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External Aspects of British Economic Policy

By Dr George Abrahamson, London

A strong pound, steadily growing industrial strength and full employment are the three proclaimed objectives of British economic policy. To them Mr Wilson's Government has devoted its energies ever since the crisis of foreign confidence forced it on the defensive soon after it acceded to power in the autumn of 1964, and these three separate but interrelated aims are still the criterion by which the Labour Government wishes its economic measures to be judged. In the past full employment and a strong pound had seemed incompatible and the aim of economic growth out of reach because of the conflict between the other two objectives. Mr Wilson promised to break the vicious circle of overfull-employment, soaring wages, excessive consumption, rising prices, a weak pound, restrictions, recession, and unemployment. But his first Government found the target as elusive as its Conservative predecessors.

Situation in the Budget Fixation

However, when the second Wilson Government introduced its budget in early May after a delay necessitated by the spring election, the British economy appeared to be close to balance. The latest statistics showed industrial production still advancing slowly; recorded unemployment was declining seasonally, but the shortage of labour, confirmed by a rise in unfilled vacancies, remained a source of embarrassment. Domestic spending as measured by the volume of retail sales had risen up to late 1965 but levelled out since; outstanding hire purchase debts had receded slightly since the preceding summer. Building contracts, house completions, factory approvals, engineering orders, machine tool deliveries and similar indices of industrial and public investment suggested that capital expenditure was being stabilised at quite a satisfactory level. The import-export gap had widened but was not larger than during most of 1965 (and considerably smaller than in 1964) and was, moreover, largely offset by a notable improvement among "invisibles", so that but for a deterioration on Government account the current balance of payments was almost in equilibrium. British holdings of gold and foreign currencies as officially disclosed had been rising continuously for some time and lately at a faster rate.

The Chancellor of the Exchequer was certainly justified in claiming progress towards his triple objective, but bearing in mind the number and weight of curbs introduced during the preceding 18 months, it had been disappointingly slow. Besides, although these curbs were designed to halt inflation, the rise in prices and wages showed no sign of abating. The cost

of imports had risen slightly (while export proceeds profited from rising costs in competing countries) but wholesale prices continued to go up quite fast, retail prices, helped along by higher indirect taxes, even more so, and wage rates most of all. The lendings by the big banks had also increased, despite a Bank of England appeal to hold them at the ceiling fixed a year earlier, and new instruments and channels of credit diverted funds at high rates of interest to borrowers like the local authorities who are not deterred from heavy spending by normal economic considerations. The Chancellor however based his budget on the assumption that the growth of demand would be checked in the next few months by his previous steps and therefore concentrated on dis-inflationary measures with an indirect and delayed effect.

Direct Measures to Improve the Balance of Payments

The subsequent debate in press and Parliament was largely concerned with two Government measures which, though very important for the British economy, have only an indirect bearing on its external aspects—the Selective Employment Tax and the Prices and Incomes Bill. Before turning to these, it is worth pointing out that the Chancellor, while refraining from any immediately effective check on the domestic economy, announced in his budget speech several measures aimed directly at stemming the outflow of capital. A "voluntary" programme subjected all new investments over £ 25,000 to advanced sterling area countries (the flow of capital to the less developed parts is kept down by ordinary commercial considerations) to Bank of England approval, and the curbs on investment outside the sterling area, which under existing controls could be financed only from foreign sources or out of the pool of foreign investments already owned by British residents, was tightened. Having earlier stated the need for reducing the outflow of private capital, the Chancellor now firmly established "quick, substantial and continuing benefit to the balance of payments" as the criterion for all further investment in the developed sterling and all non-sterling countries.

In the private sector the foreign travel allowance was cut to £ 50 a year at which it becomes an effective restraint on holidays abroad. Permissible hire purchase terms were tightened, postal charges raised, and controls on private building intensified. Government departments, local authorities and nationalised industries were instructed to defer capital expenditure, and the Government undertook to cut its foreign spending still further; promises in this direction had already

been made in the budget. All this of course was normal practice for cooling an overheated economy and not different from what was done in previous emergencies, though the mixture was not quite the same.

