite North Sea oil, the balance of payments constraint is tighter than ever. The surplus now being achieved is due only to the severity of internal recession and destocking.

The consequence of the collapse in non-oil trade has been an unprecedented fall in industrial production. What is remarkable is not that unemployment has risen, but that it has risen so little. Between 1976 and 1979 non-oil output rose by only 1½% a year, barely half of the normal trend growth of labour productivity. Yet aggregate employment did not fall at all. Unemployment was held in check by 'job-saving' schemes and subsidies in manufacturing industry, by the absorption of labour in low-productivity service occupations, by discouragement of married women from seeking jobs and by premature retirement of the elderly (a quantitative assessment of these developments is given in Chapter 3). Since 1979, with non-oil output falling, job-saving has no longer been feasible and unemployment has risen rapidly.

The failure to restore economic growth after North Sea oil came on stream must be blamed not only on the inherited structural problems of British industry but also on the failure of the last government and the present one to choose policies which would have used the benefits of oil to strengthen Britain's performance in industrial trade. The crucial mistake has been the adoption, from 1976 onwards, of restrictive monetary policy which induced a strong exchange rate for sterling

and crippled industry's already weak competitive position. The principal justification for restrictive monetary policy has been that it was necessary to reduce inflation. In our view this justification was based on an incorrect diagnosis of the reasons for inflation. Before discussing how North Sea oil was wasted we shall therefore review the processes which made inflation accelerate.

1.3 The acceleration of inflation

The conjunction of inflation with recession was at first regarded as a paradox by many economists who traditionally thought of inflation as a symptom of over-full employment. During the 1970s the blame for inflation was increasingly laid on governments who were said to be borrowing too much or financing their borrowing unsoundly, causing the stock of money to grow too fast. The argument was that growth of the money supply leads rational people to expect inflation and that the very expectation is sufficient to make inflation happen. In the mid-1970s it was confidently asserted that the money supply determines the price level with a lag of between eighteen months and two years. But events disproved this assumption. It is no longer clear which aspect of monetary conditions is most critical or whether prices react in anticipation or after the event (if, indeed, there is any relationship at all).

The paradox of inflation in recession can be readily explained by less esoteric mechanisms than expectations associated with growth in the supply of money. Our general hypothesis is that inflation accelerated because of 'income-maintenance' pressures in face of losses of income due to recession, compounded in 1973-74 by a sharp rise in oil and commodity prices. Stagnation of the economy implies rising tax rates, mounting costs of social security and unemployment relief, accelerated money wage increases to offset higher taxes and prices and accelerated price increases to offset higher costs. Income maintenance may be suppressed if the recession is made deep enough — but only (as we are now seeing) at huge cost in terms of high unemployment, reduced investment and depression of living standards. It was suppressed in the 1960s and 1970s for periods of two or three years at a time by price controls and incomes policies. But when such policies broke down inflationary pressures immediately reasserted themselves with, if anything, greater intensity than before.

The history of inflation since the mid-1960s has been erratic with incomes policies and price controls appearing and disappearing, with frequent changes in tax policies, and with losses and gains to real national income from changes in the price of oil, fluctuations in the exchange rate and the build-up of North Sea oil production.

The most important process has been the ups and downs of wage inflation. We shall first examine the record on this and then consider the

distribution of income more generally. It will be seen that in the long run the main source of accelerated inflation has been an increase in the burden of taxes on wage and salary incomes which was resisted by accelerated increases in money earnings. The 'tax push' itself was caused mainly by the slow-down in economic growth. Thus inflation was largely caused by recession.

Consider the long-run pressures on wage bargaining. Since the mid-1960s real national income per worker has grown at an average rate of 2% per year. If the distribution of income had remained constant, real take-home pay per worker would also have risen by an average of 2% per year. Presumably if workers were dissatisfied with this they would have tended to escalate their wage claims. They might not have gained much in the end if prices and taxes caught up with rising money wages but they would probably have gained something to begin with.

What actually happened is not quite so simple. There was a rising burden of income tax, national insurance contributions and taxes on consumer spending which tended to reduce the real value of post-tax wages and salaries relative to national income. If this had been passively accepted and if the share of gross wages and salaries in income had in other respects remained unchanged, real take-home pay would only have risen by about 1% per year. In fact, however, there was a compensating 'non-tax' redistribution in favour of wages and salaries so that, despite the growing tax burden, real take-home pay rose at the same 2% a year average rate as national income per worker.

Through what mechanisms do non-tax redistributions come about? There are several which we can identify. One is that consumer prices benefit more from productivity gains than some other components of domestic spending (notably public services). Since the mid-1960s the real value of take-home pay has gained about 0.5% per year, as a share of national income, through a relatively slow rise in consumer prices (before indirect taxes and subsidies) as compared with prices in general. A second mechanism is that variations in productivity associated with changes in capacity utilisation are largely absorbed by profits rather than passed on in prices. Thus in recession, real wage and salary incomes fall less than real profits. A third mechanism is that changes in the 'real' exchange rate for sterling (i.e. changes in its purchasing-power parity) redistribute income between wages and profits. A fall in the real exchange rate makes exports more profitable but pushes up the cost of imports, reducing the purchasing power of consumers; a rise in the real exchange rate reduces exporters' profits but benefits consumers. The final mechanism whereby wage and salary incomes can gain or lose relative to other incomes is through changes in the rate of inflation of money pay. This is perhaps the mechanism of last resort. As we shall now see it has had powerful effects, at least over periods of two to three years.

