## Chapter III <u>The Balance of Payments</u>

The object of this chapter is to suggest a target for the balance of trade (in goods and services) in the light of expected movements in the non-trade items of the balance of payments. The non-trade flows are treated as being determined largely, although not wholly, independently of the pressure of demand in the domestic economy. Consequently the problem of managing the balance of payments is seen as essentially one of adjusting the balance of trade to meet the (given) surplus or deficit on other items, taking one year with another.

2. The procedure will be to start by briefly reviewing the actual history of the balance of payments since 1960, showing the extent of the (cumulative) deterioration in the U.K.'s external liquidity position by 1972. A 'model' balance of payments for the par economy is then constructed for the entire period 1960-76. This is a necessary step in arriving at a target for the balance of trade (both for the past and the future) on the assumption that external payments are in approximate balance during the period. Finally some suggestions are made for a feasible trade target for 1972-76 which recognise that the economy has so far fallen short of its par trade target, and is expected to fall even further behind by 1976.

### The actual balance of payments since 1960

3. The principal features of the balance of payments since 1960 are summarised in Table III-1 (see next page) and shown in more detail in Appendix Table 4.

4. It should be noted that foreign currency borrowing by U.K. banks to finance overseas investment is included in our figures as long-term inward investment. This is done on the ground that, although the banks' liabilities in Eurodollars and other foreign currencies are technically short-term, the overall supply of funds is large and relatively stable, and the banks are consequently able to lend to investors without much risk of finding themselves short of funds, providing the latter are willing to pay whatever interest charges result from movements of overall demand and supply in the market. This is a departure from the procedure adopted in our exercise last

Table III-1

U.K. Balance of Payments and Effect on Liquidity, 1960-72

(Annual averages; £ million at current prices)

| | 1960-63 | 1964-67 | 1968-72 | 1960-72 |
|---|---|---|---|---|
| Current balance | 0 | -166 | 387 | 98 |
| (of which, net I.P.D. and transfers | 262 | 201 | 239 | 234 ) |
| Balance of long-term capital | -45 | -160 | 14 | -58 |
| Trade credit (net) | -43 [a] | -120 | -218 | -134 |
| 'Basic balance' | -88 | -446 | 183 | -94 |
| I.M.F. drawing (b) rights, etc. | 5 | 131 | 41 | 58 |
| Net liquidity effect [c] | -83 | -315 | 224 | -36 |

(a) Partly estimated

(b) Allocations of I.M.F. drawing rights, special and ordinary (net of gold contributions to I.M.F.), E.E.A. profits/losses, and revaluations affecting the reserves and short-term assets and liabilities (so far as these are identified in the official Balance of Payments Accounts: see U.K. Balance of Payments 1972, Table 41, and earlier editions).

(c) A negative sign here indicates a deterioration in the balance of reserves and net short-term liabilities.

year and has the effect of reducing the deficit on the balance of long-term capital.

5. It can be seen that, on this basis, the balance of long-term capital averaged a deficit of some £60 million between 1960 and 1972, the net outflow showing large variations and being relatively heavy in the period preceding devaluation. By contrast, net earnings on overseas investments minus (net) transfers was a large and relatively steady positive item.

6. Particular mention should be made of the behaviour of net trade credit (import credit received from 'unrelated' firms, minus export credit granted), which has become a very large negative item in recent years.

7. Table III-1 shows that there was an average net worsening of the U.K.'s liquidity position of the order of £36 million per year between end-1959 and end-1972, or an accumulated deterioration of about £470 million. This deterioration would have been much larger had it not been for allocations of ordinary and special I.M.F. drawing rights totalling nearly £1,000 million during this period.

## The par economy's balance of payments

8. Before judging what a tolerable trade target might be in practice for the next few years, a notional balance of payments is constructed for the par economy for the entire period 1960-76. Annual details of the main series at '1963 import values' can be found in Appendix Table 5.

9. Throughout this study, expenditures on resources are expressed at 1963 prices. In the case of balance of payments items there is often no meaningful constant price basis of measurement because many of the flows concerned are purely financial. It has proved convenient to use the import price deflator to measure all balance of payments items in terms of real import purchasing power.(1) In the tables the deflated series are defined as being measured 'at 1963 import values'.

