

# Chapter 3

## Prospects for management of the UK economy

This chapter examines prospects for the British economy over the next decade in the light of developments in the EEC and the rest of the world.

The main conclusions are as follows. The recession in Britain will deepen steadily during the 1980s with continued high rates of inflation, unless radically new policies are introduced. Fiscal and monetary restriction aimed at reducing inflation, whether directly or by holding up the exchange rate, will not only deepen recession and increase unemployment immediately, but will even make inflation worse in the longer term. While some form of incomes policy is desirable, it is a relatively weak policy instrument and one which can easily have perverse results. The prospect for reduced inflation in the long term depends on growth of output and real income. Growth will be constrained by the balance of payments, unless this constraint is removed either by devaluation or by control of imports. The scale of devaluation required for this purpose is now so large that it would be extremely inflationary and therefore could not in practice be sustained for very long. Control of imports operated in a non-discriminatory way, combined with fiscal expansion, could lift Britain out of recession without harming other countries and without damage to our own industrial efficiency. It remains the only practical method we can see for reducing unemployment and inflation in the long run.

### Outline of analysis

The first section analyses the recent past. The second

section presents a medium-term base projection designed to provide estimates of the scale of problems which must be faced. The third section considers methods for dealing with inflation. The fourth section considers prospects for economic growth in the UK and examines measures to bring about the expansion of output required to reduce unemployment from its present level. Finally the background analysis underlying the policy discussion is set out in more detail.

### The lessons of the recent past

*Trade performance:* Ever since 1972, successive medium-term assessments of the UK economy published by the CEPG have drawn attention to strongly adverse long-term trends in the UK's performance in industrial trade; there has been a rapidly rising penetration of the home market by imported manufactures and an almost continuous reduction in the share of world trade taken by UK exports. It has been repeatedly emphasised in past *Reviews* that, unless measures were introduced to correct these trends, balance of payments constraints would necessitate restraint on domestic expansion and cause a high level of unemployment. Corrective action has not been taken and in the last two years the trends in industrial trade have deteriorated faster than before.

As Table 3.1 shows, the volume of imports of manufactures has risen in the last two years at about 9.16% per annum, whereas exports have risen only by 3½-6½% and domestic production only 1.1½%.

**Table 3.1 Exports, imports and domestic production of manufactures**

	(% change in volume over the previous year)	
	1977	1978
Exports <sup>a</sup>	6.5	3.5
Imports <sup>a</sup>	9.1	16.0
Production	1.4	0.8

<sup>a</sup> Excluding erratic items, i.e. ships, North Sea production installations, aircraft and precious stones.

This basic predicament of the UK has, however, been partly obscured by three factors. First, the worldwide recession since 1974 made it appear as if the UK were merely suffering from depressed world trade, which also affected every other country. But the loss of output has been more pronounced in the UK than in most other developed countries: by 1977, for example, manufacturing production in the UK was only 5% higher than in 1970, whereas in OECD countries as a whole production was up 26%. Second, the build-up of North Sea oil production since 1976 has made a major contribution to the UK's trade balance. Third, the UK has experienced a significant improvement in the terms of trade, especially in 1978, largely because world prices of raw materials have fallen back in absolute terms to levels lower than obtained in 1974, enabling UK imports of raw materials to be financed by a lower volume of manufactured exports.

*Inflation:* The government's incomes policy has been breaking down and a resurgence of inflation, bringing the rate back into double figures, is now likely. We do not conclude that governments should give up the attempt to have incomes policies, and regard the view that monetary restraint is necessary or sufficient as a policy for reducing inflation as very dangerously mistaken. There is no indication that control over the money supply has contributed to the fall in inflation in the recent past. The money supply has grown fairly steadily at around 10% a year since 1973, while the annual rate of inflation has varied between 8% and 25% and the velocity of circulation has risen by over a third.

The important lessons to be learned about incomes policy from recent experience concern its limitations and the manner in which it should be used. There seem to be two things that have gone wrong. The government, expecting too much from incomes policy, has attempted for too long to keep the real value of wage settlements below what appears to be the normal negotiating target. The present position, illustrated in Fig. 1, is that, even if we postulate an increase in money wage rates of 13% between 1978 and 1979, the real post tax value of basic rates at the moment of settlement will still be lower than it was, on average, between 1972 and 1976. The government's second mistake has been to operate the policy over a period of several years with differential severity between important groups of workers, particularly those employed in the public sector itself, ultimately provoking very determined resistance by those who feel they have been treated unfairly.

Another important lesson of recent experience concerns pricing behaviour. Despite the recession, there has been no sign of any change in pricing for the home market; the level of prices appears to be totally unaffected by demand, given wages and material costs. Firms have continued to set prices by applying a fairly constant mark-up to costs at 'normal' rather than actual capacity working, although 'actual' has now been far below 'normal' for many years. The decline in profits as a share of output is explained by firms operating far below normal capacity and thereby incurring above-normal costs per unit of output. There has been no discernible

tendency for producers either to revise their notion of what constitutes normal capacity working or to reduce mark-ups in the face of the low pressure of demand, or to increase mark-ups in order to restore the share of profits in output.