Table 1.4 Real wages and inflation

(average annual increases over previous year, per cent)

	1965-80	1965-69	1970-73	1974-75	1976-77	1978-80
Growth in real national income per employee	2.0	2.8	3.3	-3.0	2.0	2.4
less effect of income tax, national insurance contributions, indirect taxes and subsidies	-0.9	-2.1	0.4	-1.6	-1.1	-0.2
<i>Prima facie</i> growth in real take-home pay	1.1	0.6	3.8	-4.5	1.0	2.2
Actual growth in real take-home pay	2.0	1.0	4.4	0.2	-2.6	4.8
Non-tax redistribution in favour of wages and salaries	0.9	0.4	0.6	4.9	-3.5	2.6
Acceleration of increases in gross money earnings during period	0.7	0.0	1.4	6.8	-7.6	2.9

Table 1.4 is designed to show what happened to real take-home pay in each of the episodes of incomes policy and its aftermath, beginning with the policy enforced from 1965 to 1969. The first two lines of the table measure growth in resources (real national income per employee) and claims on resources by the government which, *prima facie*, were made at the expense of wage and salary earners. The third line shows the implied '*prima facie*' growth in resources available for real take-home pay (assuming an unchanged distribution of real national income in all other respects). Comparing this with the actual growth of real take-home pay we derive a measure of the 'non-tax redistribution of national income in favour of, or against, wage and salary earners' which took place in each period. The last line of the table shows the acceleration or deceleration of gross money wage increases in the same periods.

The general picture which emerges is that resource availability was low, except from 1970-73, largely because of the rising tax burden. Incomes policies from 1965 to 1969 and in 1976-77 prevented wage-earners from obtaining compensation through acceleration of money wage increases (in the latter period the sharp deceleration of money wage increases reinforced tax push and cut real take-home pay quite sharply). But when incomes policies broke down or were abandoned, money wage increases accelerated and wage and salary earners restored their real take-home pay with non-tax redistributions in their favour.

During the 1965-69 incomes policy real take-home pay rose by only 1% a year. In 1970, after the end of the incomes policy, the annual rate of increase in money earnings jumped from 7% to

13% per year as workers compensated for the preceding years of restraint. Real earnings grew fast for four years. National income per worker was also rising fast and there was some reduction in the tax burden. Overall, wage inflation remained constant but public sector pay was being restrained and this led to some large 'catching up' settlements in 1974.

The peak of inflation was reached in 1975 when money earnings rose by 29% in one year. Real national income had fallen sharply because of the rise in oil prices and a decline in national output. The burden of income tax and national insurance contributions increased. *Prima facie*, in the absence of non-tax redistribution, real take-home pay would have fallen by 9% in two years. In the event, with accelerated money wage increases, the share of wages in national income rose by nearly 10% and there was no fall in real take-home pay at all.

The acceleration of money earnings in 1974-75 was powerfully aided by government sponsorship (agreed in 1973) for 'threshold' cost-of-living payments which compensated workers month by month for rising consumer prices. The redistributive effects were powerful because price increases were reduced or delayed by a wide-ranging system of price controls.

In the next two years the process was put into reverse. The annual increase in money earnings was brought down from 29% in 1975 to 10% in 1977 by another incomes policy. At the same time price control was relaxed and the real exchange rate for sterling fell. Both tax and non-tax processes of redistribution worked sharply against wage and salary earners. Thus while real national income per worker rose by 4% in two years, real

take-home pay fell by more than 5%. Finally, after the incomes policy broke down there was once again an acceleration of the annual increase in money earnings from 10% in 1977 to 20% in 1980. Real earnings rose by nearly 5% per year, twice as fast as real national income per worker.

The cumulative results for real take-home pay at the end of each stage of the process may be summarised as follows. Taking 1964 as a baseline, after the first five years of incomes policy real pay had risen by 1% per year. By 1973, the cumulative increase in real pay had improved to

2.5% per year with an inflation rate (for money earnings) of 13%; by 1975 the cumulative real increase since 1964 was down to 2.1% per year with an inflation rate of 29%; by 1977 the real increase since 1964 was further reduced to 1.3%; by 1980 it had recovered to 2% a year since 1964, with money earnings rising 20% in 1980.