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(1) The price deflator for imports of goods and services (1963 = 100) is put at about 140 for 1972. Projected values for this deflator vary with different assumptions about devaluation, but it is useful to bear in mind a rough scaling factor of 150 as applying on average to 1973-76.

10. Separate deflated series were produced for each of the main non-trade components published in the Balance of Payments Accounts, and these series were smoothed to estimate their trend or average movement. Net figures for the smoothed and deflated series are given in Appendix Table 5. These series provide the principal basis for projections to 1976; but various modifications to the trends have been introduced where information on likely new developments could be obtained.

(a) Long-term Capital

11. Perhaps the most important result of this exercise is the heavy deficit projected for the balance of long-term capital for 1973-76. It is estimated that this will average some £250 million at 1963 import values which is an unprecedented net outflow and a considerable change from the late 1960's, when the deficit was relatively modest. The movement is attributable mainly to the reduction expected in the inflow of 'oil and miscellaneous' investment, a sharp increase in the net outflow of official long-term (due partly to the commencement of capital subscriptions to the European Investment Bank and the European Coal and Steel Community, as well as to increases in loans under the aid programme and subscriptions to the International Development Association(1) ) and to an increase in outward portfolio investment not covered by overseas borrowing.

12. The estimate for inward investment in oil and miscellaneous is based on the view that foreign investment in North Sea oil and gas exploration and development, which is a large element in this inflow, has now reached a peak and will tend to decrease during the next few years. Recent confirmation of the oil producing potential of the North Sea suggests that total investment in both exploration and development of oil fields will continue at a high level throughout the decade (averaging possibly some £150-£200 million per year at 1972 prices in the U.K. sector(2)), but it seems reasonable to expect that a rising proportion of this will represent domestic investment by the U.K. oil companies (partly financed, of course, through inward portfolio investment).

13. The projection of outward investment reflects separate trends to E.E.C. and non-E.E.C. areas since 1958, and incorporates certain (fairly small) adjustments to

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(1) See White Paper Public Expenditure to 1976-77 (Cmd. 5178).
(2) T.P Chandler, commercial director of Shell Petroleum Ltd., Petroleum Times, August, 11/25, 1972, page 64.

reflect membership of the E.E.C. It is expected that there will not be a major acceleration in U.K. direct investment in the E.E.C. at least for some time. Removal of the restrictions on direct investment in the E.E.C. will not take place until 1974, but in any case there are no signs at the moment of greatly stepped-up plans by British companies to manufacture in the E.E.C., and indeed the main new emphasis for direct investment in the early years of membership is likely to be on expansion of European selling branches, dealerships, etc., which in themselves do not involve much new capital.

14. On the other hand, there is evidence of a considerable boom developing in U.K. portfolio investment in the E.E.C., mainly by institutions, despite the fact that restrictions on this type of investment are not due to be relaxed until 1977. Accordingly, we have projected a moderate deficit for portfolio investment (net of associated foreign currency borrowing by U.K. banks) for the next four years.

(b) <u>Net Property Income</u>

15. The projection of interest, profits and dividends in the context of the par economy is complicated by the problem that, if the economy were meeting its par targets, the net amount of short-term debt on which interest is payable would be smaller than that which has actually been incurred during the period, and net earnings on overseas investments, correspondingly higher. This problem was tackled by projecting the main components of earnings on the basis of trends in their volumes since 1958, and then making an adjustment to the net figure (rising steadily to about £70 million in 1976) to allow for the lower amount of short-term external debt incurred by the par economy. The net outcome for individual years can be seen in Appendix Table 5.

16. Net I.P.D. earnings (at 1963 import values) before adjustment to the par basis are expected to grow relatively slowly after 1972, at about 2.8. per cent per year. This is due mainly to a combination of very slow growth of earnings on oil investments overseas (reflecting the declining rate of profit in an industry that showed high rates of return in the early nineteen-sixties) and very rapid growth of payments in the

'oil and miscellaneous' category. Interest and profit payments on inward investment in North Sea oil and gas are expected to add about £65 million per annum (at 1963 import values) to this item by 1976 as compared with 1972 (i.e., an increase of about 40 per cent on the estimated 1972 level).

