Chapter VI Alternative policies

The calculations described in the previous chapters imply that the Government's objective of a fast expansion of GDP at 5% per year up to the end of 1974 would reduce unemployment to about 400,000; there is no reason to suppose that this would indicate an excessively high pressure of demand in the economy. Expansion could then continue up to 1976 at the par rate of 3½% per year without further reducing unemployment.

2. If the present exchange rate of about $2.35 is maintained and prices and incomes policies are quite successful in restraining U.K. inflation (see Chapter IV for the detailed assumptions), the projections show that fast expansion of GDP would lead to a large deficit on trade in goods and services in 1973 widening to over £2,000 million (at 1963 import values) in 1976. Projections of property income, transfers and capital movements (Chapter III) imply that the U.K.'s external liquidity position could only be fully protected by surpluses on trade in goods and services, rising to about £400 million (at 1963 import values) in 1976. The minimum target which could be accepted for that year would be a deficit on goods and services of not more than £100 million. The analysis therefore indicates that a strategy of fast expansion without new measures to protect the balance of payments would be impossible to carry through.

3. Further depreciation of the exchange rate would cause inflationary pressure because of the rise in prices of food and other imports and would jeopardise the success of prices and incomes policy. Even if the inflationary consequences of devaluation could be avoided, the alternative projections under various assumptions about the exchange rate imply that an immediate devaluation of nearly 30% would be needed to achieve the minimum balance of payments target under the strategy of fast expansion of GDP. But in fact such a large devaluation would certainly be followed by domestic inflation and must be considered unacceptable.

4. Projections assuming a strategy of severe deflation, restraining the growth of GDP to less than the par rate (so that unemployment started rising again) still

show large and increasing deficits on trade in goods and services for 1973-76 unless an immediate devaluation of nearly 20% is assumed. These projections also imply that if the growth of GDP were to be reduced to 2% per year after a large devaluation, the growth of personal incomes and consumption would have to be restrained to an intolerably low rate (averaging 0.9% per year between 1972 and 1974).

5. None of the various strategies for the management of demand and the balance of payments examined in these projections provide acceptable results over the next four years. There are many less conventional measures which could in principle be applied to help to avoid a balance of payments crisis without sacrificing the objectives of low unemployment and a reduced rate of inflation of costs and prices. We shall not attempt to assess the merits of particular measures here. The remainder of this chapter will outline the requirements for a viable strategy of economic management and hence suggest the kinds of effects which any new set of policies should be designed to achieve. But it may be useful to mention first some of the measures which could be brought into consideration.

Possible measures

6. Apart from manipulation of the exchange rate itself there are a number of other measures which could be used to strengthen the balance of payments position. For example a large increase in the Regional Employment Premium, possibly coupled with an extension of the areas covered, could help a number of important export industries by reducing labour costs. A more general measure of the same kind is a universal wage subsidy which as Professor Kaldor has suggested could be financed by a higher rate of V.A.T. For goods and services sold on the domestic market the wage subsidy would more or less compensate for the higher V.A.T. rate leaving average home prices and costs largely unaffected; exports would benefit from the wage subsidy without having to pay V.A.T. and imports (other than food and fuel) would suffer the higher V.A.T. rate without receiving the wage subsidy.

7. A further extension of this idea would be to introduce a multiple exchange rate system in which different classes of transactions are conducted at different exchange rates; the general aim would be to stimulate exports and discourage imports of manufactures which compete with domestic production without forcing up the prices of food, fuel and basic materials. Another possibility would be to apply quantitative restrictions to the use of foreign exchange for certain purposes somewhat on the lines of the present investment dollar market. Controlled amounts of foreign exchange could be supplied to finance particular classes of transactions such as the import of competitive manufactures. Yet another possibility is to allow the exchange rate to adjust to whatever extent is necessary to regulate the balance of payments while insulating the economy from the main inflationary effects of depreciation by subsidising specific categories of imports such as food, fuels and basic materials.

8. Finally we should mention the possibility of more vigorous control over non-trade flows which affect the reserve and liquidity position. Doubtless outward investment could be restricted and inward investment encouraged to some extent. But of course any policy of reducing the net capital outflow would yield short-term gains at the cost in the longer run of a lower net inflow of property income.

9. None of the above policies would be easy to implement and most, if not all, run contrary to the spirit or even the letter of various international agreements. They have been mentioned only to indicate the kind of measures which may have to be considered both in the U.K. and internationally if a satisfactory economic performance is to be possible for the U.K. over the coming years.

The availability of resources

10. We now turn to examine the main requirements which any viable strategy should satisfy. Our starting point is the assumption that fast growth of G.D.P. is necessary, both in order to reduce unemployment to a more acceptable level and in order to provide sufficient resources to leave something over for growth of

private consumption after other claims on resources have been met.

