CHAPTER 1
REVIEW OF BRITAIN'S ECONOMIC PROSPECTS 1975-1978

This review examines alternative ways in which the British economy is likely to develop on various assumptions about economic policy at home and about other factors, particularly developments abroad, over which the Government has little if any control.

The review falls into eight sections. The first summarises the main conclusions of the whole study, particularly those relating to the conduct of policy. The second section describes the history of the last three years and suggests reasons why the present very difficult situation has arisen. This is followed by a brief account of the framework of analysis which has been used to display the main alternative possibilities.

Section four discusses the balance of payments target which the Government must now adopt for the medium term, and implications are then drawn for the conduct of fiscal and monetary policy. In section six there is a discussion of how, consistently with full employment, it will be possible to improve our trade balance, even supposing adequate resources are made available for the purpose.

Section seven gives conditional forecasts of the real national income and the extent to which living standards can be raised over the next four years in view of other claims on resources.

The final section discusses the likely course of inflation in the immediate future and suggests rather tentatively what may happen in the medium term provided the wrong policies are not followed. The review draws heavily on the six studies and statistical appendix which follow it.

1. Summary of main conclusions

If sterling is to remain negotiable the balance of payments deficit, now running at £3.8 billion per annum, will probably have to be reduced by at least £1.5 billion to no more than £2.5 billion [1] by 1978. A policy to achieve only this amount of adjustment involves considerable risks and it may be prudent – indeed we may be forced – to undertake a much larger one.

The public sector deficit, assuming no change in policy, is likely to rise faster than the rate of inflation in the immediate future, from about 6% of national income [2] (£4.8 billion) in 1974/5 to about 7% (£6¾ billion at current prices) in 1975/6. If it continues at 7%, the trend of the balance of payments will be to deteriorate further in the medium term.

A sharp gain in the terms of trade could by itself cause a temporary reduction in the external deficit. But no lasting improvement is possible without a reduction in the public sector deficit, and an improvement of £1.5 billion by 1978 – the minimum on which any sensible strategy can be based – calls for a reduction in the public sector deficit equal to 2½% of national income (nearly £2.5 billion at current prices) compared with that forecast for 1975/76.

Not all the reduction in the public sector deficit in the medium term need come from increased taxation. Provided decisions are taken now, the growth of public expenditure can be limited so as to make a substantial contribution. Moreover by 1978 the tax revenues from North Sea oil and gas should amount to well over £1 billion.

If the fiscal deficit is not reduced substantially in the next Budget the balance of payments deficit will probably deteriorate in 1975 unless there is a big improvement in the terms of trade, while if the Government's response to rising unemployment, as invariably in the past, consists of or even includes further general fiscal and monetary expansion, the external deficit may not improve at all, whatever happens to the terms of trade.

On the other hand if *all* that the Government does immediately is start the process of fiscal restriction which will ultimately be essential, the incipient recession at home will be aggravated, perhaps very severely.

It is most unlikely that it will be possible by devaluation to achieve an expansion of net export demand large enough to sustain domestic activity and employment. Some significant amount of further depreciation of sterling will in any case be necessary merely to keep our relative costs in line with those of our competitors. To achieve enough net export demand an additional devaluation probably of the order of 20-25% would very shortly be necessary and the implications for domestic inflation would be extremely serious.

Accordingly there seems now to be no way of obtaining simultaneously an improvement in the current balance and keeping unemployment below one million other than by introducing some form of import restriction.

Provided domestic output is sustained by import controls (or any other device which increases net exports) we expect the real national income to rise more than forecast by the Treasury [1] and real personal consumption may well grow at an average rate of 3-4% per annum between 1974 and 1978 – this even if fiscal and monetary policy is restrictive enough

(1) At 1974 values. See note on the page opposite for precise definition.

(2) Throughout this study national income, whether in real or money terms, is measured at market prices. See Statistical Appendix, notes to table 9.

(1) See section 7 below.

to eliminate the deficit in the current balance altogether.

In the first half of 1975 the retail price index is likely to continue recording increases of about 20% compared with a year earlier, but there is a good chance that the rise will then fall away to 16-17% and by the end of the year it could with some good fortune be down below 15%. Provided that the risks of a large devaluation of sterling or prolonged high unemployment can both be avoided, and also that no attempt is made to enforce a sustained wage freeze, we expect the rate of inflation to fall further in the medium term.

2. The present position and how we got here

The previous Government budgeted for a public sector deficit of £2.4 billion in 1972/3 and £2.8 billion in 1973/4 and this, together with the abolition of all controls over credit, generated a pressure of domestic demand so excessive as to ensure that whatever the underlying trends of competitiveness had been the balance of payments would have moved to an annual rate of deficit of the order of £1-2 billion.

In December 1973 public expenditure was cut and credit controls reimposed – measures together worth over £1 billion [1] which might have gone, other things being equal, a considerable way towards providing the necessary fiscal and monetary conditions for bringing about a reduction in the pressure of domestic demand and a substantial improvement in the balance of payments. However, the increase in the price of oil which occurred at about the same time had the effect of reducing real demand by a further £2½ billion and simultaneously changing the appropriate balance of payments target for the immediate future downwards by a roughly equal amount. The prospect at the beginning of 1974, therefore, was that without some fiscal relaxation a rapid recession would develop and the balance of payments deficit would tend to fall more rapidly than was immediately required or desirable.

The new Government initially budgeted (in March 1974) for a much lower public sector deficit (of only £1,170 million) with little reduction in indirect taxes (net of subsidies) in prospect. If this fiscal stance had been realized there is no doubt that a severe recession and also a sizeable improvement in the balance of payments would have developed during the course of last year. In the event, partly as a series of deliberate acts of policy but also because of deplorably large errors in the March Budget estimates, the forecast public sector deficit was revised up in November by the extraordinarily large sum of £3,656 million making the estimated deficit £4,826 million for 1974/5 as a whole, a figure which is confirmed by such evidence as is now available. This very large deficit has had the effect of sustaining personal and public consumption so that unemployment has risen much less here than in other countries. But another consequence has been that the balance of payments has not improved at all; the current account deficit in the fourth quarter (£3,780 million at an annual rate) was close to the total for the year, and this is just about what is to be expected from a public sector deficit of £5,000 million odd [1].