(c) Transfers

17. Government transfers (excluding the contribution to the E.E.C.) are projected on the basis of figures in the latest Public Expenditure White Paper. The indication there is that relatively little growth is to be expected in thus item in the next few years. However, we anticipate some increase in the net outflow of private transfers, and this largely accounts for the movement in annual figure for net transfers shown in Appendix Table 5.

18. The U.K.'s (net) contribution to the E.E.C. budget is based on estimates given in the Public Expenditure White Paper (page 26), converted to 1963 import values.

19. Strictly speaking, revaluation payments on official sterling liabilities guaranteed under the Sterling Agreements of September 1968 should be included here as transfer payments. However, treatment of this item will be postponed until the overall implications for the par trade target are discussed (para. 28 below).

(d) Trade Credit

20. Trade credit is another item which cannot be treated independently of the rest of the economy, since its behaviour is closely related to export and import volumes, credit availability and, not least, the rate of inflation. Accordingly, as with I.P.D. payments, alternative projections of this item were made, one relating to the par economy and others to conditional forecasts of 'actual' movements in exports, imports and prices.

21. Trade credit was projected on the assumption that total export credit outstanding at the end of a given year will bear a constant ratio of 25 per cent to exports (of goods and services) during the year, both being measured at current values. This ratio was approximately 20 per cent before 1966 but rose to 25 per cent between 1966-69,

reflecting mainly the improvements in export finance introduced by the Bank of England in those years.[1] The corresponding assumption for imports was that total outstanding import credit will continue to run at approximately 8 per cent of imports of goods and services. This ratio fluctuated between 6½ and 7½ per cent until 1969 and has since risen to 7½ - 8 per cent. The increase in the ratio is probably due to the rising proportion of manufactures in U.K. imports.

22. Par trade credit was estimated by applying these ratios to par imports and exports (converted to current values) on an incremental basis. The par series was extended back to 1960, using smoothed values for the credit/trade ratios. Par imports and exports were converted to 'adjusted' current values using trend rather than actual values for import prices. The outcome was that par net trade credit should reach the alarming figure of some £255 million per annum in 1976 (or about £420 million at current values). Annual figures are given in Appendix Table 5. (Alternative projections on an 'actual' basis will be discussed later - see para. 35.)

The Par Trade Target

23. These estimates for non-trade items can now be brought together and their implications for the par economy's target balance of trade examined. The main results are summarised in Table III-2, derived from annual figures in Appendix Table 5.

Table III - 2

The Par Trade Target

(Annual averages: £ million at 1963 import values)

| | Net Property Income and Transfers | Contribution to E.E.C. | Balance of Long-term | Trade Credit (net) | Total of non-trade items | I.M.F. Drawing Rights, etc. | Par Trade Target |
|---|---|---|---|---|---|---|---|
| 1960-63 | 205 | - | 117 | -24 | 64 | 4 | -75 |
| 1964-67 | 176 | - | -100 | -79 | -3 | 124 | -75 |
| 1968-72 | 198 | - | -36 | -155 | 7 | 30 | 50 |
| 1973-76 | 239 | -84 | -253 | -236 | -334 | - | 325 |
| 1960-76 | 204 | -20 | -121 | -125 | -62 | 39 | 55 |

(1) See Bank of England Quarterly Bulletin, December 1969.

24. The main features that emerge here are firstly that the combined non-trade items, adjusted so as to be comparable with the rest of the par economy, are in deficit by some £60 million per year on average during the period as a whole. These items were in surplus in the early years, then moved into near-balance until about 1971, and will then slide progressively into very heavy deficit after that.

25. Secondly, it can be seen that the principal factors responsible for the deterioration projected for 1973-76 are, above all, the deficit on long-term capital and the continuing rise in net trade credit. The contribution to the E.E.C. budget is also a material factor. These items in combination heavily offset the projected increase in net property income (minus the net outflow of transfers).