*Productive potential:* Recent movements of productivity and unemployment present serious problems of interpretation. In 1978 output per head failed to increase by as much as would have been expected given the relatively rapid rate of output growth. The scale of job creation schemes is not sufficient to explain this, leaving the possibility that either the underlying trend growth of productivity has slowed down significantly or the adverse effects on productivity of the recession itself have been more pronounced than those experienced during past cyclical downturns. On the information available there is really no way of deciding between these two alternative explanations, which have different implications for the future growth of productive potential. Although it is plausible that employers have responded differently to a prolonged recession than to previous temporary downturns in activity, nevertheless the possibility of a slowdown in trend productivity and hence in the future growth of productive potential cannot be discounted.

A further uncertainty concerns the labour supply, which after increasing at an average rate of 1% a year between 1973 and 1977, largely as a result of a rise in the participation of married women, hardly rose at all in 1978, contrary to most forecasts (including our own). This may signal a slower trend rise in activity rates in future, although it may also be due to the continuing depressed state of the labour market.

### The scale of future problems

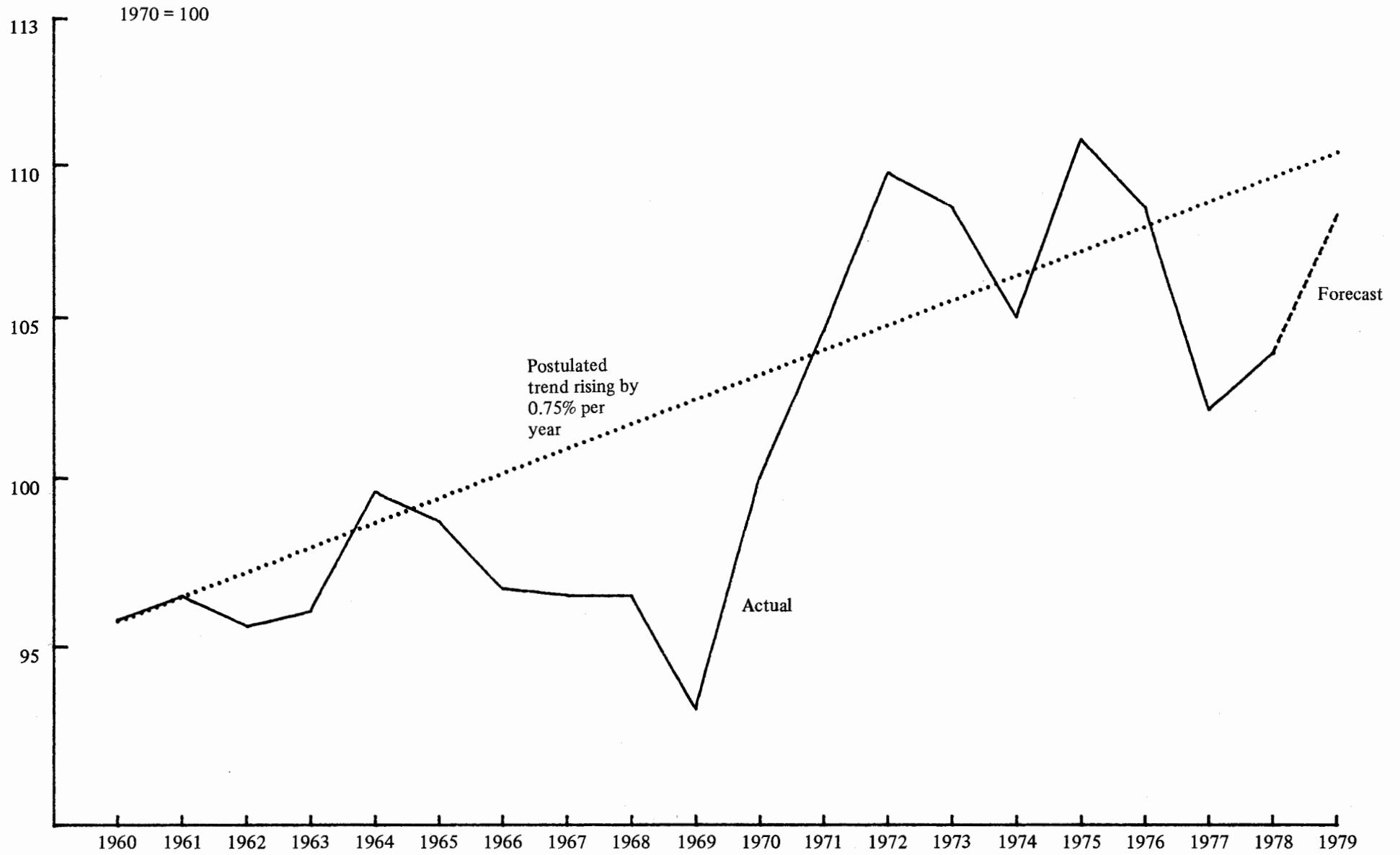
In order to measure the scale of problems that are likely to arise in the future and to identify when they can be expected to become most acute, a base projection has been derived from our model of the UK economy for the years up to 1990. In the present confused state of affairs there is no clear set of assumptions which can be called neutral, or considered to represent in any meaningful sense the continuation of existing policies. Policy constraints in our base projection are restricted to:

- (i) the continuous achievement of a zero basic balance on external account;
- (ii) maintenance of the cost competitiveness of UK producers at its average 1978 level.