These developments are illustrated in Tables 1.1 and 1.2 by figures showing sources and uses of real national income. Until recently it has been customary to discuss the disposition of resources in terms of real output (G.D.P.) and its components because it could generally be assumed that domestic expenditure in real terms can be allowed to rise at about the same rate as output; it has indeed been possible to count on an annual rise in total personal and public consumption not far off 3% per annum. This is no longer appropriate when the terms of trade deteriorate, because the volume of exports then has to increase in relation to the volume of imports if the balance of payments is not to deteriorate. It is more appropriate, when the terms of trade change, to use instead the concept of real national *income* – the total of domestic factor income plus net income from abroad deflated by the price of what we buy [2]. The real national income so defined measures the extent to which domestic expenditure can change in real terms without the current balance of payments changing in money terms.

Table 1.1 Sources of real national income

(£ billion, 1970 prices)

	1964-67	1968-71	1972	1973	1974
Real national output G.D.P. [a]	45.8	50.1	53.3	56.1	56.1
(index 1970=100)	(91)	(99)	(105)	(111)	(111)
Terms of trade effect	–0.1	–0.1	0.0	–1.0	–3.3
Net property income	0.3	0.3	0.2	0.5	0.6
Real national income [a]	45.9	50.3	53.5	55.6	53.4
(index 1970=100)	(90)	(99)	(105)	(109)	(105)

(a) At market prices (i.e. inclusive of the adjustment to factor cost).

(1) The Government probably overestimated the impact of the public expenditure cuts (put at about £1,000 million at the time) but the hire purchase controls by themselves cut demand by about £600 million in 1974.

(1) For a further explanation of this relationship see section 5.

(2) For a detailed discussion of concepts see "Measuring changes in the nation's real income" J. Hibbert, Economic Trends, January 1975.

As Table 1.1 shows, the real national income rose at about the same rate as real output between 1964-7 and 1972, but between 1973 and 1974 the terms of trade deteriorated so much that it fell about 4% although output was constant.

Claims on real national income are displayed in the following table which also shows (in brackets) the percentage of total income taken by each component of expenditure.

Table 1.2 Uses of real national income

(£ billion, 1970 prices)

		1964-67	1968-71	1972	1973	1974
1.	Real national income	45.9	50.3	53.5	55.6	53.4
2.	Consumption	29.0 (63.2)	31.2 (62.0)	34.2 (63.9)	35.8 (64.3)	35.7 (66.8)
3.	Public expenditure on goods and services	12.2 (26.6)	13.2 (26.3)	13.6 (25.5)	14.0 (25.2)	14.3 (26.8)
4.	Private investment (including stockbuilding)	4.9 (10.6)	5.4 (10.8)	5.6 (10.5)	6.8 (12.2)	6.1 (11.5)
5.	Total domestic expenditure (2+3+4)	46.1 (100.5)	49.9 (99.1)	53.4 (99.9)	56.5 (101.7)	56.1 (105.0)
6.	Current balance of payments at 1970 values (1-5) (a)	−0.2 (−0.5)	+0.5 (0.9)	+0.1 (0.1)	−0.9 (−1.7)	−2.5 (4.8)
7.	Current balance of payments at current prices (6 revalued)	−0.2	+0.5	+0.1	−1.2	−3.7

(a) A small discrepancy may arise because of the residual error between the compromise and expenditure estimates of G.D.P.

Real consumption is functionally related to real national income in the sense that one is unlikely to change very much in relation to the other without a change in fiscal or monetary policy. The figures in Table 1.2 thus represent the recent conduct of policy in a striking way. Cuts in taxation and increased subsidies introduced progressively from 1972 to 1974 allowed the proportion of consumption in the real national income to rise to 66.8% in 1974, a much higher figure that in any recent post war year. At the same time public expenditure rose. So, notwithstanding the fall in private investment (both absolute and as a proportion of real national income), the U.K. in 1974 spent 5% or nearly £4 billion (at current prices) in excess of its income.

These same developments may alternatively be looked at in terms of the financial balances of main sectors, i.e. in terms of the excess of their net current receipts over expenditure on goods and services.

The financial surplus of the private sector as a whole (by definition, equal to the difference between the other two balances) was probably around £1 billion in 1974; it is because the private sector tends on average to lend (net) at a rate of £1–£2 billion per annum that a public sector deficit of any given size tends to generate a balance of payments deficit smaller by this amount.

The financial balances of the components of the private sector moved in an unusually divergent way in 1974. There was a large and growing surplus accumulated by the personal sector because of the collapse in private house-building and a fall in H.P. debt at a time when personal disposable income was relatively well sustained by cuts in net indirect taxation and by the acceleration in pre-tax money earnings.

At the same time companies have been forced into heavy financial deficit mainly because cost inflation has made it necessary for them to borrow on a huge scale

Table 1.3 Financial balances

(£ billion, current prices)

	1972	1973	1974 est.
Public sector	−1.7	−2.8	−4.8
Current balance of payments	−0.1	1.3	3.7
Private sector (a)	1.8	1.5	1.1
of which :			
Personal sector	1.2	2.0	3.1
Company sector	0.1	−1.1	−3.1
Residual error	0.6	0.6	1.1

(a) Including the residual error between income and expenditure estimates of G.D.P.

to keep going. Already in 1973 industrial and commercial companies had to find £2,600 million just to maintain the level of stocks and work in progress in volume terms and nearly all of this was financed short-term (1). In 1974 the cash needed to finance replacement of stocks rose to about £5,000 million, a sum equal to about half of companies' gross trading profits. Companies were given moderate assistance in the November Budget by the deferment of Corporation Tax worth £800 million, but this still left them with a very serious financing problem. The predicament was made slightly worse by the collapse in share prices which virtually ruled out the Stock Exchange as a source of funds (though it should be added that the Stock Exchange has never provided a large proportion of the funds used by companies).

