

This chapter considers what target for the balance of payments should be adopted in principle and in practice. Since, in our approach, the non-trade items in the U.K.'s balance of payments are thought of as being determined largely, if not quite wholly, independently of the pressure of demand in the domestic economy, the achievement of external balance essentially involves the adjustment of the balance of exports and imports (henceforth called the balance of trade).

2. In this chapter, we discuss what is meant by external balance and show that the concept involves some consideration of the U.K.'s external short-term balance sheet. We then examine the flows of non-trade items throughout the period 1960-75 and see what they entail for the par economy in terms of a required or "target" surplus or deficit on its balance of trade. This involves us in making projections which are in some cases unusually hazardous - in that the non-trade flows are heavily influenced by special factors and therefore not on the whole amenable to the sorts of predictive techniques that can be used elsewhere in the exercise. The projections are discussed in some detail in the hope that others interested in the balance of payments field will be stimulated to agree or disagree as they think fit.
3. Briefly, the main results for the balance of payments can be summarised as follows:

Par Balance of Payments, 1960-75 (Annual averages; £ million; at 1970 values ⁽¹⁾)			
Item	1960-71	1972-5	1960-75
Long-term capital & trade credit outflows (net)	-292	-454	-333
Property income from abroad & transfers (net)	254	133	224
Par balance of trade	45	190	81
"Basic balance"	7	-131	-28

- (1) For all items, current values are deflated by a single deflator - the Blue Book price index for imports of goods and services (based at 1970). But see also paragraph 11 below.
- (2) For present purposes, "basic balance" is defined as the balance on current and long-term capital accounts, including trade credit as part of the latter.

In principle, the par "basic balance" for 1960-75 should average approximately zero; it is shown as being in slight deficit here largely because of some extremely heavy net outflows projected for the last three years of the period. It is envisaged that the par economy would deal with these by tightening exchange controls, the effects of which are not included here.

The meaning of external balance

4. Assuming that it starts with a satisfactory external balance sheet, the par economy is considered to be an external balance if, over a period of years, it earns just sufficient on current account to pay for net long-term investment and net expansion of trade credit overseas. If it fails to do this it spends reserves or accumulates monetary (liquid or near-liquid) liabilities, and if it earns more than this its liquidity position improves.
5. There is room for debate as to whether the U.K.'s liquidity position at the end of 1959 was indeed satisfactory or not, but it is a debate into which we do not wish to enter here. We have simply taken the view that, for the purposes of this exercise, the par economy should not be required to compensate in the period under review for weaknesses in the U.K. net reserve position inherited from the remoter past. Two factors may be cited in justification of this. Firstly, no international agreement has been reached, or seems likely to be reached in the immediate future, on the orderly reduction of the U.K.'s sterling liabilities; and secondly, the U.K., along with other members of the International Monetary Fund, has received several large allocations of drawing rights which have, taken on their own, substantially added to its official reserves and available lines of credit. We accordingly regard the reserve target as being met if, between 1959 and 1975, the U.K.'s net external liquidity is improved by roughly the extent of these additional "paper" and "credit" reserves.

6. Although, in principle at least, the par economy is imagined as generating current account surpluses on average to finance its "structural" capital outflows taking one year with another, it is not required to achieve this balance in each individual year. It accommodates fluctuations in the net capital outflow in the first instance partly through movements in its net liquid liabilities, and if these threaten to be very large and persistent it is considered to act to moderate the capital outflows through adjusting its exchange controls and other regulations affecting overseas investment. However, the impact of such controls taking the period as a whole is determined by reference to a policy judgment concerning the volume of resources that the par economy should reasonably expect to devote to net long-term investment overseas. (Trade credit is assumed to be determined largely by the growth of exports and imports, and is therefore not so amenable to control as long-term investment.)
7. Implicit in our balance of payments target, set out in paragraph 3 above is the view that the par economy could on average devote very roughly £300 million of resources (at 1970 values) to building up net long-term assets and trade credit overseas without undue strain on consumers, given past and projected levels of par G.D.P. and net external investment income. Given the reserve objective mentioned earlier, and after allowing for the net impact on the current account of interest, profit and dividends, public and private sector transfers, and contributions to the E.E.C. budget, this implies a required balance of trade (in goods and services) of just over £80 million per annum (at 1970 values) for the period as a whole.⁽¹⁾ The tendency of the trade target to grow, especially towards 1975, reflects primarily the heavy projected build-up of overseas investment and trade credit

(1) For annual figures, see the first column of Appendix Table 5.

flows and the need to pay for membership of the E E C towards the end of the period.