Can we name a figure for the long-run growth of real earnings which would have made accelerated wage inflation unnecessary from the point of view of wage-earners? In the mid-1970s we would have suggested (and did suggest) that if the rate of wage

Table 1.5 The distribution of national income

(per cent of national income)

	1956	1966	1976	1979	1981
<i>Factor incomes and indirect taxes less subsidies</i>					
Wages and salaries	58.1	59.5	63.2	60.7	61.9
Domestic trading income	25.3	22.0	18.3	16.9	12.3
Rents	4.2	5.3	7.0	6.7	7.0
North Sea profits and net income from abroad	0.7	0.5	1.0	1.8	3.1
Indirect taxes less subsidies	11.6	12.7	10.6	13.8	15.6
National income at market prices	100.0	100.0	100.0	100.0	100.0
<i>Transfers</i>					
From wages and salaries	-10.7	-13.6	-17.9	-15.3	-16.2
From property income	-15.4	- 6.1	- 3.3	- 2.5	- 2.8
To social security benefits	4.4	6.1	8.7	9.7	11.6
To public sector	21.7	31.6	12.5	8.1	7.4
<i>Real disposable incomes</i>					
Wages and salaries	47.4	45.9	45.3	45.4	45.7
Social security benefits	4.4	6.1	8.7	9.7	11.6
Other private income	14.8	21.7	22.8	23.1	19.7
Public sector income	21.7	26.3	23.1	21.9	23.0
National income at market prices	100.0	100.0	100.0	100.0	100.0
Real disposable wage and salary income per employee (£1975 per week)	27.62	33.19	40.56	43.71	44.79
Real social security benefits per beneficiary (£1975 per week)	7.50	10.49	14.54	17.09	17.87

Note: The shares of factor incomes are calculated at current prices. Shares of real disposable income allow for the differential incidence of relative price changes. The transfers shown include the effects of direct taxation, insurance contributions and grants as well as interest and dividends and relative price effects; they are equal to differences between the top and bottom halves of the table (with rents, domestic trading income, North Sea profits and net income from abroad regarded as being in the first instance a component of 'other private income').

inflation can be taken as an indicator of frustration, the implicit 'target' for growth of real take-home pay was around 3% per year. The trend line of the real post-tax value of nationally negotiated wage settlements outside periods of incomes policy has historically risen by 1% per year over a very long period. Wage 'drift' on top of national settlements typically added 2% per year to the increase in money earnings. But by 1980, the implicit target appears to have fallen back a little, largely on account of reduced wage 'drift'. And now, at the beginning of 1981, the real value of wage settlements is falling (see Chapter 3). Wage-bargaining objectives are evidently not entirely immune to economic pressures. What the experience of the 1970s showed is that the response is at best a gradual one.

Why was the impact of slow growth of national income persistently compounded by a rising tax burden? The common answer to this question is that there has been a disproportionate growth in public expenditure. But that answer is misleading. The share of real national income retained by the public sector to finance spending on public services and public investment has if anything fallen since the mid-1960s. What has changed is the amount of spending on grants and social security benefits and the manner in which government revenue is raised. Table 1.5 shows how transfers through the tax and social security system (as well as other mechanisms such as interest, dividends and relative price changes) have altered over the past twenty-five years.

It will be seen that pre-tax domestic profits

declined persistently and substantially as recession grew worse, the main reason being that prices could not be (or in any case were not) raised sufficiently to cover shortfalls in productivity growth. Unsurprisingly, governments reduced the effective taxation of profits and looked for revenue elsewhere.

A second trend in income distribution was the rising share of national income taken by social security benefits. To be fair, only part of the increase was due to the rise in unemployment. The proportion of elderly people in the population was rising and levels of benefits were improved relative to average wages. If economic growth had been sustained these developments would at least have been easier to cope with. As it was, the government levied rising tax and insurance deductions from wages and salaries to pay for the growing cost of social security.

The rise in the direct and indirect tax burden on wages and salaries was in these and other ways a product of the slow-down in economic growth. It was no accident, therefore, that inflation tended to worsen as the recession deepened. Does the same kind of explanation hold good for stagflation in countries other than the UK? An OECD study three years ago* found widespread evidence of tax push. In most countries the average ratio of indirect taxes to GDP has tended to fall but personal taxes and social security contributions have increased steadily. Table 1.6 sets out the best

**Public Expenditure Trends*, pp. 52-55 and Annex B, OECD, 1978.

Table 1.6 Rough estimates of the impact of tax changes in OECD countries on real personal income, 1965-78

	Effect of changes in indirect taxes less subsidies	Effect of changes in direct taxes and social security contributions	Combined effect of changes in taxes, subsidies and social security contributions
Japan	+1.5	- 4.0	- 2.5
France	+2.2	- 5.5	- 3.3
Italy	+2.3	- 6.4	- 4.1
UK	+0.2	- 5.0	- 4.8
Austria ^a	-0.2	- 4.7	- 4.9
USA	+0.6	- 6.7	- 6.1
Canada	+1.9	- 8.5	- 6.6
Germany ^a	+3.3	- 9.9	- 6.6
Australia	-1.4	- 5.5	- 6.9
Spain ^a	+1.3	- 8.4	- 7.1
Belgium	+5.3	-12.6	- 7.3
Sweden	-0.3	-15.9	-16.2

^a 1966-77

Note: Indirect taxes and subsidies are measured as a percentage of GDP and no allowance is made for changes in their incidence on household expenditure relative to expenditure of other sectors. Personal taxes and social security contributions are measured relative to gross household income.