The analysis presented in the table suggests that up to the last quarter of 1974 threshold awards were only responsible for about 3% of the total increase in retail prices. The direct effect of changes in net indirect taxes per unit of output was to reduce the price increase by about 3% but the total effect, via threshold awards, will ultimately be rather more than this. Moreover, relative to the increase in unit labour costs, they have fully offset the effects of the rise in import prices.

Import prices have not changed very much since the spring but before that there was an exceptionally large rise, and since they only have their full effect after a rather long lag they seem to have directly contributed 10% to the total increase in retail prices between the beginning and end of 1974. But the contribution of import prices cannot be taken as having been entirely caused by external events of which we have no control. Rough estimates suggest that of the total increase in import prices nearly half was the *result* of domestic inflation.

Table 1.4 Components of the change in retail prices: fourth quarter of 1974 on a year earlier (a)

	% Increase	Contribution to change in the retail price index	
		Direct contribution	Relative contribution (b)
Import prices	40	10	6
Unit labour costs (excluding thresholds)	11	9	(
			(0
			(
Threshold awards	7	3	(
Indirect taxes net of subsidies		−3	−6
Residual (price control ?)		−1	−1
Total retail price index		18	−1

(a) The analysis is in terms of the model of price determination presented in Chapter 2 where all the variables are precisely defined. The cost items have been lagged, e.g., the 35% increase in import prices refers to a change in a weighted average of the final quarter of 1973 and all four quarters of 1974 compared with a year earlier. The net indirect tax contribution includes the effect of holding down prices of nationalised industries in relation to their costs.

(b) This measures the effect of differential increases or reductions in each component relative to the increase in unit labour costs (including thresholds).

Inflation of costs and prices accelerated alarmingly last year. The third phase of the previous Government's incomes policy had included a threshold clause formulated so as apparently to guarantee an increase in real pay of 5 or 6 per cent during 1974. But the macroeconomic conditions, in particular the terms of trade, were nowhere near such as to make goods and services available to the personal sector on this scale. The national income fell by 4% and personal consumption remained roughly constant. In consequence the threshold was breached eleven times and earnings in the fourth quarter were 25% (2) up on a year earlier.

Retail prices rose 18% during 1974. Table 1.4 analyses this increase into its components.

(1) The deterioration in the net monetary position of all industrial and commercial companies was £2,300 million in 1974. See Blue Book Table 75, lines 1-18 inclusive.

(2) The index of wages rates measures nationally negotiated minimum rates. As the threshold awards were at a flat rate they increased rates a little more than earnings. Thus the wage rate index (by December, 28½% up on a year earlier) which attracted the headlines slightly exaggerates the rate of increase in money pay.

3. Analysis of future prospects

The main exogenous factors incorporated in our examination of future prospects are the growth of world trade, the movement of world prices of primary commodities, and the terms under which finance may be available for the balance of payments. These factors are inevitably uncertain, yet they largely define the context within which decisions about macroeconomic policies must be undertaken.

The choice of strategy is in the first instance related to targets for the balance of payments and the level of unemployment, and the main instruments which bear on these targets are fiscal (and monetary) policy, and protection of industry (whether via the exchange rate, tariffs and subsidies, or quantitative restriction of imports). The outcome for the balance of payments and the level of unemployment then determines the resources available for domestic expenditure and thereby influences the rate of inflation.

In the following sections, conditional forecasts (pre-

sented in full in the Statistical Appendix) are used to assess the probable outcomes of alternative strategies for adjusting the balance of payments and the level of unemployment. The conditional forecasts are based on the projection of a historical pattern of underlying trends in the economy by methods described in the Statistical Appendix.

4. A target for the balance of payments

The need for balance of payments adjustment will be considered in two parts: whether the U.K. should *want* to borrow to cover continued current account deficits during the next few years, if finance were readily available; and then, what sources of finance may actually be available and what conditions would have to be met in order to satisfy foreign lenders.

There is a presumption that, if finance were readily available, it would be in the U.K.'s best interest to aim at only a gradual reduction in the current account deficit over the next few years. The present £3.8 billion deficit means that living standards have been protected by fiscal policy against the sudden loss of national income due to the rise in oil and commodity prices. By 1980 the U.K. will be a net exporter of oil and the commodity terms of trade can be expected to return at least part of the way to a more normal level. Thus the borrowing now would be covering a period of temporary loss in national income due to an adverse movement in the terms of trade (1).

But even supposing we want to borrow, the question remains whether it will be possible to go on doing so on anything like the present scale over the next few years and what risks are involved in opting for slow adjustment (1).

The U.K. has recently borrowed heavily on the Eurodollar market and has received a large inflow of OPEC funds. In 1974 this Eurodollar and oil finance probably amounted to over £4 billion. In addition there has been a net inflow of long-term private capital amounting to some £1.5 billion, sufficient to offset the drawing down of sterling balances by non-OPEC countries and a net outflow of trade credit.

In the next few years OPEC countries will be a major possible source of funds, whether directly or through recycling schemes. In addition, ignoring for the moment any possible capital cost of state participation in the North Sea, there should be a continued inflow of long-term private capital. Further, there is still some Eurodollar credit available to the U.K. Current account deficits falling gradually from the present £3.8 billion to something like £2½ billion (2) over the next four years might perhaps be consistent with the attraction of sufficient OPEC funds to avoid the need for assistance from Central Banks and the IMF.

