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Recent Economic Developments in the United Kingdom:
January-March 1963

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Summary

On April 3, the British Government announced an expansionary budget which is intended to move the economy to a four per cent per annum growth rate from the 2-1/2 per cent annual average recorded since 1956. The 1963-64 budget deficit, projected at £687 million, would be the largest deficit since the Second World War, should it actually materialize.

The authorities decided to adopt this major shift in domestic policy only after the series of expansionary measures, which had been introduced piecemeal over the past six months, had failed to reverse the deteriorating business situation. They also decided to assume the risks to Britain's balance of payments position inherent in a vigorous domestic business expansion in spite of two episodes of appreciable exchange-market pressure on the pound since January: in late January and early February, after the breakdown in Common Market negotiations, and in March, when commercial purchases of forward dollars were stimulated by a debate about the devaluation of sterling in the London financial press.

As a result, Britain lost reserves in exchange market operations in February and March--estimated to have been $300 million. These losses, which induced the Bank of England to obtain $250 million in special dollar credits from European central banks were calculated as follows (in million of U.S. dollars):

	Published change in reserves	Foreign central bank support	Estimated market transactions
February	- 67	50	117
March	17	200	-183
Total	- 50	250	-300

Source: The Economist, April 6, 1963, p. 83.

On the domestic side, the latest economic indicators suggest that some recovery in business activity may have already gotten underway prior to the April budget. Unemployment, while still relatively high, decreased more than seasonally from February to April: between March and April the seasonally adjusted decline in unemployment was 55,000 or about 0.3 per cent of the labor force. Industrial production rose by four index points in February from the low January level, despite continued bad weather.

In the manufacturing field, domestic orders for machinery rose by about 10 per cent in January and February. Demand for consumer durables has also picked up. Automobile production has expanded steadily and has helped to restore steel production to the highest level in two years. In addition, Britain's exports were unexpectedly strong in March: they reached an all-time high of £349 million (seasonally adjusted) compared with an average of £315 million in the preceding three months.

The British authorities recognize that a sustained business expansion would threaten the balance of payments if export sales do not expand rapidly enough to offset increases in imports; they have stated publicly that the United Kingdom is prepared, if necessary, to make use of the I.M.F. stand-by credit or other international sources of funds to bolster the pound in exchange markets should the need for such support become evident.

In addition, they recently took two steps to attract foreign private capital to London financial markets. In mid-March, the Bank of England made use of its new "super-penalty" Bank rate technique on loans to the discount houses to push up Treasury bill yields. Under the procedure which was introduced on January 3, the discount houses were required to borrow at 1/2 per cent above the 4 per cent Bank rate for fairly large amounts on Tuesday, March 19. As a result, the auction rate on the 90-day bill at the March 22 tender was 3.78 per cent compared to 3.40 per cent a week earlier. Secondly, the Bank of England announced on April 19 a new Treasury bond offering with features particularly attractive to foreign investors: the bonds are tax exempt for non-resident holders and they will be available in bearer form.

In addition, the authorities have placed primary emphasis upon a voluntary incomes restraint policy to keep British exports competitive. The Chancellor set the maximum increase consistent with these goals at 3 to 3-1/2 per cent per annum; by comparison, personal income in 1962 rose by 4-1/2 per cent. However, even at the lower rate of growth in incomes, disposable incomes could grow faster in 1963 than in 1962 because of reduced personal income taxes included in the budget.

Budget confirms major change in domestic economic policy

On February 11, the Prime Minister announced in Parliament the termination of the policy initiated by the former Chancellor of Exchequer, Mr. Selwyn Lloyd which sought to "make room" for exports by holding back domestic demand. Instead, Mr. Macmillan committed the government to "seek to increase consumer demand as a basis for export demand." Prior to the budget, the government had introduced a series of stimulating measures piecemeal during late 1962 and early 1963.[1/] But the domestic business

[1/] These measures are summarized in the Appendix to "Recent Economic Developments in the United Kingdom: October 1962 through January 1963," dated Feb. 5, 1963.

situation in Britain had continued to deteriorate up to the end of 1962 in spite of these contracyclical measures.