Source: Calculated from data in *National Accounts of OECD Countries, 1961-78*, volume II, Tables 1 and 8.

estimates we can make from OECD national accounts data of the combined effect of changes in taxes and social security contributions since the mid-1960s. The figures in the table show that there has been a tax push in all major OECD countries, in many cases at least as strong as that which occurred in Britain. The consequences for inflation were generally less acute than in Britain, depending on the degree of wage resistance to tax increases, as well as on the influence of other factors such as import prices and productivity trends. But it appears that tax push was an important element in the common acceleration of inflation.

At present, with national income falling, there is in Britain no sign of an end to tax push pressures. The government has abandoned its promises to cut the burden of taxation and has pushed up indirect taxes and public sector charges very vigorously. However the severity of recession is beginning to break the 'inflation plus 3%' trend of money wages and salaries. Under the pressure of cash limits on public agencies, the near bankruptcy of industrial employers, and fears of job loss, nearly all recent wage settlements have fallen well short of the amount necessary to compensate for increases in consumer prices. In these extreme circumstances the inflation component of stagflation may conceivably come to an end. But it seems unlikely that inflationary pressures will have been permanently cured. If sterling falls, pushing up import prices and improving industrial profits, the wage-price spiral could easily begin to accelerate again.

1.4 Why North Sea oil was wasted

Tight monetary policy and restrictive budgets had mixed effects on inflation. But they have had unambiguous and extremely damaging effects on trade, output and employment. They are the reason why the potential benefits accruing from North Sea oil have been utterly wasted.

Some economists regard the sharp deterioration in Britain's non-oil trade since 1976 as a natural and inevitable consequence of North Sea oil. The crudest argument to this effect imagines that the level of activity in the economy is given and notes that if we produce our own oil we can afford to import more, or export less, of other goods and services. This argument entirely misses the point. North Sea oil should have helped to sustain a rising level of activity in the economy. What happened, by contrast, was that the level of activity fell.

A slightly more sophisticated argument is that North Sea oil was itself responsible for the rise in sterling which weakened Britain's non-oil trade performance. This argument assumes that the rise in sterling was inevitable. But in fact, if demand had been stimulated sufficiently the balance of payments would have remained in persistent deficit. This, accompanied if necessary by very

low interest rates, would surely have deterred foreign investors from rushing into sterling. Sterling could have been held down and British industry need not have lost its competitive position.

The reason why sterling appreciated persistently until the beginning of this year was that since 1976 both the previous government and the present one have tried to meet restrictive targets for the public sector borrowing requirement and the money supply. In pursuit of these targets they have cut public expenditure, raised taxes and held back the growth of domestic spending, ensuring that the balance of payments would come into surplus. And between early 1978 and mid 1980 they raised interest rates by over 10%. These policies made sterling a secure and high-yielding investment, attracting overseas funds and driving the exchange rate up. (See Chapter 3 for a more detailed assessment.)

The policies were chosen for two reasons. One was the terms of the agreement made with the IMF at the end of 1976 to restore confidence after sterling had fallen. The other was the belief that tight monetary policies were necessary to restrain inflation.

The effect of the policies on inflation has by no means been unambiguous. They have helped to reduce inflation to the extent that the rise in sterling kept down the cost of imports while recession and industrial collapse eventually depressed wage settlements. They have intensified inflation to the extent that, since 1979, tight budget targets have required the government to increase the tax burden very considerably.

The cost of the policy choice made by the last government and carried through with reinforced conviction by the present one has already been huge. To illustrate this we have made estimates of what would have happened if the cost competitiveness of non-oil exports had been held at its 1976 level. Non-oil exports could have been about 20% higher this year than they actually are. With fiscal policy adjusted accordingly, domestic output could have been 15% higher and, despite less favourable terms of trade, national income would by now have been at least £20 billion higher in real terms. Unemployment today could have been held down to about 1 million. Investment would have risen, public services and social security benefits could have improved substantially while at the same time the tax burden could have been cut. These are the opportunities which were thrown away by the choice in favour of 'sound' money and a strong exchange rate.

Worse still the costs of that choice have not yet been fully paid. There are lags between a rise in sterling, the loss of competitiveness by industry and the performance of exports and import penetration. Even if the exchange rate were put back to a reasonable level today, exports, output, income and employment next year and even the year after would suffer from the high exchange rate hitherto.

Whatever policies are followed from now on, the damage to non-oil exports can only slowly be reversed. If it is true that tight monetary policies have on balance helped to reduce inflation, the cost paid for that amelioration will have been appalling.