These constraints are assumed to be met by adjustment of fiscal policy through changes in personal income tax allowances and taxes on consumers' expenditure and by adjustment of the exchange rate. Public expenditure plans published in the January 1979 White Paper are assumed to be realised up to 1981 and from then on are revised in line with growth of national income.

The projection assumes that no new measures are taken to correct adverse trends in trade performance, and that no new form of pay restraint is enforced. The latter hypothesis is represented in the model by allowing the real post tax target for basic wage rates at the time of settlement to rise by 1981 back to the

Fig. 1 Average real post-tax wage rates at settlement



**Table 3.2 Base projection of UK problems in the 1980s**

	Historical outcome		Projected outcome		
	1964-73	1973-78	1978-80	1980-85	1985-90
Growth of GDP at factor cost (% p.a.)	2.8	1.0	2.2	0.5	0.1
Unemployment in end-year (millions)	0.6	1.4	1.5	2.7	3.7
Growth of consumers' expenditure (% p.a.)	2.6	0.1	3.3	1.1	0.8
Growth of average real earnings after tax (% p.a.)	2.3	0.3	3.8	2.1	2.1
Average annual increase <sup>a</sup> in consumer prices (%)	5.7	15.6	10.1	15.9	19.0
Exchange rate in end-year (Dec 1971 = 100)	86	63	57	37	21

Note: Series in this table and in those which follow are defined more fully in Appendix B.

<sup>a</sup> Adjusted to *Blue Book* basis.

past trend indicated in Fig. 1 and to remain on that trend throughout the projection period.

The main assumptions about world conditions are (i) growth of world trade at the same rate as in the past three years;

(ii) constant world prices of food and raw materials relative to prices of manufactures and an increase of 3% a year in the relative price of oil.

The main result shown in Table 3.2 is that, under the above conditions and despite large projected benefits from North Sea oil, growth of the economy will have to be restrained continuously throughout the 1980s in order to meet balance of payments constraints. GDP growth would average less than 1% a year. Extrapolation of past trends and relationships governing productivity and employment would imply registered unemployment rising to over 2½ million by 1985 and 3½ million by 1990. However, in a recession as deep as this, past trends and relationships would more probably break down. Various forms of hidden unemployment (including early retirement) would make official figures increasingly unrepresentative and unemployment would be kept down to some extent by emigration of those seeking work in other countries.

The other main result under base assumptions described above is that inflation would accelerate to over 15% per annum by 1981 and would remain in the 15-20% range through the decade. Real earnings of those still in work would rise steadily at much the same rate as in the 1960s; it is this increase in real earnings which on normal wage-bargaining assumptions would stabilise inflation, albeit at a high rate. Growth of real earnings for those in work will be assisted by North Sea revenues; but in circumstances of low GDP growth it would also be at the expense of profits and investment and the living standards of a growing number of unemployed. Indeed, average real earnings would be rising twice as fast as total real

consumption.

The base projection described here is artificial, in the sense that measures will presumably be taken to prevent such long-term results from materialising. It indicates that the two main problems of the last decade — inflation and stagnation — are becoming increasingly severe. At present discussion in Britain is concentrated mainly on how to deal with inflation. There is a common view that inflation must be cured before policies to stimulate economic growth can safely be adopted, or even that faster economic growth will be an almost automatic consequence of success in reducing inflation. Neither proposition really stands up to analysis. Inflationary problems can in the long run be reduced, not increased, by policies which achieve faster economic growth, as will be shown below. On the other hand, lower inflation will not of itself accelerate GDP growth at all. In a variant of the base projection discussed above, assuming an imposed 10% a year growth of money wage rates to prevent double-figure price inflation, there is no significant benefit to GDP growth or unemployment at all.

Since inflation is so widely thought to be the main obstacle to economic growth, policies to deal with it will be discussed first. We can then proceed to examine policies to deal with adverse trends in the UK's industrial trade, which are in the long run the main obstacle both to economic growth and to any permanent reduction in the rate of inflation.

#### Counter-inflation policies

There are many distinct views in Britain about how the government can best deal with inflation.

The pure monetarist view that control of the money supply is a reliable instrument has now been largely discredited, as a result of recent experience mentioned above; despite several years of strict

control of the money supply in Britain, inflation is now visibly accelerating. Another view which has been weakened by recent events is the supposition that incomes policy can be effective in the long term. Incomes policy may influence, but cannot for long over-ride, normal wage-bargaining processes. A third, still less credible, view is that, through changes in trade union organisation and bargaining procedures, wage determination in Britain can be made to conform more closely with the theoretical model of a labour market where wages contribute to inflation only when there is overfull employment.

The views which require more thorough analysis are, on the one hand, the prescription in favour of a high exchange rate for sterling and, on the other hand, prescriptions in favour of rapid economic growth.