There has been some feeling in the United Kingdom that, instead of introducing these measures one at a time, the authorities should have moved faster in reflating the economy. Two factors explain the reluctance of the government to move faster. In the first place, the sluggish reaction of British exports during 1962 limited the willingness of the government to risk a rapid increase in domestic demand. Only after a serious deterioration in the domestic business situation did the authorities finally decide to abandon the former restrictive policy. Secondly, the last expansionary budget (introduced in 1959-60 to alleviate the 1958 recession) proved to be ill-timed. Fiscal policy reinforced a major boom in private fixed capital formation. As a result, prices rose steadily from the third quarter of 1959 through the year 1961, and a large balance of payments deficit was recorded on current account in 1960 as a whole.

This period of expansion ended with the restrictive measures imposed in July 1961 to defend the pound exchange rate; expansion of private investment also came to an end at this time. The authorities had continued to hope for rising exports (accompanying a further expansion in world trade) and personal consumption (to be financed out of a boom in installment credit) to produce a further advance in domestic activity during 1962. By mid-1962, however, it had become apparent that these expectations were not going to materialize. In fact, unemployment continued to increase steadily in the last six months of 1962 and early 1963, even after the series of stimulatory measures had been introduced.

The change in British policy was announced by the Prime Minister on February 11 after the negotiations with the European Economic Community had broken down and was confirmed by the expansionary budget laid before Parliament on April 3. With the goal of achieving an annual 4 per cent per annum growth rate, the Chancellor stated that the Treasury's over-all deficit for the coming year was to be Ŀ687 million; the deficit for 1962-63 was only Ŀ66 million and for 1961-62 only Ŀ211 million. (See Table 1).

Table 1. United Kingdom: Budget 1959-60 to 1963-64, fiscal year, April to March
(In millions of pounds)

	1959-60		1962-63		1963-64
	Estimate	Actual	Estimate	Actual	Estimate
Above the line					
Revenue	5,325	5,630	6,798	6,794	6,839
Expenditure	5,223	5,244	-6,365	-6,441	-6,929
Surplus or deficit (-)	102	386	433	353	- 90
Below the line					
Net receipts or payments (-)	- 823	- 700	- 507	- 419	- 597
Borrowing requirements (-)	- 721	- 314	- 74	- 66	- 687

The enlarged Treasury deficit comprises both additions to spending and tax reductions. Expenditures for the coming year should expand by some Ŀ740 million, mainly for housing and for expanding capacity of the nationalized electricity industry. A number of changes in taxation were included in the program, including reductions of Ŀ269 million in personal income taxes. The reduced income tax is estimated to be equivalent to a 2 per cent increase in wages so far as disposable income of the average industrial worker would be affected.

Exchequer will need to borrow again on the capital market

An important implication of the budget is its probable impact on British securities markets. For the past four years, the Treasury has not had to borrow from the banking system to meet its cash needs. Even in fiscal years 1959-60 and 1960-61, when there was a substantial borrowing requirement, the Government acquired virtually all its funds without increasing the public's holdings of marketable debt. (See Table 2. In particular, there was no net increase in the banking system's holdings of Treasury bills. However, the large proposed deficit for 1963-64 may well require that the banking system supply some portion of the Treasury's needs in the coming year.

<u>Has the 1961-62 recession come to an end?</u>

Economic data for the early months of 1963 suggest that the British economy had begun to recover prior to the budget from the slump which started in mid-1961. Strong deflationary forces operated during the six months from October 1961 through March 1962. (See Table 3.) A net increase in Government expenditure was too small to offset the large drop in private capital formation. However, the second quarter saw a recovery of demand sufficient to offset the losses of the previous half-year. The renewed spurt of activity in the second quarter (a sharp rise in personal consumption--particularly on consumer durables, a recovery of inventory investment, and a steady rise in exports) may have led the Government to delay expansionary fiscal moves (except to reduce down-payment requirements on installment purchases of consumers durables).

However, the rate of expansion of inventory investment declined in the third quarter. The downswing was intensified in the fourth quarter with a sharp decline in private investment and a decline in the Government's current expenditure. An increase in consumption expenditure cushioned this break in economic activity. The index of industrial production fell two points in October, a further three points in December and then six points to 106 (1958=100) in January. The January decline, however, may be attributed in large part to the severe winter weather.