Why has it been possible to continue such damaging policies for so long? The answer lies in the time lags. The benefits in terms of the confidence of bankers and overseas investors were immediate. The damage to industry is progressively coming through. The living standards of people with jobs have only now started to suffer. Since 1976 governments followed what appeared at first to be the line of least resistance. Not until 1980 did the harshness of the policy become apparent. Even now much of the damage lies in the future and the government still persuades itself that the economy will soon begin to recover. Few people seriously questioned the policy in 1977-78. Now, the critics seem to be in a majority. But only after another year or two will it become the conventional wisdom that monetary restriction causing over-valuation of sterling has been responsible for the worst slump Britain has suffered this century — at the very moment in our history when North Sea oil could and should have been the basis for a long-awaited economic recovery.

1.5 Prospects under existing government policy

We now turn to consider policies for the future. We know, in the short term, that national output is falling, unemployment is rising and the rate of inflation of prices and money wages is lower than last year. What are the prospects looking slightly

further ahead? Most commentators seem to expect that inflation will continue to slow down and to hope, at least, that there will be some recovery in output next year.

From the detailed presentation of government policy in the March budget we can assess the fiscal policy planned for this year and next. The tax burden is being increased; by 1982 it will rise by about 2 percentage points on private consumption expenditure and 2½ percentage points on wage and salary earnings as compared with the position in 1980 (see Table 1.7). The implied cut in real take-home pay is around 5%. At the same time public spending and rates of social security benefit are being held roughly constant in real terms. Overall, therefore, fiscal policy is highly restrictive. If spending and output were rising at anything like the normal rate consistent with a stable level of unemployment, the public sector's borrowing requirement would fall by some 7% of national income. Even with declining domestic spending and output, the borrowing requirement is likely to fall by at least 1% of national income this year as compared with 1980.

The government has its own justification for choosing a tight fiscal policy and aiming to cut the borrowing requirement in the midst of slump. The logic of that justification is discussed on pp 1-3. In this section we shall assess the likely consequences of the policies chosen by the government in the light of our own understanding of how the economy works.

Here and in the Statistical Appendix we give quantitative illustrations of the likely effects of policy on specific, but in some degree arbitrary, assumptions about the future exchange rate, wage settlements, industrial performance and other matters. The assumptions are generally chosen to

Table 1.7 The 1981 budget – real tax rates and spending plans

	1980	1981	1982
Average taxes less subsidies on consumers expenditure (%)	19.6	20.7	21.5
Average income tax and insurance contributions on wages and salaries (%)	25.1	26.8	27.6
Planned public expenditure on goods and services (£1975 billion, including relative price effect)			
Public services	25.1	25.3	25.6
Investment	6.6	6.1	5.9
Total	31.7	31.4	31.5
Constant unemployment public sector borrowing requirement ^a (percent of GNP)	2.3	-2.3	-5.0

^a At 1976 pressure of demand.

bring out the main issues as clearly as possible*. The numerical results derive from a formal econometric model which enforces consistency between our explanations of the past and our assumptions about the future. But the model should not be regarded as anything more than an aid which helps us, through scrutiny of a variety of simulations (many of which it would be tedious to repeat), to introduce a sense of quantitative magnitudes into the verbal argument.

The most uncertain aspect of any assessment today is the future movement of the exchange rate for sterling. We do not believe that there is any reliable formal method for such predictions†. Our approach is to make guesses and then examine their plausibility in the light of projected outcomes for the balance of payments. Our main projection of the consequences of present policies,

summarised in Table 1.8, assumes that the exchange rate will hold up at its immediate post-budget level.

*We have sometimes been accused (for instance by Mr Sam Brittan in *The Financial Times* of 3 April, 1980) of howlers in exogenous assumptions such as those concerning the exchange rate. This misses the point of the projections which has been to illustrate, for example, that even if the exchange rate stopped rising, there would still be a major problem arising from the weakness of Britain's performance in non-oil trade. Any fair criticism must examine how the projections have been used to illustrate policy issues discussed in the text of our *Reviews*.

†The past year has demonstrated the extreme unreliability of both the purchasing-power parity and the relative money supply models of exchange rate behaviour.

Table 1.8 The 1981 budget – consequences for the economy

	1980	1981	1982	1985	Growth rates 1980-82 1982-85 (% per year)	
(£ billion at 1975 market prices)						
Private consumption	71.7	71.6	71.3	73.1	- 0.3	0.8
Total domestic expenditure	113.4	112.3	110.6	112.1	- 0.5	0.5
Exports of goods and services	33.1	31.7	31.5	31.7	- 2.5	0.2
less Imports of goods and services	-34.1	-35.6	-36.8	-42.5	3.9	4.9
GDP (including North Sea)	112.3	108.5	105.4	101.3	- 3.1	- 1.3
Real national income	114.5	113.1	110.9	109.4	- 1.6	- 0.5
Domestic trading income including stock appreciation	19.6	17.0	14.4	10.4	-14.2	-10.3
(millions)						
Employment	22.7	22.2	21.8	20.8	- 2.1	- 1.5
Unemployment	1.6	2.6	3.2	4.3	..	..
(% increase over previous year)						
Money wage settlements	17.3	10.8	13.3	8.9	12.0	9.7
Consumer prices	15.0	13.7	11.3	8.7	12.5	9.2
(£1975 per week)						
Average take-home pay	45.4	44.9	45.0	49.7	- 0.4	3.3
(£ billion at current prices)						
Balance of payments on current account	2.3	1.7	0.6	- 9.0	..	..
Public sector borrowing requirement	12.3	10.4	12.3	22.6	..	..
(Index, 1975 = 100)						
Weighted exchange rate	96.4	98.0	98.0	98.0	0.8	0.0