26. The selection of a liquidity target for the par economy is a matter for policy decision in the same sense as selection of a target for unemployment. However, for purposes of illustration, we think it appropriate to consider the behaviour of the par economy on the assumption that it aims to improve its liquidity position (i.e., the balance of official reserves, including S.D.R.'s and unused I.M.F. lines of credit, net of short-term liabilities in both official and unofficial hands) by roughly the size of additional 'paper' and 'credit' reserves received from the I.M.F. during the period, net of revaluations affecting the reserves and liabilities, etc. (This is in line with the philosophy that the purpose of such reserve creation is to finance temporary payments imbalances, but not chronic deficits.) This requires that the par economy's 'basic balance' on current and long-term capital account (including trade credit) should be about zero taking the period as a whole (whether measured in current prices or at 1963 import values).

27. Such a policy, it should be noted, would have the effect of reducing the 'real' value of net external short-term debt (i.e., the balance of short-term liabilities <u>minus</u> short-term assets, deflated by the price deflator for U.K. imports of goods and services) very substantially between 1959 and 1976 - but would still leave the U.K. with a large excess of liquid or near-liquid liabilities over reserves at the end of the period.

28. Substantial allocations of credit and paper reserves were received between 1964 and 1972, but we have included nothing for this item after 1972. Admittedly, some further allocations of Special Drawing Rights are probably to be expected before 1976, although for several reasons they are not likely to be as large as those received in the last few years; but on the other hand it must be borne in mind that, if our estimates of imports and exports described in the next chapter are correct, sizeable devaluations would be required in the later years of the period if the par economy's balance of trade is not to be in heavy deficit. Assuming that the 1968 Sterling Agreements providing for the guaranteeing of official sterling holdings would apply to the par economy, substantial revaluation payments on these liabilities would emerge some time after 1969. While it can be argued that, under a regime of floating exchange rates, the Bank of England is in a strong position to make profits in the foreign markets which could be set against the cost of revaluation payments, it seems prudent not to count entirely on this source as a means of financing such payments. Accordingly, and in view of all the uncertainties involved, it seems best not to include a favourable figure for 'drawing rights etc.' after 1972.

29. If the par economy is to meet the liquidity target oulined above, it must clearly be prepared to move from a moderate trading deficit in the early nineteen-sixties to very large surpluses after 1972. One of many possible courses for the balance of trade is summarised in the right-hand column of the table. The precise size of the target in individual years is not important; however it must, at least in principle, meet the conditions that the accumulated sum of trade surpluses approximately equals that of non-trade deficits taking the period as a whole, and that the size of year-to-year improvements in the target trade balance after 1971 must be feasible in economic policy terms (say, up to £100 million per annum).

An Actual Trade Target for 1973-76

30. The selection of an appropriate trade target for the next few years is complicated by problems which are too important to ignore. The first is that the economy in 1972 is quite far from the par liquidity target discussed above and the second is that, as will be explained in the next chapter, a large deficit is projected for the balance of trade. Even if measures are applied to correct this deficit, it seems inevitable that the actual balance of payments will fall further, and more seriously, behind the par target set for it.

31. It was shown earlier (para. 7), that the U.K.'s net liquidity position has deteriorated by some £470 million at current values between end-1959 and end-1972, whereas the par economy would have been required to improve its net liquidity by roughly £600 million at 1963 import values (or very roughly £800 million at current prices) over this period (see the final column of Appendix Table 5). Without attempting to judge whether the U.K.'s liquidity position at the end of 1959 was 'satisfactory' or not, it is clear that by 1972 the balance of reserves and short-term debt has fallen far behind the par target, and that any significant attempt to reach this target by 1976 would place a very heavy burden on the economy.

32. In the circumstances, a fairly ambitious policy would be to aim to balance the basic balance of payments over the next few years (i.e., the current account and long-term capital account, including trade credit), so avoiding further deterioration of the liquidity position, as we have defined it.

33. It must be recognised however that unless the trade projections described in the next chapter are entirely wrong, it will be difficult to prevent the basic balance of payments from moving heavily into deficit in 1973 and remaining in deficit right through to 1976. It is therefore necessary to consider how much scope there will be for financing deficits from the official reserves or with the aid of official borrowing in order to see how far the balance of payments targets could be relaxed.