Foreign lenders will require a reasonably competitive and secure return on sterling assets. This in turn means that sterling should not become vulnerable because of progressive overvaluation and that anticipated depreciation of sterling should be covered by an interest rate differential. These conditions could be fulfilled by a passive policy on the exchange rate and interest rates provided that domestic inflation was not too far in excess of inflation in other countries, and that fiscal policy was tight enough to demonstrate that the current account deficit was under control.

If the current account showed no perceptible improvement or if domestic inflation accelerated, sterling would quickly look vulnerable and a reduction in the inflow of oil funds and withdrawal of speculative support would be precipitated. To keep the market for sterling open,

Table 1.5 Balance of payments finance on optimistic assumptions

	(£ billion, 1974 export values)				
	1974	1975	1976	1977	1978
OPEC funds and recycling	2.4	2.5	2.3	2.2	2.0
Other public sector borrowing abroad	1.9	0.8	0.4	–	–0.1
less					
Reduction in other sterling balances	–1.0	–0.5	–0.5	–	–
Monetary finance	3.3	2.8	2.2	2.2	1.9
Net long-term capital	1.2	0.9	0.8	0.9	1.0
Net trade credit	–0.6	–0.3	–0.3	–0.3	–0.3
Finance for the current account	3.9	3.4	2.7	2.8	2.6

Furthermore a rapid reduction in the U.K. current account deficit would create difficult problems both for the U.K. and the rest of the world. There would have to be a sharp cut-back in the growth of domestic spending, there would be an additional deflationary effect on world income and trade, and other countries already facing balance of payments difficulties would find these intensified as the U.K. eliminated its own deficit.

(1) "Terms of trade" here means the ratio of the national income deflator for exports of goods and services relative to that for imports of goods and services taking 1970 as the base year. Since the price of oil vastly increased between 1970 and 1974 a decline in the volume of oil imported will substantially reduce the import *deflator* from 1974 onwards compared with what it otherwise would have been.

(1) For a more detailed discussion of sources of finance see Chapter 5.

(2) At 1974 values.

the U.K. would then be forced to seek assistance from Central Banks and the IMF. The condition for their support would be acceptance of a programme of fiscal and monetary restriction aimed at rapid and substantial reduction in the current account deficit.

Decisions on state participation in the North Sea will have a large effect on the formal balance of payments accounts. Buying out 51% of the stake of foreign oil companies would involve a sizeable capital outflow of the order of £1½ billion, against which must be set the saving on profits due abroad worth some £500 million a year by 1978. The net effect on the balance of payments in the next few years will depend on the timing of capital payments to the foreign oil companies. If these are spread out, the net cost in the first years will not be large.

The conclusion of this section is that the current balance of payments must be reduced fast enough for it to be seen to be improving. We may then be able to borrow so much that the deficit could still be as large as £2½ billion (at 1974 values) by 1978 and it is probably in our advantage to do so if we can. But this will be a risky strategy and may mean that a sharp adjustment is sooner or later forced on us.

5. Implications for fiscal policy

It has been argued by the C.E.P.G. (in particular in the evidence given last summer to the Select Committee on Public Expenditure[1]) that there exists a functional relationship which can be estimated with a reasonable degree of accuracy between total private expenditure (including investment) on the one hand and total private income (including profits and certain kinds of borrowing) less total tax payments on the other : that this enables an inference to be made (given the level of public expenditure and the conduct of credit policy) about the full-employment yield of the tax system which is the necessary but not sufficient[2] condition for simultaneously achieving over a sustained period any pair of targets for the current balance of payments and the level of employment; and that the inference (in so far as it relates to underlying trends) can be made independently of external conditions such as the terms of trade. The operational significance of this contention, if correct, is that it entirely changes the principles according to which fiscal policy should be conducted. The objection to the use of short term forecasting as the basis for fiscal policy ceases to be that these forecasts are inaccurate; it is rather that short term forecasts are the wrong basis *in principle* for budgetary policy. If the functional relationship holds good, tax rates should be set by reference only to the external and internal targets, the likely full-employment yield of the tax system, and likely level of public expenditure. But an appropriate setting of tax rates under this set of rules in no way ensures that both targets will be reached; for this to be achieved it is necessary that the economy should succeed in selling enough exports relative to imports.

(1) For details including the econometric results see the memorandum by Cripps, Fetherston and Godley which was submitted to the Select Committee on Public Expenditure which appears among evidence printed with their 9th Report for 1974 (HC 328 for 1974).

(2) Last January's L.C.E.B. made a logically equivalent statement that an adequate *ex post* yield of the tax system is the necessary and sufficient condition for equilibrium in the balance of payments.

A plan for reducing the current balance of payments deficit by at least £1½ billion (at 1974 values) carries a clear implication for fiscal policy in the medium term – *the public sector's financial deficit must be brought down by about the same amount*[1]. If a larger balance of payments adjustment is thought essential, the reduction in the public sector deficit must be larger to a roughly equivalent extent; a zero balance of payments on current account requires a reduction in the public sector deficit of about 4% of national income (about £3½ billion at today's prices) compared with 1974.

If there is no change in policy compared with what was announced in the November Budget our forecast is that the public sector deficit will rise to 7% of national income[2], i.e. from £4.8 billion in 1974/5 to about £6¾ billion (at actual prices) in 1975/6. If this is correct the necessary adjustment over the medium term will have to be correspondingly larger; the reduction *compared with what is forecast for 1975/6* must be as large as £2–3 billion (at today's prices) while to achieve a zero external balance the fiscal reduction will have to be £4–5 billion.

While a firm conclusion can be drawn about the conduct of fiscal policy in the medium term – say over the next four years as a whole – there remains the difficult question what should be done immediately.