The starting point of the assessment is that exports are bound to fall this year because of the high exchange rate in the past two years and because of recession in other countries. If the exchange rate continues to hold up, the extreme cost disadvantages facing UK industries imply that non-oil exports will stagnate for years to come. At the same time import penetration of domestic markets is bound to continue, with the volume of imports rising once the peak of destocking is past. The strong deflationary impulse coming from a worsening foreign trade performance, combined with the government's deflationary fiscal policy, implies a continuing fall in domestic output and continuously rising unemployment. The volume of GDP may fall by about 6% between 1980 and 1982 with the officially registered total of wholly unemployed (excluding school leavers) rising to a level in excess of 3 millions.

The fall in national income this year and next will be less than the fall in output thanks to terms of trade gains arising from world recession and the strength of sterling. But these factors will not alleviate the squeeze on domestic profits. As before, personal income and consumption spending will be comparatively protected while investment falls.

The decline in output is unlikely to be reversed, except momentarily, by such factors as an end to destocking or a fall in private savings (induced, for example, by a 'real balance' effect) on which commentators sometimes rely. The combined contribution of these short-run factors to

aggregate real demand, allowing for the import content, could add about 1½% to GDP and the gain will not come all at once. Their effect will be to slow the rate of contraction by ½% or 1% over a period of two or three years.

Low import prices and depressed wage settlements are certainly now helping to reduce inflation of consumer prices. But the government is pushing up consumer prices by raising taxes and withdrawing subsidies and we doubt that the real value of wage settlements will fall indefinitely. Therefore the rate of inflation, comparing the average price level year by year, will only gradually come down.

Surely, at least, with growing tax revenues from the North Sea, the government will next year be in a position to reduce the burden of taxation? Our estimates, set out in Table 1.9, imply no such thing. North Sea revenues seem large enough when projected at current prices. But they are small compared with total government expenditure and revenue. With rising unemployment, our estimate is that they will be entirely swallowed up by the mounting cost of social security. So far from there being anything for the government to give away, by next year the fall in the tax base and the rising cost of social security are likely to be pushing up the government's borrowing requirement once again. The balance of payments will be moving from surplus to deficit as destocking comes to an end and import penetration continues. Logically, we should assume another deflationary budget designed to hold public sector

Table 1.9 Fiscal prospects after the budget

	1980	1981	1982	1983	1984
	(£1975 billion)				
North Sea tax revenue	1.6	2.9	2.9	3.2	3.4
Direct taxes	22.1	22.8	22.9	22.9	22.9
Indirect taxes less subsidies	16.7	17.2	17.3	17.4	17.3
Other income	6.4	6.1	5.7	5.4	5.2
Total income	46.8	48.9	48.8	48.7	48.7
Expenditure on goods and services	31.7	31.4	31.5	32.5	33.3
Social security	12.1	13.3	14.1	14.4	14.4
Other grants	3.5	3.3	3.3	3.2	3.2
Debt interest	6.0	5.7	5.1	4.7	4.5
Public sector borrowing requirement	6.5	4.8	5.1	7.9	6.7
(£ billion)					
Borrowing requirement at current prices	12.3	10.4	12.3	15.9	19.9
North Sea tax revenue at current prices	3.0	6.2	7.0	8.6	9.9

borrowing down — and yet another one the year after, and so on. If we do make such an assumption, we can safely suppose that the balance of payments will be kept in surplus by ever-deepening internal recession. Unless interest rates are cut drastically, there is then no particular reason why the exchange rate should ever fall significantly. But GDP would contract continuously, unemployment would climb to 4 or 5 millions in three or four years time, profits would fall to zero and even private consumption would be on a firm downward trend. Public expenditure, including social security benefits, would have to be cut drastically. Even so, taxes on those still at work would rise steadily. In such extreme circumstances anything could happen to inflation. Money wage increases might be ground out of the system altogether by the fear of unemployment and the bankruptcy of employers. Or trade unions might make last-ditch stands in an attempt to prevent the collapse of real wages, causing inflation to accelerate.

The scenario of repeated budgets similar to the one this year, aimed at achieving the impossible target of a falling public sector borrowing requirement which the government has set itself, seems highly implausible. The course to which the government still firmly commits itself appears to be running into a political and economic impasse. But, how sensitive are the qualitative conclusions to quantitative uncertainties?