Indirect Measures to Improve the Balance of Payments

In addition the Government resorted to one more controversial measure which had been used only once before, a general standstill on all incomes and prices, like the pay pause which Mr Selwyn Lloyd imposed when he was Chancellor of the Exchequer in 1961. Unpopular and manifestly unfair at that time, it was now adopted in a somewhat different form—as a complete ban on all pay increases for six months, to be followed by “severe restraint” for another six months; upward corrections of prices and charges are allowed only if higher import prices or taxes cannot be fully absorbed, dividends are not to be raised at all for one year, and rents and local rates are “expected” to be kept unchanged.

The wage-price standstill was the inescapable consequence of the failure of voluntary restraints and the threat of legislation to control prices and wages similarly the result of the failure to achieve a voluntary adherence to a prices and incomes policy. Both mark the end of the attempt to limit rises in wages by fixing a margin for permissible wage increases in line with the anticipated growth of production. At the time of the budget the Government still thought that excessive labour costs could be avoided by redeploying workers. This was the economic argument behind the Selective Employment Tax, though the fiscal aim of opening a new source of revenue was probably decisive for its introduction. A weekly tax was to be levied on all employees, varied between men, women and youths according to their average earnings, which made all labour more expensive. The tax was however to be refunded to manufacturing industry together with a premium, so that its labour costs would actually be cut.

The Selective Employment Tax has the advantage of broadening the tax base, bringing the growing service trades into the tax system, permitting discrimination in favour of desirable forms of employment, especially export industries, and facilitating adjustments in total taxation to changing circumstances. Although the Chancellor made much of the point that distributive and personal services had not made their fair contribution to total taxation, his principal non-fiscal consideration was undoubtedly to discourage home consumption and encourage investment and exports.

Whatever may be said of the Selective Employment Tax as a tax or economic regulator in the long term, its immediate effect was nil as it was scheduled to come into effect only in September. Moreover, the public discussion revealed many snags and raised misgivings about its efficacy for stopping the hoarding of labour. The piecemeal announcement of this and

other corrective measures created an atmosphere of uncertainty, and official estimates of the total withdrawal of purchasing power from the British economy over the whole of the fiscal year did not resolve the doubts about the immediate effect of the various curbs. The psychological impact was slight; neither the consumer nor the investor saw cause to change his basic attitude. Foreign observers, so often disappointed by tardy and inadequate responses to urgent problems, suspended judgment.

Primary Effects

Meanwhile the international financial climate was changing. Cost and price increases in other industrial countries, the boom in the US economy and continuing expansion in Europe all favoured the British exporter. But US curbs on foreign investment and the hardening of interest rates in the world put an additional strain on sterling. The British authorities have of course always been aware of the dual nature of their responsibility for the British balance of payments, on one hand, and for sterling as a reserve currency, on the other. Experience has shown any unbalance in British overseas payments to impair almost automatically sterling's role as a reserve currency; a fall in visible sterling area gold and currency reserves leads regularly to withdrawals of hot money from London. But it was only in the last two years that sterling was subjected to outside pressures which were not originated, though certainly aggravated, by economic developments at home and consequently all the more difficult to tackle.

The British Government takes the view that the strain on sterling is essentially a long-term problem, capable of solution only by long-term measures, and that hasty or excessive action might aggravate the problem. Having inherited a balance of payments deficit of over £ 700 mill. in 1964, the Labour Government insisted on maintaining full employment so as to keep up production and productivity and encourage productive investment as a precondition of future efficiency. The balance of payments was to be righted gradually; equilibrium was expected by late 1966, and a surplus is now being forecast for 1967. Curbs on private investment abroad saved £ 90 mill. of foreign currency in 1965; further curbs in the 1966/67 budget and reduced Government spendings, especially on British troops overseas, are to save another £ 50-100 mill., a figure increased in July to £ 150 mill. (incl. £ 25 mill. from reduced aid to developing countries). Seeing that Government expenditure abroad, both military and other, was still increasing in the first half of this year and that cuts in private investment abroad may be offset by reduced foreign investment in the British economy, these figures must be regarded as estimates, the more so as the Government economies depend on the outcome of negotiations with foreign Governments and the cutback in private investment in sterling areas is, at least in name, voluntary as befits the voluntary character of the sterling area.