### The high exchange rate prescription

For any given relativity between domestic and foreign prices, the government can maintain a higher exchange rate for sterling by fiscal restriction, which deflates internal demand and reduces imports, and by monetary restriction, which raises interest rates and attracts capital inflows. A higher sterling exchange rate reduces the sterling cost of imported inputs and reduces prices of foreign producers, measured in sterling, whose competition in home and overseas markets may influence prices charged by domestic producers. This complex of relationships means that fiscal and monetary restriction designed to maintain a high exchange rate can reduce inflation, but at the cost of output and jobs.

Thus the maintenance of a high exchange rate adversely affects the cost competitiveness of UK producers *vis-à-vis* foreign suppliers and therefore reduces net exports. Further fiscal tightening, in the form of either public expenditure cuts or increases in tax rates, is then required to restrain the growth of GDP so as to satisfy the balance of payments constraint. To the extent that taxes are increased to keep the exchange rate high, these contribute directly to inflation and the scale of revaluation has to increase further in order to compensate for this. Public expenditure cuts can for a time reduce the amount by which taxes need to be raised and can protect real wages in some degree from the effects of low output growth. However, even if it is assumed that public

expenditure on goods and services is reduced by 10% by 1982 in relation to the latest government expenditure plans, this is not sufficient to prevent deepening recession, which increases inflationary pressure, so necessitating further revaluation and fiscal restriction. Indeed, unless higher unemployment reduces the growth of money wages, it would only be possible to maintain any initial benefit to inflation by deflation which caused the exchange rate to appreciate and output to fall below productive potential at accelerating rates. Even as early as 1982 the cost of keeping inflation in single figures by means of this policy would by our reckoning require output to be 5½% less and unemployment half a million higher than in the base projection (see Table 3.3).

Attention is sometimes drawn to the strong exchange rates and low inflation rates of European countries like Germany. This is misleading for the UK. Quite apart from the point that not all currencies can be revalued against each other, it is necessary to recognise that a country can only derive long-run benefits from a high exchange rate if it has a permanently strong balance of trade, which the UK so evidently lacks.

The consequences indicated in Table 3.3 are clearly not those that advocates of such a policy envisage. In their view, costs of production would gradually be reduced below those in other countries, so improving UK trade performance. But for this to occur, it has to be assumed either that some higher level of unemployment would dampen inflation (in which case unemployment might have to be held permanently at that higher level) or, against the evidence of what is now happening in the UK, that inflation of domestic prices and wages will fall in the short term by a large amount in response to the high exchange rate.

### The real income growth prescription

Expansion of the real national income which enables the real objectives of wage bargaining to be more nearly satisfied seems to represent the best chance of bringing inflation under control. In our view it is only in the context of growth that incomes policy has any chance of survival, because only in this context can it form part of a realistic political bargain.

Table 3.3 Effects of using exchange rate appreciation to control inflation

(Projected outcome in 1982)

	Base projection	Exchange rate appreciation	% difference
Consumer price inflation (% change over previous year)	16.0	9.1	- 6.9
Cost competitiveness (1978 = 100)	100	124.4	+24.4
Exports of goods and services (1978 = 100)	121.7	112.5	- 7.6
GDP (1978 = 100)	105.6	100.0	- 5.6
Unemployment (millions)	1.9	2.4	

**Table 3.4 Effects of fast GDP growth on inflation**

(Comparisons with base projection assuming a strategy of import controls)

	1980	1982	1985
Effect on GDP (%)	+2.9	+9.1	+22.1
Effect on unemployment (millions)	-0.1	-0.6	- 1.6
Effect on consumer price inflation (% p.a.)	-1.2	-3.7	- 8.8

It is more likely that people will agree to moderate claims for money wages when their real incomes are rising than under some general threat of punitive unemployment.

Table 3.4 shows projected effects on inflation of a fast growth strategy compared with our base projection, assuming the same real wage bargaining objectives in both cases. The reduction in inflation achieved by fast growth, although gradual, is a cumulative process. The result will not be believed by those who assume that wage bargaining targets are very sensitive to the level of unemployment. But the evidence of the 1970s is against such an assumption since the trend of real wage targets, shown earlier in Fig. 1, has been much the same in this period of high and rising unemployment as it was previously.

The effect of faster economic growth on inflation will depend in part on how growth is achieved. The 9% reduction in inflation by 1985 (compared with what would otherwise have happened), shown in Table 3.4, derives from an assumption that growth is sustained by import controls. A similar, if smaller, benefit could be achieved by growth made possible through a radical change in EEC transfers (considered in Chapter 2) or by any other windfall such as, for example, large new oil developments offshore. But the effects on inflation would be very different if growth were achieved by devaluation, because this has immediate adverse effects, precisely the opposite of short-run benefits from a high exchange rate, which were discussed above.

To achieve by devaluation additional growth of GDP comparable with that assumed in Table 3.4 would require a very large improvement in the cost competitiveness of UK producers, if this were the only measure used to alleviate the balance of pay-

ments constraint. With the exchange rate falling rapidly to secure improved cost competitiveness as assumed in Table 3.5, inflation would be significantly and continuously worse than under the base projection. A reduction in inflation could be achieved by abandoning the policy after some years and giving up growth objectives beyond that point. In this sense devaluation could yield some long-term reduction in inflation at the expense of faster inflation in the short term. When inflationary problems are already pressing in the short term, growth via devaluation must evidently be excluded as a policy for dealing with inflation.