Suppose, for example, that the exchange rate for sterling in fact declines, as it well may when investors come to appreciate the full extent of the government's difficulties. A steady depreciation of the exchange rate by 5-10% a year would certainly help after a year or two to secure some modest growth of exports and reduce the rate of import penetration of home markets. But it would also raise import prices and reduce the squeeze on wage settlements in industry. Price inflation would very likely continue in double figures and improvement in the competitive position of industry would then be small. We would still expect GDP to fall sharply this year and next without any subsequent recovery. Unemployment would still be 3 millions and rising. The balance of payments would still go into deficit, though not perhaps for two or three years. And the public sector borrowing requirement would still start rising again unless there were further tax increases or spending cuts.

Much the same applies if industry starts to perform better in export markets or in resisting import penetration (although in this case there would be much less feedback into inflation). For example, a 2% a year addition to the growth of exports (by comparison with our central projection) would be quite insufficient to induce any recovery in GDP next year or later. Given the deflationary stance of government policy, unemployment would still quickly reach 3 million and continue to rise.

Finally, what if money wage settlements are

more powerfully and permanently depressed than we have assumed? The rate of inflation will come down more quickly and there will be a slower deterioration in the competitiveness of industry. But again, this cannot possibly be enough to reverse the decline in GDP, the remorseless rise in unemployment and the tendency for the public sector borrowing requirement to go up.

On the evidence of a range of quantitative projections only a miracle or a major shift of government policy can now rescue Britain from ever-deepening slump.

1.6 How far is the 1981 budget to blame?

Many commentators supposed until shortly before the budget that the government was in the process of relaxing its policies. Hints had been given by the Prime Minister and the Bank of England that a fall in the exchange rate would be welcome. Government Ministers had indicated that public spending must rise in response to special needs caused by the recession. It may be tempting to suppose, therefore, that the 1981 budget was an unfortunate mistake and that the prospects would have been much better if the government had followed these hints through.

What would the prospects have been without a tough budget? We must note, first, that some measures were already in the pipeline, such as the additional tax on North Sea profits, the rise in national insurance contributions, and reductions in various subsidies. On the other hand, it is reasonable to assume that tax allowances and tax rates in general could have been adjusted in line with inflation. Most important of all, the exchange rate had started to fall quite rapidly and might well have gone on falling by 5-10% per year in future.

But although the fall in the exchange rate would have helped exports and fiscal policy would have been less deflationary, the prospect overall would still be dreadful. The cost position of industry in overseas markets would have remained 15-20% worse than it was in the 1970s, implying a continuously poor export performance. It is doubtful whether there would have been any recovery in GDP.

Most important of all, without the tax increases announced in the budget, the balance of payments would have been likely to go into deficit next year. This could easily have led to more rapid depreciation of the exchange rate. Inflation would probably have started to accelerate.

Reflation

Many of the government's critics, far from suggesting that the budget should have been neutral, would have liked to see a major act of fiscal reflation designed to bring the slump to an end. These critics have been denounced by the Prime Minister on the grounds that they are unwilling to contemplate the tax increases needed

to finance the public spending they desire. This charge misses the mark because people who advocate reflation believe a large increase in the public sector's financial deficit is necessary to reverse the recessionary trend. The real obstacle, in our view, is quite a different one. Any major reflation implies a huge balance of payments deficit and/or an utter collapse of sterling, unless it is accompanied by exchange controls and import controls.

To illustrate the scale of the problem, suppose that the objective is merely to stabilise officially registered unemployment at 2½ millions and that the 'desired' or acceptable rate of depreciation of sterling (assuming it can be controlled) is in the range of 5-10% per year. To stop the rise in unemployment the downward momentum of output would have to be halted quickly and GDP would have to start growing again by approaching 3% a year. To procure such a recovery in the face of the present decline of exports, a huge stimulus

would have to be given to domestic spending and imports would rise rapidly.

Just how fast would imports rise? During the last period of expansion between 1976 and 1979 when GDP grew by just over 2% a year, total non-oil imports rose by an average of 4% a year in real terms. But the cost of imports was being held down by terms of trade gains as sterling appreciated, import penetration was presumably being retarded by the lagged effects of a very low exchange rate, and imports of equipment for the North Sea were falling*. This time a reflation designed to get GDP growing again at 3% per year would entail a more rapid increase in the total import bill. Industry is now much less competitive and we could not expect further terms of trade gains. As destocking is reversed imports of materials will quickly pick up from their present depressed level. On past

*There was also a large saving on tanker services as Britain became self-sufficient in oil.

Table 1.10 The risks of reflation

	1980	1982	1985	Growth rates 1980-82 1982-85 (% per year)	
<i>Demand and output</i> (£ billion at 1975 market prices)					
Domestic expenditure	113.4	119.4	132.1	2.6	3.4
Exports of goods and services	33.1	32.4	36.5	-1.1	4.0
less Imports of goods and services	-34.1	-38.5	-45.5	6.2	5.8
GDP (including North Sea)	112.3	113.4	123.1	0.5	2.8
<i>Balance of payments</i> (£ billion, 1975 export purchasing power)					
Non-fuel exports	30.9	29.8	33.6	-1.8	4.1
less Non-fuel imports	-28.0	-32.6	-40.3	7.9	7.3
plus Net export of fuels	- 0.2	1.4	1.5	..	..
Balance on goods and services	2.7	- 1.4	- 5.2	..	..
plus Net income from abroad	- 1.5	- 1.3	- 3.4	..	..
Balance on current account	1.2	- 2.6	- 8.6	..	..
less Net direct investment and long-term capital outflow ^a	- 1.6	- 2.0	0.9	..	..
Balance for private and official financing	- 0.4	- 4.6	- 7.5	..	..