Table 2. United Kingdom: Exchequer financing, fiscal year ending March 31, 1959-60 to 1963-64
(in millions of pounds)

Type of borrowing	1959-60	1960-61	1961-62	1962-63 Preliminary	1963-64 Estimated
I. Marketable debt:					
1. From banking system:					
Bonds	-448	-306	- 63	137	
Treasury bills	121	-269	5	-118	
Total	-327	-575	- 58	19	n.a.
2. From non-bank and foreign:					
Bonds	71	627	39		
Treasury	-341	- 50	-238		
Total	270	577	-199	n.a.	n.a.
3. Statistical discrepancy	n.a.	2	44		
4. Total marketable debt	- 57	4	-252	n.a.	n.a.
II. Non-marketable debt	304	296	96		
III. Total borrowing	247	300	-156	n.a.	n.a.
IV. Other financing	67	94	367	47	n.a.
V. Total financing	314	394	211	66	687

Table 3. United Kingdom: Change in the Demand for Domestic Goods and Services, Fourth quarter 1961 through Fourth quarter 1962
(In millions of pounds; revaluating 1958 prices; seasonally adjusted)

	1961	1962			
	Oct.-Dec.	Jan.-Mar.	Apr.-June	Jul.-Sept.	Oct. Dec.
PRIVATE INVESTMENT	- 1	-114	+ 70	+ 24	-101
Fixed capital formation	-26	- 41	+ 12	- 3	- 48
Inventory investment	+25	- 73	+ 58	+ 27	- 53
PERSONAL CONSUMPTION	-11	- 7	+ 69	+ 4	+ 64
EXPORTS	-10	- 5	+ 48	- 8	+ 1
GOVERNMENT EXPENDITURE	-17	+ 36	+ 16	+ 7	- 32
Current	+ 6	+ 9	+ 9	+ 5	- 35
Capital	-23	+ 27	+ 7	+ 2	+ 3
TOTAL	-39	- 90	+203	+ 27	- 68

Fragmentary statistics for the early months of 1963 point to a revival of business activity. The index of industrial production rose from 106 in January to 110 in February, in spite of continued unseasonal weather. Steel production rose rapidly in February and again in March to the highest level in two years. It was associated with an expansion in automobile production and in new orders received by engineering industries. Unemployment began to decline in March and April, and the number of unfilled vacancies increased. On the credit side, bank advances increased from mid-December through mid-March much more than is usual for this time of year. In mid-February stock prices began to surge upwards in expectation of a strongly expansionary budget.

The likelihood that there was a turning point in the British situation in early 1963 raises the question whether 1963 will be a repetition of 1959: that is, will an expansionary budget take effect just when private investment revives? The consensus of published opinion in Britain is that this is not very probable. On the contrary, a Federation of British Industries survey for January suggest further declines in private capital formation for 1963. Further declines in capital spending are also expected in the steel industry, chemicals, textiles, and shipbuilding, according to The Financial Times (April 11, 1963), added spending is likely only in the service and in consumer goods industries (other than automobiles, which in 1961 completed major investment programs).

The weakness of sterling in early 1963

Even without an immediate threat of demand inflation due to revived private capital spending, the restoration of full employment and an accelerated growth rate for the British economy have obvious implications for the balance of payments. While no pressure has yet been felt in the current account, sterling has been weakened by two waves of speculation in foreign-exchange markets since January.

In the last few days of January, there was a brief run on the pound touched off by the breakdown of the Common Market negotiations. The spot rate fell only from 280.53 cents to 280.35 cents, because there was substantial support given to sterling by the British Exchange Equalisation Account. (See Table 4.)

There were also minor reserve losses in late February and early March, when Spain and some Scandinavian countries shifted reserves out of sterling when, under the new European Monetary Agreement, Britain removed the gold guarantee from sterling balances held by other E.M.A. countries. The British government was itself responsible for ending the mutual gold guarantee feature of the European Monetary Agreement, in part at least because Commonwealth countries had been objecting to the preferential treatment given to E.M.A. countries.