Our conclusion is that inflation can only be reduced by a growth strategy which does not rely on devaluation. Fiscal and monetary restriction designed to maintain a high exchange rate would soon lead to an impasse. Incomes policy, if operated with care, may help to a small extent. The important question is how growth can be achieved.

#### Policies for economic growth

The analysis in Chapters 1 and 2 has drawn attention to problems of recovery from world recession and to EEC policies which affect the prospects for growth in the UK. If, as seems likely, world trade continues to grow rather slowly and EEC policies are not fundamentally changed, then our base projection indicates that growth in the UK will be severely constrained by the balance of payments. The volume of exports will rise only about 4% a year after 1980 (see Table 3.6), and with a rising import propensity continuous deflation with very little GDP growth will be necessary if balance of payments deficits are to be avoided.

**Table 3.5 Effects of devaluation on inflation**

(Comparisons with base projection)

	1980	1982	1985
Effect on GDP (%)	+1.9	+ 6.4	+17.2
Effect on unemployment (millions)	-0.1	- 0.4	- 1.2
Effect on consumer price inflation (% p.a.)	+1.4	+ 2.6	+ 2.3
Effect on cost competitiveness (%)	-7.8	-15.1	-24.8

Table 3.6 Growth of GDP and growth of world trade

	(% per year)		
	1978-80	1980-85	1985-90
<b>Base projection<sup>a</sup></b>			
Exports of goods and services	5.8	4.1	3.8
Imports of goods and services	5.4	4.4	4.3
GDP	2.2	0.5	0.1
<b>Fast growth of world trade<sup>b</sup></b>			
Exports of goods and services	7.2	5.5	5.2
Imports of goods and services	7.1	6.2	6.1
GDP	2.9	1.4	0.9

Note: GDP growth is determined in each case by the need to meet balance of payments targets under the assumption of constant international competitiveness.

<sup>a</sup> See Appendix B.

<sup>b</sup> Growth at 2% a year faster than base assumptions.

The UK would certainly benefit from policies on the part of other countries which stimulate faster growth of world trade. If the volume of world trade in general grew at the same rate as in the 1960s, the UK could expand GDP by about 1½% a year; in particular, the more other EEC countries expand, the better the prospect for the UK. The benefits to the UK of faster world expansion would be diminished by a small amount if this caused world prices of imported raw materials to rise faster; but self-sufficiency in oil will effectively insulate the UK economy in the 1980s from the effects of rising world oil prices.

The prospect for growth may conceivably be improved further by reform of the system of EEC transfers. The estimate, discussed in Chapter 2, of a possible 6% benefit to the level of UK national income assumed, not merely the elimination of net cash payments to the rest of the EEC by the UK, but a complete reversal of the present situation, in which the UK would become a large net beneficiary of the EEC transfer system. On the extreme assumption that such a change is made within a few years, combined with fast growth of world trade, the UK's growth rate could average nearly 3% a year up to 1985. Thereafter, with no new additional external benefits, growth would still be as low as 1% a year.

Thus in the UK's case no international solution can be conceived which would permit an adequate growth rate in the next decade.

If deepening recession in the 1980s is to be avoided in the UK, the UK must pursue expansionary policies of its own and such action must of necessity be combined with measures to alleviate the balance of payments constraint on growth.

#### Devaluation

To many economists, exchange rate depreciation represents the conventional means of correcting a

fundamental balance of payments constraint. In present-day foreign exchange markets devaluation is hard to control. Ideally, judicious sales of sterling combined with moderately expansionary fiscal and monetary policy will nudge the exchange rate down gently. But there is no guarantee that a devaluation initiated in this way will not go much too fast or too far. The sterling crisis in 1976 illustrates just how difficult it can be to control a devaluation in practice.

With slow growth of world trade, we estimate that to sustain growth of GDP sufficient to hold unemployment roughly constant through the 1980s at about its present level would require a continued improvement in UK cost competitiveness of about 4% a year from now onwards. To achieve this by means of devaluation the exchange rate would have to fall rapidly and the rate of inflation would rise to around 20% a year within two or three years. The exchange rate for sterling would probably have to decline to around 1/3 of its present level by 1985. Even if one assumes that pay settlements are held down to 10% a year, regardless of price inflation, the exchange rate would probably still need to fall to about half its present level.

The scale of the devaluation required and its inflationary effects are therefore such as to rule it out as a practicable policy.

#### Import controls

The only other means of alleviating the balance of payments constraint on growth is by imposing restrictions on imports. Whether this were done by means of tariffs or quotas, it would be contrary to EEC rules. But, given the scale of UK problems outlined earlier, the case for import controls is strong enough to justify considering whether the rules should if necessary be broken.

Although the imposition of tariffs would increase the domestic price of imports, it would also provide

the revenue to finance a reduction in tax rates; there would be no direct effect on inflation overall. The main indirect effect of import controls on inflation would be to raise real incomes and earnings, thereby reducing money wage settlements. It is not likely, given the rigid pricing behaviour of UK producers noted earlier, that reduced competition from imported manufactures would provoke a significant general rise in price mark-ups on home products. Nor, as we have stressed, is it plausible that faster growth of home output would in itself substantially increase real wage bargaining targets. None of this implies that inflation will necessarily fall under an import control strategy, but only that growth made possible by import restrictions is likely to make inflation less of a problem than it otherwise would have been.

