

Chapter I Par estimates and alternative projections

The objectives and methodology of the present study remain substantially the same as those of the earlier paper. The framework of analysis described there has now been formalized as a set of computer programs which were used to produce the tables given in the Appendix. These tables are the source of all the quantitative estimates given in the following chapters; sources and definitions of the figures in the tables are also given in the Appendix.

2. It must be recognized that all the estimates presented here depend on the particular method of analysis used. At many points judgments have had to be made in order to complete the specification of the system of analysis. Apart from this subjective element in the results, there is of course real uncertainty as to whether past trends will continue and indeed whether the economy will behave according to the same relationships as appear to have held in the past.

3. It would be tedious to repeat these qualifications in each of the following chapters. We have preferred to make the analysis and the assumptions as explicit as possible and have produced a full set of figures in the Appendix so that the reader may take issue with us at any point where the quantitative estimates seem to him to be wide of the mark.

Par estimates

4. The basic set of par estimates has been constructed to abstract from short-term fluctuations in the pressure of demand and from shortfalls in the balance of payments position. The par estimates describe the economy as it could have been in the past, or would be in the future, if demand were adjusted to maintain a steady level of unemployment (a level of 2½% has been used in this study) and if U.K. producers were always sufficiently competitive to ensure a viable balance of payments and reserve position (explicitly defined in Chapter III).

5. Projections for the par economy give a picture of the medium-term trends of

productive potential and of claims on resources. The par figures are not intended to represent an ideal path for the economy which economic management should aim to reach. They do provide a basic measuring rod against which a range of alternative paths for the actual evolution of the economy can be compared.

Alternative projections

6. To illustrate the implications of different strategies for managing the economy starting from its actual position in 1972, a range of alternative projections has been calculated on various assumptions about the pressure of demand and the competitiveness of the economy in international trade. Although each of these projections starts from the actual position in 1972, they are not intended to be realistic forecasts of what will actually happen. These projections explore the consequences of rigid assumptions about future policy and exogenous influences on the economy. In the present study they sometimes lead to absurd conclusions - for example, to huge balance of payments deficits which almost certainly could not actually occur.

7. Our purpose is to work out the apparent implications of different policy assumptions to see if they represent feasible courses of action. If some of them lead to absurd results one must infer either that the policies in question would rapidly break down, or that the analysis is defective.

Main characteristics of the par economy, 1972-6

8. Despite the continued rise in numbers of students and pupils staying on at school, especially in 1974 when the school leaving age is raised, the labour force potentially available for employment is expected to be at least as large in 1976 as in 1972. The average rate of productivity growth has remained at about 3% per year or a little more over the last seven years and may be expected to continue at much the same rate. The par rate of growth of G.D.P., at which the level of unemployment would remain steady, would therefore be just over

3% per year. This is of course rather faster than the average rate of growth actually achieved since 1966.

9. Imports would grow at about 8% per year in volume terms if the pressure of demand is held steady. To secure a reasonable balance of payments the volume of exports would have to grow slightly faster. The growth of exports required for a par performance has accelerated steadily during the past few years because of the increasing importance and fast growth of imports of manufactures.

10. Private investment, under par conditions, would continue to grow at nearly 6% per year; and public expenditure on goods and services is projected to rise by an average of 3% per year. The resources available in the par economy would allow for private consumption to grow at an average of about 3% per year, or slightly faster than it has actually grown since 1960.

The implications of growth at 5% per year from 1972

11. The first set of alternative projections starts from the Government's stated objective of a 5% rate of growth over the next two years which is here taken to mean that G.D.P. should expand at an annual rate of 5% for two years starting from the actual position in the second half of 1972. Such an expansion of demand, if realized, would yield the fastest two-year increase in G.D.P. since the war. It implies a year-on-year increase of 6% for 1973 compared with 1972 and an increase of over 11% for 1974 compared with 1972.

12. Reflation on this scale would reduce unemployment to about 400,000 by 1974 and raise the number of people at work to over 25 million. If the rate of growth of demand levelled off in 1975 to the par growth rate of just over 3% so that the level of unemployment was held steady, the average growth of G.D.P. from 1972 to 1976 would still be about 4½% per year.

13. There are three important questions about such a strategy of fast expansion.

Could producers expand output at such a rapid rate? Could a tolerable balance of payments position be maintained? Could the Government secure a sufficient growth of domestic demand by its fiscal and expenditure policies?