11. The target growth of G.D.P. is taken to be that projected under the fast growth assumption of the previous chapters, and it is assumed that public sector expenditure, private investment and stockbuilding will be allowed to grow at the rates estimated in Chapter V. The remaining resources then have to be allocated between the foreign balance and private consumption.

The balance of trade

12. It was indicated in Chapter III that there is some scope for interim relaxation of the long-term target for the balance of trade in goods and services. There are first of all two items in the estimated capital flows which can be adjusted to some extent. If strict controls on outward direct investment are maintained (and the relaxation of controls on outflows to the E.E.C., beginning in 1974, is postponed) the projected net outflow of long-term capital might plausibly be reduced by some £150 million (at current prices) in 1976. One might also allow for the fact that a considerable portion of the extension of trade credit is normally financed through foreign borrowing by the banks. Since this borrowing is short-term it was not included in the credit items influencing the liquidity position. But provided there is some confidence in the long-term viability of the management of the balance of payments it may be acceptable to allow another £150 million per year for this borrowing.

13. Finally it must be recognized that the U.K. can draw on a considerable fund of credit from central banks and international institutions for a number of years provided there is a convincing plan to restore the balance of payments position. We assumed in Chapter III that quite large deterioration of the liquidity position is possible over the next few years providing that a trend towards recovery is established and the net reserve effect is reduced below £500 million per year by 1976.

14. Putting these items together, the 1976 target for the balance on goods and services can perhaps be relaxed by some £800 million at current values or £500 million at 1963 import values. The minimum target for goods and services is therefore a deficit of £100 million (at 1963 import values) rather than a surplus of £400 million.

15. The next step is to make an assumption about the maximum effective stimulus to exports which could reasonably be given in the present circumstances. Here we adopt the export growth estimated to result from a devaluation by 15% to $2.00 at the beginning of 1973; the stimulus could of course in fact be given at least in part by other measures. The implied growth rate is over 8% per year, almost the same as that achieved after the 1967 devaluation. The terms of trade is assumed to deteriorate slightly because of the measures taken to stimulate exports.

16. Under the above assumptions the volume of imports of goods and services could be allowed to rise to £12,400 million at 1963 prices in 1976, a level 30% higher than in 1972. After providing for imports of food, fuels, industrial materials and services, this leaves nearly £2,900 million (at 1963 prices) for imports of finished manufactures compared with £2,000 million actual imports in 1972.

17. These figures imply that the average rate of growth of imports of finished manufactures must be restricted to just over 9% per year in volume terms, whereas in the absence of any special measures they could have been expected to grow at nearly 18% per year, given the fast growth of G.D.P. The implied import saving is nearly £1,000 million (at 1963 prices) in 1976.

18. Table VI-1 gives the year by year movement of the balance of trade expected if exports are stimulated as indicated above and imports of finished manufactures are constrained to rise by just over 9% in volume each year.

Table VI-1 Projected balance on goods and services, 1972-76

Year	Exports	Imports	Terms of trade (1963 = 100)	Balance of trade (£ million, 1963 values)
	(£ million, 1963 prices)			
1972	9127	9595	102.3	-260
1973	9916	10457	100.0	-543
1974	11092	11288	98.3	-388
1975	11856	11863	98.4	-200
1976	12520	12427	98.5	-100

See text for assumptions underlying these projections

<u>The prospects for private consumption</u>

19. The resources available for private consumption can now as usual be found as the residual element of expenditure on G.D.P. Table VI-2 shows the estimated levels of private consumption required in each year. The average growth rate is about 4.3% per year, considerably faster than has been achieved in any previous four-year period. But the estimates of 'generated consumption', on the same basis as those given in Chapter V, show that the very fast assumed growth of G.D.P. would in itself tend to generate more than the required growth of consumption.

20. As was indicated in Chapter V, the impact of the 1972 budget has already raised consumption by the end of 1972 at least 3% above its average for the year. This means that, compared with the present position, there would have to be a virtual freeze on consumption for the next twelve months, despite the fast growth of output and employment. Bearing in mind the need to insulate the domestic economy from any sharp increases in the prices of food, fuel and basic materials it would clearly be desirable to force up the prices of other imports very sharply, both in order to constrain the growth of import volume and to provide a deflationary effect on domestic demand.

Table VI-2 The consumption gap

(£ million, 1963 prices)

Year	Required consumption		Generated consumption	Initial gap
1972	25500	(100.0)	25500	0
1973	26715	(104.8)	26834	-119
1974	27526	(108.0)	28042	-516
1975	28728	(112.7)	29040	-312
1976	30183	(118.4)	30116	-67

21. More room for expansion of consumption could have been provided if the public sector were not committed and already engaged in an unusually rapid increase in expenditure on goods and services. It seems that as in previous reflations the increase in public expenditure has come at the worst possible moment.