To indicate the scale of restrictions which might be required, growth of output at 4% a year, which would reduce unemployment by around 200,000 by 1985, would tend to be associated, on past relationships and in the absence of restrictions, with an increase in non-fuel imports of 9½% per year. This compares with a likely permissible increase of 4 to 5% a year. To hold non-fuel imports down to this growth rate, it would be necessary and sufficient to hold the share of manufactures in total imports roughly constant, as opposed to allowing it to rise fast, as in the past.

So long as import controls are not used to bring about a balance of payments surplus, total imports need be no lower than under the alternative policy of deflation. There is no reason why other countries should be any worse off. The case already demonstrated in Chapter 1 for US import restrictions holds equally for the UK.

The benefits of fast growth, summarised in Table 3.7, would provide a complete reversal of the dismal performance of the UK economy since 1973. Public and private expenditure could rise together. As real earnings improved, inflation could be reduced slowly but permanently. Unemployment would gradually fall.

By the standards of most other countries, even during the world recession, the performance implied by our projection is not impressive. But for the UK it would be a great improvement. Conceivably, dynamic benefits in terms of productivity might

allow UK performance to improve more. This is indeed to be hoped, because with gradual exhaustion of its oil reserves the UK may have to contend with still more difficult problems in the 1990s.

### Background to the policy assessment

The remaining sections of this chapter set out the main elements of projections for the UK economy, with summary tables. They cover productive potential and unemployment, the balance of payments and North Sea oil, real income and its distribution, taxation and public expenditure, and inflation.

### Productive potential and unemployment

There is more than usual uncertainty about future growth of the labour force and about future growth of productivity, because the recession has confused recent trends. The labour force, after increasing over 1% a year between 1973 and 1977, appears to have suddenly stopped rising in 1978; output per head, even allowing for the recession, has since 1974 risen abnormally slowly. Our guess is that up to 1985 the labour supply will increase annually by 0.6% or 150,000 and thereafter by only 0.1% a year, because of low birth rates in the 1970s. Output per head is assumed to rise from now on by about 2½% a year if unemployment is constant. This implies that the 'constant-unemployment' rate of growth of output will be around 3% a year up to 1985. The full scope for output growth is much greater than this, if jobs can be provided for those at present out of work, and if expansion of employment enables various job-saving measures to be withdrawn.

Projections of GDP, output per head and employment are shown in Table 3.8. Under the target set for an import controls strategy, which is to reduce registered unemployment by 200,000 up to 1985 and by a further 300,000 up to 1990, GDP should grow at an average rate of 4% a year between now and 1985 and at 3% a year from then until 1990.

On the other hand the growth of GDP in the base projection, where no major action is taken to overcome balance of payments constraints, is so low as to imply an *increase* in registered unemployment

Table 3.7 Benefits of fast growth achieved with import restrictions

	Historical outcome	Projected outcome	
	1973-78	1978-85	1985-90
Growth of real national income (% per year)	0.3	3.9	2.8
Growth of public expenditure on goods and services (% per year)	0.3	2.0	2.3
Growth of consumers' expenditure (% per year)	0.1	4.8	3.5
Growth of average real earnings after tax (% per year)	0.3	3.8	2.7
Average annual increase in consumer prices (%)	15.6	10.3	7.1
End-year unemployment (millions)	1.4	1.2	0.9



**Table 3.8 Output, employment and unemployment**

	GDP	Output, excl. North Sea (average annual % changes)	Output per head <sup>a</sup>	Employment	Unemployment in final year (thousands)
<b>Historical</b>					
1964-73	2.8	2.8	2.9	-0.1	610
1973-78	1.0	0.6	0.6	0.0	1380
<b>Base projection</b>					
1978-80	2.2	1.3	1.0	0.3	1500
1980-85	0.5	0.4	1.1	-0.7	2720
1985-90	0.1	0.1	1.2	-1.1	3740
<b>Target for import controls strategy</b>					
1978-80	3.6	2.8	2.1	0.7	1380
1980-85	4.0	4.0	3.0	1.0	1150
1985-90	2.9	3.1	2.6	0.5	860

<sup>a</sup> Non-North Sea output divided by total employment.

to over 2½ million by 1985 and to over 3½ million by 1990.

Relatively modest employment targets have been set for the first years of the projection of a strategy based on import controls, because, although the labour supply is sufficient to permit a high growth rate by UK standards, production bottlenecks might arise if a high growth rate were attempted immediately following the past five years of virtual stagnation. Such bottlenecks would in the main be localised and temporary: they were evident in previous upturns,

but did not prevent the attainment of a high rate of GDP growth, at least for short periods. Sustained expansion would induce higher capital expenditure on production capacity, as well as additional training of labour, both of which have been cut back during the recession. But in the first few years, expansion of demand intended to raise domestic output continuously at the rate required to bring down unemployment might nevertheless encounter bottlenecks sufficient to cause some export diversion.