34. In moving from the par to the actual world, certain adjustments are required to the projections of non-trade flows discussed earlier. Firstly, net I.P.D. earnings received by the actual economy will be lower than those for the par economy because the actual economy accumulates a progressively larger burden of external short-term debt. This can be dealt with by 'adding back' some or all of the adjustment made to this item, mentioned in para. 15 ( and described more fully in 'sources and definitions' in the Appendix). The precise amount to be added back depends on the size of expected deficits.

35. Secondly, alternative projections are needed for trade credit which allow for differences in projected levels of exports and imports and movements in their prices. On the basis of the fast growth projection of the economy (see Chapter I para. 11, et seq.) and assuming that the deficit on the balance of trade is held to quite moderate levels through a combination of devaluation in 1973 and other measures (for precise figures, see Chapter VI), the deficit on trade credit should rise very sharply to well over £325 million (at 1963 import values) in 1973, reflecting the effect of devaluation in that year on import and export prices, and then fall back to about £175 million by 1976. (The average for 1973-76 would be slightly lower than for the par economy.) Alternatively, on the basis of a slow growth of G.D.P. (see Chapter I, para. 21), and assuming the same devaluation, net trade credit will be running slightly lower at about £165 million (at 1963 values) by 1976.

25. Further substantial devaluation below $2.35 could well affect the non-trade flows quite heavily, depending on the way in which the authorities handled it and the extent to which speculators anticipated it. In view of all the uncertainties involved it is impossible to arrive at a definite figure, but we would guess that if devaluation took place in advance of the emergence of strong speculative pressures, the net effect of this step taken on its own would be moderately favourable on the non-trade flows for a number of years, and the liquidity position might well benefit

on this account. However, it would be rash to count on a positive figure for this effect.

36. Further attention will be paid to the temporary relief that could be obtained from emergency policies in Chapter VI, but it should be mentioned here that, if restrictions on long-term capital outflows are tightened, rather than relaxed as the U.K. enters the E.E.C., it might be possible to cut the projected deficit on long-term capital account by perhaps £100 million per annum (at 1963 import prices) for a number of years, without suffering much immediate reduction in earnings on overseas investments on this account.

37. The preceding considerations can be summed up as follows. The avoidance of further deterioration in the U.K.'s liquidity position would, if restrictions on capital outflows are relaxed after entry into the E.E.C., imply a trade target for 1973-76 very similar to that projected earlier for the par economy; the main difference would be that annual I.P.D. payments would be perhaps £30 million higher, thereby making the required balance of trade about £350 million per year on average. In view of the heavy trade deficits anticipated for the next few years, this figure is of little more than academic interest.

38. The most that can be hoped for from the balance of trade is probably that it can be confined to a quite moderate deficit (in the orders of magnitude shown in Table VI - 1). Table III - 3 shows the implications of this outcome on the assumption that about £100 million per annum can be saved on the long-term capital account.

Table III - 3

Target Balance of Payments, 1973-76

(Annual Averages; £ million at 1963 import values)

| | |
|---|---|
| Trade Balance | -300 |
| Net property income and transfers (including contribution to E.E.C.) | 90 |
| Balance of long-term capital | -150 |
| Net trade credit | -230 |
| Net liquidity effect | -590 |

39. It can be seen that the balance of reserves and short-term debt would deteriorate on this reckoning by about £600 million per annum on average. The deterioration would be heavy at first (reflecting the timing of the trade deficits shown in Table VI - 1) but would reduce to an annual rate of roughly £400 million by 1976.

40. It would be difficult to justify the adoption of a larger deficit than this for the trade target. It is hardly likely in the circumstances that much relief will be forthcoming in terms of an inflow of short-term funds, except perhaps to finance part of the projected extension in export credit. On the contrary, the emergence of large trade deficits in 1973, unless accompanied by well-timed measures to rectify the imbalance and by steps to secure emergency credits from overseas monetary institutions, is likely to provoke an outflow of funds which would add greatly to the financing problem indicated in the table. At least, the trade target can be regarded as no more than an interim one, viable only on the promise of a rapid improvement in the trade balance after 1976.