It is quite likely that there will be large further gains in the U.K. terms of trade this year as the world recession deepens, and therefore that the current balance will improve in the period immediately ahead without any policy change. On these grounds the Government may be tempted to postpone the fiscal action which will ultimately be necessary. This temptation is likely to be reinforced by the recent rise in unemployment which will probably continue.

But consider the risks. The future of the terms of trade is very uncertain; there might be no improvement, in which case the current balance will deteriorate further during 1975. But the more fundamental risk is that there are substantial time lags, of one to two years, before policy takes full effect. If the public sector deficit in 1975/6 is as large as £6¾ billion, processes will be set in train such that any improvement in the current balance arising from changes in the terms of trade will only be temporary. In a year to eighteen months the improvement will be substantially reversed even if the terms of trade gain remains. In other words, if the Government budgets for a public sector deficit as large as £6¾ billion in 1975, the external deficit is likely to be moving back during 1976 to the present level.[3]

An identical argument applies to the use of direct measures to improve the balance of payments. If they are adopted with no reduction in the public sector deficit the whole of any initial improvement in the external balance compared with the present rate of deficit, would subsequently be reversed.

(1) The target level of unemployment does not alter the public sector deficit to be budgeted for, but does of course alter the tax *rates* necessary to achieve it.

(2) See Chapter 6.

(3) This will be the case even though an improvement in the terms of trade raises domestic income and expenditure and reduces the public sector deficit at constant tax rates compared with what it otherwise would have been; i.e. if the public sector deficit were held at £6¾ billion the external deficit would tend to be *larger* than at present.

In sum, the risks involved in postponing fiscal restriction seem large. It might mean that the balance of payments does not improve this year at all, in which case a violent adjustment will probably be forced on us soon, while if, for one reason or another, there is some improvement in the immediate future, this will inevitably be reversed within a year or so. It would then be too late to adopt any policy of moderate adjustment; the *minimum* correction would be a very large one.

In reaching conclusions about the fiscal deficit it has been assumed that the financial balance of the private sector, at present not far off zero, returns to its usual surplus of around 2% of national income. Under inflationary conditions it is to be expected that the private sector surplus is lower because companies borrow more to finance stock appreciation. Therefore if inflation continues at a rapid rate it will be necessary to reduce the fiscal deficit even more than suggested above to achieve any given balance of payments target. In such inflationary circumstances companies are likely to encounter ever growing difficulties in obtaining the finance they need. Either taxation would have to be restructured in favour of companies and/or adequate new finance would have to be made available to them and/or they would have to move nearer to replacement cost pricing policies.

There are two final points to be made about the public accounts looking over the whole period to 1978. From 1977 tax revenues from North Sea oil should make a significant contribution to public sector receipts; calculations given in detail in Chapter 4 suggest this may amount to about £500 million in 1977 and £1.2 billion in 1978. Second, there is no reason at all why the whole adjustment to the public sector's deficit has to be on the side of taxation; a severe control on the growth of public expenditure can make an important contribution in a year or two if decisions are taken immediately.

6. Competitiveness; the main policy problem

The correct fiscal policy, about which we have been able to make a fairly precise and confident prescription, though necessary if we are to achieve external and internal balance, is not a sufficient condition for doing so. The other condition is, of course, that the demand for U.K. exports (plus net income from abroad) does actually rise adequately in relation to the value of imports. It is here that there is the greatest uncertainty about what the correct policy is. The dilemma for the immediate future is indeed poignantly obvious. Unemployment is rising, apparently quite rapidly, and the severe recession of world trade now developing rules out the possibility that at today's relative costs export demand will anywhere near sustain activity in the U.K. let alone generate an expansion. Therefore if the Government's *only* policy were to hold the fiscal position, still more if it were to start immediately on the restraint which will soon be necessary in any case, the result will be a continuing rise in unemployment through 1975, probably at an unprecedented rate. Moreover underlying trends are so adverse that neither a recovery in world trade nor the arrival of North Sea oil seem at all likely to generate net export demand on an adequate scale in the medium term.

In 1974 the current account deficit of £3.7 billion comprised a £4.5 billion deficit on trade in goods and services, partly offset by a surplus of nearly £1 billion on net receipts of property income and transfers from abroad. But by 1978 net flows of property income and transfers can be expected to show a deficit of over £1 billion a year (at 1974 export values)(1) because of the build-up of interest payments on borrowing and the outflow of profits earned by foreign oil companies on North Sea operations. Thus whatever target is set for improvement in the current balance as a whole the balance of trade in goods and services will have to improve by far more. If the current account deficit is to improve by £1½ billion, the balance on goods and services must improve by about £3½ billion; if the current account is to be brought to a zero balance in 1978, the balance on goods and services must improve by about £5½ billion.

Three alternative strategies to obtain the minimum essential improvement in the trade balance – £3½ billion at 1974 values – are considered in turn.

The first possibility (illustrated in detail in table B of the Statistical Appendix) is that the only action taken, other than the essential reduction in the public sector deficit, is to allow sterling to depreciate to the minimum extent necessary to keep U.K. costs, relative to costs in other countries, on the past trend. The conditional forecast shows that on this assumption unemployment would rise to 5%, or well over a million, by 1978. (A zero current balance, on comparable assumptions, would require 6½% unemployment in 1978).

The second possibility is that sterling is depreciated sufficiently to sustain domestic activity by increasing net export demand (for details see table D of the Statistical Appendix). The conditional forecast indicates that to bring unemployment down to 2½% would require an effective devaluation of U.K. relative costs by about 15%, maintained throughout the period from now to 1978. There is no reason whatever to suppose that, if the appropriate fiscal action is taken, market forces alone will generate a fall in sterling anywhere near sufficient to achieve such a reduction of U.K. relative costs. The required fall in the sterling exchange rate would be some 30% in 1975, followed by further rapid depreciation in 1976 to offset the domestic inflation triggered by the initial devaluation.