The actual picture to 1971

8. The starting point for detailed construction of the balance of payments target is the actual record of payments flows since 1960 (see Appendix Table 4) Commencing at end-1959, the cumulative totals of these flows by end-1971 (at current prices) can be summarised as follows:

	<u>£ million</u>
Current balance	1042
Long-term investment overseas (net)	-1474
Outflow of trade credit (net)	-1490
"Basic balance"	-1922
New allocations of reserves, etc	728 (1)
Net reserve effect	-1194

- (1) Increases in the U K's ordinary drawing rights at the I M F ; allocations of special drawing rights; and the net impact of revaluations etc affecting the reserves and E E A losses on forwards in 1967 and 1968 following devaluation

It can be seen that the outflows of long-term investment and trade credit greatly exceeded the actual current balance, creating a "financing problem" of some £1900 million. The latter was partially offset by new allocations of reserves from the I M F. but, despite these, the U K.'s net liquidity position at end-1971 had worsened by nearly £1200 million, with heavy adverse effects in most years before 1969 being only partially compensated for by rapidly increasing favourable effects thereafter (1)

- (1) These figures are based among other things on the assumption that the "balancing item", which has been heavily positive since devaluation, represents mainly unrecorded short-term (and highly volatile) capital inflows. To the best of our knowledge, this interpretation is the correct one

9. Examination of the U K 's estimated balance sheet of reserves and liquid liabilities at end-1971 suggests that the financing problem has been overcome by a build-up of liquid and near-liquid external liabilities of nearly £2,500 million, enabling an accumulation of reserves (including unused I.M.F drawing rights) of nearly £1,300 million to take place. If these figures are broadly correct, the present embarrassingly healthy state of the U K 's reserves can be attributed largely to allocations of I M F overdraft facilities and to a massive inflow of short term funds, it is apparently by no means the case that the improvement in reserves as compared with end-1959 can be traced to trading surpluses following devaluation.

Projection of the non-trade flows

- 10 As stated earlier, the non-trade flows in the balance of payments are regarded as being determined largely independently of the pressure of demand at home, and are therefore treated in our exercise as exogenous, at least as a first approximation. Future estimates were obtained for these items by projecting them, at constant prices, on the basis of the best information available to us.
11. Each of the major non-trade items was projected separately, on a gross basis and in volume terms. This procedure may not be quite consistent with the use of a single (import price) deflator in arriving at 1970 values for past flows if individual prices of the various items do not move in step with U.K. import prices, but the resulting distortion is likely to be unimportant over the projection period, except in the eventuality of changes in the exchange rate. The latter raises a particular kind of problem for the treatment both of the non-trade flows - especially investment earnings - and asset values which will be dealt with below (see paragraphs 21 to 24)
12. Public sector transfers and inter-government loans were projected mainly on

the basis of the aid programme in the White Paper. Grants and loans by the U.K. Government are expected to grow steadily by about 8 per cent per annum in real terms, loan repayments by the U.K. are expected to reach about £75 million in 1975, and "other" long-term official lending, about £50 million. Net private transfers overseas were made to continue the rapid increase in this item in recent years, but at a decelerating rate.

13. Particular difficulties attach to the prediction of private overseas investment because of the extreme variability of these flows in recent years. Special factors that must be taken into account are the effects of the voluntary restraints on U.K. investment in the overseas sterling area, and the possibility that these may be eased if, for instance, the U.K.'s net reserve position continues to improve, the encouragement that is now being given to nationalised industries to raise long-term finance overseas; the probability that entry into the E.E.C. will induce both substantially greater direct investment by U.K. firms on the Continent and, more importantly, by American firms in the U.K.; the possibility that adoption of E.E.C. rules on free capital movements will result in a heavy outflow of U.K. portfolio investment, seeking to avoid the investment dollar premium - which we think unlikely in the context of our time period; and, not least, major uncertainties surrounding the future levels of inward and outward investment by the oil companies.