Table 4. United Kingdom: Selected Exchange Rates
(In U. S. cents per pound)

	Spot Rate	3-mo. fwd. Premium or Discount (-)	Investment Dollar Premium	Security Sterling
Jan. 24	280.53	-0.60	7.00	279.63
30	280.35	-0.93	9.50	279.88
Feb. 14	280.34	-0.67	7.62	279.13
28	280.24	-0.79	8.75	279.13
March 8	280.08	-0.83	9.87	278.75
11	279.92	-0.93	10.25	278.75
13	280.19	-1.01	10.87	278.63
20	280.13	-1.31	9.62	278.50
April 1	280.02	-1.31	10.87	278.50
15	280.14	-1.26	9.94	278.75
24	280.05	-0.86	10.06	279.38

Sterling also deteriorated steadily in the first half of March at a time when the financial press was debating the pros and cons of devaluation should the Government's expansionary program create a balance of payments crisis. In particular, British importers purchased dollars forward. This wave of speculation reached its climax on March 11 and 12.

The spot rate fell only from 280.24 on February 28 to 279.92 on March 11, but the forward discount on sterling widened and the covered differential on Treasury bill arbitrage increased to 0.62 per cent per annum in favor of the U. S. bill by mid-March. To correct this situation, the Bank of England forced the discount market on March 19 to borrow at a rate 1/2 per cent above Bank rate; the effort was to make the London market more attractive to foreigners without increasing the cost of credit within the United Kingdom. This move was a success: the March 22 Treasury bill tender rate jumped to 3.78 per cent from 3.40 the week before. The covered advantage of U. S. over U. K. bills fell below 1/2 per cent per annum. Covered arbitrage movements in Treasury bills have been limited since then.

As a result of these speculative moves against sterling, reserves declined appreciably in February and March.

Fourth quarter balance of payments favorable

The adverse balance of payments situation in the first quarter of 1963 contrasts with the relatively balanced situation which prevailed in the fourth quarter of 1962. The private short-term capital account was then in surplus by £73 million compared to a small deficit incurred furing the third quarter. (See Table 5.) The improvement was due mainly to a build-up of sterling balances by foreigners (other than official institutions). Also, on a seasonally adjusted basis, the current account improved by £55 million, due mainly to the decline in imports from the high third-quarter level.

One big question for 1963 is how the trade balance will be affected by the expansionary program. It is generally agreed that imports will rise as full employment is restored. Therefore, if a sterling crisis is to be avoided, the additional import bill must, in the long run, be financed by an expansion of exports or by capital inflows. The current trend in exports is difficult to assess as the figures for January and February were distorted by the U. S. dock strike and by the disruption to production and transportation by the severe cold weather. However, British observers have drawn much encouragement from the unexpectedly steep rise of March exports to a record high. (See Table 6.)

Table 6. United Kingdom: Foreign Trade
(In millions of pounds; seasonally adjusted monthly averages)

	1962		1963		
	July-Sept.	Oct.-Dec.	Jan.	Feb.	Mar.
Imports, c.i.f.	-385	374	361	380	384
Exports and re-exports, f.o.b.	332	332	320	335	361
Trade balance	- 53	- 42	- 41	- 45	- 23

Table 5. United Kingdom: Balance of Payments, Fourth Quarter 1961 through Fourth Quarter 1962
(in millions of pounds)

	1961	1962			
	IV	I	II	III	IV
Balance of Payments					
A. Goods, Services, and Transfer Payments, Seasonally Adjusted					
Exports, f.o.b.	961	963	1,013	1,006	1,006
Imports, f.o.b.	-981	-982	-1,016	-1,047	-1,014
Trade balance	- 20	- 19	- 3	- 41	- 8
Services and transfer payments	19	38	34	22	44
Total, seasonally adjusted	- 1	19	31	- 19	36
Seasonal influences	- 8	--	50	- 19	- 31
Total	- 9	19	81	- 38	5
B. Long-Term Capital	74	28	- 43	- 23	- 46
C. Private Short-term Capital					
Sterling liabilities to foreign private:					
Sterling area	- 4	9	42	6	28
Other	37	- 36	--	- 23	35
Miscellaneous	- 26	123	- 29	7	10
Total	7	96	13	- 10	73
D. Net Errors and Omissions	- 21	80	- 15	87	- 24
Surplus or Deficit(-)	51	223	36	16	8
Financed by:					
E. Extraordinary Aid	- 28	--	--	--	--
F. Sterling Liabilities to Foreign Official					
Sterling area	36	- 72	73	- 30	- 12
Other	7	- 12	- 26	- 20	11
G. Reserve Movements (increase-)					
Drawing rights at IMF	-150	- 91	- 90	-196	- 2
Gold and foreign exchange	84	- 48	7	230	- 5
Total Financing	- 51	-223	- 36	- 16	- 8