These calculations strongly suggest that devaluation is not a feasible method for securing a substantial improvement in the trade deficit at the same time as a reduction in unemployment. Very large falls in the exchange rate and accelerating inflation would not be acceptable either to foreign lenders or to British consumers. Moreover the immediate effect of devaluation is to reduce aggregate demand and raise unemployment because the fall in real personal income precedes by a long way the rise in export demand.

Restriction of imports by quotas or high tariffs (see tables E and F of the Statistical Appendix) now appears to be the only way in which the trade deficit can be reduced without either very high unemployment or very large falls in the exchange rate. Provided that U.K. exports are not reduced by retaliation, by 1978 the current account deficit could be reduced to about £2 billion and unemployment brought down to 2½% through limitation of the future growth of imports of finished

(1) All value figures in this section are adjusted for inflation and expressed at 1974 export values. See note on page 2.

manufactures to an average of about 9% a year. This compares with an actual average growth rate of 18% a year from 1969 to 1974 which would be expected to continue up to 1978 in the absence of restrictions.

It is often said that import restrictions would enable the U.K. to maintain higher output and employment only at the expense of other countries. The truth is that if they are used as an alternative to domestic deflation in order to secure the minimum necessary reduction in the trade deficit, they will have no harmful effect on demand in the rest of the world as a whole, while substantially raising demand in the U.K.

It is also feared that import restrictions would provoke retaliation from those industrial countries directly affected. But in fact those countries most dependent on U.K. markets are ipso facto those which would have most to lose from escalation into a trade war. Finally, it is feared that import restrictions would diminish the efficiency of U.K. industry. But in fact the greater security afforded to U.K. industry would safeguard productivity by avoiding the collapse of investment and increased restrictive practices.

To complete the picture of alternative strategies, Table 1.6 shows what would be likely to happen if the Government were to act in the same way as most Governments have tried to act in the past – namely to use fiscal policy to reverse the rise in unemployment with no new measures to improve the balance of payments at all.

This conditional forecast shows the deficit in the current balance reaching £5.2 billion (at 1974 values) in 1978 although the oil deficit falls sharply, implying a rise in the non-oil deficit from £600 million in 1974 to £3.5 billion in 1978. Despite these absurd medium-term results the table shows for 1975 and 1976 a very slight improvement in the deficit and accordingly underlines the dangers of basing policy on short term forecasts even if these are accurate.

Table 1.6 The road to ruin

	1974	1975	1976	1977	1978	Average growth rate 1974–78 (% per year)
Volume. £ billion, 1970 prices						
Exports of goods and services	14.3	14.5	14.8	15.5	16.5	3.5
Imports of goods and services	14.2	14.3	15.4	17.2	19.3	8.1
Terms of trade (1970 = 100)	82	85	94	99	101	5.5
Value, £ million, 1974 export values (a)						
Exports of goods and services	21.7	21.9	22.4	23.4	24.9	3.5
Imports of goods and services	26.2	25.5	24.9	26.1	28.9	5.2
Balance of trade in goods and services	−4.5	−3.5	−2.5	−2.7	−4.0	—
Net property income and transfers	0.8	0.0	−0.5	−0.9	−1.2	—
Current balance	−3.7	−3.6	−3.0	−3.6	−5.2	—
of which, deficit attributable to high oil prices	−3.1	−3.1	−2.9	−2.2	−1.7	—

Source: Table C of the Statistical Appendix

(a) See note on page 2.

7. Availability of resources and claims on them

The discussion so far has been virtually confined to the targets for the balance of payments and unemployment together with the implications of these targets for fiscal and trade policy.

This section considers the prospects for the availability of real resources and the extent to which personal consumption can grow over the next four years given other claims on resources.

Notwithstanding the need for fiscal restriction in the future, it is expected that so long as very high unemployment can be avoided, the growth of personal consumption can be at least as fast in the future as in the past. This conclusion is rather different from that reached by the Treasury in the White Paper on Public Expenditure to 1978-79 (Cmnd. 5879).

The availability of resources

The prospective growth of national income can be assessed in terms of three distinct factors – domestic production, the terms of trade, and net property income and transfers from abroad.

Even if a start is made soon with restriction of imports, little or no increase in domestic production can be expected for 1975 because of the strongly recessionary movement of demand, with falling fixed investment and destocking. But if unemployment is to be reduced to 2½% in 1978, the average growth of domestic output from 1974 to 1978 should exceed 3% a year, with 2.8%

average productivity growth, some increase in the labour force, and a rising contribution to output from the North Sea.

The terms of trade should contribute an extra 1½% a year average growth in national income between 1974 and 1978 if as we expect the relative prices of imported food and raw materials fall and the share of oil in total imports declines because of rising deliveries from the North Sea. The terms of trade contribution is particularly large, measured by deflators based on 1970, because of the large increase in the price of oil since 1970. But this statistical effect is offset by the relatively small direct contribution to G.D.P. imputed to the North Sea when measured at 1970 prices.

Net property income from abroad is expected to turn negative because of the outflow of profits due on North Sea operations to foreign oil companies and because of rising payments of interest on borrowing to cover the balance of payments deficit.

Overall, the future growth of real national income should be sufficient to compensate for the 4% fall in 1973-74 and bring it back to trend by 1978. Depending on the extent and speed of recovery from domestic recession, the average growth of national income in 1974-78 should be in the range 3½–4½% per year. But very little of the increase can be expected before 1976.

Claims on resources

The increase in domestic expenditure will probably have to be slightly less than the increase in national income to allow some reduction in the balance of payments deficit. But even if the current account deficit

Table 1.7 Sources of growth in national income (a)

(£ million, 1970 prices)

	1974	1975	1978	Contribution to % increase in national income 1974-78
Domestic output at factor cost	47112	47475	53758	+12.4
North Sea output at factor cost	117	144	616	+0.9
GDP at factor cost	47229	47619	54374	+13.4
Terms of trade effect	−3282	−2515	−127	+5.9
Net receipts of income and transfers from abroad	553	−29	−842	−2.6
Net indirect taxes at 1970 rates	8913	9114	10593	+3.1
Real national income at 1970 market prices	53413	54189	63998	+19.8

Source: Table 9B of the Statistical Appendix

(a) Assuming restriction of imports to reduce unemployment to 2½% by 1978.