14. As regards inward oil investment, we have taken the view that the massive inflow of some £350 million for "oil and miscellaneous" (at 1970 values) estimated to have occurred in 1971 represents a peak in the capital inflow associated with the exploration and development of North Sea oil and gas, and that this figure will fall by about £100 million in real terms by 1975; and for outward oil investment we expect that the British oil companies will raise their present investment overseas of some £150 million p.a. to about £200 million in 1975 (although this will to some extent be offset by greater

long-term borrowing by the companies from overseas - particularly European-sources)

15. In projecting direct investment (other than oil and miscellaneous) we have allowed flows in each direction to increase steadily in real terms to reach about 142 per cent of their 1970 levels in 1975, which implies average annual growth of about $7\frac{1}{2}$ per cent. This represents an appreciable acceleration as compared with the trend in outward direct investment observed before 1970 (a period that witnessed substantial tightening of restraints), and more or less unaltered continuation of the trend in inward direct investment

16. As can be seen from Appendix Table 5, the implication of these various projections is a net long-term capital outflow of some £335 million in 1975, which amounts to a turnaround of about £460 million from the exceptional net inflow in 1971

17. Equal if not greater difficulty attaches to the projection of trade credit. The "net" of this item appears to have grown with considerable rapidity since about 1965 although it is estimated to have fallen back quite appreciably in 1971. In the absence of any acceptable method of relating trade credit to trade flows, interest rates, etc., and without clear information about what to expect in the future, we allowed the net outflow of "unrelated" credit to build up to about £250 million in 1975 thereby continuing the approximate order of increase in real terms observed since the mid-1960s. It must be admitted that major uncertainty attaches to this estimate, but we would be unable to improve it without a great deal more research, and the uncertainty is not critical to the trade target, as will be explained in due course

18. Having projected investment flows, the estimation of future payments of interest, profit and dividends was a relatively straight-forward matter. Earnings and payments on direct investment and "oil and miscellaneous" were projected using simple lagged income/net asset ratios that seemed with a little trial and error to fit past data. (1)

(1) Ratios of 10 per cent with a two-year lag and 12 per cent with a three-year lag were adopted, with some minor modifications, for direct investment and "oil and miscellaneous" respectively

U.K. interest payments on public sector debt held overseas were projected in line with anticipated actual movements in liabilities outstanding. The net outcome of these projections was a reduction in the net flow of investment income from some £520 million in 1971 (at 1970 values) to some £440 million in 1975

19. The figures for the U.K. contribution to the E.E.C. budget were obtained from the Government's latest published estimate contained in the White Paper The United Kingdom and the European Communities (Cmd. 4715)

20. Annual figures for these various items are brought together for the entire period under study in Appendix Table 5. The pattern of flows can be summarised as follows:

Current Non-trade and Capital Flows, 1960-75

Period	(1) Net I.P.D. and transfers	(2) Long-term capital and trade credit (net)	(1) + (2)
(Annual averages, £ million; at 1970 values ^(a))			
1960-63	258	-223	35
1964-67	254	-369	-115
1968-71	251	-284	-33
Projected			
1972-75	133 ^(b)	-454	-321

Notes: (a) For 1971 and earlier, current values were divided by the Blue Book price index for imports of goods and services, 1970 = 100.

(b) Includes contributions to E.E.C. budget.

Particularly noteworthy are the heavy outflows of capital in the period preceding devaluation and those projected for the period 1972-75. The latter, in conjunction with the projected fall-off in net I.P.D. and transfers, implies a combined adverse balance for all these items in 1972-75 of truly unprecedented proportions