By September there was evidence of a decline in private-sector demand. Some industries subject to cyclical and seasonal fluctuations had to lay off labour or work short-time, and others forecast redundancies. These however reflected temporary over-expansion rather than a long-term downturn in demand. If thus production and employment have not so far shown the contraction which some, especially foreign, experts regard as an indispensable feature of effective disinflation, this does not indicate the failure of Government policy. Mr Wilson and his colleagues still believe that full employment (which does not exclude a small increase in unemployment) can be maintained if a check is kept on prices and wages. Mr Brown, while in charge of the Department of Economic Affairs, moreover stressed that a halt to price movements had to precede a halt to wages. With retail prices stable (apart from tax changes), there is now a better case for insisting on a wage standstill, and wages have in fact at last been brought to a halt.

Continuation of the Pursued Policy

Whatever the success of its incomes policy, the British Government remains convinced that pressure on sterling arising outside the domestic economy should be cured primarily by acting directly on the source of this pressure, the unbalance in payments other than visible trade. Hence the discouragement of investment abroad, the curbs on capital transfers and the cuts in Government spending. The Labour Government has accepted the loss of future income resulting from present curbs on investment abroad as a necessary evil. It did not hesitate to draw on its substantial holdings of foreign securities to counter the outflow of money and improve visible reserves. It continues to offer every inducement to foreign industrialists to set up plants in Great Britain and allows high interest rates to retain foreign monies even though the dangers of hot money were again clearly demonstrated during the current crisis. Last spring British local authorities owed over £ 300 mill. and hire-purchase finance companies £ 140 mill. to foreign creditors. Such vast debts, mostly short-term, are bound to magnify inter-currency movements, and the recall of some of these monies was the principal cause of the drain on the sterling reserves this year. Some idea of the size of these money movements is given by the fact that British banks, which were net debtors abroad to the amount of £ 300 mill. in March 1965, were virtually in balance by the middle of 1966, while British liabilities to non-sterling countries fell over this period by nearly £ 150 mill. The help by other central banks was used to offset these large and persistent withdrawals of short-term credits and the short-selling of sterling by banks, traders and speculators which accompanied them. To counter the latter, the Bank of England successfully resorted to support operations in forward sterling. How far these have mortgaged the future is not known, nor can it be said what total the short-selling of sterling had reached. But after the heavy outflow in last spring and summer sterling is certainly less vulnerable.

It is often thought that the strain on sterling results from a more or less permanent unbalance in current trade for which devaluation would be an effective if drastic remedy. But British products are certainly fully competitive in the markets of the world in quality, price and performance, and the export trend has been unsatisfactory, not because British manufacturers find foreign outlets unremunerative, but because the home market has been so much easier and more convenient. It is equally fallacious to regard the strain on sterling as mainly due to lack of international liquidity or sterling's role as a reserve currency. In the latest crisis of confidence the sterling area connection was a help, not a hindrance. The gold and currency reserves, deplorably small as they are, could have bridged a temporary gap but were found inadequate in the face of a persistently strong import demand (which may prove even more powerful when the import surcharge comes off in November), combined with a heavy outflow of capital and hot money movements.

The international swap facilities were extended twice this year, in June and September, and after their latest expansion are capable of absorbing the shock of quite substantial withdrawals of sterling. They strengthen sterling as an international trading currency but cannot and are not expected to cover a deficit in the British balance of payments. Nor do the British authorities expect an early contribution to the solution of their problems from the negotiations on international liquidity among the Ten. Whatever their outcome, the role of sterling (and the dollar) must be expected to decline to the extent to which other countries step in to fill the gap in the provision of finance for international trade and development. The City of London would not be unhappy if European centres took on a larger share of this burden; for there is plenty of scope for all and British expertise could make a useful contribution in any international system.

First Success Effective

By late September the British authorities felt convinced that the immediate danger for sterling was over. The rise of wages and prices had been halted; production was once again rising, albeit slowly after a pause which has upset previous economic plans. With private consumption certain to be held back by new and higher taxes and investment abroad kept under strict control, the high level of imports of manufactures was the principal problem left. The British Government however has been reluctant to subject them to quotas or restrictions after the evident failure of the surcharge because Great Britain has a fundamental interest in liberal commercial policies. It hopes that enlightened self-interest which brought the central banks to the rescue of sterling in a crisis of confidence will be a sufficient incentive for lowering the barriers between the trading blocs and encouraging the flow of investment capital.