Table 1.8 Claims on available resources (a)

(£ million, 1970 prices)

	1974	1975	1978	Share of % increase in national income 1974-78
Real national income	53413	54189	63998	19.8
Balance of payments	−2534	−2282	−1579	1.8
Total domestic expenditure	56098	56603	65751	18.1
Public consumption	10300	10600	11550	2.3
Fixed investment and stockbuilding	10132	9629	12450	4.3
Private consumption	35666	36374	41751	11.4

Source: Table E of the Statistical Appendix

(a) Assuming restriction of imports to reduce unemployment to 2½% by 1978.

were completely eliminated by 1978, resources should still be available for average growth of domestic expenditure at 2½% a year, provided net export demand is high enough.

On present policies, public sector current expenditure on goods and services is expected to increase quite fast and resources must be allowed for a substantial rise in fixed investment, including housebuilding, from 1976 onwards. Under the optimistic assumption that unemployment can be brought down to 2½% by 1978 with a current account deficit of about £2 billion (at 1974 export values), the average growth of private consumption from 1974 to 1978 should be about 3½% per year. But if unemployment remains much higher than 2½%, or if the current account deficit has to be reduced below £2 billion, less resources will be available for consumption. With unemployment at 4% in 1978 and a zero current balance, the prospective growth of private consumption from 1974 to 1978 would be almost eliminated.

Despite the favourable medium-term prospect, domestic expenditure is expected to show almost no increase from 1974 to 1975. Investment will fall and consumption is likely to rise very little.

Comparison with Treasury estimates

Table 1.9 compares the C.E.P.G. forecasts with those published by the Treasury in Cmnd. 5879. The only differences concern resources required for net exports in 1978 and, in consequence, resources available for private consumption. The larger resource requirement for net exports forecast by the Treasury could be the result either of a much more stringent target for the current account (i.e. a target *surplus* of about £1 billion at 1974 values) or of a less favourable estimate of the terms of trade (i.e. at least 10% below our estimate), or some combination of the two. It is certainly conceivable that the U.K. may be forced to accept full elimination of the current account deficit by 1978, and that the terms of trade will be 5% less favourable than our estimate, and this outcome would be consistent with the Treasury's forecast. If the required shift of resources into net exports is as large as is implied by the Treasury's forecasts, it could, on our estimates, only be achieved at the assumed level of GDP (corresponding to 2½% unemployment) by large scale restriction of imports. In the absence of any such measure, the shift of resources would have to be achieved at the cost of unemployment in the range 1.5–2.0 million; and then resources available for private consumption would be lower in 1978 than in 1974.

The main uncertainties

The main external uncertainties are the growth of world demand, the intensity of competition from other industrial countries and trade restrictions adopted abroad, the movement of commodity prices and the availability of finance for the balance of payments deficit.

The volume of world trade might well grow 2% a year faster or slower than has been forecast, either on account of changes in world demand or because of trade restrictions. This could be expected to alter the forecast volume of exports in 1978 by 5% either way. The intensity of foreign competition may vary in home markets, affecting import penetration, or abroad, affect-

Table 1.9 Comparison of White Paper and CEPG estimates of resource availability

(£ billion, 1970 factor cost)

	1973	1974	1978		Average growth rate 1974-78 (% per year)	
	Cmnd 5879 (1)	CEPG estimate (2)	Implied by Cmnd 5879 (3)	CEPG Forecast (4)	Implied by Cmnd 5879 (5)	CEPG forecast (6)
Supply of resources						
GDP	46.9	47.2	54.5	54.4	3.7	3.6
less Net exports [a]	+0.9	+0.4	–0.9	+1.3	..	..
Available for domestic use	47.8	47.6	53.6	55.7	3.0	4.0
Use of resources						
Public expenditure	13.0	13.2	14.4	14.4	2.2	2.2
Private investment [b]	5.3	5.0	7.0	7.1	8.8	9.2
Private consumption [b]	29.5	29.6	32.2	34.4	2.1	3.8

Notes: (a) Exports of goods and services at 1970 factor cost *less* imports of goods and services at 1970 market prices
(b) Private investment in housing is included in private consumption rather than private investment.

Sources: (1) Cmnd. 5879, table 1.1, p.5.
(2) From Table A of the Statistical Appendix.
(3) Based on the Central Case in Cmnd. 5879, table 1.1, extrapolating average annual increases (shown for 1973-79) from 1973 up to 1978.
(4) Assuming import restrictions, as in Table F of the Statistical Appendix.
(5) From (2) and (3)
(6) From (2) and (4)

ing U.K. export sales. On this count we might regard export and import volumes as having a further 3% margin of error. To some extent, risks on the volume of world trade and the intensity of foreign competition should be mutually offsetting. Thus a range of uncertainty about net export volume equivalent to ±5% of the volume of exports seems reasonable.

Assumptions about the terms of trade are mainly vulnerable to unexpected changes in world commodity prices. Here again the range of uncertainty by 1978 might be of the order of ±5%. Fortunately risks on the terms of trade and the volume of net exports are in part mutually offsetting because changes in the volume of world demand tend to alter net exports and the terms of trade in contrary directions.

An unexpected loss of OPEC inflows or speculative support for sterling could force the U.K. to depend on finance from the IMF and foreign Central Banks, who might well insist on elimination of the current account deficit by 1978. The worst conjuncture would be for this to happen while the U.K. still suffered the effects of an adverse terms of trade.(1) Unless net exports could be increased sufficiently, there would have to be very high unemployment and little or no growth of domestic expenditure. Thus the presence of these risks underlines the importance of measures to prevent high unemployment by ensuring growth of the volume of net exports.