Effect of exchange rate changes and inflation

21. Both in arriving at par estimates for the past (1960-71) and in making projections for 1972-5, we have ignored the effect of exchange rate changes and (for 1972-5) inflation on non-trade flows and asset values. This is not a very serious matter for the par estimates covering 1960-71 since the movement of the par terms of trade over the period as a whole is almost identical to that of the actual terms of trade, and the effects of the actual devaluation at end-1967 are contained in the estimated past actual figures. But for 1972-5 we have estimated all flows at constant 1970 values, thus abstracting from world inflation as reflected in import prices, and we have not made any provision for non-trade effects of implied sterling devaluation.
22. In the past, devaluation has contributed a substantial improvement in net property income from abroad, and this effect is expected to apply for any future devaluation. But against this we must set the effect of devaluation on the price of imported food under the Common Agricultural Policy of the E.E.C. Rough calculation suggests that by 1975 the effect of devaluation on the cost of food imports will more than offset any increase in net property income. We have not made any allowance for either of these effects.
23. The effects of world inflation on the net reserve position, excluded from our projections for 1971-5 because flows are expressed in 1970 values, is to reduce the magnitude of any past net credit or debit position relative to current flows. This tends to work in the U.K.'s favour since the reserve position, as we have defined it, always shows an excess of liabilities over assets. But our projections make no attempt to quantify this advantage.
24. Exchange rate changes will also, as noted above, result in some asset revaluation. The estimated gain in the reserve position resulting from the 1967 devaluation was a £220 million reduction in net liabilities; but this was more than offset by a large E.E.A. loss on forward transactions. For par

estimates, or the hypothetical future devaluation, one may assume that the balance of these two effects would not be adverse because large losses on forward transactions could probably be avoided.

The par balance of trade

25 The derivation of a balance of trade requirement for the par economy from these flows is very much a matter for judgment. In arriving at the target of just over £80 million per annum shown in paragraph 3 above (and in greater detail in Appendix Table 5) a number of related objectives and conditions were borne in mind. Firstly, it was considered that the par economy would attempt to improve the balance of its reserves and short-term liabilities by something approaching the sum of new I.M.F. drawing rights received in the entire period, net of gold subscriptions (nearly £1000 million). Secondly, the overall impact of actual exchange controls etc. on flows of long-term capital between 1960 and 1971 was taken to be about right for the par economy (although the timing of changes might have been different) - implying that net "structural" capital outflows averaging slightly under £300 million (at 1970 values) were broadly acceptable for the period as a whole. Thirdly, while meeting the target deficit on non-trade items of just over £80 million per year for the period as a whole, the par trade balance was made to follow a sharply rising trend in reflection of the need to provide for rapid expansion in net investment overseas and trade credit. Furthermore, the balance was made to vary around this trend in response to fluctuations in the net total of other items, the possible improvement in any one year being limited, in line with actual experience, to not more than £40-50 million.

26. The stimulus for adjustment both of the par trade balance and of par exchange controls, etc., can be conceived of as coming from movements in the net liquidity position. Should large cumulative movements occur in the par

economy's net reserves despite the effect of adjustments to the trade balance (say, appreciably in excess of £1,000 million from the target liquidity position), these would provide a signal for adjustments in par controls on overseas investment and credit expansion as well as for further trade correction, in fact, given the allocations of new reserves and adjustments to these controls that actually took place during the period, the target trade balance proved just capable of handling swings in the non-trade items throughout the period, although it is clearly under increasing strain to do so as 1975 approaches.

27. The series finally selected for the target balance of trade grows steadily from a postulated deficit in 1960 of £50 million (at 1970 values) to a surplus of £100 million in 1969; it then remains stationary for three years in response to the rapid build up of reserves then postulated as taking place, and increases very sharply thereafter at something approaching the maximum permitted rate as the liquidity position deteriorates, eventually reaching a surplus of £250 million in 1975.
28. It will be observed from Appendix Table 5 that the trade target meets all the requirements we imposed on it apart from the desired improvement in the net liquidity position. (The balance of reserves and liquid liabilities is shown as having improved by only £443 million by 1975, as compared with a target of nearly £1,000 million.) This failure is best interpreted as being a signal to the par economy that the actual outflows of long-term capital and trade credit projected for 1972-75 (partly on the expectation of a relaxation in exchange controls and voluntary investment restraints) are in excess of the targets postulated for it. The result can be envisaged as a strengthening rather than weakening of overseas investment and credit restraints by the par economy as the loss of reserves in the last three years of the period threatens to go beyond tolerable limits. The effect of this policy might be to reduce the net capital outflow shown in Appendix Table 5 by some £150 million per

annum in 1973-5, thereby adding £450 million to the par economy's closing total of reserves.