**Table 3.9 Balance of payments targets**

(£1975 billion)

	Basic balance	Long-term capital and trade credit	Balance on current account	Net property income and transfers	Balance on goods and services	of which North Sea net exports <sup>a</sup>
<b>Historical outcomes</b>						
1974	-3.9	0.6	-4.5	1.1	-5.6	-0.2
1975	-1.5	0.3	-1.9	0.2	-2.1	-0.6
1976	-1.7	-0.7	-1.0	0.4	-1.4	-0.2
1977	1.1	0.8	0.3	-0.6	0.9	1.0
1978	0.0	-0.1	0.1	-0.9	1.0	1.4
<b>Base projection targets</b>						
1979	0	0.0	0.0	-1.5	1.5	2.7
1980	0	-0.2	0.2	-2.0	2.2	3.9
1981-85 average	0	-0.6	0.6	-2.2	2.8	5.0
1986-90 average	0	-1.0	1.0	-2.4	3.4	5.6

<sup>a</sup> See Table 3.10.



Table 3.11 Growth rates of exports, imports and GDP<sup>a</sup>

(% per year)

	Volume of exports <sup>b</sup> excluding fuels	Total volume of exports <sup>b</sup>	Volume of imports of manufactures	Volume of imports <sup>b</sup> excluding fuels	Total volume of imports <sup>b</sup>	GDP
<b>Historical</b>						
1964-73	6.4	6.4	11.4	5.6	5.8	2.8
1973-77	4.6	4.8	4.4	1.3	-0.6	0.3
1977-78	1.4	2.3	15.1	7.3	6.2	3.6
<b>Base projection</b>						
1978-80	3.4	5.8	9.4	6.5	5.4	2.2
1980-85	3.9	4.1	6.7	4.8	4.4	0.5
1985-90	4.2	3.8	6.0	4.6	4.3	0.1

<sup>a</sup> Growth rates calculated from past and projected balance of payments accounts in Appendix B.

<sup>b</sup> Including services.

the same end. In the short term output growth will be protected by the build-up of North Sea production; it may be maintained at 2-3% a year in 1979 and 1980. Between 1980 and 1985, however, the permissible growth of GDP would average less than 1% a year and thereafter virtually no growth at all would

be possible.

Growth rates of exports, imports and GDP projected under an import control strategy and a devaluation strategy are shown in Table 3.12 in comparison with those in the base projection.

Table 3.12 Growth of exports, imports and GDP under variant policies

(% per year)

	1978-80	1980-85	1985-90
<b>Base projection</b>			
Export of goods and services	5.8	4.1	3.8
Imports of goods and services	5.4	4.4	4.3
GDP	2.2	0.5	0.1
<b>Projected under import controls strategy</b>			
Exports of goods and services	5.7	4.1	3.8
Imports of goods and services	5.3	4.3	3.6
GDP	3.6	4.0	2.9
<b>Projected under devaluation strategy</b>			
Exports of goods and services	7.5	8.1	7.0
Imports of goods and services	5.5	7.1	6.9
GDP	3.1	3.4	2.5

**Notes:** Assumptions about world conditions and domestic trends are the same in each case. See Appendix B for details of the various policies. The principal characteristics of each are as follows:

**Base assumptions:** maintenance of constant cost competitiveness.

**Import controls:** restriction of imports of manufactures so as to achieve the GDP growth shown.

**Devaluation:** cost competitiveness reduced by 4% a year up to 1985, 2% a year thereafter.

### Real income and its distribution

Although in the 1960s and early 1970s real national income grew at almost exactly the same rate as GDP, this has not been the case since 1973. World price changes and costs of EEC membership have disturbed the relationship.

In future the UK terms of trade will not be so sensitive to world oil prices, because Britain will be roughly self-sufficient in oil. Without major changes in EEC transfers, national income will grow at nearly the same rate as GDP (see Table 3.13). The growth in national income on base assumptions would average under 1% a year between 1980 and 1985 and would barely be positive from then onwards. On the assump-

tion that public expenditure on goods and services increased more or less in line with national income, and given that private investment would be very depressed, consumers' expenditure could rise just over 1% a year between 1980 and 1985 and by just under 1% a year thereafter.

On the other hand, the growth of output possible under an import controls strategy would enable private consumption to increase from its present depressed, consumers' expenditure could rise by just faster rate than has been sustained since the war, while still leaving room for investment growth and increases in public expenditure.

Table 3.13 Growth of GDP, national income and expenditure

	(% per year)					
	Output excluding North Sea, at market prices	GDP at market prices	National income	Private consumption	Private fixed investment	Public expenditure on goods and services
<b>Historical</b>						
1964-73	2.8	2.8	2.8	2.6	4.5	2.7
1973-77	-0.1	0.2	-0.8	-1.2	-1.2	0.6
1977-78	3.3	3.8	4.7	5.5	11.5	-0.8
<b>Base projection</b>						
1978-80	1.4	2.3	2.2	3.3	-1.5	2.0
1980-85	0.5	0.6	0.8	1.1	-2.1	1.1
1985-90	0.2	0.2	0.4	0.8	-2.7	0.6
<b>Projected under import controls strategy</b>						
1978-80	2.8	3.6	3.6	4.4	0.7	2.0
1980-85	4.1	4.1	4.0	4.9	3.8	2.0
1985-90	3.1	3.0	2.8	3.5	2.1	2.3

Table 3.14 Post-tax shares of real national income

	(%)			
	Wages and salaries	Welfare benefits	Income from property and self- employment <sup>a</sup>	Net income of public sector (receipts less transfers)
<b>Historical</b>				
1964	48	6	23	23
1973	45	7	25	22
1978	45	10	23	22
<b>Projected for 1985</b>				
Base projection	48	13	17	22
Import controls strategy	48	11	22	20
Devaluation strategy	47	10	22	21

<sup>a</sup> Excluding stock appreciation.