14. There is of course no real evidence in the U.K.'s recent past about the ability of producers to achieve such a rapid expansion of output. The largest year-on-year increase in output recorded since 1950 was 5.6% in 1963-4. In most other European countries faster growth rates have been achieved habitually. There is no good reason to suppose that U.K. producers could not meet such a rapid expansion of demand - although a certain degree of caution is reasonable.

15. The rapid growth assumption is bound to put considerable strain on the balance of payments. Will the combination of a freeze followed by a moderately successful prices and incomes policy and the newly depreciated \$2.35 exchange rate for sterling leave the balance of payments strong enough to take the strain? We find the underlying trends to be so unfavourable that even after allowing for a rather successful policy on prices and incomes the prospects would still be for a deficit on goods and services of some £2,100 million at 1963 values. This would imply a deficit on the current balance of payments (at current prices) of some £3,000 million in 1976. This extremely pessimistic conclusion is discussed in detail in Chapter IV.

16. The balance-of-payments implications of a strategy of fast expansion are sufficiently serious to rule it out as a viable policy, unless some very powerful measures to improve the balance of trade could be put into effect. If nothing more were done to stimulate exports and reduce the growth of imports, the growth of G.D.P. could only be maintained by an additional fiscal stimulus to domestic demand of some £1,000 million each year. But it is of course inconceivable for balance of payments and other reasons that fast growth could be sustained in this way for more than a very short period.

Alternative exchange rate policies

17. There are quite important objections to any very large further depreciation of sterling. Internally, devaluation would push up import prices and make continued restraint over prices and incomes much more difficult. Further devaluation of sterling might also be resisted abroad by the other major trading countries. But since the exchange rate is conventionally regarded as the most appropriate instrument for correcting prolonged payments deficits, we have estimated the effects of a number of alternative exchange rate assumptions.

18. The present rate of just under \$2.35 was only reached in the last quarter of 1972. We have estimated the effects of continued depreciation of the exchange rate by 5% per year, bringing sterling to about \$2.00 in 1976 (assuming no changes in other currencies). The policy of continued depreciation does not bring about any very large improvements within the next four years because of the time lags in the response of exports. In 1976 there is a net gain of about £450 million at 1963 values or some £700 million at current prices.

19. Estimates have also been made for immediate devaluations to \$2.00, \$1.80 and \$1.60 respectively, at the beginning of 1973. These all show much larger improvements by 1976 than a policy of gradual depreciation. The \$1.60 rate (representing a 30% devaluation) is estimated to result in exports growing at an average of nearly 13% per year in volume terms to 1976. Given the fast growth of G.D.P. discussed above, this large devaluation would still yield a current surplus of some £500 million in 1976, representing an improvement of £3,500 million compared with the estimated result of pegging the pound at \$2.35.

20. It must be emphasized that estimates based on these alternative exchange rate assumptions, particularly the large devaluations, completely ignore any implications for inflation and incomes policy. It is assumed throughout that domestic costs in sterling terms are held steady relative to those of our competitors measured in terms of their own currencies. From this point of view

the estimates of the effects of large-scale devaluation are quite unrealistic.

Slower growth

21. The obstacles to a sustained fast growth rate are sufficiently serious to make it worth investigating an alternative projection with a lower rate. We assume a check to the growth of demand starting in 1973, so that G.D.P. grows at an annual rate of only 2% from the first half of 1973. The spurt of growth already under way in 1972 and the beginning of 1973 is sufficient to reduce unemployment to about 600,000 during 1973; but by 1976 the level of unemployment would be back up to the 1972 peak and would exceed 1,000,000 by the end of that year.

22. If the exchange rate were pegged at \$2.35 there would still be a current payments deficit of about £1,800 million by 1976. This could apparently be eliminated by a devaluation in 1973 of about 20% to a rate between \$2.00 and \$1.80.

23. The combination of slow growth with a substantial devaluation would not really provide an acceptable strategy. Unemployment would be rising from 1974 onwards and private consumption could only be allowed to grow by an average of under 2% per year.

The need for new instruments of economic management

24. The various alternative projections discussed above define quite well the main options attainable using the conventional instruments of demand management and balance of payments adjustment. None of the alternatives have acceptable implications for unemployment, inflation and the growth of real incomes and at the same time achieve a tolerable balance of payments position.

25. If conventional instruments of management cannot yield acceptable results, the question of less conventional remedies must be explored. In Chapter VI we discuss briefly the main requirements of any new instruments of control over the balance of payments.