Source: U. K. Central Statistical Office *Economic Trends*, March 1963. Data have been rearranged by Federal Reserve Board Staff.

Making British exports competitive: An incomes policy

In his budget message, Mr. Maudling pointed out that there must be some restraint in the rise of personal incomes if the British economy is to move towards its growth target of 4 per cent per annum without inflation and without jeopardizing sterling. Maudling appealed to labor leaders and to management to cooperate in this venture:

> . . .Without expansion, we cannot have an incomes policy, without an incomes policy we cannot have expansion. We can break out only by launching deliberately on a policy of expansion and inviting those who have responsibility in management and unions to join with us not only in the prospects, but also in the necessary conditions of a policy of expansion. The country cannot achieve success, nor can "stop-go" policies be avoided, if this compact cannot be made between the three main partners in our economic life.1/

The importance of an incomes policy was also highlighted in the final portion of the first report of the National Economic Development Council, "The Conditions Favourable to Faster Growth," released on April 17. A large part of the lag in British exports is directly attributed to the relatively high level of export prices; the report states that the export target will not be met unless, as a minimum, British prices rise more slowly than those of competing countries.

To achieve price stability, the Government is asking for voluntary restraint in the rise of incomes to between 3 to 3-1/2 per cent per annum. This figure is an upward revision of the 2 to 2-1/2 per cent figure which was put forth by Government spokesmen in March during the hearings held by the National Incomes Commission. In spite of the fact that personal income rose by 4-1/2 per cent in 1962--a year characterized by slack labor markets--the Government is hopeful that the unions will show restraint, in part because reduced personal income taxes of the average industrial worker is the equivalent of a 2 per cent wage increase.

1/ Hansard, April 3, 1963, Col. 476.

Labor leaders, however, are hostile to the idea of an incomes policy. Disagreement on this issue was responsible for the delay in issuing the final section of the NEDC report (which probably still would not have been released had not the staff report been leaked to the press in February). Furthermore, leaders of the large unions are adamant that the National Incomes Commission should play no role in making an incomes policy effective in individual industrial cases. A very hostile reaction was given to the first N.I.C. recommendation on a wages-hours dispute. The N.I.C. said that the Scottish builders' 40-hour week agreement would raise earnings by 9 per cent and, therefore, the agreement should be accepted as covering a period of three years. Commenting on this decision, the General Secretary of the Trade Union Congress stated that the N.I.C."is really in a field in which it is irresponsible. It has no responsibility for regulating relations in industry or defining the national interest."

During the first quarter of 1963, the index of weekly wage rates did not increase. (See Table 7.) This was the first quarter during which wage rates have held steady since the third quarter of 1961. On the price side, wholesale prices edged up one point between November and December of last year, but they have remained unchanged since then. Export and import prices each rose one point in January, leaving the terms of trade unchanged.

Table 7. United Kingdom: Prices and Wages
(1958=100)

	Wholesale Prices: Home Market Sales	Cost of Living	Export Prices	Import Prices	Terms of Trade	Weekly Wage Rates
1960 - Dec.	103	103	101	99	102	107
1961 - Nov.	104	103	102	98	104	109
June	104	105	102	99	103	110
Sept.	105	106	102	96	106	110
Dec.	106	107	103	97	106	111
1962 - Mar.	107	108	103	97	106	112
June	107	111	103	97	106	113
Sept.	107	109	103	96	107	115
Dec.	108	110	104	97	107	116
1963 - Jan.	108	111	105	97	108	116
Feb.	108	112	105	98	107	116
Mar.	108	112	105	99	106	116