Given the limited possibility of effective devaluation, they reinforce the case for restriction of imports.

8. Inflation

So far as the immediate future is concerned, the movement of retail prices will be largely governed by changes in costs that have already taken place. The analysis presented in Chapter 2 suggests that after allowing for a substantial increase in prices charged by nationalised industries the retail price index in the first half of 1975 is likely to show increases of about 20% compared with a year earlier. If, as expected, import prices do not rise much more and the present pattern of wage settlements (analysed in Chapter 3) continues, the rate of increase in retail prices should fall back in the second half of 1975. If import prices actually fall – and it is clearly possible in view of the developing world recession that they will do so – the rise in retail prices by the end of 1975 will probably be down to 15% or less.

In the past the conventional procedure has been to discuss macroeconomic policy and the management of resources in real terms, leaving inflation as a process governed by forces largely independent of resource availability and management. But it has already been pointed out that the Phase 3 threshold arrangements, by purporting to guarantee an increase in real income which could not be made good, generated a rapid acceleration in the growth of wage inflation. In this case, at least, the availability of real income had a critically important effect on the growth of money income; had real income not fallen because of the deterioration in the terms of trade, little if any of the acceleration of the wage inflation would have occurred.

The Phase 3 arrangements and the TUC guidelines on pay negotiation have suggested to us a model(1) which relates the progress of inflation systematically to the outcome of pay settlements denominated in terms of *ex ante* real increases and to the subsequent availability of real income as governed by macro-economic policy. In any settlement the *ex ante* increase in real earnings may be defined as the excess increase in money earnings over and above compensation for price increases since the previous settlement. Resources available for average real earnings before tax depend on macro-economic conditions including the terms of trade and on the amount of fiscal drag which is permitted in direct taxation (income tax and insurance contributions). In the short term the growth of real earnings is directly influenced by pay settlements as well, but any excess or shortfall which is inconsistent with macro-economic policy must then be corrected by changes in taxation. The model allows also for changes in the frequency of adjustment of money pay through settlements or threshold arrangements which determine how far on average pay lags behind prices.

It is evident that with full compensation for past price increases in pay settlements there will be an element of inertia in the rate of inflation. But if the available increase in real earnings is less than the *ex ante* increase negotiated in settlements, price inflation must accelerate to erode negotiated real earnings; and if the available growth of real earnings exceeds negotiated increases, price inflation must decelerate.

The above holds good only as long as the frequency of pay negotiation or adjustment does not change. An increase in the frequency of settlements (or increased adoption of automatic 'threshold' pay adjustments) will in itself accelerate inflation; and the cessation of threshold schemes or reduced frequency of settlements will in itself slow inflation down.

Table 1.10 shows that over the past five years the average *ex ante* increase in real earnings incorporated in settlements seems to have been about 5½% per year – perhaps in part a reaction to the long period of pay restraint in 1965-69, and in part a reflection of growing dissatisfaction over relativities. The *ex ante* increase in 1970 is estimated at over 6%, and since then the rate of increase seems to have fallen only slightly up to 1973 despite the introduction of another Counter-Inflation policy.

The large increase in actual real earnings in 1970, and the lower increase in 1971, were probably more a result of the sudden acceleration of pay increases than of intended macro-economic policy. But the table suggests that the decision to reflate the economy, which produced a large increase in actual real earnings in 1972, did slow down the rate of inflation. The acceleration of consumer prices in 1974 was much greater than the gap between *ex ante* settlements and actual real earnings would normally imply because of the effect of threshold payments in speeding up the mutual adjustment of pay and prices.

In the next three years resources available for increases in real earnings will depend critically on the size of the external deficit and on the level of unemployment.

(1) Such an assumption appears to underlie the Treasury forecasts discussed above.

(1) The model is described in the Statistical Appendix, notes to table 8.

Table 1.10 Real earnings and inflation [a]

(% increase per year)

	'Ex ante' increase in real earnings		Actual increase in real earnings	Increase in consumer prices	
1970	6.2		6.1	5.8	
1971	5.2		3.9	8.2	
1972	5.0		5.7	6.7	
1973	4.7		3.7	8.6	
1974 est	5.7 [b]		4.4	14.4	
Conditional forecasts [c]	A	B		A	B
1975	4.1	3.0	3.9	15.0	12.0
1976	4.0	2.8	5.1	12.0	6.0
1977	4.6	4.9	6.1	8.0	3.0
1978	5.3	5.1	6.5	5.0	0.0

See text and notes to Table 8 of the Statistical Appendix for definitions and assumptions

(a) Average real earnings, pre-tax, per full-time adult male employee.
(b) Estimated average increase at settlements after allowing for cost-of-living compensation through threshold adjustments.
(c) Forecasts conditional on macro-economic assumptions (reduction of unemployment to 2½% and of the current account deficit to £2 billion by 1978), the distribution of personal income, the extent of fiscal drag and the frequency of adjustment of money pay. See notes to Table 8 in the Statistical Appendix.

If policies are adopted which bring unemployment down to 2½% by 1978 while reducing the current account deficit to about £2 billion (at 1974 export values), the growth of average pre-tax real earnings should be able to accelerate from about 4% in 1975 to over 6% in 1978. This conditional forecast is the counterpart of the forecast for a large increase in real national income and also assumes substantial fiscal drag in 1975-76.

Whether this would lead to further acceleration of inflation or to a slowing down then depends on the level of *ex ante* increases in pay settlements. The table shows that to secure an immediate slow-down, the average *ex ante* increase would have to be of the order of 3% per year over the next two years. But even if the *ex ante* increase were in the range 4–5% per year, a gradual slowing down of inflation could still be expected.