Table 3.14 shows the distribution of real post-tax income projected for 1985 under alternative policies, and compares this with figures for the past. The base projection implies a substantial increase in the share of welfare benefits, because of the rising number of people out of work; the share of profits would fall, because of deepening recession, unless profit margins were raised (which does not appear to have happened since the recession began in 1974). Company earnings might decline to a level where many companies ceased to be financially viable.

Under an import controls strategy the share of wages and salaries would rise at the expense of the public sector's share, as national income grows exceptionally fast. The share of property income would hold up under the import control strategy because of much improved capacity utilisation and under a devaluation strategy because of higher export profits, combined with a smaller improvement in capacity utilisation.

### Taxation and public expenditure

The base projection of growth of public expenditure in Table 3.15 is broadly consistent with government plans, as set out in the January 1979 White Paper; public expenditure is assumed to grow faster under an import controls strategy. Required changes in tax rates will depend largely on the rate at which the economy as a whole expands.

Under the base projection, real tax rates (after indexing income tax allowances and specific duties in line with inflation) would need to be increased in

1981 and subsequently, in order to keep the growth of private expenditure down to a rate compatible with the balance of payments constraint. This is necessary despite increasing tax revenue from the North Sea, which will build up to an estimated £4½ billion (at 1978 prices) by 1985.

On the other hand, under an import controls strategy, tax cuts would be possible immediately and could occur on an increasing scale through the 1980s.

### Inflation

The key element in inflation, apart from commodity price booms or events such as the OPEC price increase, is wage bargaining behaviour, which has been discussed at length above.

The medium-term implications for inflation of bargained real wage rates returning to their estimated historical trend by 1981 are shown in Table 3.16. On this assumption inflation will remain in single figures in 1979 but will rise significantly in the following two years, whatever overall economic strategy is adopted. From 1981 onwards, however, the rate of inflation might begin to decline, as the benefits of fast output growth under an import control strategy came through, whereas in the base projection and under a devaluation strategy inflation would continue at between 15% and 20% a year.

If increases in wage rates were fixed at 10% a year in 1980 and subsequent years, price inflation would be less, but at considerable cost to bargained real wage rates and average real earnings after tax.

Table 3.15 Growth of public sector revenue and expenditure<sup>a</sup>

	(% per year)				
	Expenditure on goods and services	Transfers	Total expenditure	Required revenue	Revenue at constant real tax rates
<b>Historical</b>					
1964-73	3.8	5.3	4.3	4.2	n.a.
1973-78	0.6	5.2	2.4	2.5	n.a.
<b>Base projection<sup>b</sup></b>					
1978-80	4.8	4.5	4.7	5.2	5.6
1980-85	2.7	2.3	2.6	2.7	1.4
1985-90	1.9	2.6	2.2	2.2	0.6
<b>Projected under import controls<sup>b</sup> strategy</b>					
1978-80	5.0	4.8	4.9	5.1	6.6
1980-85	3.9	2.4	3.3	3.9	4.8
1985-90	3.6	3.0	3.4	3.5	4.0

<sup>a</sup> Including relative price effects.

<sup>b</sup> See Appendix B for assumptions.

**Table 3.16 Inflation of wages and prices**

	Real post tax value of settlements <sup>a</sup>	Negotiated basic rates <sup>a</sup>	Average earnings before tax	Consumer prices <sup>b</sup>	Level of average earnings after tax in real terms (1978 = 100)
	(increase over previous year, %)				
<b>Historical</b>					
1977	-6.0	6.9	9.2	13.7	94.0
1978	1.7	9.5	13.1	8.8	100.0
<b>Base projection<sup>c</sup></b>					
1979	5.3	14.4	14.3	9.1	104.5
1980	1.7	14.5	17.2	12.3	107.8
1985	0.8	19.3	20.8	17.5	119.5
<b>Projected under import controls<sup>c</sup> strategy</b>					
1979	5.3	14.3	14.3	9.0	104.6
1980	1.7	12.9	16.8	11.1	109.5
1985	0.8	9.6	12.3	8.7	129.4
<b>Projected under devaluation<sup>c</sup> strategy</b>					
1979	5.3	15.1	15.0	9.9	104.2
1980	1.7	15.3	18.6	13.7	108.1
1985	0.8	20.2	22.4	19.8	123.3
<b>Base projection with money wage rates restrained to 10% annual increase</b>					
1980	-1.0	10.0	13.7	10.5	105.8
1985	-0.2	10.0	11.5	9.4	113.0

<sup>a</sup> Excluding public services.

<sup>b</sup> Deflator for consumers' expenditure inclusive of relative price effect for total home sales.

<sup>c</sup> See Appendix B for assumptions.