^a Includes 'oil and miscellaneous' private capital transactions.

relationships total non-oil imports would rise by 7-8% per year. In practice after the wave of factory closures, the outcome might be even worse.

Our estimates for the balance of payments are given in Table 1.10 at 1975 prices. At current prices, the deficit on current account would come to around £5 billion next year and £10 billion the year after. Allowing for long-term capital and direct investment abroad, the financial deficit on the balance of payments would be something like £10 billion next year and £15 billion in 1983. To keep reflation going the public sector borrowing requirement would have to reach some £20 billion next year and nearly £30 billion the year after. This sort of thing (scaled for inflation) has happened before — in 1973. It was only sustained then by huge and temporary inflows of OPEC money, and it could not be kept going for long.

This time round, it seems unlikely that the reflation could last even for a year without provoking a sterling crisis.

Devaluation

If a plunge into large-scale reflation is too risky, what about a policy designed to secure an accelerated fall in sterling accompanied by reflation on a more modest scale? This would certainly help to slow the rise in unemployment. But if the targets were at all ambitious there would soon be a build-up of inflationary pressures.

The example illustrated in Table 1.11 sets out with the objective of getting industrial costs vis-à-vis overseas competitors back to what they were in the 1970s by 1984. Allowing for inflation feedbacks, this appears to require depreciation of

Table 1.11 The risks of sustained devaluation

	1980	1982	1985	Growth rates	
				1980-82	1982-85
	(% per year)				
(£ billion at 1975 market prices)					
Domestic expenditure	113.4	112.3	117.5	- 0.5	1.5
Exports of goods and services	33.1	33.5	39.6	0.5	5.8
less Imports of goods and services	-34.1	-35.6	-39.8	2.1	3.8
GDP (including North Sea)	112.3	110.2	117.3	- 0.9	2.1
Real national income	114.5	112.1	116.6	- 1.1	1.3
Domestic trading income (including stock appreciation)	19.6	17.0	17.3	- 6.9	0.6
(millions)					
Employment	22.7	22.2	21.9	- 1.3	- 0.4
Unemployment	1.6	2.8	3.1	..	..
(% increase over previous year)					
Import prices	9.6	20.3	23.2	16.9	24.9
Money wage settlements	17.3	18.3	22.4	16.0	21.7
Consumer prices	15.0	17.2	22.7	17.2	21.6
(£1975 per week)					
Average take-home pay	45.4	46.2	51.8	0.8	3.9
(£ billion at current prices)					
Balance of payments on current account	2.3	- 0.7	- 4.1	..	..
Public sector borrowing requirement	12.3	17.9	45.6	..	..
(Index, 1975 = 100)					
Weighted exchange rate	96.4	75.2	46.2	-11.7	-15.0

the exchange rate by some 15% per year, rather faster than the downward 'float' after June 1972 which ended with a collapse of confidence in 1976.

Supposing sustained depreciation at such a rate to be feasible, and assuming that world trade recovers from its present recession, the growth of exports could be expected to pick up again, with some lag, to something like the historical rate of 6% per year. Judging fiscal reflation so as to keep the balance of payments in modest deficit, domestic expenditure and GDP could rise by 1½-2% per year after this year. Import prices would be rising by 20% per year or more and there would be a loss on the terms of trade. We see no reason why money wage settlements should not pick up again as the present extreme competitive pressure on industry was lifted by the fall in the exchange rate. With import prices feeding into the cost of living, we would expect inflation to be back up to 20% within two years.

Some people regard incomes policy as a mechanism by which the benefits of a devaluation of sterling could be realised without the need for an acceleration of inflation. It could certainly suppress inflationary pressures in the short run which, in the circumstances, might well be a good thing. But it will not remove the strains which generate inflationary pressures, nor will it make devaluation more effective unless it bites deeply into real wages.

Inflation, incomes policy or both might be acceptable if sustained and rapid depreciation of sterling were capable of inducing a major recovery of output and employment. Our estimate is, however, that with the exchange rate down to less than half its present level by 1985, there would still be a chronic 3 million level of unemployment.

Conclusion

The government's strategy, confirmed in the budget, appears to be running into an impasse where, as the tax base is destroyed, an increasingly drastic and ultimately impossible degree of fiscal severity would be required to meet the government's own financial targets. Reflation without major and sustained devaluation of sterling is impossible. Devaluation, the only orthodox policy which has any plausibility at all, is unlikely to halt the rise in unemployment this side of three million and will stoke up inflationary pressures even in the midst of recession. Within the range of what could conceivably be described as conventional policies, there is no longer any strategy left which could now rescue the economy from the appalling condition to which it has been brought by the policies followed since North Sea oil came on stream.